DCAAM 7640.1

January 2011

DCAA CONTRACT AUDIT MANUAL

Vol. 1 of 2
Chapters 1 - 8

DEPARTMENT OF DEFENSE
DEFENSE CONTRACT AUDIT AGENCY

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DCAA Contract Audit Manual

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DCAA CONTRACT AUDIT MANUAL

FOREWORD

The DCAA Contract Audit Manual (DCAA Manual 7640.1) is an official publication of the Defense Contract Audit Agency (DCAA). It prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in the performance of the DCAA mission.

All DCAA supervisory personnel should promote the study and use of the manual by their audit staffs. Further, all DCAA personnel are encouraged to submit recommendations for constructive changes or improvement to the manual.

The manual is designed to minimize the necessity of referring to other publications for technical and procedural guidance; therefore, technical supplemental guidance or instructions will not be issued by regional offices except as specifically authorized by the Director, DCAA.

Patrick J. Fitzgerald
Director

DCAA CONTRACT AUDIT MANUAL

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January 2011 EDITION OF THE DCAA CONTRACT AUDIT MANUAL --DCAAM 7640.1
NOTES ON SUBSTANTIVE CHANGES

Open Audit Guidance MRDs

Page (12)	Audit Guidance MRDs outstanding at December 31, 2010 are listed by the CAM section(s) affected. These MRDs and Audit Guidance MRDs issued after December 31, 2010 are available on the DCAA Web site at http://www.dcaa.mil

For your convenience, the following is a list of substantive changes to this edition of the DCAA Contract Audit Manual (CAM). Each one is summarized in the notes below. The full revision is shaded (as shown) in the referenced sections. MRDs superseded by this edition are identified following the notes.

Chapter 1

1-403.3 & 1-403.4	**Language was added to CAM 1-403.3 to address the guidelines set forth in DPAP's December 4, 2009 memorandum on resolving significant disagreements between the auditor and the contracting officer.**

Chapter 3

3-103.3 & 3-103.4	**CAM 3-103.3 and 3-103.4 have been revised to reflect current guidance for modifying standard audit programs. The revised guidance indicates auditors will no longer delete standard audit program steps. Unnecessary steps must be lined out and the auditor will provide an explanation prior to submitting for supervisory approval.** **10-PPS-027 (R), September 30, 2010**

Chapter 4

4-403.f	**CAM has been revised to clarify the procedures and documentation requirements for handling disagreements on audit findings between the auditor and supervisor or higher levels of management. CAM has also been revised to incorporate requirements for retaining working papers, including working papers for cancelled assignments.** **08-PAS-022 (R), July 31, 2008,** **10-PAS-020 (R), August 20, 2010,** **10-PAS-029 (R), October 15, 2010**

	Chapter 4 (cont.)
4-707	CAM is revised to eliminate references to and guidance regarding the Voluntary Contractor Disclosure Program which no longer exists, per DoD Instruction 5505.15, DoD Contractor Disclosure Program, dated June 16, 2010. Section 4-707 of the CAM is reserved to incorporate guidance regarding the Contractor Disclosure Program once it is finalized.
	Chapter 6
6-609.1	CAM 6-609.1 has been updated to reflect the threshold dollar value of $700,000 for applicable contracts awarded on or after October 1, 2010.
	Chapters 7, 8, 9, 12, & 14
7-703.1, 8-502.5d, 9-1202.4b, 12-503c, 14-103.2b	Various CAM sections have been updated for the recent changes in the TINA and Simplified Acquisition Thresholds.
	Chapter 8
8-414.2	The interest rate established by the U.S. Secretary of the Treasury for Cost of Money purposes is 3.125 percent for the period July 1, 2010 through December 31, 2010. CAM 8-414.2 has been updated to reflect this change.
	Chapter 9
9-104.2	CAM 9-104.2 was revised to remind auditors to consider all risk and materiality factors in assessing the need for a subcontract assist audit. Audit teams should not rely on arbitrary dollar thresholds alone for determining the need for assist audits.
9-205(d)	CAM 9-205(d) is being revised to remind auditors that continued requests to audit inadequate proposals should be elevated to FAO management and procurement command management.
	Chapter 10
Chapter 10 Various Sections	Language in various sections of Chapter 10 were changed to replace “evaluating” with “obtaining an understanding of” the contractor’s internal controls to reflect the new scope of audit language.

Chapter 10 (cont.)

10-103.2b, 10-304.7d-h, & 10-504.5e(3) & (c)	**Guidance on Variable Sampling revised Agency policy regarding what information will be disclosed in the audit report concerning the use of statistical and/or nonstatistical sampling. Various sections in CAM Chapter 10 were updated to reflect the changes to policy.** **10-OTS-051 (NR), August 31, 2010, later issued as 11-OTS-001(R), January 3, 2011**

Chapter 14

14-104.7	**The guidance at 14-104.7, Errors in Cost or Pricing Data, was clarified to provide a better understanding to the reader that accounting or administrative errors (e.g., computational errors) attributable to underlying cost or pricing data are considered factual information and may result in defective pricing.**
14-125	**The interest rate applicable to postaward audit adjustments for the calendar quarter beginning October 1, 2010 is 4 percent and for the calendar quarter beginning January 1, 2011 is 3 percent.**

Chapter 15

15-400	**CAM 15-400 has been revised to emphasize that it is DCAA's policy to support contracting officers at negotiations and to clarify the auditor's role and the type of advice that can be provided in support of negotiations.**

OPEN AUDIT GUIDANCE MEMORANDUMS FOR REGIONAL DIRECTORS (MRDs)

Audit Guidance MRDs are issued by the Operations and the Policy and Plans Directorates to change or supplement the Contract Audit Manual (CAM). As the supplemental guidance is incorporated into the CAM, the related MRD is canceled.

Open MRDs can be found on the DCAA web sites under Open Audit Guidance. The listing of open MRDs is updated monthly on the DCAA web site (http://www.dcaa.mil). All Open Audit Guidance will be coordinated with the electronic real-time web version of the CAM.

DCAA CONTRIBUTORS TO THIS EDITION

CAM is updated under the general direction of the Headquarters Auditing Standards Division. One of the primary sources for changes to improve the Contract Audit Manual (CAM) is suggestions from DCAA employees. As discussed in 0-007, it is very easy to make changes and all suggestions will be considered. DCAA employees are encouraged to use the DCAA Single-Source Suggestion Program on the Intranet home page. Other users may provide suggestions to the mailing address or fax number shown at 0-007.

We thank all individuals who make or have made suggestions to improve the CAM. However, the contributor's names are not listed, in consideration of the Department of Defense (DoD) policy on the release of lists of names of DoD employees, as implemented by DCAA in MRD 02-CM-013(R), Release of Employee Names and Other Identifying Information to the Public, dated April 23, 2002.

The names of contributors are posted on the Policy web site located on the DCAA Intranet.

0-000 INTRODUCTION TO THE DCAA CONTRACT AUDIT MANUAL

0-001 Introduction

Introductory material is presented in this section, along with an explanation of certain terms and abbreviations used frequently in this manual.

0-002 Purpose and Applicability of the Manual

a. This manual is issued to provide technical audit guidance, audit techniques, audit standards, and technical policies and procedures to be followed by DCAA personnel in the execution of the contract audit mission (see also 0-006). The material in this manual is instructive. Reference to this manual should not be made in audit reports or correspondence addressed to offices other than those of DCAA.

b. The procedural and audit guidance in the manual is applicable to the audit of all types of contracts. The auditor, however, must use professional judgment in (1) selecting the procedures and techniques best suited to the audit objectives, and (2) determining the scope of the audit in each instance.

0-003 Citation

The manual bears the title "DCAA Contract Audit Manual." It may be referred to as "CAM" and individual paragraphs may be cited as "CAM" followed by the paragraph number; for example, "CAM 1-103." Within the manual this citation is "1-103."

0-004 Numbering

a. Pages are numbered at the top of the page as follows:

102

Chapter Number (or Appendix Letter)

Page Number

b. Paragraphs are numbered as follows:

4-104

Chapter Number (Or Appendix Letter)

Section

Paragraph

Generally, paragraphs whose numbers include a decimal (as 1-203.1 through 1-203.3) are major, first-level subdivisions of the basic paragraph subject (as 1-203).

0-005 Revisions

Printed editions of the CAM are currently published in January and July. The process to update the CAM is continuous. The electronic version of the CAM is the most current. Cut-off dates of January 1 and July 1 are established for incorporating changes to each printed edition of the CAM. The CAM incorporates all changes as of that date and the printed CAM will be available as soon as possible after those cut-off dates. CAM is distributed by paperback, available online at DCAA's Intranet, and on the AT&L Knowledge Sharing System (AKSS) web site. CAM users are encouraged to access the electronic edition, because it is maintained on a current basis.

0-006 Other DCAA Audit Guidance

Memorandums for Regional Directors (MRDs) provide a mechanism for disseminating audit guidance which supplements or revises audit guidance. Audit guidance in open Memorandums for Regional Director (MRDs) is available on DCAA web sites under Open Audit Guidance and generally supersedes the guidance reflected in the Contract Audit Manual (CAM). Changes in audit policy issued in an MRD are often incorporated in the CAM at a later date and the MRDs will remain open until the guidance is incorporated into the CAM.

When an auditor starts a new assignment, open MRDs must be reviewed for any guidance that may apply to that assignment. Open MRDs can be identified using the link provided on the DCAA Intranet home page for "MRDs, AGMs, & AMGMs" and the date range function.

The online CAM, available on the DCAA intranet home page and the public web site (http://www.dcaa.mil), is the most current version of the audit manual and should be used, considering any open MRDs, over other CAM versions to the extent possible. The hardcopy CAM is available for interim use when access to the DCAA intranet or the DCAA public website is not available, such as at contractor sites. However, before acting on guidance obtained from the hardcopy CAM or copy available through icons on DCAA user computer desktops, auditors must review the online CAM and MRDs to ensure the guidance is the most current.

0-007 User Comments/Suggestions

User comments/suggestions are welcome. DCAA employees are encouraged to report any errors noted in the manual using the DCAA Single-Source Suggestion Forum available from the intranet home page.

Non-DCAA users can send comments/suggestions by fax to (703) 767-3234, by e-mail to DCAA-PAS@dcaa.mil, or mail to:

Headquarters, DCAA
Attention: Auditing Standards Division (PAS)
8725 John J. Kingman Rd., Suite 2135
Fort Belvoir, VA 22060-6219

0-008 Explanation of Terms and Abbreviations

DCAA --- The Defense Contract Audit Agency.
Director --- Director, DCAA.
Headquarters --- Headquarters, DCAA.
DoD --- The Department of Defense.
Regional office --- The DCAA office having responsibility for all DCAA audit offices and auditors within a specified geographical area. Each is headed by a regional director and is the only organizational echelon between Headquarters and the field audit offices. Within each regional office, a particular regional audit manager exercises line authority over designated field audit offices.
Field audit office (FAO) --- A DCAA term which encompasses both branch offices and resident offices. It does not include regional offices.
Resident office --- The field audit office having responsibility for the DCAA mission, generally at one contractor location, and physically located at the contractor's plant.

Branch office --- The field audit office having responsibility for the DCAA mission for all contractor locations in a designated area except those assigned to a resident office.

Auditor --- An auditor performing the contract audit function of DCAA.

Financial liaison advisor (FLA) --- A DCAA auditor assigned responsibility for coordinating contract audit matters with a procurement or contract administration office.

Assignment Code --- The smallest scope of audit review which may be separately programmed, including a five-digit identifier, a title and a scope statement or the five-digit number recognized by the DCAA DMIS as specifying a discrete audit scope.

Audit Area --- A set of interrelated internal controls or elements of risk within one of the four major functional groupings.

Major Functional Grouping --- An element of the contractor's cost accounting system. The four major groupings presently in use are: General Controls (accounting and estimating systems, balance sheet, and income accounts); Direct Labor; Direct Material; and Indirect Expense.

Subarea --- An element of internal control or risk within an audit area. For example, the audit area E.1, Special Purpose Reviews within the major functional grouping Indirect Expense is further analyzed through the subareas Insurance, Pensions, Cost Allocation Bases, IR&D/B&P, and Other Audits.

Workpackage --- Any combination of predefined scopes of work programmed separately on the DMIS. It can include:

* A single assignment code.
* Two or more assignment codes.
* An audit area or subarea (some subareas contain only a single assignment code).
* A major functional grouping.
* All direct costs or all indirect costs.
* All costs included in the submission.

This manual also uses definitions stated in Federal Acquisition Regulation (FAR) and Defense FAR Supplement (DFARS).

Acronym/Abbreviation	Description
A-E	Architect-Engineer
ABC	Activity Based Costing
ACMS	Advanced Cost Management Systems
ACO	Administrative Contracting Officer
ACRS	Accelerated Cost Recovery System
ADR	Alternative Dispute Resolution
ADR	Asset Depreciation Range
ADV	Auditable Dollar Volume
AFAA	Air Force Audit Agency
AID	Agency for International Development
AICPA	American Institute of CPAs
APPS	Audit Planning and Performance System
ASBCA	Armed Services Board of Contract Appeals
AT	Attestation Standards
B&P	Bid & Proposal
BCA	Board(s) of Contract Appeals
BOA	Basic Ordering Agreement(s)
BOE	Basis of Estimate
BOM	Bill of Material
CAC	Contract Audit Coordinator (DCAA)
CACO	Corporate/Home Office ACO
CACS	Contract Audit Closing Statement(s) (DCAA)
CACWS	Cumulative Allowable Cost Worksheet
CAD/CAM	Computer-Aided Design & Manufacturing
CAIG	Cost Analysis Improvement Group (DoD)
CAM	Contract Audit Manual (DCAA)
CAOs	Contract Administration Offices
CAS	Cost Accounting Standard(s)
CCDR	Contractor Cost Data Report(s)/ing
CCR	Central Contractor Registration
CDA	Contract Disputes Act
CECSR	Contractor Employee Compensation System Review
CFAO	Cognizant Federal agency official
CFR	Code of Federal Regulations
CFSR	Contract Funds Status Report(s)/ing
CFY	Contractor Fiscal Year
CHOA	Corporate Home Office Auditor (DCAA)
CIPR	Contractor Insurance/Pension Review
CLIN	Contract Line Item Number
CMTL	Computer Managed Training Library
CO	Contracting Officer
COBOL	Common Business-Oriented Language (EDP)
COE	Corps of Engineers (Army)

Acronym/Abbreviation	Description
COR	Contracting Officer's Representative
CPA	Certified Public Accountant(s)
CPAF	Cost-Plus-Award-Fee (Contract)
CPFF	Cost-Plus-Fixed-Fee (Contract)
CPIF	Cost-Plus-Incentive-Fee (Contract)
CPR	Contract Performance Report (previously Cost Performance Report)
CPSR	Contractor Purchasing System Review
CPU	Central Processing Unit (EDP)
C/SCSC	Cost/Schedule Control System Criteria
CSRA	Civil Service Reform Act
CSSR	Cost/Schedule Status Report(s)/ing
CY	Calendar Year
DAC	Defense Acquisition Circular
DAR	Defense Acquisition Regulation
DCAAI	Defense Contract Audit Agency Instruction
DCAAM	Defense Contract Audit Agency Manual
DCAAP	Defense Contract Audit Agency Pamphlet
DCAAR	Defense Contract Audit Agency Regulation
DCAI	Defense Contract Audit Institute
DCMA	Defense Contract Management Agency
DCMD	Defense Contract Management District
DFARS	Defense Federal Acquisition Regulation Supplement
DFAS	Defense Finance & Accounting Service
DHHS	Department of Health & Human Services
DIIS	DCAA Integrated Information System
DL	General Counsel (DCAA Hqs)
DLA	Defense Logistics Agency
DLAD	Defense Logistics Agency Directive
DLAM	Defense Logistics Agency Manual
DMIS	Defense Contract Audit Agency Management Information System
DoDAAC	Department of Defense Address Activity Code
DoDD	Department of Defense Directive
DoDI	Department of Defense Instruction
DoDIG	Department of Defense Inspector General
DOE	Department of Energy
DOJ	Department of Justice
DOL	Department of Labor
DOT	Department of Transportation
DPAPSS	Defense Procurement, Acquisition Policy, and Strategic Sourcing
DPRO	Defense Plant Representative Offices
DSCA	Defense Security Cooperation Agency
EAC	Estimate At Completion (Cost)
ECPF	Electronic Contractor Permanent File

Acronym/Abbreviation	Description
EDP	Electronic Data Processing (Computer(s))
EEO	Equal Employment Opportunity
EEOC	Equal Employment Opportunity Commission
EPA	Economic Price Adjustment
EPA	Environmental Protection Agency
ERISA	Employee Retirement Income Security Act (1974)
ERP	Enterprise Resource Planning
ESOP	Employee Stock Option Plan
ESS	Estimating System Survey
ETC	Estimate to Complete (Cost)
EVMS	Earned Value Management System
FAC	Federal Acquisition Circular
FAO	Field Audit Office
FAR	Federal Acquisition Regulation
FASB	Financial Accounting Standards Board
FASC	Financial Advisory Services Center
FAT	First Article Testing
FCR	Federal Contracts Report (BNA)
FCRC	Federal Contract Research Center(s)
FEMA	Federal Emergency Management Agency
FERC	Federal Energy Regulatory Commission
FFP	Firm-Fixed Price (Contract)
FFRDC	Federally Funded R&D Center(s)
FICA	Federal Insurance Contributions Act (Social Security)
FLA	Financial Liaison Advisor
FLRA	Federal Labor Relations Authority
FLSA	Fair Labor Standards Act
FMS	Foreign Military Sales
FOUO	For Official Use Only
FPI	Fixed-Price Incentive (Contract)
FPR	Fixed-Price Redeterminable (Contract)
FPRA	Forward Pricing Rate Agreement(s)
FUTA	Federal Unemployment Tax Act
FY	Fiscal Year
G&A	General & Administrative (Expense)
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAC	Group Audit Coordinator (DCAA)
GAGAS	Generally Accepted Govt. Auditing Standards (GAO)
GAO	Government Accountability Office
GASB	Governmental Accounting Standards Board
GBL	Government Bill of Lading
GFAE	Government-Furnished Aeronautical Equipment
GFM	Government-Furnished Material

Acronym/Abbreviation	Description
GFP	Government-Furnished Property
GOCO	Government-Owned, Contractor-Operated (Plant)
GPO	Government Printing Office
GSA	General Services Administration
GSBCA	General Services Administration Board of Contract Appeals
HCFA	Health Care Financing Administration
I/PS	Insurance/Pension Specialist
ICAPS	Internal Control Audit Planning Summary
ICQ	Internal Control Questionnaire
IG	Inspector General
IIA	Institute of Internal Auditors
IPA	Independent Public Accountant
IPT	Integrated Product Team
IR&D	Independent Research & Development (Cost)
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IS	Information Systems
IT	Information Technology
JCL	Job Control Language (EDP)
JTR	Joint Travel Regulation
MAAR	Mandatory Annual Audit Requirement(s)
MICOM	U.S. Army Missile Command
MMAS	Material Management and Accounting System
MOU	Memorandum of Understanding
MRD	Memorandum for Regional Directors (DCAA)
MRP	Material Requirements Planning (Inventory Control System)
MWS	Major Weapon System
NASA	National Aeronautics and Space Administration
NGB	National Guard Bureau (DoD)
NRC	Nuclear Regulatory Commission
OAL	Audit Liaison Division (DCAA Hqs)
ODC	Other Direct Cost
OFPP	Office of Federal Procurement Policy (OMB)
OIG	Office of the Inspector General
OMB	Office of Management and Budget
ONR	Office of Naval Research
OPSEC	DoD Operations Security Program
OT	Other Transactions
OTS	Technical Audit Services (DCAA Hqs)
OWD	Workload and Trends Division (DCAA Hqs)
PAC	Accounting & Cost Principles Division (DCAA Hqs)
PACO	Principal ACO
PAS	Auditing Standards Division (DCAA Hqs)
PAT	Process Action Team

Acronym/Abbreviation	Description
PBIS	Performance Based Incentive System
PBP	Performance Based Payment
PCO	Procuring Contracting Officer
PDR	Plantwide Data Report
PII	Personally Identifiable Information
PL	Public Law
PMM	Personnel Management Manual
PNM	Price Negotiation Memorandum
PPD	Programs Division (DCAA Hqs)
PQA	Quality Assurance Division (DCAA Hqs)
PROCAS	Process Contract Administration Services (DLA)
PS&C	Production Scheduling & Control
PSAD	Planning and Staff Allocation Document
PSP	Special Projects (DCAA Hqs)
PWT	Participative Work Team
R&D	Research & Development (Cost)
RAM	Regional Audit Manager
RD	Regional Director
RFP	Request(s) for Proposal(s)
SAS	Statement on Auditing Standards (AICPA)
SAS	Statistical Application Software
SEC	Securities & Exchange Commission
SF	Standard Form
SIC	Suspected Irregular Conduct
SIS	Synopsis Information System(s) (DCAA)
SSAE	Statements on Standards for Attestation Engagements
SSEB	Source Selection Evaluation Board
T&M	Time-and-Materials (Contract)
TBSR	Total Business System Review (ONR)
TCO	Termination Contracting Officer
TEFRA	Tax Equity and Fiscal Responsibility Act
TQM	Total Quality Management
TRASOPs	Tax Reduction Act Stock Ownership Plans
TSC	Technical Services Center
U.S.C.	United States Code
VAP	Vulnerability Assessment Procedure(s) (DCAA)
VLSI	Very Large Scale Integration
WAWF	Wide Area Workflow
W/P	Working Papers
WBS	Work Breakdown Structure(s)
ZBB	Zero-Based Budgeting

CHAPTER 1

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CHAPTER 1

1-000 Introduction To Contract Audit

1-001 Scope of Chapter

This chapter introduces the chapters and appendixes which follow. It provides information on the contract audit mission; responsibilities of DCAA and the contract auditor; and the relationships of DCAA to other Department of Defense components, other Government agencies, and contractors.

1-100 Section 1 --- Establishment and Responsibilities of DCAA

1-101 Introduction

This section describes the establishment, responsibilities, and inter-organizational relationship of DCAA.

1-102 Establishment and Responsibilities

a. The Defense Contract Audit Agency was established by a directive of the Department of Defense for the purpose of performing all contract auditing for the Department of Defense (DoD) and providing accounting and financial advisory services, in connection with the negotiation, administration and settlement of contracts and subcontracts, to all DoD procurement and contract administration activities. DCAA also furnishes contract audit service to other Government agencies (see 1-302b.).

b. The role of the auditor is advisory, except that on cost-type contracts the auditor is required to comply with specific contract provisions. Procedures for such compliance are discussed in Chapter 6.

c. Although the detection of fraud or similar unlawful activity is not the primary function of contract audit, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the contractor submissions and supporting data are free of material misstatement, whether caused by error or by fraud. When fraud or similar unlawful activity is suspected, the auditor shall be guided by 4-700.

1-103 Relationship --- DCAA and the Office of the Secretary of Defense

DCAA is a separate agency of the Department of Defense under the direction, authority, and control of the Under Secretary of Defense (Comptroller). Supplement 1-1S1 contains the Agency charter, DoD Directive 5105.36.

1-104 Nature of Contract Auditing

1-104.1 Introduction

The following paragraphs state the objective of contract auditing and in broad terms how the objective is accomplished.

1-104.2 Contract Audit Objective

a. The purpose of contract auditing is to assist in achieving prudent contracting by providing those responsible for Government procurement with financial information and advice relating to contractual matters and the effectiveness, efficiency, and economy of contractors' operations. Contract audit activities include providing professional

advice on accounting and financial matters to assist in the negotiation, award, administration, repricing and settlement of contracts. Audit interest encompasses the totality of the contractor's operations. Audits are performed to assure the existence of adequate controls which will prevent or avoid wasteful, careless, and inefficient practices by contractors. These audits include the evaluation of a contractor's policies, procedures, controls and actual performance, identifying and evaluating all activities which contribute to, or have an impact on, proposed or incurred costs of Government contracts. Areas of concern to the auditor include the adequacy of contractor's policies, procedures, practices, and internal controls relating to accounting, estimating, and procurement; the evaluation of contractors' management policies and decisions affecting costs; the accuracy and reasonableness of contractors' cost representations; the adequacy and reliability of contractors' records for Government-owned property; the financial capabilities of the contractor; and the appropriateness of contractual provisions having accounting or financial significance. Contract auditors perform evaluations of contractors' statements of costs to be incurred (cost estimates) or statements of cost actually incurred to the extent deemed appropriate by the auditors in the light of their experience with the contractors and relying upon their appraisals of the effectiveness of the contractors' policies, procedures, controls, and practices. Such evaluations may consist of test checks of a limited number of transactions or in-depth examinations at the discretion of the auditor.

b. To accomplish the objective of contract auditing, the auditor must examine or develop sufficient evidence to support a valid opinion of the extent to which costs or estimates contained in a contractor's claim or proposal are:

(1) reasonable as to nature and amount,

(2) allocable, and measurable by the application of duly promulgated cost accounting standards,

(3) generally accepted accounting principles and practices appropriate to the particular circumstances; and

(4) in accordance with applicable cost limitations or exclusions as stated in the contract or in FAR.

The auditor will find it extremely useful at the onset of the examination, in planning the audit program and approach to review the contractor's accounting nomenclature, chart of accounts, accounting manuals and financial statements. It should, however, be recognized that professional opinions and conclusions on the acceptability of contract costs must be based on the auditor's knowledge of the contractor's classification practices and the actual nature of the expenditures charged to the various accounts and classifications. This knowledge is best gained by selective testing of transactions recorded in the various accounts.

c. The auditor should at all times be alert to any matters that may affect the Government's prudent and efficient management of its procurement program. When the auditor becomes aware of the need for improved Government practices, the appropriate office should be advised and, to the maximum extent feasible, the corrective measures should be recommended in the audit report.

d. In performing normal auditing procedures in connection with an examination, auditors should be alert for indications of excessive contract prices or profits and for evidence of overcharges or inadequate compensation to the Government. If the auditor finds an indication of such a condition, he or she should discuss it with the supervisor to decide whether further evaluation is warranted and whether the condition is properly reportable as one involving:

(1) suspected fraud or other similar irregularities (4-700);

(2) defective pricing (14-100); or

(3) solicitation of a voluntary refund (4-800).

Guidance for determining which of the above reporting procedures should be used is contained in the referenced paragraphs. If the condition is not reportable under the

foregoing guidance, a report stating the pertinent facts should nevertheless be submitted to Headquarters, DCAA, Attention: Deputy Assistant Director, Operations.

e. FAR 15.408(b) prescribes the insertion of a "defective pricing" clause (FAR 52.215-10) which accords the Government a contractual basis for reducing the contract price under certain conditions. When, after contract execution, it is learned that the contract price was negotiated on the basis of cost or pricing data furnished by the contractor that was incomplete, inaccurate or not current, the contracting officer may reduce the contract price. Guidance concerning the auditor's role in this area is stated in Chapter 14.

f. FAR 52.230-2 prescribes the insertion into contracts and subcontracts of a "cost accounting standards" clause which requires certain contractors or subcontractors to disclose in writing their cost accounting practices, to follow the disclosed practices consistently, to comply with duly promulgated cost accounting standards, and to agree to contract price adjustment for any increased cost to the Government as a result of the contractor's failure to comply with applicable cost accounting standards. Guidance concerning the auditor's role with respect to cost accounting standards is stated in Chapter 8.

g. FAR 16.102(c) provides that the cost-plus-a-percentage-of-cost system of contracting shall not be used by the Government for any prime contract; or allowed to be used in any chain of cost or redeterminable subcontracts, unbroken by a firm-fixed-price subcontract. If such a contract or subcontract is encountered, the entire cost, including the amount representing the percentage added, will be disapproved under cost-type contracts and recommended for nonacceptance under fixed-price redeterminable contracts.

1-1S1 Supplement --- DoD Directive 5105.36 --- Defense Contract Audit Agency Charter

Department of Defense

DIRECTIVE

NUMBER 5105.36
January 4, 2010

DA&M

SUBJECT: Defense Contract Audit Agency (DCAA)

References: See Enclosure 1

1. PURPOSE. Under the authority vested in the Secretary of Defense by sections 113, 191, and 192 of title 10, United States Code (U.S.C.) (Reference (a)), this Directive reissues DoD Directive (DoDD) 5105.36 (Reference (b)) to update the mission, organization and management, responsibilities and functions, relationships, and authorities of the DCAA.

2. APPLICABILITY. This Directive applies to OSD, the Military Departments, the Office of the Chairman of the Joint Chiefs of Staff and the Joint Staff, the Combatant Commands, the Office of the Inspector General of the Department of Defense, the Defense Agencies, the DoD Field Activities, and all other organizational entities within the Department of Defense (hereafter referred to collectively as the "DoD Components").

3. MISSION. The DCAA, while serving the public interest as its primary customer, shall perform all necessary contract audits for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all DoD Components responsible for procurement and contract administration. These services shall be provided in connection with negotiation, administration, and settlement of contracts and subcontracts to ensure taxpayer dollars are spent on fair and reasonable contract prices. DCAA shall provide contract audit services to other Federal agencies, as appropriate.

4. ORGANIZATION AND MANAGEMENT

a. DCAA is a Defense Agency under the authority, direction, and control of the Under Secretary of Defense (Comptroller) (USD(C))/Chief Financial Officer (CFO), Department of Defense, consistent with DoDD 5118.03 (Reference (c)).

b. DCAA shall consist of a Director and such subordinate organizational elements as are established by the Director within resources assigned by the Secretary of Defense.

c. No separate contract audit organization independent of the DCAA shall be established in the Department of Defense.

5. RESPONSIBILITIES AND FUNCTIONS. The Director, DCAA, shall:

a. Organize, direct, and manage DCAA and all assigned resources.

b. Assist in achieving the objective of prudent contracting, by providing DoD officials responsible for procurement and contract administration with financial information and advice on proposed or existing contracts and contractors, as appropriate.

c. Audit, examine, and/or review contractors' and subcontractors' accounts, records, documents, and other evidence; systems of internal control; and accounting, costing, and general business practices and procedures in accordance with Government Auditing Standards (Reference (d)), the Federal Acquisition Regulation (Reference (e)), the Defense Federal Acquisition Regulation Supplement (Reference (f)), and other applicable laws and regulations to the extent and in whatever manner is considered necessary to permit proper performance of the other functions described in paragraphs 5.d. through 5.j. of this Directive.

d. Approve, suspend, or disapprove costs on reimbursement vouchers received directly from contractors, under cost-type contracts, transmitting the vouchers to the cognizant Disbursing Officer.

e. Provide information and advice on proposed or existing contracts and contractors, consistent with paragraph 5.b. of this Directive, including, but not limited to:

(1) Acceptability of costs incurred under redeterminable, incentive, and similar-type contracts.

(2). Acceptability of incurred costs and estimates of cost to be incurred as represented by contractors incident to the award, negotiation, modification, change, administration, termination, or settlement of contracts.

(3). Adequacy of financial or accounting aspects of contract provisions.

(4). Adequacy of contractors' accounting and financial management systems, estimating procedures, and property controls.

f. Assist responsible procurement or contract administration activities in their surveys of the purchasing-procurement systems of major contractors.

g. Direct audit reports to the Government management level having authority and responsibility to take action on the audit findings and recommendations.

h. Cooperate with other appropriate DoD Components on reviews, audits, analyses, or inquiries involving contractors' financial position or financial and accounting policies, procedures, or practices.

i. Establish and maintain liaison auditors and financial advisors, as appropriate, at major procuring and contract administration offices.

j. Review Government Accountability Office reports and proposed responses thereto, that involve significant contract or contractor activities for the purpose of ensuring the validity of appropriate pertinent facts contained therein.

k. In an advisory capacity, attend and participate, as appropriate, in contract negotiation and other meetings where contract cost matters, audit reports, or related financial matters are under consideration.

l. Provide assistance, as requested, in the development of procurement policies and regulations.

m. Report incidents of suspected fraud, waste, and abuse to the appropriate authorities.

n. Design and manage DCAA activities and programs to improve standards of performance, economy, and efficiency, and demonstrate DCAA's attention to the requirements of its organizational customers, both internal and external to the Department of Defense.

o. Perform such other duties as may be assigned by the Secretary and Deputy Secretary of Defense or USD(C)/CFO.

6. RELATIONSHIPS

a. In performing assigned functions and responsibilities, the Director, DCAA, shall:

(1) Report directly to the USD(C)/CFO.

(2) Maintain liaison with the DoD Components, other Federal agencies, foreign governments, and private sector organizations for the exchange of information concerning assigned programs, activities, and responsibilities.

(3) Use existing systems, facilities, and services of the Department of Defense and other Federal agencies, when possible, to avoid duplication and to achieve maximum efficiency and economy.

(4) Receive support from the Military Departments and other DoD Components within their respective fields of responsibility to assist in carrying out the assigned responsibilities and functions of the DCAA.

b. The OSD Principal Staff Assistants and Heads of the other DoD Components shall coordinate with the Director, DCAA, as appropriate, on matters under their purview relating to DCAA operations, functions, responsibilities, and programs.

c. Procurement and contract administration activities of the DoD Components shall utilize audit services of the DCAA to the extent appropriate in connection with the ne-

gotiation, administration, and settlement of contract payments and prices that are based on cost (incurred or estimated), or on cost analysis.

7. AUTHORITIES. The Director, DCAA, is hereby delegated authority to:

a. Communicate directly with the Heads of the DoD Components, as necessary, to carry out assigned responsibilities and functions, including the transmission of requests for advice and assistance. Communications to the Military Departments shall be transmitted through the Secretaries of the Military Departments, their designees, or as otherwise provided in law or directed by the Secretary of Defense in other DoD issuances. Communications to the Commanders of the Combatant Commands normally shall be transmitted through the Chairman of the Joint Chiefs of Staff, except those communications dealing solely with contract audit functions.

b. Communicate with other Government officials, representatives of the Legislative Branch, members of the public, and representatives of foreign governments, as appropriate, to carry out assigned responsibilities and functions. Communications with representatives of the Legislative Branch shall be coordinated with the Assistant Secretary of Defense for Legislative Affairs or the USD(C)/CFO, as appropriate, and be consistent with the DoD Legislative Program.

c. Obtain reports and information consistent with DoD Instruction (DoDI) 8910.01 (Reference (g)), as necessary, to carry out assigned responsibilities and functions.

d. Establish DCAA facilities using appropriate established physical facilities and services of other DoD Components whenever possible to achieve maximum efficiency and economy.

e. Exercise the administrative authorities contained in Enclosure 2 of this Directive.

8. ADMINISTRATION

a. The Director, DCAA, shall be a civilian appointed by the Secretary of Defense, with the advice of the USD(C)/CFO.

b. The appointment of other personnel to DCAA will be subject to the approval of the Director, DCAA, or his or her designee.

9. RELEASABILITY. UNLIMITED. This Directive is approved for public release and is available on the Internet from the DoD Issuances Web Site at http://www.dtic.mil/whs/directives.

10. EFFECTIVE DATE. This Directive is effective immediately.

William J. Lynn III
Deputy Secretary of Defense

Enclosures
1. References
2. Delegations of Authority

ENCLOSURE 1

REFERENCES

(a) Sections 113, 173, 191, 192, and 2667 of title 10, United States Code
(b) DoD Directive 5105.36, "Defense Contract Audit Agency (DCAA)," February 28, 2002 (hereby canceled)
(c) DoD Directive 5118.03, "Under Secretary of Defense (Comptroller) (USD(C))/Chief Financial Officer (CFO), Department of Defense," January 6, 1997
(d) U.S. Government Accountability Office, Government Auditing Standards, current edition[1]
(e) Federal Acquisition Regulation, current edition[2]
(f) Defense Federal Acquisition Regulation Supplement, current edition[3]
(g) DoD Instruction 8910.01, "Information Collection and Reporting," March 6, 2007
(h) Executive Order 10450, "Security Requirements for Government Employment," April 27, 1953, as amended
(i) Executive Order 12333, "United States Intelligence Activities," December 4, 1981, as amended
(j) Executive Order 12968, "Access to Classified Information," August 2, 1995, as amended
(k) DoD Directive 5200.2, "DoD Personnel Security Program," April 9, 1999
(l) DoD 5200.2-R, "Personnel Security Program," January 16, 1987
(m) Joint Federal Travel Regulation, Volume 1, "Uniformed Service Members," December 1, 2004
(n) Joint Travel Regulations, Volume 2, "Department of Defense (DoD) Civilian Personnel," January 1, 2009
(o) Title 5, United States Code
(p) Section 412 of title 37, United States Code
(q) Title 44, United States Code
(r) DoD Directive 5015.2, "DoD Records Management Program," March 6, 2000
(s) DoD Instruction 5025.01, "DoD Directives Program," October 28, 2007
(t) DoD Instruction 5200.08, "Security of DoD Installations and Resources," December 10, 2005
(u) DoD Instruction 1400.25, "DoD Civilian Personnel Management System," December 1, 1996
(v) DoD Instruction 5105.04, "Department of Defense Federal Advisory Committee Management Program," August 6, 2007

[1] Available at http://www.gao.gov/govaud/ybook/pdf
[2] Available at https://www.acquisition.gov/far/
[3] Available at http://www.acq.osd.mil/dpap/dars/dfarspgi/current/index.html

ENCLOSURE 2

DELEGATIONS OF AUTHORITY

Under the authority vested in the Secretary of Defense, and subject to the authority, direction, and control of the USD(C)/CFO, and in accordance with DoD policies and issuances, the Director, DCAA, or, in the absence of the Director, the person acting for the Director, is hereby delegated authority, as required in the administration and operation of DCAA, to:

a. Maintain an official seal and attest to the authenticity of official records under the seal.

b. Enforce regulatory procedures in accordance with Executive Order (E.O.) 10450 (Reference (h)), E.O. 12333 (Reference (i)), E.O. 12968 (Reference (j)), and DoDD 5200.2 (Reference (k)), as appropriate, and:

(1) Designate any position in DCAA as a “sensitive” position.

(2) Authorize, in case of emergency, the appointment of a person to a sensitive position in DCAA for a limited period of time and for whom a full field investigation or other appropriate investigation, including the National Agency Check, has not been completed.

(3) Initiate personnel security investigations and, if necessary, in the interest of national security, suspend a security clearance for personnel assigned to, detailed to, or employed by DCAA. Any actions under this paragraph shall be taken in accordance with procedures prescribed in DoD 5200.2-R (Reference (l)).

c. Authorize and approve:

(1) Temporary duty travel only for military personnel assigned or detailed to the DCAA in accordance with Joint Federal Travel Regulation, Volume 1 (Reference (m)).

(2) Travel for DCAA civilian personnel in accordance with Joint Travel Regulations, Volume 2 (Reference (n)).

(3) Invitational travel to non-DoD personnel whose consultative, advisory, or other highly specialized technical services are required in a capacity that is directly related to, or in connection with, DCAA activities, in accordance with Reference (n)).

(4) Overtime work for DCAA civilian personnel in accordance with subchapter V of chapter 55 of title 5, U.S.C. (Reference (o)) and applicable Office of Personnel Management (OPM) regulations.

d. Approve the expenditure of funds available for travel by military personnel assigned or detailed to the DCAA for expenses incident to attendance at meetings of technical, scientific, professional, or other similar organizations in such instances when the approval of the Secretary of Defense, or designee, is required by sections 4110 and 4111 of Reference (o) and section 412 of title 37, U.S.C. (Reference (p)).

e. Develop, establish, and maintain an active and continuing Records Management Program, pursuant to section 3102 of title 44, U.S.C. (Reference (q)) and DoDD 5015.2 (Reference (r)).

f. Utilize the Government purchase card for making appropriate purchases of material and services, other than personal services, for the DCAA when it is determined more advantageous and consistent with the best interests of the Government.

g. Authorize the publication of advertisements, notices, or proposals in newspapers, magazines, or other public periodicals as required for the effective administration and operation of the DCAA, consistent with section 3702 of Reference (q).

h. Establish and maintain, for the functions assigned, an appropriate internal publications system for the promulgation of regulations, instructions, and reference documents, and changes thereto, pursuant to the policies and procedures prescribed in DoD issuances published under DoDI 5025.01 (Reference (s)).

i. Enter into support and service agreements with the Military Departments, other DoD Components, or other Federal agencies, as required, for the effective performance of DCAA functions and responsibilities.

j. Enter into and administer contracts directly or through the Military Departments, a DoD contract administration services Component, or other Federal agency, as appropriate, for supplies, equipment, and services required to accomplish the DCAA mission.

k. Establish and maintain appropriate property accounts for the DCAA and appoint Boards of Survey, approve reports of survey, relieve personal liability, and drop accountability for DCAA property contained in the authorized property accounts that has been lost, damaged, stolen, destroyed, or otherwise rendered unserviceable, in accordance with applicable laws and regulations.

l. Issue the necessary security regulations for the protection of property and places under the jurisdiction of the Director, DCAA, pursuant to DoDI 5200.08 (Reference (t)).

m. Lease property under the control of the DCAA, under terms that promote the national defense or that are in the public interest, pursuant to section 2667 of Reference (a) and applicable DoD policy.

n. Exercise the powers vested in the Secretary of Defense by sections 301, 302(b), 3101, and 5107 of Reference (o) on the employment, direction, and general administration of assigned employees.

o. Fix rates of pay of wage-rate employees exempted from the Classification Act of 1949 by section 5102 of Reference (o) on the basis of rates established under the Federal Wage System. In fixing such rates, the Director, DCAA, shall follow the wage schedule established by the DoD Wage Fixing Authority.

p. Administer oaths of office to those entering the Executive Branch of the Federal Government or any other oath required by law in connection with employment therein, in accordance with section 2903 of Reference (o), and designate in writing, as may be necessary, officers and employees of the DCAA to perform this function.

q. Establish a DCAA Incentive Awards Board and pay cash awards to, and incur necessary expenses for the honorary recognition of, civilian employees of the Government whose suggestions, inventions, superior accomplishments, or other personal efforts, including special acts or services, benefit or affect the DCAA, in accordance with section 4503 of Reference (o), OPM regulations, and DoDI 1400.25 (Reference (u)).

r. Use advisory committees and employ temporary or intermittent experts or consultants, as approved by the Secretary of Defense or the Director of Administration and Management, for the performance of DCAA functions, consistent with sections 173 and 174 of Reference (a), section 3109(b) and Appendix 2 of Reference (o), and DoD Instruction 5105.04 (Reference (v)).

s. Redelegate these authorities as appropriate, and in writing, except as otherwise specifically indicated in this Directive or prohibited by law, Executive order, or regulation.

ENCLOSURE 2

1-200 Section 2 --- Relationships with the Government Accountability Office

1-201 Introduction

This section contains procedures and guidance on: (1) relationships between DCAA and the Government Accountability Office (GAO), (2) granting the GAO access to DCAA audit records and files, (3) submitting information and comments to Headquarters for replies to GAO reports, and (4) coordinating DCAA and GAO activities to ensure effective working relationships. Relationships with members of Congress and Congressional committees are discussed at 1-410.

1-202 Relationship --- DCAA and GAO

a. The GAO has broad authority for conducting audits and investigations to enable the Comptroller General, as an agent of Congress, to determine whether executive departments and Government agencies properly discharge their financial responsibilities. In connection with the audit of the procurement function, the GAO is granted access to contractors' records by law and by contract provisions. DoD personnel at all levels will cooperate fully with representatives of the GAO.

b. The Quality Assurance Division (PQA) monitors and coordinates all GAO matters in accordance with DoD Directives No. 7650.1, General Accounting Office (GAO) and Comptroller General Access to Records; No. 7650.2, General Accounting Office Reviews and Reports; and No.7650.3, Follow-up on General Accounting Office (GAO), DoD Inspector General (DOD IG), and Internal Review Reports.

1-203 GAO Access to Records and Files

a. When requested by GAO, furnish audit reports and associated working papers in accordance with DoDD 7650.1; DCAAR No. 5205.1, DCAA Information Security Program; and the procedures below. Advance approval of regional offices or Headquarters is not required, provided that the GAO has notified the Secretary of Defense and DCAA of the review and has conducted an entrance conference with DoD officials.

b. Do not furnish non-DoD agency reports, military department reports, non-DoD Inspector General reports, or criminal investigation organization reports (including the FBI) unless approved by DCAA Headquarters. This restriction also applies to summaries of such reports.

c. Promptly submit pertinent information to the Regional Quality Assurance Division (or other designated regional office element) and Headquarters, ATTN: PQA. Identify the information furnished to GAO.

1-203.1 Access to Audit Records and Files on Completed Audits

a. When requested, grant GAO representatives unlimited access to audit records and files applicable to completed audits. This includes access to files on all types of system surveys, audit programs, working papers, correspondence on cost allowances, notices of cost suspended or disapproved, contracts, and audit reports.

b. Cooperate with GAO representatives by providing copies of existing reports and other documents. When furnishing contractor proprietary information to the GAO (e.g., documents marked For Official Use Only (FOUO) or documents that are believed to contain contractor proprietary data), include the following statement in the transmittal memorandum:

> "Please be advised that the contractor financial and accounting system information contained in this [letter / report / enclosure] is considered proprietary by the company and should not be released to the public. The information made available to you in this [letter / report / enclosure] contains financial data furnished to the Government in confidence. Such information must be protected from unauthorized dis-

closure under 18 U.S.C. 1905. For this reason, the [letter / report / enclosure] has been marked FOR OFFICIAL USE ONLY."

c. FAOs should also cooperate with GAO representatives in the completion of questionnaires dealing with DCAA's audit responsibilities and performance. Refer GAO questionnaires that require the preparation of extensive analyses or schedules or would require significant audit resources to Headquarters, ATTN: PQA. (Also see b above and 1-203.4 below.)

d. Encourage the GAO representatives to perform their analytical effort onsite, both to minimize the use of DCAA resources and to enable the auditor to explain or clarify data if required.

1-203.2 Access to Audit Working Papers Relating to Incomplete/In-process Assignments

FAOs may grant the GAO access to any factual data contained in the records or files. However, FAOs should dissuade the GAO representative from examining audit working papers relating to incomplete/in-process assignments, because any audit conclusions included therein are tentative and do not represent the official DCAA position until the audit is completed. If the GAO insists on examining incomplete/in-process assignment working papers, elevate the matter through the Regional Quality Assurance Division (or other designated regional office element) to Headquarters, ATTN: PQA.

1-203.3 Access to Audit Records on Replies to GAO Reports

Refer GAO requests for access to copies of correspondence or memorandums prepared to assist DCAA Headquarters and military departments or agencies in the formulation of an official reply to a GAO draft report or final report to Headquarters, ATTN: PQA. This information requires special consideration because it does not represent the final position of DCAA or the military department or agency concerned with the report.

1-203.4. GAO Requests for Audit-Related Information and Non-Audit-Related Information

a. The GAO may request an FAO to use its access rights to obtain and/or validate contractor information that is not otherwise required by the FAO in carrying out DCAA's audit mission. The information could be either (1) audit-related (e.g., the GAO asks that a postaward audit be done on a contract not selected by the FAO) or (2) non-audit-related (e.g., the GAO asks the FAO to complete a survey instrument or gather information for the purpose of statistical aggregation, and the information requested is not necessary for performing DCAA's audit functions). Written confirmation of the request for assistance will be furnished to the GAO within seven working days of receipt. The GAO request should be provided to Headquarters, PQA, through the RQA, with the agreed to course of action to be taken.

b. FAOs should generally accept and respond to requests for audit-related information taking into consideration the following: (1) Government's overall policy to have one contract audit face to the contractor and to avoid duplication of Government audit effort when possible, (2) DCAA resources required to fulfill the request, and (3) impact that acting on the request would have on meeting current audit requirements.

c. Except as noted below, FAOs should generally not accept and respond to requests to obtain non-audit-related information from contractors. Instead, the FAO should ask the GAO to have the contractor directly respond to such requests. An exception to this policy is when the non-audit information requested by GAO can be readily retrieved from the FAO's files, and the contractor has no objection to the release of the information. In these cases, FAO's should provide the GAO with requested information. If the

GAO obtains non-audit information directly from contractors, the FAO will, upon request of the GAO, assist the GAO in the evaluation or validation of that information. When in doubt as to how best to handle a given GAO request for non-audit information, FAOs should contact their RQA Chief for guidance.

d. Promptly forward copies of all correspondence, memorandums of conversations, and reports prepared in response to such requests to Headquarters, ATTN: PQA, with copies to the cognizant regional office and RQA.

1-204 Replies to GAO Reports

a. GAO reporting on defense contracting is primarily accomplished through: (1) reports (draft and final) issued by its headquarters office and addressed to the Secretary of Defense, the Secretaries of the Military Departments, or heads of Defense agencies; (2) letter reports issued by GAO regional offices directly to officials of field activities of the Military Departments or DoD agencies, and (3) congressional testimony.

b. DCAA is routinely requested to submit comments and participate in formulating the official DoD position on the cost aspects and related recommendations in GAO reports issued on defense contractors and on contract audit matters. In cases where DCAA Headquarters or other DCAA organizational element is providing comments, that element will often require (and therefore solicit) input from regional and FAO activities. (Also see 1-203.3 and 1-203.4 above.)

1-204.1 Replies to GAO Headquarters Reports

a. These reports generally pertain to defense contracting. They are initially submitted in draft form with a request for an official response and comments. The response is usually incorporated in the final GAO report.

b. The Audit Follow-up and GAO Affairs Division, under the Assistant Inspector General for Audit Follow-up, Office of the Deputy Inspector General for Auditing, refers all proposed DoD responses to GAO Headquarters reports related to procurement or contract audit matters to DCAA Headquarters for concurrence or comment. DCAA Headquarters will provide a response to the DoDIG.

c. In advance, Headquarters reviews GAO reports that may require comment. The cognizant Headquarters element will immediately transmit the report to the regional office(s) and FAO(s) involved if field action or input is required. The cognizant regional office or FAO will prepare the field office response in accordance with paragraph d. below and any special requests stated in the Headquarters transmittal.

d. Regional offices or FAOs will review and evaluate the factual information, the surrounding circumstances, and the conclusions presented in the report. Comments should be made on any corrective action taken or proposed. In addition, note any GAO report statements that are not fully compatible with audit findings or on which information is not available. To minimize elapsed time, conferences with the GAO review team may be necessary. In this case, make an appropriate request to the local GAO office or to the cognizant Headquarters element, depending on the origin of the GAO report.

e. In some cases, the primary action office requests Headquarters to perform audits or examine specific contractor records to aid in formulating the DoD position on a GAO report. In these instances, Headquarters will establish a firm due date for the response and forward the request directly to the field audit office, with copies to the regional office. Submit the field audit office's reply to the cognizant Headquarters element with a copy to the regional office.

f. Field audit offices may receive direct requests from procurement or contract administration field components for audit service on specific GAO reports. Promptly forward copies of all correspondence, memorandums of conversations, and reports prepared in response to such requests to Headquarters, ATTN: PQA, with copies to the cognizant regional office.

g. Procedures for responding to GAO reviews are set forth in DCAAI 7050.2, Responding to Oversight Reviews. Procedures for monitoring compliance with GAO recommendations are set forth in DCAAR 7640.12, Follow-up on Audit Reports Concerning Defense Contract Audit Agency Operations.

1-204.2 Replies to GAO Letter Reports

a. GAO may issue letter reports on defense contracting directly to officials of field activities of DoD agencies or the military departments. Letter reports include any written communication from GAO requiring written response. These reports generally relate to matters of less significance than GAO Headquarters reports. They are addressed to the particular field activity responsible for the matters reported upon or for the implementation of any recommendations contained in the report. Thus, letter reports may be addressed to field procurement or contract administration offices or to DCAA field offices.

b. Prepare responses to GAO letter reports for the signature of the regional director. To assure uniformity in responses and conformity with DCAA policy, submit drafts of the proposed responses to Headquarters, ATTN: PQA, for concurrence prior to issuance. When necessary to meet a deadline, concurrence of Headquarters (PQA) may be obtained by telephone.

c. FAOs may receive requests directly from a field procurement or contract administration office for audit information in connection with their responses to letter reports that were addressed to them. Honor such requests pertaining to contract audit responsibility. Prepare the response for the regional director's signature and reply directly to the requesting activity. Forward copies of all correspondence and reports prepared in response to such requests to Headquarters, ATTN: PQA.

1-204.3 Congressional Testimony

a. GAO reports on defense contracting through testimony presented before Congress. Occasionally DCAA Headquarters is requested to analyze the testimony in advance for factual accuracy and concurrence. These requests often have a short response time, and regional or field office input is usually not feasible.

b. Procedures to be followed in providing testimony to Congress are set forth in DCAAR 5030.16, Supporting Congressional Requests for Information.

1-204.4 Explanations of Delays in Submission of Responses to GAO Reports

Promptly submit an interim reply to the cognizant Headquarters element, with a copy to the regional office, when a complete response cannot be submitted by the established due date. State the specific reasons the due date cannot be met and the estimated time needed to complete the evaluation. Address as many of the report findings, conclusions, and recommendations as possible.

1-205 Liaison Between DCAA and Government Accountability Office Activities

DCAA will maintain formal and informal liaison with GAO at the headquarters and/or regional levels to establish an effective working relationship. This is not intended to diminish or detract from the statutory and executive responsibilities, functions, or independence of either GAO or DCAA. The Headquarters, Policy Quality Assurance Division (PQA), will act as the primary liaison between DCAA and GAO to (1) resolve field operating problems requiring Headquarters attention, (2) coordinate GAO studies affecting the contract audit area, and (3) exchange ideas and training material in connection with improving performance of the two agencies.

1-205.1 GAO Reviews Affecting DCAA

a. Except for congressional requests, GAO regional directors are expected to inform DCAA of the scope of GAO planned and in-process reviews concerning contractors under DCAA audit cognizance. GAO generally contacts DCAA at the start of every review, conducts an exit conference at the end of such reviews, and furnishes a copy of the draft and/or final report. Before providing access to the GAO reviewer, determine that the review has been properly coordinated in accordance with DCAAI 7050.2, which also contains detailed procedures for supporting oversight reviews affecting DCAA.

b. When the GAO is involved in reviews of DCAA or in audits at contractor plants under DCAA cognizance, work closely with the GAO to assure that there is proper understanding of DCAA objectives and methods to avoid GAO duplication of our work and to determine reliance to be placed upon the work of the GAO (see 4-1000).

c. Provide written notification to the Regional Quality Assurance Division (or other designated regional office element) and Headquarters, ATTN: PQA, of all GAO visits to FAOs or contractor sites.

d. As required by DCAAI 7050.2, a GAO reviewed FAO will provide a written memorandum of significant issues to the regional office, including the Chief, Regional Quality Assurance Division, within ten working days of an oversight visit. The region will forward the FAO's memorandum to Headquarters, PQA, within five additional working days.

1-300 Section 3 --- Audit Services for Non-DoD Agencies

1-301 Introduction

This section provides guidance for performing audit services for non-DoD agencies. The underlying audit policies, procedures, and support requirements pertaining to such services are presented in 15-100.

1-302 General Rules for Establishing Cognizance and Accepting or Rejecting Non-DoD Requests

a. Federal agencies are required to establish audit cross-servicing arrangements when doing so is in the best interest of the Federal Government and the organization being audited. Normally, the agency with the predominant financial interest should arrange for all audits at an organization. Department of Defense implementing guidance is provided by DoDI 7600.02, "Audit Policies." Thereunder, contract audit services may be provided to other Federal agencies upon request, with reimbursement at cost, as prescribed by the Under Secretary of Defense (Comptroller).

b. Cross-servicing arrangements have been made through memorandums of understanding (MOU) with various non-DoD agencies under the OMB criteria and DoD implementing guidance.

c. There are many Federal agencies with which DCAA has not established MOUs or had any contact concerning audit cognizance. Should DCAA auditors become aware of contract audit effort being performed by or on behalf of other Federal entities at contractor locations where DCAA is the cognizant contract audit agency, they should advise DCAA Headquarters, Attention: OWD, through their regional offices.

d. Any non-DoD agency request concerning a change in audit cognizance or related matters should be addressed to DCAA Headquarters, Attention: OWD.

e. DCAA is responsible for determining the scope of audit, including the manner and level of effort necessary to provide complete contract audit coverage at a contractor location. The Contract Audit Manual will be the determining guide for the conduct of audits. Complete contract audit coverage may include examinations of internal controls and of contractor accounting and financial management systems considered necessary to satisfy government auditing standards, as incorporated in Comptroller General of the United States pamphlet “Government Auditing Standards,” June 1994. When possible, auditors should be responsive to any additional coverage suggested by the requesting agency.

f. Audit working papers prepared during the course of audits for Federal agencies are the property of DCAA and will generally remain in the possession of the auditor. However, they will be made available for review by properly authorized procurement and other representatives of the Federal agencies for which the audit services were performed. If audit cognizance is transferred from DoD to another Federal agency, audit files may be released to the successor agency if (1) the files are no longer required by DCAA, (2) the files will benefit the agency in carrying out its audit responsibilities, and (3) there are no restrictions on the release of the files, e.g., SIC and classified. FAOs should keep a record of files transferred. Audit folders or other documents which are still required by DCAA may be copied by the successor agency provided they meet the above criteria. However, prior to the actual transfer of audit files, the instructions contained in DCAAM 5015.1 Chapter 4, paragraph B.3, must be followed.

g. Audit reports will be addressed in the manner prescribed in 10-206 .

h. The auditor's responsibility for attending negotiation conferences requested by non-Defense procurement officials is essentially the same as that outlined in 15-400 for Defense procurement officials. The auditor will also be responsive to inquiries and personal visits from representatives of non-Defense agencies concerning the status and performance of requested audits. The objectives of such personal visits should be to

seek information and to discuss mutual problems. They are not to be used to supervise and/or evaluate the performance of the audit.

i. Responsibility for follow-up of DCAA audit recommendations and reviews of program results remain with the non-DoD agencies for which audit services are performed.

j. Field activities will prepare reimbursable billings in accordance with the requirements of the DMIS User Guide.

1-303 Processing Non-DoD Agency Requests for Audit Information or Services

a. DCAA will be responsive to requests received from Government agencies outside the Department of Defense for information available in the audit files when the circumstances clearly show that the inquirer is entitled to the requested information. There is a presumption of entitlement if the requesting agency has a contract or is proposing to contract with the contractor and the information desired is related to the negotiation or administration of that contract. Requests for specific cost information which are readily available without audit effort will be accommodated without reimbursement. If the auditor has any doubt as to whether the requesting agency is entitled to the information, the auditor must obtain clearance from the contractor before releasing any specific cost or financial data, such as overhead rates. A request for cost or financial data, written material, or access to working papers or audit files by a non-Defense agency, except for the Internal Revenue Service, which pertains to a matter (except an investigation or litigation) unrelated to the negotiation or administration of a contract by the requesting agency, will be referred to Headquarters, Attention: PAS, for consideration. The referral will include all pertinent details, such as the names of the representatives involved, a summary of the information requested, purpose of the request, a summary of any discussions held with respect to the information desired, and any other pertinent observations. See 1-405 for guidance when requests by a non-Defense agency pertain to a matter involving an investigation or litigation; see 1-408 for all requests by the Internal Revenue Service.

b. Cross-servicing agreements with non-DoD agencies provide for audit requests to be forwarded directly to the cognizant field office. Audit requests will be honored at locations where DCAA maintains a continuing audit interest under DoD contracts.

c. A request for audit services to be performed at a contractor location where DCAA does not have a continuing audit interest is considered a "casual audit request." A continuing DCAA audit interest exists at any location where DCAA has performed audit effort on a continuing basis over the past several years, whether the contracting agency is affiliated with DoD/NASA or not.

d. Except for those agencies identified in DCAAP 7230.1, Reimbursable Audit Program Manual, requests for audit services at locations where DCAA does not maintain a continuing audit interest will be referred to the Regional Audit Manager. Seasoned professional judgment and common sense must be applied to each casual audit request in making a decision as to whether or not to accept the audit engagement. The following criteria will be used to determine whether to accommodate or decline a request:

(1) Is the requested service compatible with normal DCAA responsibilities?

(2) Would acceptance or refusal to perform the work result in establishment of duplicative audit activity?

(3) Is another Government agency performing audit work at the contractor location that could perform the requested audit?

(4) The extent and cost of DCAA TDY travel that would be required to honor a casual audit request should be a key factor. If honoring the request would require the incurrence of TDY travel time and costs, it may be just as efficient for the requesting agency to make other audit arrangements. In addition, if the requesting agency maintains a local audit organization, rejection may well be the appropriate response.

(5) It is important to consider the type of audit being requested and the contract audit capabilities of the requesting agency. For example, if a price proposal examination is re-

quested, we should consider the nature of the proposed services or products, the urgency of the procurement, and the ability of the requesting agency to arrange for adequate timely contract audit service.

A regional determination that a casual audit request should be accepted will be coordinated with Headquarters, Attention: OAL.

e. When requested to provide audit services that include auditing indirect cost rates, auditors should remember that 10 U.S.C. 2313(d), 41 U.S.C. 254d(d) and FAR 15.404-2(c)(2) and 42.703-1(a) provide that contracting officers are required to determine whether a previously conducted audit of indirect costs meets the current audit objectives for indirect costs on executed contracts, subcontracts, or modifications and on a preaward basis. Federal Agencies are not to conduct duplicative audits for the same objectives. This means that, where DCAA has audit cognizance, other agencies should not perform audits of indirect costs which duplicate the DCAA audits and that DCAA should not perform audits of indirect costs which duplicate the audits of other Federal Agencies. In situations where auditors find potential duplicative requests for audits of indirect costs, auditors should exercise professional judgment in analyzing the requests, identifying pertinent facts, and communicating the facts to the requestor. Requests which can not be satisfactorily resolved should be reported to regional offices. Requests which regions can not resolve should be reported to Headquarters, Attention: OAL.

f. When an auditor observes the presence of non-DoD contracts subject to audit coverage for which audit requests have not been received, they will be brought to the attention of appropriate non-DoD agency officials, to facilitate issuance of requests for audit.

g. Regional offices will notify Headquarters, Attention: OAL, of audit requests from non-DoD agencies not identified in the DMIS User Guide. Such requests must be processed promptly, since the requesting agency will need to make other arrangements if DCAA does not agree to accept the engagement. Typically, such work will be accepted if the audit effort falls within the normal scope of DCAA work and the requesting agency agrees to pay for the audit effort.

h. All audit requests should be promptly responded to in writing (see 4-103 for the content and format of the Acknowledgment letter). The response should state whether DCAA will accommodate or decline the request. If the request is declined, the reasons should be stated. If the request is accepted, the response should include the anticipated audit report date.

i. Based on prior agreements, DCAA will perform all contract audit work requested by NASA. DCAA has also agreed to perform contract audit work at all DOE prime contractor locations other than those designated as Management and Operating Prime Contractors.

1-400 Section 4 --- Relationships with Other Government Organizations

1-401 Introduction

This section provides guidance and procedures governing relationships with other Government organizations.

1-402 General

Other Government personnel may communicate with DCAA personnel on official business. In all cases, the identity of the individual and his or her need to know should be established prior to furnishing any information either written or oral. Appropriate security precautions should be observed with respect to both classified military information and contractor information.

1-403 Relationships with DoD Procurement and Contract Administration Organizations

1-403.1 DCAA Responsibilities to Procurement and Contract Administration Organizations

a. As the audit and financial advisor to procurement and contract administration activities, auditors must understand and support the service needs of these organizations. DCAA is committed to providing timely and responsive services and will maintain communications and liaison services sufficient to continuously assess if customer needs are being met.

b. Organizationally, DCAA is separate and independent from acquisition components of the DoD. Auditors are expected to exercise independent judgment in planning the type and extent of audit testing sufficient to render unqualified audit opinions, but will consider and address special areas of concern or informational needs of requestors. The auditor will also exercise independence in the formulation of audit opinions, recommendations, and conclusions contained in audit reports.

c. Government interests can best be served by maximum cooperation and exchange of useful information between audit and procurement personnel. DoD Instruction 7600.02 requires that DCAA coordinate annual contract audit plans with procurement and contract administration organizations. Effective liaison between the DCAA auditor and the contracting officer's representatives, and a clear understanding of the respective responsibilities of each in the overall procurement function, are essential. To ensure continuous close cooperation, DCAA should give procurement personnel timely notification of any significant changes in audit plans.

d. Regulations of the military departments and DLA require the contracting officers' representatives to use advisory audit services to the fullest extent practicable and to aid audit performance by furnishing the auditor with appropriate administrative and technical assistance. Appendix D-200 of this manual refers to the procedures whereby the auditor obtains technical assistance and guidance which may be required in the evaluation of a contractor's proposal. For those contractor locations where there is a significant and continuing volume of audit workload, e.g., audit residency or suboffice, the auditor should establish an effective working relationship with the major field contract administrators to keep each other informed on procurement and audit matters including forthcoming contractor proposals which will require audit services.

1-403.2 Procurement and Contract Administration Responsibilities to DCAA

Procurement and contract administration personnel have responsibility for the following:

a. Requesting contract audit service.

b. Providing sufficient time for the performance of the audit.

c. Furnishing to the auditor, in connection with a request for audit, copies of any contracts (including change orders, supplements, amendments, and termination notices), cost statements, proposals, and other financial data submitted by contractors or, as appropriate, requested by the auditor.

d. Establishing access to contractor records required by auditors.

e. Furnishing such other information, data, or service as may be required (such as technical evaluation of the need for the quantity and type of labor and material proposed in contract pricing actions) or otherwise may be useful in performing the audit.

1-403.3 Resolving Contract Audit Recommendations

a. DCAA audit report recommendations may lead to disagreements between the auditor and the contracting officer. When disagreements occur, the auditor should maintain communications with the contracting officer to improve the potential for a satisfactory resolution of the issue prior to contract negotiations.

b. On December 4, 2009, the Director of the Defense Procurement and Acquisition Policy (DPAP) issued a policy memorandum outlining a process for resolving significant contract audit recommendations. DoD Components have established corresponding policies and procedures implementing the policy. DCMA has established the Contract Management Board of Review process that essentially implements the DPAP policy (see 1-403.4).

(1) The DPAP Policy places the responsibility upon the contracting officer to discuss significant disagreements with the auditor prior to negotiations. For any significant disagreements that exist after these discussions, the contracting officer is required to document the discussion and the basis for the disagreement in the pre-negotiation objective and in a written communication to the auditor (e.g., an email confirming the discussion or a copy of the applicable portion of the pre-negotiation objective). DCAA's management may request that the DoD Component's management review the decision. The request should occur within three business days of receiving the contracting officer's written communication. Therefore, it is imperative that upon receipt of the contracting officer's communication, the auditor immediately discuss the basis of disagreement with the Supervisory Auditor and FAO Manager to ascertain the need to elevate the issue to a higher level of management.

(2) While the DPAP Policy defines significant disagreements in the context of audits of forward pricing proposals (i.e., when the contracting officer plans to sustain less than 75 percent of the DCAA questioned costs from a proposal valued at $10 million or more) the policy also provides that the DCAA Director may elevate any disagreement which he believes requires further attention. Examples of circumstances below the threshold that the DCAA Director may choose to elevate include those of high interest to the department or those which could establish a precedent.

c. Auditors should discuss all significant disagreements (i.e., not limited to forward pricing) with the contracting officer and attempt to resolve the issues at the lowest level possible. Should those discussions not result in a resolution, the process for elevating would begin with the FAO Manager discussing the basis for DCAA's disagreement with the contracting officer's higher-level management. If unresolved, the disagreement should continue to be elevated. Ultimately, the Regional Director should attempt to resolve the disagreement directly with the Component's Senior Executive or Flag Officer in the contracting officer's chain of command. In those cases where the disagreement remains unresolved, Regional Directors should elevate the disagreement to Headquarters, Policy and Plans Directorate, for resolution with senior leaders in the Department.

1-403.4 DCAA Participation on DCMA Contract Management Boards of Review

a. DCMA has established procedures to review and approve selected contract actions. The purpose of the Board of Review procedures is to ensure reasonable exercise of judgment and adequate documentation in support of final contract decisions. Those procedures including a listing of the contract actions subject to Board Review are available at http://guidebook.dcma.mil/282/index.cfm. In addition to the contracting actions listed in its procedures, DCMA requires board review of any high risk, controversial, or precedent-setting contracting action, regardless of transaction type or dollar value. When a contracting action is subject to Board review, the ACO shall obtain Board approval before negotiating or taking any action to settle the issue.

b. Auditor Participation on DCMA Contract Management Boards of Review

The DCMA Board of Review procedures specify that DCAA may participate as advisory members. DCAA supports the DCMA Board of Review procedures as auditor participation in review board activities has proven beneficial in many instances. DCAA will only serve in this advisory capacity in support of issued DCAA audit reports and DCAA Forms 1.

c. Processing Requests for Participation

Requests may be received by Headquarters, regional offices, or field audit offices to furnish audit personnel to participate on review boards. The Assistant Director, Policy and Plans, is responsible for action on requests for board participation by Headquarters personnel. The cognizant regional director is responsible for action on requests for board participation by regional office and FAO personnel.

d. Documenting Participation on Boards of Review

The auditor should prepare a memorandum for the record (MFR) to document his/her participation and the results of the Board of Review. File the MFR in Livelink in the same folder with the official audit working paper files (see 4-407e(9))

1-403.5 Signing Certificates of Non-Disclosure and Statements of Financial Interest

Source Selection Authorities (SSA) from various Service program offices may ask FAO auditors and Financial Liaison Advisors (FLAs) to sign Certificates of Non-Disclosure and Statements of Financial Interest to acknowledge understanding of the requirements set forth in FAR 3.104-4, “Disclosure, Protection, and Marking of Contractor Bid or Proposal Information and Source Selection Information.” However, FAO auditors should not be required to sign a non-disclosure agreement. In accordance with 1-507, DCAA auditors are required to perform audits in such privacy as warranted under the circumstances, and provide all necessary safeguards to contractor confidential data at all times. Therefore, FAO auditors are already required by 18 U.S.C. 1905 and Agency policy to protect contractor data from unauthorized disclosure. It is permissible for FLAs advising on Source Selection Evaluation Boards (15-304.10) to sign such certificates as they may have access to all of the bidders’ source sensitive information.

Figure 1-4-1
Certificate of Non-Disclosure Statement

I acknowledge that [*insert name of program office*] has provided me with contractor proprietary and source selection information to enable me to perform my official duties.

As required by FAR 3.104, I agree not to divulge, publish, or reveal by word, conduct, or any other means, any such information to any other person, except in accordance with applicable law and regulations.

I also understand that I must exercise appropriate care to safeguard such information against unauthorized disclosure, and I will promptly report any mishandling, loss or unauthorized disclosure of contractor proprietary information of which I am aware to my supervisor, the Source Selection Authority (SSA), and/or the [*insert program name*] Security Director.

I understand that information marked "Competition Sensitive" must be handled as contractor proprietary or Government non-public information, as applicable.

I understand that failure to comply with this policy may result in penalties.

If an actual or potential conflict of interest (as described in Title 5, Code of Federal Regulations (CFR), Part 2635, “Standards of Ethical Conduct for Employees of the Executive Branch,” and implementing Department of Defense regulations) arises in connection with my access to, or use of, any contractor proprietary information provided to me by the [*insert name of program office*]. I will promptly report such actual or potential conflict of interest to my supervisor.

_____
[Signature of FAO Auditor]

Name of FAO Auditor
Title of FAO Auditor
FAO Name
FAO Address
FAO Telephone No.

1-404 Relationship with DoDIG and Other Executive Branch Internal Audit Organizations

1-404.1 Organizations for Government Internal Audit

a. The DoD Inspector General is responsible for DoD level internal and oversight audits and investigations. Responsibilities of the DoDIG include (1) evaluating activities relating to contract audits; (2) investigating fraud, waste, and error; (3) monitoring adherence to contract audit principles, policies, and procedures; and (4) monitoring actions taken by DoD components in response to contract audits.

b. Internal audit, oversight, and investigative services are performed by the offices of the Assistant DoDIGs for Auditing and Investigations and the Director for Departmental Inquiries. DoD component internal audit organizations include the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency. The various Military Services also have additional internal review and audit groups such as the Inspector Generals of the Army, Navy and the Air Force. Most non-DoD agencies have similar activities for the performance of internal audit within their organizations. The following guidance also applies to non-DoD executive agencies.

1-404.2 DCAA Assistance to Government Internal Audit Organizations

a. When internal audits require verification of contractor data or records at contractors' plants, the internal audit organization normally will obtain fact-finding assistance from DCAA.

b. Support will be furnished to the internal auditor where doing so does not conflict with the contract auditor's basic role of providing advisory services to contracting officers. Requests requiring contract auditors to evaluate contracting officers' performance are inappropriate, whereas assistance concerning contractors' performance is appropriate.

c. Contract audit working papers, reports, and files relating to completed assignments will be made available to internal auditors in their audits of procurement, contract administration or related functions, provided DCAA has received written notice of the objective and the scope of the internal audit evaluation. However, FAOs should dissuade auditors from examining working papers relating to incomplete/in-process assignments, because any audit conclusions included therein are tentative and do not represent the official DCAA position until the audit is completed. If the internal auditor insists on examining incomplete/in-process assignment working papers, elevate the matter through the RQA (or other designated regional office element) to Headquarters, ATTN: PQA. The DoDIG's right of access to DCAA records is set forth in DCAAI No. 7050.1.

d. Government internal audit organizations, on occasion, may request an FAO to use its access rights to gather and/or validate information that is not otherwise required by the FAO in carrying out DCAA's audit mission. The information could be either (1) audit-related (e.g., the DoDIG asks that a post-award audit be done on a contract not selected by the FAO) or (2) non-audit-related (e.g., the DoDIG asks the FAO to complete a survey instrument or gather information for the purpose of statistical aggregation). Written confirmation of the request for assistance will be furnished to the internal auditor within seven working days of receipt. The request should be provided to Headquarters, PQA, through the RQA, with the agreed to course of action to be taken.

e. FAOs should generally accept and respond to requests for audit-related information; however, several factors should be considered before doing so. These factors include the (1) Government's overall policy to have one contract audit face and avoid duplication of Government audit effort when possible, (2) DCAA resources required to

fulfill the request, and (3) impact that acting on the request would have on meeting current audit requirements. DoD internal auditors are required by DoD audit policy to coordinate all audits involving contractor records with DCAA and the appropriate contract administration office to avoid duplication of audit work.

f. Except as noted below, FAOs should generally not accept and respond to requests for non-audit-related information. Instead, the FAO should ask the internal audit organization to have the contractor directly respond to such requests. An exception to the preceding guidance is when the non-audit information requested by the internal auditor can be readily retrieved from the FAO's files and the contractor has no objection to the release of the information. In these cases, FAO's should provide the internal auditor with the requested information. When in doubt as to how best to handle a given request for non-audit information, FAOs should contact their RQA Chief for guidance.

g. Supplement 1-4S1 presents illustrative audit situations involving interface between contract and internal audit organizations.

1-404.3 Government Internal Audit Organization Assistance to DCAA

In certain instances, contract audits involve work at a defense installation or remote location where the nature of the work, proximity of an internal audit office, or other factors make it more practical or economical for the contract auditor to obtain assistance from a Government internal auditor. Such cross-service audit assistance shall be referred to DCAA Headquarters, ATTN: PQA, for a determination before the request is issued.

1-404.4 Interfacing with Government Internal Audit Organizations

a. This section deals with requests for assistance from Government internal audit organizations. Oversight reviews are discussed in 1-404.5.

b. Requests from Government internal audit organizations are normally coordinated through DCAA Headquarters, PQA, which will notify the cognizant Headquarters division. That division, in turn, will notify the affected RQA (or other designated regional office element) and field office(s). Regional and field offices may receive requests for audit assistance directly from the internal audit organization without prior Headquarters coordination. When such requests are limited in nature, e.g., factual information at a specific location, Headquarters need not be notified. However, all other requests should be referred to Headquarters, PQA, before any action is taken.

c. During the course of visits or telephone contacts by a Government internal audit organization, the FAO manager should answer questions raised and tactfully clarify or correct any misinterpretation of factual information. Discussions with representatives of the Government internal audit organization should be limited to factual matters related to specific DCAA audits and/or the management of those audits. Matters regarding overall Agency policy, operations or resources that are not covered in published Agency guidance should be referred to Headquarters, Attention: PQA.

d. The FAO manager should promptly report to the RQA (or other designated regional office element) the results of any Government internal audit organization's visit or telephone contact. If DCAA's response has been limited to providing access to or copies of pre-existing material, the FAO manager's report need only identify the general nature of the materials provided. If DCAA has been asked to prepare additional materials for the Government internal auditor's use, the FAO should comply with the region's instructions regarding appropriateness of such activity.

1-404.5 Oversight Reviews

a. Oversight reviews are coordinated through DCAA Headquarters, PQA, which will notify the Headquarters division cognizant of the review's subject area. Before providing access to an oversight reviewer, determine that the review has been properly coordinated in accordance with DCAAI 7050.2. Oversight organizations, particularly the DoDIG, may request answers to questions arising from their visits to DCAA field elements.

b. Provide written notice to the RQA (or other designated regional office element) and Headquarters, ATTN: PQA, of all DoD oversight visits to FAOs or contractor sites.

c. As required by DCAAI 7050.2, a reviewed FAO will provide a written memorandum of significant issues to the RQA (or other designated regional office element) within ten working days of an oversight visit. The information in the memorandum should be limited to factual data relating to the oversight reviewer's observations on the specific audits reviewed. Matters relating to overall Agency policy, operations or resources should be separately referred to Headquarters, Attention: PQA, and should not be commented on in the memorandum. The region will forward the FAO's memorandum to Headquarters, PQA, within five additional working days.

d. When interim DCAA responses to field visits are required, regions are responsible for receiving draft responses from FAOs; preparing responses; and forwarding responses directly to the oversight organization, with a concurrent copy to Headquarters. Technical guidance and overall coordination will be available from Headquarters as required. Procedures for responding to oversight reviews are contained in DCAAI 7050.2.

1-404.6 Issuance of Audit Reports

When an audit performed at the request of an internal audit organization requires corrective action by the contractor involving such matters as unallowable costs and cost avoidance, the auditor will follow the normal procedures and issue the audit report to the cognizant ACO to assure timely corrective action. A copy of the report will also be forwarded to the requesting internal audit organization by a transmittal letter indicating that the audit report has been issued directly to the ACO. When an audit performed at the request of an internal audit organization does not require corrective action by the contractor, the audit report will be issued to the internal audit organization (see 10-206).

1-404.7 Visits by the DoDIG and Military Inspectors General

When an Inspector General of a DoD component, or his/her representative, visits an audit office, the auditor should, after satisfying himself/herself as to the identity of the individual, cooperate fully in responding to inquiries pertaining to the audit of contracts under the auditor's cognizance. Requests for sensitive information, or requests that require the assignment of an auditor for a substantial period of time, should be in writing. The auditor should report such visits to the RQA (or other designated regional office element) and furnish copies of all correspondence and memorandums. Before furnishing any sensitive information, the auditor should coordinate the matter with the regional director. Unusual or significant inquiries should be reported to Headquarters, Attention: PQA.

1-405 Relationship With Investigative Agencies of the Government

a. Auditors will cooperate with representatives of the Federal Bureau of Investigation, DoD criminal investigators, and criminal investigators from other agencies. (See 4-702.6 and DCAA Regulation 7640.15.) Written material and access to files or work-

ing papers will be made readily available to such investigators. The contractor need not be informed when such information is provided to investigators. Original documents may be provided to investigators if a subpoena is issued for the documents. If investigators insist upon obtaining original documents in other situations, promptly refer the matter to Headquarters, Attention: OTS. In either case, original documents cannot be released until copies have been prepared for retention by DCAA. Document all meetings with members of Governmental investigative agencies in the audit working papers or the DCAA Form 2000 files as appropriate in the circumstances. Guidance pertaining to the protection of information related to investigations is provided in 4-702.5d., e., f., and g.

b. Except as otherwise provided in this section (1-400 et seq.), inform Headquarters, Attention: OTS, of any requests for written material or access to files and working papers made by representatives of other agencies (e.g., civil investigators from the DOL, EEOC, etc.). Ask that the request be put in writing, and that it include the names of the investigators, a summary of the information requested, and purpose of release. Obtain the approval of Headquarters before complying with such requests. The FAO manager may grant representatives of a civilian agency access to audit files pertaining to that agency's contracts regardless of whether the request is made in conjunction with an investigation; however, Headquarters should be notified of the visit. If the request arises under a joint investigation with an agency with access rights and the request is made by the privileged agency, Headquarters need not be notified.

c. Occasionally an investigator will interview an auditor in connection with an inquiry of contractor activities. The auditor should request to review the investigator's write-up of the interview before its release, to ensure statements have been accurately recorded. Report investigative interviews of an unusual or important nature to Headquarters, Attention: OTS. Identify the investigative agency, name of investigator(s), summary of the questions asked, and other pertinent information. It is not necessary to report routine investigative contacts by DoD investigators.

1-406 Relationship with Government Legal Counsel in Contract Disputes, Bid Protests, and Other Matters

a. When requested, it is Agency policy to assist Government counsel in auditing matters in all contract disputes, bid protests, and other matters, whether initiated through an Agency finding or by other means. Audit support should fully respond to the needs of counsel and may consist of comprehensive audit and accounting advisory services; accounting research applicable to the specific case, including testimony relative to the audit report; or testimony as an expert on accounting and auditing practices and procedures. All work done at the request of the Government trial attorney is subject to the attorney work product privilege. As such, while DCAA may maintain custody of any documents developed while providing support to the trial attorney, control over the documents, and any decision pertaining to the release of these documents, rests with the trial attorney or his/her successor. This policy is in keeping with the Agency’s assigned responsibility to provide accounting and financial advisory services to all DoD procurement and contract administration activities in negotiating, administering, and settling contracts.

b. Although control of the documents rests with the trial attorney, the DCAA auditor is responsible for their content (see 15-500, which also applies to cases before the Court of Federal Claims). Should the trial attorney attempt to obtain audit working papers prior to release of the report, the cognizant FAO should:

(1) offer to provide copies of any relevant documents and

(2) explain to the trial attorney that the audit process is incomplete until required supervisory reviews are completed.

Review of incomplete audit files may lead the attorney to draw erroneous inferences regarding the DCAA audit position. Should the trial attorney persist in a request for

incomplete working papers, Headquarters, PAS, should be notified before incomplete audit files are released.

c. Under certain circumstances, trial attorneys may request DCAA auditors to sign a litigation protective order. A litigation protective order usually restricts the use of contractor information to the conduct of the trial; i.e., it could not be used for any other purpose. The restrictions could impair DCAA's audit rights and use of contractor data for all other appropriate Government purposes. Auditors approached by trial attorneys to sign a litigation protective order should not sign the order. However, if trial attorneys insist, auditors should elevate the request to their region.

1-406.1 Armed Services Board of Contract Appeals (ASBCA)

a. Details of the ASBCA Charter are found in Appendix A to the DoD FAR Supplement. The ASBCA is the authorized representative of the Secretaries of Defense, Army, Navy, and Air Force in hearing, considering, and determining appeals by contractors from decisions of contracting officers or their authorized representatives or other authorities on disputed questions. These appeals may be taken pursuant to:

(1) the Contract Disputes Act of 1978,

(2) the provision of contracts requiring the decision by the Secretary of Defense or by a Secretary of a Military Department or their duly authorized representative or board, or

(3) the provisions of any directive whereby the Secretary of Defense or the Secretary of a Military Department has granted a right of appeal not contained in the contract on any matter consistent with the contract appeals procedure.

b. Rules on submitting contractor appeals and preparing for and conducting a hearing are in Part 2 of Appendix A to the DoD FAR Supplement. These rules may vary from a case requiring the submission of a substantial amount of evidence, the presentation of witnesses, and a prehearing and formal hearing to a situation in which the hearing is waived and the case settled on the basis of the submitted record. The rules also provide for decisions of appeals involving $10,000 or less, under an optional small claims (expedited) procedure or for appeals where the amount in dispute is $50,000 or less, under an optional accelerated procedure.

c. The auditor will be mainly concerned with ASBCA procedures which require the contracting officer and Government trial attorney to submit a file of applicable documents and to produce documents, admit facts, and answer questions when properly requested by the other party to do so. Guidance regarding requests for such information is in DCAA Regulation No. 5410.11, *Release of Official Information in Litigation and Testimony by DCAA Personnel as Witnesses.* That regulation requires that all such inquiries be transmitted to the DCAA General Counsel (DL) and that responses not be provided without specific instructions from DL. Further details on audit procedures and responsibilities in connection with ASBCA cases are in 15-500.

1-406.2 Other Boards

In addition to the ASBCA, there are boards that service various other agencies and departments of the Government. On occasion, the DCAA auditor may be called on to assist in hearings before these boards. While the size of the board and the rules may vary, the type and degree of services an auditor must provide will generally be the same.

1-406.3 Bid Protests

a. An unsuccessful bidder or offeror for a Government contract may file a bid protest with GAO. The GAO bid protest regulations, found at 4 CFR Part 21, allow for hearings on protests. Occasionally, audit issues will arise during the course of a protest.

When this occurs, auditors shall cooperate with counsel representing the Government by making records and working paper files readily available. Additionally, circumstances may occur which require the auditor to testify in such proceedings. Such testimony is permitted when requested by counsel representing the Government. If such testimony is requested by any other party, the provisions of DCAAR 5410.11 apply.

b. If the acquisition involves ADPE hardware, services or maintenance, a protest may be filed with the GSBCA or the GAO. If the protest is filed with the GSBCA, that board's rules for resolving contract disputes cases apply to bid protests as well. In such cases, the auditor will follow the guidance contained in 1-406.2.

1-407 Relationship with Component Remedies Coordinators

The head of each DoD component must establish a remedies coordinator in order to meet DoD Instruction 7050.05 (Coordination of Remedies for Fraud and Corruption Related to Procurement Activities) requirements. The remedies coordinator will be responsible for establishing procedures to develop a specific remedies plan for each significant investigation involving fraud or corruption relating to procurement activities. Under this remedies plan, appropriate DoD officials would consider all appropriate civil, administrative, and contractual remedies available to the Department of Defense, including suspension or debarment. Agency policy is to assist component remedies coordinators in developing effective remedies plans. The plan should be consistent with our mission of providing accounting and financial advice to DoD officials regarding negotiation, administration, and settlement of contracts. Further, FAO's will consider obligations imposed on a contractor by a remedies plan during the planning process. For an example, see 4-711 (Reviewing contractor compliance with administrative suspension and debarment agreements).

1-408 Relationship with the Internal Revenue Service (IRS)

a. Procurement-related requests from the IRS (Department of the Treasury) should be handled in accordance with 1-303, following 15-115 for distribution of any resulting report. The procedures contained in 1-404 should be followed regarding contacts by the IRS internal audit staff.

b. Field audit offices may receive direct requests from the IRS for records and files related to an IRS investigation or tax matters. The field audit office should coordinate IRS requests for investigative or tax information with the regional office, before providing any information of this type to the IRS. With regional approval, information related to an IRS fraud or criminal investigation, or in connection with a docketed case before the U.S. Tax Court, should be released directly to the IRS. The field audit office should request the IRS to provide information showing that the requested information relates to these situations.

c. For requests related to civil investigation or administrative inquiry, the field audit office is only authorized to release information that would normally be releasable to the general public under the Freedom of Information Act (for example, publications and most MRDs). If the requested documents would not normally be releasable by DCAA to the general public (for example, audit reports or contractor proprietary information), the region should forward the request to Headquarters, ATTN: DL, for a release determination. The region should provide Headquarters with a summary of the information requested, purpose of release, and other pertinent information.

1-409 Relationship with Members of Congress and Congressional Committees

a. DCAA personnel will cooperate with members of Congress and congressional committees by responding fully and promptly to their official requests for information on this Agency's programs and operations. All written responses and/or copies of

DCAA documents will be provided directly by the appropriate Headquarters element. Detailed guidance relative to:

(1) inquiries from members of Congress,

(2) visits by congressional committees,

(3) preparation of material for testimony or use before congressional committees, and

(4) comments on legislation and legislative matters is set forth in DCAA Regulations Nos. 5020.3 and 5030.16.

b. The Headquarters Auditing Standards Division (PAS) should be notified immediately of any inquiry from members of Congress, congressional committees, or their staffs.

c. The Headquarters Auditing Standards Division (PAS) should also be notified of any customer (Government agency) requests for assistance in responding to an inquiry from members of Congress, congressional committees, or their staffs. In these situations:

(1) DCAA audit reports and related materials prepared at the customer’s request or otherwise in the customer's possession are releasable to Congress at the customer's discretion. If possible, the customer should be encouraged to include the following statement with the materials:

> "Please be advised that the contractor financial and accounting system information contained in the attached [report, memo, presentation] is considered proprietary by the company and should not be released to the public. The information made available to you in this [report, memo, presentation] contains financial data furnished to the Government in confidence. Such information must be protected from unauthorized disclosure under 18 U.S.C. 1905. For this reason, the attachment has been marked FOR OFFICIAL USE ONLY."

(2) Should the customer request that DCAA update existing materials or prepare additional materials to support the customer's response to Congress, the FAO should provide the new or updated material to Headquarters, attention PAS, for review by the cognizant Headquarters division prior to releasing it to the customer.

1-409.1 Written Requests for Information

a. Written requests for information received from Congressional members or their staffs should be forwarded to Headquarters, ATTN: PAS, as expeditiously as possible. When requested by Headquarters, field and regional elements will provide, through the regional director, the following information to the responsible Headquarters staff element not later than the date established by the head of the staff element:

(1) the congressional inquiry,

(2) a copy of any interim acknowledgment,

(3) a copy of the requested audit report(s), if applicable,

(4) a proposed final reply to the inquiry, and

(5) the information upon which the proposed final reply is based.

When proposing to furnish contractor proprietary information (e.g., documents marked For Official Use Only (FOUO) or documents that the FAO/region believes contain contractor proprietary data), include the following statement in the proposed final reply:

> "Please be advised that the contractor financial and accounting system information contained in this [letter / report / enclosure] is considered proprietary by the company and should not be released to the public. The information made available to you in this [letter / report / enclosure] contains financial data furnished to the Government in confidence. Such information must be protected from unauthorized disclosure under 18

U.S.C. 1905. For this reason, the [letter / report / enclosure] has been marked FOR OFFICIAL USE ONLY."

b. When a proposed final reply cannot be forwarded to the responsible staff element within the established due date, the regional director will forward a brief memorandum stating the anticipated date that the reply and information will be provided. (See DCAAR No. 5030.16 for detailed processing requirements.)

1-409.2 Meetings with and Visits by Congressional Committees

a. Field and regional elements will immediately notify Headquarters, PAS (through the regional director) of written or oral requests received from Congressional committees or their staff to visit a DCAA office.

b. In accordance with DCAAR No. 5030.16, regional and field personnel will permit committee members or their staff to examine records which pertain to areas of interest to the committee. Regional directors will refer any committee requests to remove or retain records (including audit reports and working papers) to Headquarters, PAS. Headquarters, PAS will coordinate receipt and transmission of requested files to the committee's offices in Washington, D.C. Requests for any other information to be provided to committee representatives will be forwarded to Headquarters, PAS, within 10 working days following the visit. In any case, no information should be released until authorized by PAS.

c. Field and regional elements will forward a memorandum (through the regional director) summarizing visits by Congressional representatives within five working days following the visit. The memorandum should specifically enumerate the subjects discussed during the visit, any requests for data, and questions and answers still to be provided. If a request has been made for audit reports or working papers, the memorandum should also include an assessment of the requested materials' compliance with Agency policy. If the assessment discloses any deficiencies in the reports or working papers, additional comments should be included to clearly establish the steps taken to correct the deficiency.

1-4S1 Supplement --- Illustrative Audit Situations Involving Interface Between Contract and Internal Audit Organizations

1. Audit of Japanese master labor contract.

The Defense Contract Audit Agency has responsibility for audit of contractual payments. Many of the functions relating to the contract such as the need for, utilization, classification, and control of contract employees; establishing pay and allowances in conformance with the terms of the contract; and submission of payroll data are the responsibility of Army, Navy, and Air Force activities. Internal audit normally would encompass evaluation of these functions. Contract auditors may need internal audit assistance in confirming the accuracy and reliability of reports from military activities which form the basis of contract reimbursements.

2. Audit of small cost-type contracts at remote defense installations.

Travel and per-diem costs may be saved by DCAA obtaining internal audit assistance on audit of relatively small contracts performed at remote defense installations where internal auditors are in residence or in the vicinity. Factors to consider are the location, complexity of the contract audit work, and the availability of internal auditors. An example is a small construction contract at Goose Air Base in Labrador. Audit by DCAA would require travel from New York. Audit can be performed by internal auditors in residence.

3. Audit of administration of Government property furnished to contractors.

Prime responsibility for audit of the administration of Government property, including that furnished to contractors, is a part of the internal audit mission. However, DCAA likewise performs property auditing in its role of advisor to the property administrator and contracting office, as well as in connection with cost determination. When an internal audit of the Government property administration function requires verification of detailed records maintained by a contractor, assistance ordinarily can be obtained from the cognizant contract auditor. However, if necessary to performance of the internal audit mission, internal auditors will be afforded access to contractor-maintained records.

4. Audit at Government-owned, contractor-operated plants.

At GOCO plants DCAA is responsible for audit of the cost-reimbursement operating contracts. Internal auditors are responsible for auditing operations of the Contracting Officer. DCAA should assist the internal auditors by providing such cost and financial information from contractor records as is essential to permit evaluation of the management of the facility.

5. Audit at military installations where services and/or maintenance are purchased under contracts subject to DCAA audit.

Circumstances may be such that the internal auditors need fact-finding assistance from contract auditors to obtain or verify information from contractors' records. For example, the internal auditor may be reviewing the potential for savings from elimination of duplicating supply operations and information is needed from the contract auditor regarding the contractor's supply system.

6. Audit of a weapon system where supply, maintenance, funding, and other functions are closely integrated with input from or operations of major contractors.

Internal audits of this nature give rise to various situations where audit information is needed from contractors' books and records. Assistance from contract auditors would be appropriate in some cases and not in others. Examples follow:

a. Internal auditors are reviewing a contract pricing action. Contract audit assistance ordinarily should not be requested since the contract auditor participated in the procurement team effort.

b. Internal auditors determine that substantial quantities of end items which have been inspected and accepted are found subsequently to have defects requiring major modification. In trying to ascertain the cause for this situation, the auditors find it necessary to determine whether the contractor has responded timely to contract change orders requiring modification during production. Contract audit assistance in conjunction with technical

assistance would be appropriate as determinations of this nature are an integral part of operations audits of contractors' production scheduling and control systems. These determinations are also made during reviews of contractors' internal planning and control systems when performing Earned Value Management System Criteria reviews.

c. An internal auditor is reviewing the computation of requirements which involve data on assets in the hands of the contractor and reports thereon. Contract audit assistance would be appropriate to verify data furnished by the contractor.

d. An internal auditor is reviewing funding status and validity of obligations which involve data and reports from contractors. Contract audit assistance would be appropriate to verify data furnished by contractors.

7. Audit at contractor location where DCAA is the cognizant contract audit organization

Government internal auditors may need fact-finding assistance from contract auditors to confirm, obtain or verify information from contractors' records. For example, the internal auditors may be performing an audit to identify potential conflicts of interest on the part of consultants working both for the Government and its contractors. Appropriate DCAA assistance to the internal auditors might consist of providing information from audit files on evidence of services rendered.

1-500 Section 5 --- Relationship with Contractors

1-501 Introduction

Requirements for specific audit conferences with contractors are stated in 4-300. This section covers other aspects of the relationships between DCAA and contractors.

1-502 Establishment of DCAA Field Audit Offices (FAOs) and Suboffices

1-502.1 General

The DCAA Organization Manual, Chapter 9, contains the procedures for activation and deactivation of DCAA FAOs. The activation or deactivation of DCAA FAOs (excluding suboffices) is subject to approval by the Director, DCAA, upon the recommendation of the cognizant regional director. The regional director may establish or discontinue suboffices. Regional directors should periodically review the operations of existing FAOs to determine if they still meet the criteria referred to in the manual or whether, due to changed conditions, any of these offices should be discontinued. Conversely, consideration should be given to establishing FAOs at those locations where the workload so warrants. If any such changes are indicated, submit recommendations to Headquarters, ATTN: OWD (with concurrent copy directly to CP), containing the information required by the manual.

1-502.2 Establishment of Branch Offices

a. A branch office is defined as a DCAA field audit office that (1) performs mobile audit work at all contractors within its designated geographic areas that are not audited by a DCAA resident office and/or (2) performs resident audits of several unrelated contractors through suboffices. Branch offices are established at appropriate locations within DCAA regions for these purposes.

b. A branch office may be located in a contractor facility only if there is unrestricted access to the DCAA office by other (nonhost) contractor representatives and adequate security is provided for data of such other contractors. Regional directors are responsible for establishing the most efficient and economical arrangements for specific locations within these restrictions. If a branch office is located in a contractor facility, the name of the branch office will not include the contractor's name, and the mail system will be arranged so that DCAA mail does not go to or through the host contractor's system.

c. A branch office may have one or more suboffices. A suboffice is defined as a subordinate element of an FAO. A suboffice may be established:

(1) at a geographic point distant from the main branch office location if a concentrated workload of mobile audits exists in the area which can be performed more economically by stationing one or more auditors permanently at that distant point,

(2) at a particular contractor location which has a continuous workload requiring the full-time assignment of one or more auditors (see 1-502.3e), or

(3) at a location where a significant combination of the two preceding conditions exists. A suboffice with both mobile and resident workload must meet the criteria of b above, unless the exception in 1-502.3b applies.

1-502.3 Establishment of Resident Offices

a. A resident office is defined as a DCAA field audit office located at a contractor's facility for the purpose of performing the contract audit workload at the contractor. The office may be made up of suboffices located at components of the same company and still meet the resident office definition.

b. On a case-by-case basis with prior Headquarters approval, limited amounts of mobile work may be assigned to resident offices without changing the office designation. This exception applies only to situations where it is uneconomical or impractical to assign the mobile work to a branch office.

c. Resident offices are usually established at principal locations of major defense contractors. The main criteria for establishing a resident office are whether the audit workload at the contractor is of a continuing nature and is sufficient in significance, complexity, and volume to warrant a full-time staff large enough to require a resident audit manager and clerical staff.

d. A resident office has the important advantage of enabling auditors assigned to the contractor location on a continuing basis to develop a comprehensive understanding of the contractor's operations and basic management policies and practices in relation to Government contracting. This understanding enables more efficient audits of major contractors and more timely and effective audit advice on these contractors to procurement and contract administration activities.

e. FAR 52.215-2 provides the basis for DCAA to occupy space at contractor locations when warranted. This clause provides that the "right of examination shall include inspection at all reasonable times of the contractor's plants, or parts of them, engaged in performing the contract." Additionally it provides that the contractor shall make its records available at all reasonable times "at its office." Implicit in FAR 52.215-2 is the requirement for a contractor to provide space at its office if audit work is of a sufficient magnitude to require a permanent DCAA presence. Although FAR 52.215-2 provides an implicit right, it is the ACO's authority to enforce FAR 52.215-2. Therefore, any issues that arise concerning DCAA occupying contractor space should be resolved through the ACO. The space provided should be comparable to what is furnished to contractor employees. If questions arise regarding this issue, auditors should also make the contractor aware that, while DCAA has the right to remove copies of contractor records from contractor locations, FAR 52.215-2 provides for review at the contractor's office, and it is preferable to audit original records on-site rather than requiring contractors to make copies available for off-site audit.

1-502.4 Change of FAO Cognizance

a. Occasionally, FAO cognizance of a contractor organization will change because of such contractor actions as relocations, reorganizations, or consolidations. FAO cognizance of a contractor may also need to be reassigned as a result of DCAA's actions, such as establishing new FAOs, consolidating FAOs, or deactivating FAOs. When audit responsibilities of a contractor need to be transferred, the branch or resident office having audit cognizance prior to the change is required to coordinate with the gaining office to assure that continuity of audit services is maintained.

b. Actions to be taken by the losing FAO include:

(1) Issue notification to the contractor, major procurement and contract administration activities that do business with the contractor; providing the name, address, and telephone and facsimile numbers of the FAO gaining cognizance of the contractor, and the effective date of the change. In addition, provide the appropriate DCAA DoDAAC for the gaining office and advise the contractor that the new DoDAAC must be used in contract documents as well as electronic invoices and billings submitted using the DoD Wide Area Workflow (WAWF).

(2) Provide the gaining FAO with a listing of all auditable contracts. The listing should include the name of the procurement office, contract number, type, amount of award, cognizant ACO, and identify those contracts that provide for DCAA provisional approval of public vouchers.

(3) Transfer permanent files information to the gaining FAO, with a transmittal memorandum that lists the content of the files. A copy of the transmittal memorandum should be

sent separate of the files and retained in the permanent files of both the gaining and losing FAO.

(4) Provide the gaining FAO with a copy of all requirements and program plan data relating to the contractor for the current and prior years.

(5) Prepare a summary of all unresolved issues and forward it to the gaining FAO. This summary should include the current status of these issues. Wherever possible, resolution of the issues should be accomplished prior to transferring cognizance to the gaining FAO.

(6) Notify the CAC/GAC of the change in audit cognizance and provide information concerning status of audit issues affecting the CAC/GAC network.

(7) Provide a listing of files maintained at the Federal Records Center to the gaining FAO.

(8) Issue a change of address notification to the Federal Records Center for any audit files that are in records retention. The change of address should be forwarded through the regional resources office, ATTN: Records Management Officer .

(9) Provide the regional resources manager, with a concurrent copy to Headquarters, ATTN: CP and OWD, a brief explanation of all contractor data maintained in the DMIS that will need to be transferred to the gaining FAO and the effective date of the transfer. When possible, provide this information at least 60 days in advance of the anticipated change.

(10) Transfer any data relating to the contractor that is included in regional or Headquarters periodic reports to the gaining FAO, complete with any computer-based files (e.g., incurred cost status report database). Concurrent notification of the change in FAO cognizance should be made to the responsible regional office element.

1-503 Notification of Visits to Contractor Facilities

1-503.1 Security Requirements and Procedures

a. Section 3-101d of the DoD Industrial Security Regulation (DoD 5220.22R) and Chapter 6 of the DoD Industrial Security Manual for Safeguarding Classified Information (DoD 5220.22M) require that the contractor be given advance notice in writing when access to classified information held by the contractor is involved. The manual requires such notification to include:

- The name and title of person(s) to be visited.
- The name, title, date and place of birth, citizenship, and security clearance status of the DCAA representative(s).
- The purpose of and justification for the visit, including identification of related program(s) or contract(s) and classified information to which access is required, if known.
- The date of the proposed visit or period during which the notice is to be valid.

It is DCAA policy to also include the following information:

- DCAA identification number (auditor credential card number or equivalent).
- Visitor Category (the Industrial Security Manual designates category 1 for U.S. Government employees).

b. When a visit will require access to classified matter held by the contractor and/or access to a secured contractor plant, DCAA Form 5220-1 will be used to notify contractors of planned visits. This form will also be used for DCAA personnel permanently located at contractor facilities (such as those assigned to resident offices and suboffices) and for those visiting contractors on a regular basis (such as regional audit managers and members of regional audit teams). Notification in these cases will normally consist of blanket notices submitted on an annual basis. A copy of each notification sent to the contractor will be forwarded to the cognizant contract administration office.

c. DCAA personnel will inform their security officer of planned visits to contractor facilities in sufficient time to enable timely notification.

1-503.2 Required Notification to Contract Administration Offices and Courtesy Notice to Contractors

a. Whether or not access to classified matter or secured area(s) is required, to preclude duplicate demands on the contractor, prospective visitors to contractor facilities are to provide information concerning the visit to the cognizant Contract Administration Office (CAO) sufficiently in advance and in adequate detail so as to permit the CAO to advise the visitors in the event information related to the contract administration functions currently exists that may satisfy the stated purpose of the visit (FAR 42.101(a) and 42.402(a) and (b)). The visitor will make a courtesy telephone call to inform the contractor and make appropriate arrangements if a planned visit will involve contractor personnel. If desired, the visitor may send a letter to confirm arrangements made. Such a letter will not substitute for any notification required by 1-503.1.

b. If a planned visit will involve contract administration personnel, make advance arrangements comparable to those for contractors as stated in a above.

1-504 Access to Records of Contractor

1-504.1 General

a. Statutes, implementing regulations, or contract terms may provide access to contractors' records for purpose of audit (1-504.2). The clause at FAR 52.215-2 provides the auditor's primary authority for access to contractor records. This clause must be inserted in all negotiated contracts, except those (1) not exceeding the simplified acquisition threshold; (2) for commercial items; or (3) for utility services. (See FAR 15.209(b)). This clause provides the contracting officer's representative with the authority to examine and audit contractors' books, records, documents and other evidence and accounting procedures and practices, regardless of form (e.g., machine readable media such as disk, tape, etc.) or type (e.g., data bases, application software, data base management software, utilities, etc.), sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred in performing cost-reimbursement, incentive, time-and-material, labor-hour, or price-redeterminable contracts. The clause also provides access rights for the purpose of evaluating the accuracy, completeness, and currentness of cost or pricing data.

b. In addition to access to specific cost records, access to records refers to contractor policies, procedures, systems, management reports, personnel, minutes of its board of directors meetings, charter and bylaws, and any other information source which affects and reflects the incurrence, control, and allocation of costs to contracts.

c. Adequate audits are possible only when all existing evidence which pertains to the representations, claims, or proposals under audit is available to the auditor. A contractor's failure to make all pertinent records available to the auditor when needed leads to audit reports that contain qualified or adverse opinions, and may result in more difficult negotiations and delay in the contract award or settlement.

d. For field pricing support audits, FAR 15.404-2(c)(3) states that the auditor is responsible for determining the scope and depth of audit. Inherent in this responsibility is the right of auditors to determine the specific records or other evidential matter needed to accomplish the audit. DCAA auditors must adhere to generally accepted Government auditing standards in determining what comprises competent, relevant, and sufficient evidential matter. Therefore, auditors must use good judgment and rationale in deciding what contractor records or other evidential matter should be sought. In determining the sufficiency of evidence needed, auditors must consider the audit objective, the risk, and materiality of an error or misstatement in the area being audited and the effect on the audit opinion. See 5-502.1 for additional guidance on access to contractor budgets and 14-305.2 on access to cash flow forecasts.

e. FAOs should not enter into written nondisclosure agreements with contractors or concur with contractor letters containing access to records provisions or procedures. Any

such written agreements may give the appearance of limiting access. Furthermore, auditors are required to protect proprietary information from unauthorized disclosure under 18 U.S.C. 1905 (see CAM 1-507). Therefore, agreements addressing the protection of proprietary information are not necessary. However, responses to contractor requests for confirmation that proprietary data will be protected in accordance with applicable laws and regulations are permissible. See 1-805 for guidance on memorandums of agreement pertaining to matters other than access to contractor records.

f. While FAOs will not sign agreements, letters or procedures indicating concurrence on access to records matters, they will obtain and review any such documents containing contractor procedures or policies. If the FAO believes the policies and procedures will invoke unreasonable delays, waste audit time or otherwise impede the orderly process of the audit, the contractor should be notified in writing of such concerns in accordance with procedures in 1-504.4, and 1-504.5. If no such concerns exist, the FAO should follow contractor procedural arrangements for obtaining access to needed information.

g. Agreements between a contracting officer and a contractor which appear to restrict DCAA's access to a contractor's records should be transmitted through Headquarters, ATTN: PAS, to the General Counsel for a legal analysis.

1-504.2 Statutory and Regulatory Requirements

Among statutory bases for access to contractor records are 10 U.S.C. 2313(a), "Examination of Records of Contractor," 10 U.S.C. 2306a, ("Truth in Negotiations"), and 41 U.S.C. 422(k) (Cost Accounting Standards). The following acquisition regulations have implemented these statutory and other access requirements:

a. FAR 15.209(b)(1) requires an "Audit - Negotiation" clause (FAR 52.215-2) in all negotiated contracts other than those which are not expected to exceed $100,000.

b. FAR 15.408 Table 15-2, Instructions for Submission of a Contract Pricing Proposal.

c. FAR 52.215-20 and 52.215-21 (Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data).

d. FAR 52.230-2 and 52.230-3 (Cost Accounting Standards).

e. FAR 52.216-4 (Economic Price Adjustment - Labor and Material).

f. FAR 52.232-16 (Progress Payments).

1-504.3 Guidance for Requesting Access to Contractor Records

a. Records should first be informally requested during the FAO's normal course of business with the contractor (either verbally or in writing). The auditor should be ready to discuss the basis for the request with the contractor. CAM or other Agency guidelines should not be cited as the reason for requesting a record in lieu of explaining the underlying audit need.

b. Occasionally contractors may ask that requests for records be in writing. Auditors should generally accommodate the contractor where it will facilitate access and avoid misunderstanding. However, contractor requirements that all requests for records be in writing are unacceptable as such a process would unnecessarily impede the audit process.

c. All requests should be for specific records rather than a general class of records. For example, requests should be for "the general ledger for FY 2000," or "the payroll register for the pay period ending July 4, 2000" rather than "the general ledger," or "payroll data." Addressing specific records relates the request to a specific audit. This action should avoid lengthy discussion with the contractor on the merits of the request.

d. When the auditor does not know precisely what records exist, a listing of what does exist (such as "recurring financial reports" or "IT files") should be requested. The listing itself may be considered a record, particularly if the contractor already produces such a list for other purposes.

e. Unusual or extensive requests for reproduction of contractor records should be made by supervisors and be in writing if requested by the contractor.

f. When original records or documents are provided by the contractor, auditors will ensure that all such records and documents are returned to the contractor as soon as possible.

g. Circumstances justifying an evaluation of original records at locations other than contractor facilities include records seized by investigators under a warrant or obtained by Government counsel through criminal, investigatory, or civil subpoena. DCAA has the right to evaluate any records in the hands of Government agents. Regardless of the circumstance under which the auditor obtains access to contractor records, due professional care will be exercised in protecting the records while in the auditor's possession.

h. Auditors will not remove original records from the locations at which they are furnished without prior Agency approval. Auditors who might be confronted with an unusual circumstance and need to move the contractor's original records from the location at which they are furnished will request their regional office to obtain the contractor's authorization. Auditors will fully explain in their request the reasons the contractor's original records cannot be used at its site. Regional offices will submit their approved auditors' requests to Headquarters, attention: PAS, for evaluation and coordination with legal counsel.

i. Auditors should not request copies of contractor records for the sole purpose of allowing the auditor to work at home rather than at the contractor's site. Auditors who might be confronted with an unusual circumstance related to working at home, and need to obtain and remove a copy (total or a portion) of the contractor's original records from the location at which they are furnished will request the FAO manager's written request to obtain and document the contractor's authorization. Auditors will fully explain in their request the reasons the records cannot be used at the contractor's site and why a copy is needed. Contractors who encourage auditors to take copies of records from their premises rather than work onsite should not be accommodated without good cause. Auditors may continue to request copies of selected records which are necessary to document audit files and support audit positions. See 1-507 guidelines for safeguarding contractor information.

1-504.4 Conditions Representing Denial of Access to Contractor Records

The following conditions qualify as access to records problems where a specific record is needed within these general areas:

a. Contractor refusal to provide access to any requested record including (i) support for unclaimed costs excluded under CAS 405 or (ii) records maintained in an electronic or optical format (even if paper copies are available).

b. Unreasonable delays by contractor representatives in permitting the audit commencement or in providing access to needed data or personnel. Since the determination of unreasonable delay is subjective, it is important to distinguish between occasional delays due to unexpected circumstances (for example, a key employee is out sick) and recurring delays which suggest that it is a contractor's practice to engage in delaying tactics. Recurring delays should be carefully documented with the names of contractor employees, data requested, dates when requested, dates when provided, etc.

c. Restrictions on reproduction of necessary supporting evidential matter.

d. Partial or complete denial of access to internal audit data or other management reports on contractor operations.

e. Denial of access to the contractor's data base. This denial can be a refusal to produce the necessary reports, or allow DCAA to validate reports by testing the database using DATATRAK, or other data retrieval software.

f. Chronic failure of contractor personnel to comply with agreed-to dates for furnishing data.

g. Assertion of attorney-client privilege or attorney work product rule. The auditor is not in a position to accept a claim of attorney-client privilege or the work product rule. Therefore, auditors should request that Headquarters, Policy and Plans obtain a legal opinion from DCAA counsel when a claim of privilege is made.

1-504.5 Resolution of Contractor Denials

a. When contractor personnel deny or unreasonably delay access to records needed for audit, auditors should immediately notify and thoroughly discuss the issue with responsible contractor officials authorized to make decisions. Reasonable effort should be made to resolve the issue in a timely manner at the lowest possible DCAA and contractor management level. If access is denied following the initial conference with the contractor, the auditor should follow the procedures cited in DCAA Instruction No. 7640.17.

b. When implementation of DCAA Instruction No 7640.17 does not resolve contractor denial of access to records, then the regional office should consider requesting Headquarters to subpoena the records in accordance with DCAA Regulation No. 5500.5. The DCAA Director is authorized to subpoena contractor documents and records needed to audit costs incurred under flexibly priced Government contracts and subcontracts, and to audit the accuracy, completeness, and currentness of cost or pricing data used for negotiated Government contracts and subcontracts.

1-504.6 Impact of Contractor Denial of Access

a. When the contractor denies the auditor access to records/data, the costs affected by the denial should be questioned under price proposals. Such costs should also be questioned on progress payments and suspended under cost-reimbursement contracts per 6-902a. A contractor's denial of access to records may be so extensive that it is impractical to perform any audit or determine an amount affected by the denial. In such a case, immediately notify all procurement and contract administration activities that may be involved with the subject audit and request their assistance. In addition, the auditor should recommend suspension of payments on all affected contracts until the access to records problem is resolved.

b. The impact of a contractor's denial of access to records on the scope of audit should be described in the "Qualifications" and "Results of Audit" paragraphs of the audit report. The report should identify the records that were sought, discuss the need for the records, and describe the measures that were taken to gain access (see 10-210.4).

1-505 Other Access to Records Issues -- Transfer of Records from Hard Copy to Computer Medium

a. FAR 4.703(d), which was effective February 27, 1995, and Public Law 103-355 allow contractors to retain records in any medium or any combination of media if the following requirements are met:

(1) The requirements of FAR Subpart 4.7 are satisfied.

(2) The process used to create and store records must reproduce the original document, including signatures and other written or graphic images, completely, accurately, and clearly.

(3) The procedures for data transfer, storage, and retrieval protect the original data from alteration.

b. To comply with FAR 4.703(d), a contractor's system of transferring records from hard copy to computer medium should contain the following elements:

(1) A reliable computer medium (typically, this includes vendor supported benchmark data).

(2) Documented procedures for data retention and transfer which provide reasonable assurance that the integrity, reliability, and security of the original hard copy data will be maintained.

(3) An audit trail describing the data transfer.

(4) A computer medium which cannot be destroyed, discarded, or written over. The contractor will need to consider appropriate transition, after exception reporting, to non-eraseable storage.

(5) A transfer process that includes all relevant notes, worksheets, and other papers necessary for reconstructing or understanding the records (this also includes appropriate back-up procedures).

(6) Adequate internal control systems, including segregation of duties, particularly between those responsible for maintaining the general ledger (and related subledgers) and those responsible for the transfer process.

(7) A procedure prohibiting record destruction during the implementation phase until it can be shown that the system is actually providing acceptable copies of the records being transferred.

(8) An acceptable system of continuing surveillance over the computer medium transfer system. This includes comparisons of the original records and the computer generated copies, as well as periodic internal control audits. The policies and procedures should provide for the maintenance of adequate evidence to support the nature and extent of the continuing surveillance.

(9) A requirement to maintain all original records for a minimum of one year after the date of transfer.

(10) Adequate procedures for periodic internal and external audit.

(11) Adequate procedures for labeling and storing the computer medium in a secured environment. The storage procedures should meet the minimum standards prescribed by the National Archives and Records Administration for maintenance and storage of electronic records.

(12) Adequate procedures for the random sampling and testing of all records retained in accordance with the requirements of the National Archives and Records Administration. Procedures should include provisions for notifying the contracting officer of any significant data losses on a timely basis.

(13) Procedures for retrieving retained records at the time of audit. Procedures should include provisions for printing a hardcopy of any record. In addition, policies should include provisions for access by Government representatives, at the time of examination, to the necessary computer resources (terminal access, printer, etc.) that are necessary for the production of the retained records.

(14) Procedures for preventing the destruction of any hard copy records that are required to be maintained by existing laws or regulations.

1-506 Other Access to Records Issues -- Records Destroyed or Not in Condition for Audit

a. When the contractor's records are inadequate, not current, or otherwise not in condition for audit, immediately bring the deficiency to the contractor's attention. If corrective action is not instituted promptly, notify the regional office, the requesting procurement activity, and other Government offices affected. Except as authorized by law, regulation, or court order, the auditor should not undertake or participate in correcting the deficiencies.

b. When records are alleged to have been destroyed, lost, stolen, or otherwise cannot be located, obtain a written statement from appropriate high-level contractor management (i.e., at a level no lower than the business segment vice president or chief financial officer) with a detailed explanation of the circumstances. The FAO should also immediately notify the contracting officer of the extent to which an audit can be made using the remaining available records. Under these circumstances, denial of access to records should not be pursued. Additionally, the auditor should not attempt reconstruction of contractor's records.

c. Any audit reports issued under these circumstances should contain appropriate comments on all the facts, with any necessary disclaimer, adverse opinion, qualifications, and/or explanations of questioned costs.

1-507 Security Requirements for Contractor Information

a. Auditors should perform audits in such privacy as warranted under the circumstances, and should provide all necessary safeguards to contractor-confidential data. Working papers, audit reports, unpublished financial statements, correspondence, files, and other records and sources available to or in the possession of the auditor usually contain information that the contractor regards as confidential. Auditors shall use such information only for performance of official duties. Except as authorized by law, regulation, or court order, the auditor shall not disclose the information to other persons except with the contractor's permission, and shall not discuss information in a manner that might permit disclosure to unauthorized persons.

b. The law pertaining to unauthorized disclosure of contractor information, and penalties for violation thereof, is contained in 18 U.S.C. 1905, as amended, and is quoted below:

> Whoever, being an officer or employee of the United States or of any department or agency thereof, any person acting on behalf of the Office of Federal Housing Enterprise Oversight, or agent of the Department of Justice as defined in the Antitrust Civil Process Act (15 U.S.C. 1311-1314), or being an employee of a private sector organization who is or was assigned to an agency under chapter 37 of title 5, publishes, divulges, discloses, or makes known in any manner or to any extent not authorized by law any information coming to him in the course of his employment or official duties or by reason of any examination or investigation made by, or return, report or record made to or filed with, such department or agency or officer or employee thereof, which information concerns or relates to the trade secrets, processes, operations, style of work, or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, partnership, corporation, or association; or permits any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; shall be fined under this title, or imprisoned not more than one year, or both; and shall be removed from office or employment.

c. Contracting commands and contract administration offices may use contractors, commonly referred to as third party service providers (TPSPs), to assist in contracting activities, such as contract closeouts and pricings. DCAA personnel are not to provide contractor proprietary information directly to TPSPs. Before discussing contractor proprietary data with individuals from contracting commands or contract administration offices, or release of such information, DCAA personnel should confirm the contacts are U.S. Government employees. If U.S. Government officials request that DCAA provide contractor proprietary information directly to a TPSP, the auditor should explain that DCAA cannot provide proprietary data to non-Government employees and arrangements should be made to provide the information to the contracting officer or his/her designated U.S. Government staff member.

d. Release of contractor information to the Government Accountability Office, members of Congress and congressional committees and their staffs, offices of inspector general, and Government investigative agencies, should be handled in accordance with the procedures outlined in the applicable paragraph under 1-203, 1-404.6, or 1-405. Release of contractor provided information in litigation is governed by DCAAR 5410.11 and the discovery rules of the forum involved. Release of contractor provided information in response to requests under the Freedom of Information Act is governed by DCAAR 5410.8.

1-508 Assistance in Preparing Claims Against the Government

a. Officers and employees of the Government are prohibited by law (18 U.S.C. 205) from acting as agents or attorneys for prosecuting any claim against the United States or aiding or assisting in the prosecution or support of any such claim other than in the proper discharge of

their official duties. A part of the auditor's official duties is to inform contractors of the manner in which public vouchers, termination settlement proposals, cost statements, and other financial representations connected with the negotiation and performance of Government contracts should be prepared and submitted.

b. The auditor may advise contractors as to types of costs which are considered allowable and unallowable and on request may orally express an opinion as to the acceptability of a specific item of cost.

c. The auditor may advise contractors to screen and not claim costs specifically unallowable by contract terms, statute, public policy, or Government regulations. If the contractor consistently claims costs which are clearly unallowable under the contract terms, refer the matter to the Plant Representative/ACO for appropriate action. (See 8-405.)

1-600 Section 6 --- Relationship with the News Media

1-601 Introduction

This section contains guidelines regarding contacts with the news media.

1-602 General

DCAA Regulation 5230.1 implements DoD Directive 5230.9, Clearance of DoD Information for Public Release. The Regulation includes guidance regarding information to be furnished the news media. Information in any form concerning Agency plans, policies, programs, or operations must be cleared through Headquarters before release.

1-603 Processing Requests for Information

Agency personnel are often contacted directly by the news media. Although talking with the news media is not prohibited, the above references govern the release of information. If contacted by the media, the employee should obtain the person's name, the organization represented and telephone number, and the questions to be answered. This information and the circumstances surrounding the request should be conveyed to the Agency Executive Officer (DX), Headquarters. The Executive Officer is responsible for deciding how the request from the media will be satisfied and for obtaining appropriate clearance for the release of information.

1-700 Section 7 --- Processing Freedom of Information Act (FOIA) Requests

1-701 Introduction

This section contains information and pertinent references for processing Freedom of Information Act (FOIA) requests.

1-702 General

The Freedom of Information Act, 5 U.S.C. 552, is a public law which is designed to allow the general public access to Government records. DCAA Regulation 5410.8, DCAA Freedom of Information Act Program, implements DoD Directive 5400.7, DoD Freedom of Information Act Program. DCAA's implementing regulation is codified as 32 C.F.R. Part 290 and contains policy and procedural information relative to the Act. This issuance is supplemented by DCAAP 5410.14, DCAA Freedom of Information Act Processing Guide. Additional information may be found on the DCAA web site.

1-703 Scope of the Statute

a. All audit work products are subject to public demand under the Freedom of Information Act. Although there is a preference for release of Government documents, aspects of these documents may be subject to withholding under one or more of the established exemptions contained in the Act. The Agency must prove that a specific harm will be realized to preclude release of the requested records. An explanation of the exemptions is contained in DCAAP 5410.14.

b. Typically, requestors seek copies of audit reports and working papers. Some requests are specific to a particular audit report while others are more general. Since the release of most audit reports is at the sole discretion of the contracting officer, the primary demand for records will be limited to the working papers. Requests for DCAA records compiled to support an ongoing investigation are normally referred to the investigative agency for processing until all actions related to the case have been resolved. Similarly, requests that would cover records generated in support of a trial attorney are covered by the attorney work product privilege. Their release should be coordinated with the trial attorney or his/her successor.

1-704 Processing Requests for Information under FOIA

Request for records may require a search of the Agency's records to identify potentially responsive documents and information pertinent to the releasability of each record. Specific instructions for the processing of each request will be provided by the FOIA Coordinator at the regional level and the DCAA Information and Privacy Advisor for the Headquarters. A listing of Agency FOIA personnel may be found in DCAAR 5410.8 and DCAAP 5410.14.

1-800 Section 8 --- Auditor Participation on Contractor and Government Process Action Teams (PATs); Integrated Product Teams (IPTs); Management Councils; and Related Streamlined Acquisition Initiatives

1-801 Auditor's Role on Contractor and Government Teams Such as PATs, Steering Committees, and Management Advisory Boards

Audit Guidance on PATs is currently under revision. Questions should be referred to Headquarters, PAS.

1-802 Integrated Product Teams (IPTs) - Background

Guidance on Integrated Product Teams is currently under revision. In the meantime, the guidance in MRD 08-PAS-024(R), dated August 5, 2008, and MRD 08-PAS-026(R) should be followed.

1-803 Auditor’s Role on DoD IPTs and Related Streamlined Acquisition Initiatives

See note under 1-802 above.

1-804 Management Councils, Single Process Initiative (SPI), and Cost-Benefit Analysis

Audit guidance on management councils, single process initiative, and cost-benefit analysis is currently under revision. Questions should be referred to Headquarters, PAS.

1-804.1 Management Councils

See note under 1-804.

1-804.2 Single Process Initiative (SPI)

See note under 1-804.

1-804.3 Cost-Benefit Analysis

See note under 1-804.

1-805 Memorandum of Agreement

The guidance is currently under revision. Questions should be referred to Headquarters, PAS.

Figure 1-8-1
Notification Letter to Contractor

Danica Smith, Controller
ABC Corporation
507 Main Street
Any City, State 00000

Dear Ms. Smith:

You have requested that DCAA provide a participant on a PAT you are establishing to study and suggest improvements in your processes and internal controls for {identify system or process that is being evaluated}. I believe your desire to pursue continuous process improvement in this critical area has significant potential benefit to the Government. Accordingly, I have assigned Ms./Mr.{insert name}of my staff to participate. They may be contacted at {telephone no.}.

While I am supportive of your PAT efforts and understand the value of a DCAA participant, it is important that you acknowledge the following conditions regarding such participation. Ms./Mr.{insert names}'s participation in the PAT is in a nonvoting, purely advisory capacity on issues related to his/her knowledge and skills as an auditor. He/she will not be involved in making management decisions or performing management functions. As such, DCAA reserves the right to conduct audits in the future as are considered necessary, in accordance with FAR, and to render independent opinions as a result of such work, even if such opinions are contrary to the recommendations or conclusions of this PAT.

Sincerely,

James Jones
FAO Manager

CHAPTER 2

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CHAPTER 2

2-000 Auditing Standards

2-001 Scope of Chapter

This chapter discusses the auditing standards that apply to DCAA audits. Auditing standards differ from audit procedures in that procedures relate to acts to be performed, whereas standards deal with measures of the quality of the performance of those acts and the objectives to be attained by use of the procedures.

2-100 Section 1 --- Auditing Standards and DCAA Audits

2-101 Generally Accepted Government Auditing Standards (GAGAS)

a. By reference, DoD Instruction 7600.2, "Audit Policies," dated April 27, 2007, incorporates Government Auditing Standards (commonly referred to as the "Yellow Book" and developed and published by the Comptroller General), and guidance issued by the Council of Inspectors General on Integrity and Efficiency and the DoDIG. These standards are applicable to DCAA.

b. The Yellow Book, alternately referred to as generally accepted government auditing standards (GAGAS), incorporates certain standards of the American Institute of Certified Public Accountants (AICPA). When the Yellow Book incorporates standards of other authoritative bodies, such as the AICPA or the Office of Management and Budget, those standards become GAGAS.

c. A major revision of the Yellow Book, which supersedes the 2003 revision, was issued in July 2007. A copy is included in each DCAA FAO library, and is available on the DCAA Intranet under Useful Audit Links or at the GAO web site, http://www.gao.gov/govaud/ybk01.htm. This is the fifth revision of the overall standards since they were first issued in 1972. The July 2007 Yellow Book includes changes to the standards in the following areas:

- Stressed the critical role of professional judgment in all aspects of GAGAS audits, in considering risk, and in complying with GAGAS overall;
- Expanded the description of competence to emphasize its importance and relate it to key steps in performing an audit and reporting the findings and conclusions;
- Heightened emphasis on ethical principles as the foundation, discipline, and structure behind the implementation of the standards;
- Adopted new definitions related to reporting internal control deficiencies as material weaknesses;
- Clarified and streamlined the discussion of nonaudit services and their impact on auditor independence.

The revised standards are applicable for financial audits and attestation engagements for periods ending on or after January 1, 2008, and for performance audits beginning on or after January 1, 2008.

d. All audits begin with objectives, and those objectives determine the type of work to be performed and the auditing standards to be followed. The types of work that are covered by

GAGAS are classified as financial audits, attestation engagements, or performance audits. The majority of the work performed by DCAA falls under the attestation engagement classification. The general, field work and reporting standards for attestation engagements are in Chapter 6 of the Yellow Book (see 2-300 and 2-400 for a discussion of the field work and reporting standards, respectively). In addition, DCAA routinely performs economy and efficiency audits (operations audits) that fall under the performance audit classification. The field work and reporting standards for performance audits are in Chapters 7 and 8 of the Yellow Book (see 2-500 and 2-600). DCAA may also occasionally perform financial statement audits. Auditors performing such audits should follow the field work and reporting standards in the Yellow Book Chapters 4 and 5. The GAGAS general standards (Yellow Book Chapter 3) apply to all types of GAGAS engagements (see 2-200).

e. Fieldwork and reporting requirements for attestation engagements and performance audits are implemented through CAM guidance, supplemented by the Audit Planning and Performance System (APPS), standard audit programs and internal control matrices, and standard audit report paragraphs appearing in 10-200 (general), the balance of Chapter 10 (reports on specific types of audits), and in the audit report shells delivered by APPS and on the DCAA Intranet.

2-102 AICPA Attestation Standards

a. For attestation engagements, the Yellow Book incorporates the AICPA's general standard on criteria, and the field work and reporting standards and related Statements on Standards for Attestation Engagements (SSAEs) unless specifically excluded or modified by GAGAS. Currently none of the field work and reporting standards and related SSAEs are excluded from GAGAS. The AICPA attestation standards that are incorporated into GAGAS deal with suitable and available criteria, adequate planning and supervision, sufficient evidence, and appropriate reporting (see 2-200, 2-300 and 2-400). A copy of the codification of the SSAEs is in each DCAA field audit office library.

b. An attestation engagement is defined in the Yellow Book and the SSAEs as one in which an auditor is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on a subject matter, or an assertion about the subject matter, that is the responsibility of another party. In reporting on an attestation engagement, it is important to identify the assertion or subject matter being reported on. In some instances, the auditor will report on an assertion, which may be certified (e.g., incurred cost proposal), or explicit (e.g., price proposals, certified or not). In other instances, the auditor will report directly on a subject matter (e.g., an audit of a contractor’s business systems).

2-102.1 Types of Attestations

The attestation standards define three types of attestation engagements providing different levels of assurance in relation to the auditor's opinion or conclusions as reflected in the table below.

Type of Attestations	Type of Assurance	Type of Report Statement
Examination	Positive	Unqualified, Qualified, Adverse, or Disclaimer of Opinion
Review	Negative	Disclaimer of Opinion
Agreed-Upon Procedures	None	Disclaimer of Opinion

a. An examination consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter or assertion is based on or in conformity with the criteria in all material respects. An examination report provides a high level of assurance and the auditor's conclusion is expressed in the form of an opinion (stated as positive assurance). Therefore, the audit objective is to gather sufficient evidence to restrict attestation risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance that is imparted by the audit opinion. In such an engagement, the auditor should select a combination of procedures to assess inherent and control risk and restrict detection risk such that attestation risk is restricted to an appropriately low level. In the contract audit environment, evaluations of complete submissions (price proposals, claims, and overhead rate proposals), where the auditor establishes the scope, are performed as "examinations." Additionally, the auditor may examine sufficient evidence to support an opinion for the audit of "parts of a proposal" while disclaiming an overall opinion on the proposal taken as a whole (see 10-305).

b. A "review" consists of sufficient testing to express a conclusion about whether any information came to the auditors' attention based on the work performed that indicates that the subject matter or assertion is not based on or in conformity with the criteria in all material respects. The auditor accumulates sufficient evidence to restrict attestation risk to a moderate level and the work performed is substantially less than an examination. Therefore, the auditor would disclaim an opinion, and instead the conclusion is expressed in the form of negative assurance. Procedures performed are generally limited to inquiries and analytical procedures, rather than including search and verification procedures. Under GAGAS and the SSAEs auditors are precluded from performing a review in certain cases, e.g. if the report expresses an opinion on internal controls or compliance with laws and regulations. Because DCAA generally does not perform "reviews," i.e., give negative assurance, such engagements are not discussed further in this chapter.

c. In an agreed-upon procedure engagement, an auditor is asked by the requestor to report on findings based on specific procedures performed on a subject matter or an assertion. The requestor and auditor must agree on the procedures to be performed and the criteria to be used. The procedures must be specific and include objective criteria. Auditors should not agree to perform procedures that are subjective and/or that would call for an opinion or opinion-like findings (see 14-1000). An agreed-upon procedures (AUP) report does not provide positive or negative assurance, and the report must disclaim an opinion. The AUP report should state the specific procedures performed and specific findings that should not be expressed in terms of questioned costs or recommendations. In addition, the standards require that all findings be reported unless materiality thresholds have been established by the requestor (see 10-1000).

2-102.2 Types of Report Statements - Unqualified, Qualified, Adverse Opinion and Disclaimer of Opinion

a. When an examination discloses that the assertion is both complete and accurate and the auditor followed all applicable GAGAS requirements, the report opinion will be unqualified and give positive assurance.

b. When an examination discloses that the assertion is not in conformity with the criteria (i.e., the auditor has reservations about the assertion (see 2-402.3), e.g., it is incomplete or inaccurate), the auditor must issue either a qualified or adverse opinion, depending on the materiality of the departure from the criteria (e.g., considering the nature and significance of the audit exception(s)).

c. If the auditor did not comply with all applicable GAGAS requirements (i.e., the auditor has reservations about the engagement (see 2-402.3), e.g., the auditor was not able to perform all the procedures that he or she considers necessary in the circumstances) the auditor must issue either a qualified opinion or disclaim an opinion, depending on the significance of the potential effects of the departure from the requirements.

d. A qualified opinion indicates that, except for the effects of the matter to which the qualification relates, the subject matter or the assertion is in compliance with the established criteria (e.g., FAR/DFARS). A qualified opinion is expressed when:

(1) the auditor has significant reservations about the engagement; i.e., there is a lack of sufficient evidence, restrictions on the scope of the examination, or other departure from GAGAS that have led the auditor to conclude he or she cannot express an unqualified opinion and the auditor has concluded, based on the nature and magnitude of the potential effects of the issues and their significance to the subject matter or assertion, not to disclaim an opinion; and/or

(2) the auditor has significant reservations about the subject matter or assertion; i.e., the auditor believes, based on the audit, the subject matter under audit contains a departure from the established criteria, and based on the materiality of the departure, the auditor has concluded not to express an adverse opinion.

e. An adverse opinion states that the subject matter is not in conformity with the criteria, including the adequacy of the disclosure of material matters. In determining whether to express an adverse opinion rather than a qualified opinion, the auditor must consider the materiality of the departures from the criteria, keeping in mind that lower materiality levels are generally appropriate for GAGAS audits because of Government accountability and the visibility and sensitivity of Government programs (see 2-309). An adverse opinion is still an opinion and, therefore, should be expressed only when the auditor has performed an audit of sufficient scope.

f. A disclaimer of opinion is issued when there are scope restrictions and the departures from GAGAS requirements are so significant that the examination has not been performed in sufficient scope to enable the auditor to form an opinion. A scope restriction may be imposed by the contractor, the requestor, or by other circumstances such as the timing of the work or the inability to obtain sufficient evidence (see 10-210.4c).

g. When the auditor performs an application of agreed-upon procedures engagement (see 10-1000 and 14-1000), the resulting report must disclaim an opinion because the scope is limited to the procedures agreed upon by the specified parties. This is true even when the auditor has recommended the procedures to be applied and the requestor has

merely agreed that the proposed procedures will provide enough information for the requestor's purpose.

h. If, in the course of an examination, the auditor encounters a scope restriction, the engagement may not be converted to an application of agreed-upon procedures merely to avoid disclosing the scope restriction. However, under certain circumstances, an examination may, before the completion of the audit, be converted to an agreed-upon procedure engagement. A request to change to an agreed-upon procedure engagement may result from a change in circumstances affecting the requestor’s requirements, or a misunderstanding about the nature of the original services or alternative services originally available. Before an auditor agrees to change to an agreed-upon procedure engagement, the auditor should consider:

(1) The possibility that certain procedures performed as part of an examination are not appropriate for inclusion in an agreed-upon procedures engagement.

(2) The reason given for the request.

(3) The additional effort required to complete the original engagement.

(4) If applicable, the reasons for changing from a general-use report (unlimited users) to a restricted-use report (limited to specified users) which is required under an agreed-upon procedures engagement.

2-102.3. Terminology

The AICPA attempts to reserve the words "audit" and "auditor" to financial statement audits. The attestation standards convert the terminology "examination," "review," and "application of agreed-upon procedures" to verbs to describe the process that generates a report, and refer to auditors as "practitioners." The AICPA does not refer to an evaluation affording the highest level of assurance interchangeably as an "examination" or an "audit." DCAA will continue to use "audit" to describe, in general terms, the work performed. DCAA will use specific terminology in the reporting language for audits requiring different levels of assurance (i.e., an examination or an application of agreed-upon procedures).

2-103 Other Auditing Standards

a. AICPA. In addition to its attestation standards, the Auditing Standards Board of the AICPA has also issued ten auditing standards, referred to as generally accepted auditing standards (GAAS), that generally apply to audits of financial statements. The AICPA, through its Auditing Standards Board, has also issued an extensive series of interpretations of GAAS (referred to as Statements on Auditing Standards (SAS)) which independent public accountants (IPAs) are expected to follow when performing financial audits of non-public companies. The SAS generally do not apply to the work DCAA performs (except for infrequent financial statement audits). However, DCAA guidance occasionally incorporates the principles and concepts of certain SAS. A codification of the SAS is in each DCAA field audit office library.

b. Public Company Accounting Oversight Board (PCAOB). The Sarbanes-Oxley Act (Public Law 107-204) gives the PCAOB the authority to set auditing standards to be used by registered public accounting firms in the audit of publicly traded companies. PCAOB auditing standards do not apply to DCAA.

2-104 Performance Audits

a. GAGAS define performance audits as engagements that provide assurance or conclusions on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices. Performance audit

objectives vary widely and include objectives related to assessing program effectiveness, economy and efficiency (operations audits); internal control; compliance; and prospective analyses (GAGAS 1.28).

b. The audit objectives of economy and efficiency audits (GAGAS 1.29) address the cost and resources used to achieve program results. DCAA operations audits are economy and efficiency audits. Examples of such audit objectives include:

(1) evaluating whether the entity is following sound procurement practices and obtaining resources at reasonable costs while meeting timeliness and quality considerations;

(2) determining whether and how costs can be decreased or productivity increased; and

(3) assessing whether the entity has complied with the laws and regulations concerning matters of economy and efficiency.

c. The other categories of performance audits are generally performed by oversight agencies such as the DoDIG and the GAO. For example, the objectives of an audit of program effectiveness and results address the value of a program and typically measure the extent to which a program is achieving its goals and objectives (GAGAS 1.29).

2-105 Nonaudit Services

Professional services provided by auditors other than audits and attestation engagements, referred to as nonaudit services, are not performed in accordance with GAGAS and must not be reported as such. GAGAS also require that an audit organization that perform nonaudit services for entities for which it also conducts GAGAS engagements, clarify that the scope of the work performed does not constitute an audit under GAGAS (GAGAS 1.33). Therefore, memorandums to the contracting officer on the results of nonaudit services performed by FAOs should include the following statement:

The scope of the work performed does not constitute an audit or attestation engagement under generally accepted auditing standards.

Nonaudit services are discussed in more detail in 2-203.4.

2-200 Section 2 --- General Standards

2-201 Introduction

This section explains the GAGAS general standards which apply to all types of GAGAS engagements. General standards relate to the competence of the staff, the independence of the audit organization and the individual auditor, the exercise of professional judgment in performing the audit and in preparing related reports, and quality controls and external peer reviews.

2-202 Competence (GAGAS 3.40 – 3.49)

a. This standard requires that those assigned to the audit collectively have the technical knowledge, skills, and experience necessary to be competent for the type of work being performed. Their qualifications should collectively be commensurate with the scope and complexities of the assignments and should include:

- Knowledge of GAGAS applicable to the type of work they are assigned and the education, skills, and experience to apply this knowledge to the work being performed;
- General knowledge of the environment in which the audited entity operates and the subject matter under review;
- Skills to communicate clearly and effectively, both orally and in writing; and
- Skills appropriate for the work being performed. For example, staff or specialist skills in:
  (1) statistical sampling if the work involves use of statistical sampling;
  (2) information technology if the work involves review of information systems;
  (3) engineering if the work involves review of complex engineering data;
  (4) specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests; and
  (5) specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter, if the work calls for such expertise.

Audits vary in purpose and scope. Some require an opinion on the adequacy of financial representations; others an opinion on compliance with specific laws, contractual provisions, and other requirements; others require evaluations of efficiency and economy of operations; and still others require some or all of these elements. Since audits frequently require a wide variety of skills, an auditor may need technical assistance from other disciplines, such as legal, engineering, and production/quality control. The auditor should make arrangements to secure any needed technical assistance from the ACO/plant representative or responsible acquisition agency (see Appendix D).

b. The effectiveness of contract audits is governed in large measure by the caliber and training of the person or persons performing the work. The auditor is expected to have acquired through continuing education, training, and experience the ability to plan; develop and apply effective audit procedures; to determine facts; to make reasonable judgments and decisions; and to prepare objective and effective audit documentation and reports.

c. Competence is derived from a blending of education and experience. GAGAS 3.46 and DCAA require all audit staff members to complete 80 hours of professional training or development during each two-year reporting period. At least 24 of the 80 hours should be earned in subjects directly related to Government auditing or the Government environment. At least 20 of the 80 hours of training must be completed in each fiscal year. These hours of training are referred to as continuing professional education (CPE) credits. The

terms “training” and “education” are used interchangeably. Additionally, auditors who use the work of external specialists should assess the professional qualifications of such specialists (see D-302c).

d. Continuing professional education is a shared responsibility of Headquarters and the regions; however, the primary responsibility resides with the individual supervisors and staff members. DCAA staff must have satisfied the CPE requirement to meet the Government Auditing Standards underlying audit planning, directing, conduct, and reporting. The specific responsibilities of all parties are defined in the DCAA Personnel Management Manual, DCAAM 1400.1.

e. These standards do not exclude the use of auditors in a training status, as long as trainees are assigned duties commensurate with their experience and capabilities and are adequately supervised. Proper supervision of the work done by trainees will contribute to their development and should assure maintenance of acceptable standards.

f. Auditors should be knowledgeable in the AICPA general attestation standard related to “criteria,” the AICPA attestation standards for field work and reporting, and the related Statements on Standards for Attestation Engagements (SSAE). They should also be competent in applying these standards and SSAEs to the task assigned.

2-203 Independence (GAGAS 3.02 – 3.30)

In all matters relating to the audit work, the audit organization and the individual auditor, whether Government or public, must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments to independence.

a. As an employee of DCAA, the contract auditor's primary responsibility is to protect the interests of the Government and taxpayers. However, the auditor's effectiveness depends on the ability to develop and evaluate facts and arrive at sound conclusions objectively (based on unbiased judgments) and independently (not influenced or controlled by others). Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information. The matter of independence and objectivity also requires that the auditor not identify so closely with contractor personnel that practices or decisions of the contractor go unexamined or are examined only cursorily.

b. Each auditor has an obligation to refrain from entering into any relationship (financial, social, or other) with contractors and their officers and employees, that would impair his or her objectivity or reflect discreditably on him/her, the Agency or DoD. In addition to complying with the GAGAS independence requirements, it is essential that the auditor observe the prescribed Joint Ethics Regulations (DoD Directive 5500.7-R) to ensure compliance with the ethical standards demanded of all public servants.

c. To comply with the independence standard, an auditor should avoid situations that could lead objective third parties with knowledge of the relevant information to conclude that the auditor is not able to maintain independence and, thus, is not capable of exercising objective and impartial judgment on all issues associated with conducting and reporting on the work. In this connection, there are three general classes of impairments that the auditor should consider: personal, external, and organizational. If one or more of these impairments affects or can be perceived to affect independence, GAGAS requires the audit organization (or auditor) to decline to perform the work. However, in those situations in which a Government audit organization, because of a legislative requirement or for other reasons, cannot decline to perform the work, the impairment(s) must be disclosed in the scope section of the audit report. DCAA policy (see 2-S103.1b(5)) does not allow auditors with a personal or external impairment to work on any assignment affected by the impairment. Therefore, although GAGAS provides for a scope qualification, such qualification will generally not be used in DCAA reports.

d. If an impairment to independence is identified after the audit report is issued, GAGAS requires the audit organization to assess the impact on the audit and communicate the impairment to certain parties if the audit organization determines it did not comply with GAGAS. In such cases, the FAO should coordinate its assessment with the Region, which should coordinate with Headquarters (PAS). If it is determined that the FAO did not comply with GAGAS, the impairment and its impact on the audit report will generally be communicated to the parties included on the audit report distribution.

2-203.1 Personal Impairments (GAGAS 3.07 – 3.09)

a. Personal impairments result from relationships and beliefs that might cause an auditor to limit the extent of the inquiry, limit disclosure, or weaken or slant audit findings in any way. Auditors should notify the appropriate officials within DCAA if they have any personal impairment to independence (see 2-S103.1). Examples of personal impairments of individual auditors include, but are not limited to, the following:

(1) immediate family or a close family member who is a director or officer of the audited entity, or as an employee of the audited entity, is in a position to exert direct and significant influence over the entity or the program under audit (immediate family member is a spouse, spouse equivalent, or dependent (whether or not related); a close family member is a parent, sibling, or nondependent child);

(2) financial interest that is direct, or is significant/material though indirect, in the audited entity or program;

(3) responsibility for managing an entity or for making decisions that could affect operations of the entity or program being audited, for example serving as a director, officer, or other senior position of the entity, activity, or program being audited, or as a member of management in any decision making, supervisory, or ongoing monitoring function for the entity, activity, or program under audit;

(4) concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records when such services involved preparing source documents or originating data; posting transactions; authorizing, executing, or consummating transactions; maintaining an entity's bank account or having custody of the audited entity's funds; or exercising or having authority on behalf of the entity. (The auditor's independence is impaired if he or she performed functions as a former employee of a contractor that affect the subject of audit. The auditor needs to be free from this personal impairment for the period covered by the audit. In addition, to avoid any appearance of impairment, auditors who were formerly employed by contractors should not be assigned to audit that contractor for a reasonable cooling off period, generally two years, regardless of the position held while employed by the contractor.);

(5) preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit;

(6) biases, including those resulting from political, ideological, or social convictions, that result from membership or employment in, or loyalty to, a particular group, organization, or level of Government; and

(7) seeking employment with an audited organization during the conduct of the audit.

b. Audit organizations should include as part of their internal quality control system procedures to identify personal impairments and help ensure compliance with GAGAS independence requirements. At a minimum, audit organizations should:

- Establish policies and procedures to identify, report and resolve personal impairments to independence.
- Communicate the audit organization's policies and procedures to all auditors in the organization and promote understanding of the policy and procedures.
- Establish internal policies and procedures to monitor compliance with the audit organization's policies and procedures.
- Establish a disciplinary mechanism to promote compliance with the audit organization's policies and procedures.

- Stress the importance of independence and the expectation that auditors will always act in the public's interest.
- Maintain documentation of the steps taken to identify potential personal independence impairments (see 2-S103.1).

DCAA's current system to comply with these requirements is described in 2-S10.

c. GAGAS 3.05 states that when auditors use the work of a specialist, they should assess the specialist's ability to perform the work and report the results impartially. [Specialists to whom this section applies include, but are not limited to, actuaries, appraisers, attorneys, engineers, environmental consultants, medical professionals, statisticians, and geologists. This section does not apply to DCAA technical audit specialists.] If the specialist has an impairment to independence, the auditor should not use the work of that specialist. All Executive Branch Federal employees are required to follow the Office of Government Ethics Joint Ethics Regulations, which require employees to be impartial and free from conflicts of interest in the performance of their official duties. As a result, DCAA has determined that the ethics policies and procedures of the specialist' organizations provide reasonable assurance of the impartiality of specialists employed by other Executive Branch agencies, e.g., DCMA. Therefore, additional documentation is not required when using the work of those specialists. In obtaining representations from specialists employed by DCAA, follow the guidance in 2-S103.1.

d. When the audit organization identifies a personal impairment to independence, prior to or during an audit, the audit organization should take action to resolve the impairment in a timely manner. In situations in which the personal impairment is applicable only to an individual auditor on a particular assignment, the audit organization may be able to eliminate the personal impairment. For example, the audit organization could remove that auditor from any work on that audit assignment or require the auditor to eliminate the cause of the personal impairment (e.g., the auditor could sell a financial interest that created the personal impairment). Auditors participating in the audit assignment, including those who perform reviews of a report, and all others within the audit organization who can directly influence the outcome of the audit, need to be free from personal impairments. If the personal impairment cannot be eliminated, the audit organization should withdraw from the audit. In situations in which Government auditors cannot withdraw from the audit because of a legislative requirement or for other reasons, GAGAS requires that the impairment should be reported in the scope section of the audit (however, see 2-203c).

2-203.2 External Impairments (GAGAS 3.10 – 3.11)

a. External impairments to independence occur when an auditor is deterred from acting objectively and exercising professional skepticism by pressures, actual or perceived, external to the audit organization, such as from management and employees of the audited entity or outside organizations (e.g., procurement officials). GAGAS includes several examples of conditions that could result in external impairments. Examples of potential external impairments that DCAA auditors could face include:

- Contracting officer or contractor inappropriately trying to influence the scope of an audit.
- Contracting officer pressuring auditor to limit procedures in order to complete the audit within a designated timeframe (10-304.4e).
- Contracting officer requesting the audit be cancelled after the field work is complete and the findings disclosed.
- Contractor denial of access to information, such as books, records, and supporting documents or contractor officials or employees (see 1-504 for procedures to follow when denied access to contractor information).

- Attempts to influence the assignment of audit personnel to a particular audit assignment or contractor location.
- Restrictions on funds or other resources such as reimbursable hours provided to the audit organization that adversely affect its ability to carry out its responsibilities.
- Contracting officer or contractor pressuring the auditor to provide a clean audit opinion or to not question costs. For example, the contractor may pressure the auditor to delay issuing a report on deficiencies in its business system to allow time for the contractor to correct the reported deficiencies. Auditors should never delay issuance of the audit report for this reason. Additionally, all significant deficiencies must be reported even if the contractor corrects some of the deficiencies during the course of the audit.

b. An audit organization's internal quality control system for compliance with GAGAS independence requirements should include internal policies and procedures for reporting and resolving external impairments (see 2-S10).

2-203.3 Organizational Independence (GAGAS 3.12 – 3.19)

Government audit organizations' ability to perform the work and report the results objectively can be affected by their placement within Government and the structure of the Government entity audited. Government auditors can be presumed to be free from organizational impairments to independence when the audit function is organizationally placed outside the reporting line of the audited entity and the auditor is not responsible for entity operations. DoD Directive 5105.36 (see Supplement 1-1S1) established DCAA as an independent agency of DoD; accordingly, an environment exists where DCAA can function in an independent, objective manner in performing its contract audit services.

2-203.4 Organizational Independence When Performing Nonaudit Service (GAGAS 3.20 – 3.30)

a. GAGAS 3.20 states that audit organizations at times may perform other professional services (nonaudit services) that are not performed in accordance with GAGAS. It requires audit organizations that provide nonaudit services to evaluate and use professional judgment based on the facts and circumstances to determine whether providing the services creates an independence impairment either in fact or appearance with respect to entities they audit.

b. Although nonaudit services are not performed in accordance with GAGAS, performing certain types of nonaudit services can impair an auditor's independence and, in some cases, the independence of the entire Agency, for current or future audits or attestation engagements. An audit organization's independence will be impaired if it performs nonaudit services that violate either or both of the following two overarching principles:

- Audit organizations must not provide nonaudit services that involve performing management functions or making management decisions.
- Audit organizations must not audit their own work or provide nonaudit services in situations in which the nonaudit services are significant or material to the subject matter of the audits.

c. GAGAS Chapter 3 discusses three categories of nonaudit services and GAGAS Appendix I discusses a fourth:

- Nonaudit services that do not impair the audit organization's independence, and therefore, do not require compliance with supplemental safeguards.

- Nonaudit services that do not impair the audit organization‘s independence if the audit organization complies with additional safeguards.
- Nonaudit services that always impair the audit organizations independence because they violate one or both of the overarching principles.
- Nonaudit services generally unique to audit organizations in government entities that are not performed for the audited entity and do not impair independence.

d. It is DCAA’s policy that auditors only perform nonaudit services that do not impair independence and do not require supplemental safeguards (those in the first and fourth category). The vast majority of DCAA’s nonaudit services are provided to the contracting officer or other procurement officials; therefore, they generally fall within the last category. Such nonaudit services include providing technical advice based on the auditor’s technical knowledge and expertise. For example, auditors may provide advice on general accounting matters, such as explaining accounting and cost principles, including FAR, GAAP and CAS. In addition, auditors may provide the contracting officer information or data without verification, analysis, or evaluation, such as in response to a request for specific information. These routine types of interactions are normal between auditors and Government agencies that request DCAA services given the knowledge auditors gain of the contractor’s operations and do not impair independence or require supplemental safeguards.

e. In addition to providing technical advice and specific cost information, DCAA performs the following assignments as nonaudit services:

- Desk reviews of incurred costs for low-risk non-major contractors; and
- Evaluations of final vouchers.

f. Since nonaudit services are not performed in accordance with GAGAS, any correspondence regarding such services should include a statement to that effect (see 2-105).

g. To avoid impairing independence or even the appearance of impairment, auditors will not participate as team members of Integrated Product Teams (IPT), which typically involve teaming with the contractor to develop a proposal. Auditors will also not participate in similar teaming arrangements or provide input to contractors on such items as draft proposals, draft policies and procedures, or draft CAS disclosure statements. Such activities could result in violation of the overarching principle against auditing one’s own work. In addition, auditors must report significant deficiencies or other findings discovered during an audit even when the contractor takes corrective action during the audit.

h. Auditors must always consider the potential for an impairment to independence before providing nonaudit services. FAOs should coordinate with the region before agreeing to provide any nonaudit services that they believe may go beyond the types of acceptable nonaudit services described in this section.

2-204 Professional Judgment (GAGAS 3.31 – 3.39)

a. Auditors should use professional judgment in planning and performing audits and attestation engagements and in reporting the results. Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care concerns acting diligently in accordance with applicable professional standards and ethical principals. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Professional skepticism includes a mindset in which auditors assume neither that management is dishonest nor of unquestioned honesty.

Believing that management is honest is not a reason to accept less than sufficient, appropriate evidence.

b. Using professional judgment in all aspects of carrying out professional responsibilities, including following the independence standards, maintaining objectivity and credibility, assigning competent audit staff to the assignment, defining the scope of work, evaluating and reporting the results of the work, and maintaining appropriate quality control over the assignment process is essential to performing and reporting on an audit.

c. The matter of professional judgment concerns what the auditor does and how well he or she does it. For example, professional judgment in the matter of working papers requires that their content support the auditor's opinion. Auditors should use professional judgment in determining the type of audit to be performed and in establishing the scope, selecting the methods, and choosing tests and procedures for the audit. Exercising professional knowledge, skills, and experience to diligently perform in good faith and with integrity, the gathering of information and the objective evaluation of the sufficiency and appropriateness of evidence is a critical component of audits. The auditor must be fully aware of the purpose of the audit and be mentally alert, inquisitive, and responsible while performing the tests and procedures and in evaluating and reporting the audit results.

d. Professional judgment and competence are interrelated because judgments made are dependent upon the auditor's competence. Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved in an assignment, as well the professional judgment of individual auditors. In addition to the personnel directly involved in the audit, professional judgment may involve collaboration with other stakeholders, outside experts, and management in the audit organization. For example, before beginning an audit of a proposal, the auditor should hold verbal discussions with the requestor to identify specific areas of concern or other relevant information they may have that could impact the risk.

e. Audit assignments and supervision should be commensurate with the auditor's level of knowledge, skill and ability. Final responsibility for audit quality rests with the audit team, who are expected to know the relevant accounting and auditing standards and to familiarize themselves with significant aspects of the contractor and submission being evaluated. Responsibility for assignment of audits to field auditors rests with the supervisor.

f. Considering the risk level of each assignment, including the risk that the auditor may come to an improper conclusion is another important issue. Within the context of audit risk, exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

g. Auditors should document significant decisions affecting the audit objectives, scope, and methodology; findings; conclusions; and recommendations resulting from professional judgment.

h. GAGAS places responsibility on each auditor and audit organization to exercise professional judgment in planning and performing audits. However, it does not imply unlimited responsibility or infallibility on the part of the individual auditor or audit organization. Absolute assurance is not attainable because of the nature of evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with GAGAS may not detect a material misstatement or significant inaccuracy, whether from error or fraud, illegal acts, or violations of provisions of contracts or grant agreements. Professional judgment does not mean eliminating all possible limitations or weaknesses associated with a specific audit, but rather identifying, considering, minimizing, mitigating, and explaining them.

i. Some contractor representations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor

exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to a specified date, such as the contractor's certified cost or pricing data. The auditor often must rely on evidence that is persuasive rather than convincing.

2-205 Quality Control and Assurance (GAGAS 3.50 – 3.63)

Each audit organization performing audits in accordance with GAGAS must establish a system of quality control designed to provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements and have an external peer review at least once every three years.

a. A strong, well-documented internal quality control system has been in place within DCAA since its inception. That system encompasses the Agency's leadership, and places emphasis on performing high quality work.

(1) Key elements of the system are described throughout this manual and summarized in 2-S10. The system is further documented in the Agency's charter, regulations, instructions, personnel management manual, etc. Agency managers and supervisors serve as focal points for assuring that policies and procedures are adequate (including an appropriate reflection of auditing standards) and are properly applied. The functioning strength of the Agency's system is apparent in the attention given to improving it over the years. In particular, the Agency's implementation of the Federal Managers' Financial Integrity Act and related DCAA internal management control system requirements (DCAA Regulation No. 5010.7) was achieved by consolidating the various existing quality controls. Procedures are in place for periodic vulnerability assessments and internal reviews.

(2) The Agency also documents its system of quality control for the DoDIG through completion of the form entitled (DCAA's) Audit Quality Control Policies and Procedures. The form is part of the Council of Inspectors General on Integrity & Efficiency (CIGIE) External Quality Control Review Guide.

b. Audit organizations performing audits in accordance with GAGAS must have an external peer review at least once every three years by reviewers independent of the organization being reviewed. The external peer review should be sufficient in scope to provide a reasonable basis for determining whether, for the period under review, the reviewed audit organization's system of quality control was suitably designed and whether the audit organization is complying with its quality control system to provide the audit organization with reasonable assurance of conforming with applicable professional standards. For DCAA, this function is performed primarily by the DoDIG.

2-206 Suitable Criteria (GAGAS 6.03)

a. In addition to the general standards summarized above, for attestations, GAGAS incorporates the AICPA attestation general standard on criteria. The general standard related to criteria states that the auditor must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users. Criteria are suitable when they have each of the following attributes:

(1) Objectivity – Criteria are free from bias. To be free from bias, the criteria should be constructed so they do not color the subject matter in a way that leads to a predetermined result.

(2) Measurability – Criteria should permit reasonable, consistent measurements, qualitative or quantitative, of the subject matter. That is, measurable criteria provide results that would be substantially duplicated by different people using the same measurement methods.

(3) Completeness – Criteria should be sufficiently complete so that relevant factors that would alter a conclusion about subject matter are not omitted.

(4) Relevance –Criteria should be relevant to the subject matter.

b. The attestation standards require all four attributes to be present for the criteria to be considered suitable. Examples of suitable criteria routinely used by DCAA are FAR, DFARS and CAS.

2-300 Section 3 --- Field Work Standards

2-301 Introduction

The Generally Accepted Government Auditing Standards (GAGAS) for attestation engagements incorporate the AICPA field work standards and related Statements on Standards for Attestation Engagements (SSAE), unless specifically excluded or modified by GAGAS, and prescribe additional standards. This section explains how the GAGAS attestation field work standards are integrated with contract audit field work guidance.

2-302 AICPA Field Work Standards

2-302.1 Adequate Planning (GAGAS 6.04a)

The first AICPA field work standard states that the work must be adequately planned and properly supervised. Proper supervision is addressed in 2-302.2. Some of the additional GAGAS field work standards include specific requirements related to planning. Those specific requirements are covered in 2-303 and the following. This section addresses adequate planning in general.

a. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application. Planning an audit involves developing an overall strategy for the expected conduct and scope of the audit. To do this, the audit team needs sufficient knowledge to enable them to understand adequately events, transactions, and practices that, in their judgment, have a significant effect on the subject matter or assertion.

b. Factors to be considered in planning an audit include:

(1) The criteria to be used;

(2) Preliminary judgments about attestation risk and materiality,

(3) The nature of the subject matter or the items within the assertion that are likely to require revision or adjustment,

(4) Conditions that may require extension or modification of the audit procedures,

(5) The nature of the report expected to be issued (e.g., examination report or agreed-upon procedures report).

c. Based on AT 601.32 (of the AICPA's Statements on Standards for Attestation Engagement (SSAEs)), Attestation risk is the risk that the auditor may unknowingly fail to modify appropriately his or her opinion when there is a material misstatement or noncompliance. It is composed of inherent risk, control risk, and detection risk.

(1) Inherent risk is the risk that a material misstatement or noncompliance could occur, assuming there are no related internal controls.

(2) Control risk is the risk that a material misstatement or noncompliance that could occur will not be prevented or detected on a timely basis by the contractor's internal controls.

(3) Detection risk is the risk that the auditor's procedures will lead him or her to conclude that a material misstatement or noncompliance does not exist when, in fact, such a misstatement or noncompliance does exist.

d. Before beginning an audit assignment, it is essential to coordinate with contracting officials requesting the audit or responsible for disposition of the findings and recommendations to understand the contracting officer/requestor's needs and/or specific concerns; contractual, regulatory, or other factors pertinent to the evaluation; and to establish the type of report to be prepared upon completing the assignment.

e. The initial planning phase includes an evaluation of pertinent files, such as the working papers from previous audits, copies of contracts, and correspondence related to the current audit. It also includes discussion and coordination with contractor personnel, so that the work may proceed smoothly and efficiently. When appropriate, arrangements should be made for audits of costs of subcontractors or other divisions of the contractor and for technical assistance.

f. The audit team should consider the methods the contractor used to process accounting information in planning the audit because such methods influence the design of the accounting system and related internal controls (see 2-306). The nature and extent of audit procedures may be influenced by the extent to which information technology (IT) is used in significant applications, as well as the complexity of that technology.

g. GAGAS 3.42 requires that those assigned to the audit collectively have the technical knowledge, skills, and experience necessary to be competent for the type of work being performed. In some cases, this requires the use of specialists. Therefore, when planning the audit, the audit team should consider whether specialized skills are needed to achieve the objectives of the audit and make arrangements accordingly.

h. Before preparing audit programs, a risk assessment should be performed. A properly performed risk assessment should provide and consider information about risk factors relevant to the subject matter of audit; e.g., the size and scope of the contractor's activities or any areas in which there may be weaknesses in internal controls, uneconomical or inefficient operations, ineffectiveness in achieving prescribed goals, or lack of compliance with applicable laws and regulations that could have a material effect on the subject matter. Tests to determine the significance of such matters are to be performed in the detailed audit work and should be carefully set out in the audit program. The risk assessment discussed here is primarily a review of prior audit work (e.g., permanent files, previous audit assignments, etc.). Understanding the contractor’s internal controls and assessing control risk is an essential part of the risk assessment (see 2-306).

i. A written program should be prepared for each audit assignment to effectively communicate objectives to all staff members, to facilitate control of the audit work, and to provide a permanent record of the work to be accomplished. The Agency's electronic workpackages (audit planning and performance system; APPS) or standard audit programs can be used to meet these objectives; or, if necessary, an existing set of audit steps can be used as a starting point for developing an audit program tailored to the specific evaluation being planned (see 3-103.3).

j. When multi-location programs are to be performed, the audit organization that is centrally planning the work should assure that assist auditors receive appropriate background information, including purpose, scope, level of evaluation (audit or agreed-upon procedures), and relevant documentation to assure that the resultant fieldwork can be assembled into a single report. However, this should be done in a manner that does not restrict the auditor's professional judgment. Audit programs should never be used as a blind checklist or in a way that stifles initiative, imagination, and thoroughness in performing an audit.

2-302.2 Proper Supervision (GAGAS 6.04a)

Auditors must be properly supervised. Supervision is generally the responsibility of the supervisory auditor and FAO Manager and involves directing the efforts of subordinate staff members who participate in accomplishing the objectives of the audit and determining whether the objectives were accomplished.

a. Elements of supervision include instructing auditors, staying informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among personnel. The extent of supervision appropriate on a given assignment depends on many factors, including the nature and complexity of the audit and the qualifications of the individual audit team members performing the work (i.e., the auditors’ experience and competence). The supervisory auditor should inform the audit

team of their responsibilities, including the objectives of the procedures for the particular segments of work assigned and matters that may affect the nature, extent, and timing of such procedures. The FAO manager should direct the audit team to bring to his or her attention significant questions raised during the audit so that their significance can be assessed.

b. The work performed should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusion to be included in the report. The supervisory review must be completed and documented in the working papers prior to report issuance, and should include verification that:

(1) the auditors conformed to the auditing standards,

(2) the audit programs are followed, unless deviation is justified and authorized,

(3) the working papers adequately support findings and conclusions (see 2-307 for the GAGAS on documentation),

(4) the working papers provide adequate evidence to prepare a meaningful report, and

(5) the audit team accomplished the audit objectives.

c. Supervision of individual audit assignments applies before, during, and after completion of the field work. Oral and written instructions, approval of the risk assessment and detailed audit programs, on-site guidance, and review of working papers and report drafts are all critical aspects of supervision. The depth and extent of supervision in individual cases will vary in relation to the materiality and complexity of the audit assignment and the competence and experience of the auditors assigned. The geographic location of the audit site should not limit or influence the amount of supervisory guidance and involvement. For example, supervision of a complex audit assignment which must be conducted on a TDY travel basis is usually not adequate if it first begins with the review of working papers in the branch office after the field work is completed.

d. The various levels of supervisory responsibility discussed in the preceding and following paragraphs do not relieve each individual auditor of the responsibility for the professional adequacy of his/her own work. Similarly, the necessity for a detailed audit program prepared or approved at a higher supervisory level should not preclude any auditor from applying ingenuity during the course of the assignment to achieve the audit objectives and to recommend improvements of the program.

e. The auditor is primarily responsible for preparing and executing the audit program and for drafting the audit report. Thus, experience and grade level may differ depending on the complexity or sensitivity of the particular assignment, but must be adequate for satisfactory performance. He or she may act alone, or may be assisted by one or more auditors of the same or lower grade levels for part, or all, of the duration of the assignment. When the audit is conducted by a team, a lead auditor may, in addition to participating in the audit, monitor the day-to-day activities of all auditors assigned to assist and may review their working papers for both format and content.

f. The supervisory auditor plays a large role in the success of branch office operations. He or she has the fundamental responsibility of assuring that each team assignment is conducted in accordance with GAGAS, as well as the responsibility of participating in the overall planning and management of branch activities. The effectiveness of audit guidance and supervision depends in large part on his or her personal familiarity with the contractors assigned to the team. To carry out the responsibilities properly, the supervisory auditor must spend a considerable share of his or her time interacting and communicating with the field audit sites.

g. Many factors must be weighed in planning and scheduling supervisory visits. The supervisory auditor should visit each contractor having a continuing work-load at least once a year, but the timing and frequency of visits depend upon the materiality of the various audits in progress, the experience and proficiency of the auditors performing the assignment, and the type and significance of any audit problems encountered.

h. Before each field audit assignment is started, the supervisory auditor must ensure that the audit team understands clearly the purpose and scope of the audit, and any special

matters which may be involved. He or she should ascertain that the auditors assigned have familiarized themselves with all relevant information available in the FAO permanent files (4-405). On recurring type audit assignments at active contractors, he or she should ascertain that an adequate audit program has been developed, with the purpose and scope of the audit, references, audit planning considerations, and preliminary, detailed and concluding steps tailored specifically for the assignment (3-103). In cases where the FAO does not have enough information about either the contractor or the assignment to develop an audit program in advance, the supervisory auditor should be sure that a general agenda has been prepared, sufficient to indicate the broad scope and approach planned, and that it will be supplemented with an audit program as soon as adequate background information has been obtained during the risk assessment. On all assignments, the supervisory auditor should also ensure that adequate arrangements have been made for any necessary external support, such as assist audits or technical assistance. This should preferably be done shortly after the request for audit was received.

i. While the audit is in process, the supervisory auditor should keep in contact with the auditor at the site, either through visits or by telephone or e-mail, frequently enough to:

(1) give timely technical guidance on audit or accounting problems,

(2) coordinate on any major changes the auditor proposes to make to the audit program or time budget,

(3) perform interim reviews as warranted based on the complexity of the assignment (with any written review comments documented on APPS working paper A-2, Interim Guidance – Corrective Actions) and

(4) maintain familiarity with the status of the audit.

These supervisory activities can generally be conducted more effectively by site visits than by telephone or e-mail.

j. After the conclusion of an assignment, the supervisory auditor will review the working papers and the report draft for compliance with GAGAS, professional quality, accuracy, and responsiveness to the audit request. The review should be in sufficient depth to evaluate the adequacy of significant technical judgments, findings, and recommendations made by the auditor. As well as making or suggesting any necessary changes to the report draft, the supervisory auditor should also prepare written review comments and include them in the working paper file (typically APPS working paper A-3, Final Review Comments). For contractors at which there is a recurring workload, the supervisory auditor may also include written observations or any recommended modifications to the audit program for subsequent audits.

k. Reviews of complex or sensitive audits should be conducted onsite if at all possible. In this way, any additional audit work or necessary discussions with contractor personnel can be readily accomplished. The supervisory auditor should particularly try to complete the review onsite in those instances where monitoring of audit progress or past experience indicates the existence of complex problems which require resolution.

l. On the more significant or sensitive assignments, the supervisory auditor and, in some cases, the FAO manager, should participate in entrance, exit, and other significant conferences held with the contractor.

m. The FAO manager is responsible for all aspects of the FAO operations. He or she establishes office procedures and management controls over the programming, scheduling, and timely completion of audits and reports. In some cases, as discussed in p. below, he or she may participate directly in audit assignments that are in process. In addition to day-to-day supervision of overall audit activities, he or she should review on a continual basis the status and progress of each team's performance.

n. The FAO manager should review all significant audit reports. The reviews should be in sufficient depth to provide continuing visibility into the technical proficiency of the audit efforts and the compliance with applicable Agency policies. He or she should also make selective examinations of working paper files with sufficient frequency to ensure that GAGAS field work and reporting standards are being observed. He or she should assure that technical problems which are expected to require referral to higher levels are

brought to his or her attention as soon as practicable rather than at the time of final report review.

o. The FAO manager or acting FAO manager shall not redelegate signature authority on certain significant audit reports. DCAA Regulation No. 5600.1, Delegation of Signature Authority for Audit Reports and Other Audit Related Documents, establishes procedures for delegation and redelegation of authority to sign audit reports and identifies those audit reports for which signature authority cannot be redelegated.

p. The FAO manager may be more directly involved in audits of unusual materiality or sensitivity. He or she will also participate in supervising individual audit assignments which involve significant administrative problems, such as denial of access to records or timeliness of reporting. He or she should attend any especially significant conferences with contractors.

2-302.3 Evidence (GAGAS 6.04b)

The auditor must obtain sufficient evidence to provide a reasonable basis for the conclusion expressed in the report. This requires that sufficient procedures be performed to test the contractor's assertion to provide reasonable assurance that unallowable costs and other noncompliances with applicable Government laws and regulations are identified. The first step in obtaining sufficient evidence is to perform an adequate risk assessment to identify risk areas for the performance of substantive procedures. Substantive procedures include analytical procedures and detailed testing. The nature and extent of substantive procedures is a matter of auditor judgment based on the risk assessment. However, audit risk would never be low enough to eliminate the need for substantive procedures. Furthermore, inquiry and/or analytical procedures alone are not sufficient to support the high level of assurance provided in examination engagements. Detailed testing must be performed in all examination engagements. (Detailed guidance on audit evidence is in 3-104.14.)

2-303 Auditor Communication During Planning (GAGAS 6.06 – 6.08)

When planning the audit, auditors should communicate certain information in writing to entity management, those charged with governance, and to the individuals requesting the engagement. In the Government contract audit environment, those charged with governance may be the same individuals within entity management that are responsible for overseeing the financial reporting process, subject matter, or program under audit and related internal controls.

a. Auditors should communicate in writing the following information related to the conduct and reporting of the audit to the individuals who requested the audit, i.e., normally the contracting officer (generally in the acknowledgement letter):

- The nature, timing, and extent of planned testing and reporting.
- The level of assurance the report will provide. This will generally be the type of engagement/audit service provided; e.g., examination or agreed-upon procedures.
- Any potential restriction on the auditor's report to reduce the risk that the needs or expectations of the parties involved may be misinterpreted. For example, DCAA audit reports generally include restriction on the release due to proprietary information and also state that the report should not be used for purposes other than action on the subject of the audit.

b. Auditors should also communicate the above information to the appropriate representatives of the organization audited (generally at the entrance conference). This will generally be the corporate controller, chief financial officer, or their designated representative; e.g., audit liaison).

c. If an audit is terminated and the assignment is cancelled before it is completed, auditors should write a memorandum for the record to fully document the work performed and why the audit was terminated/cancelled (see 4.403f).

2-304 Audit Follow-up (GAGAS 6.09)

Auditors should evaluate whether the contractor has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the subject matter. Auditors should use this information in assessing risk and determining the nature, timing, and extent of current work, including determining the extent to which testing the implementation of the corrective actions is applicable to the current engagement.

a. Much of the benefit of audit work is not in the findings reported or the recommendations made, but in their effective resolution. Contractor management is responsible for resolving audit findings and recommendations. Continued attention to significant deficiencies and recommendations can help auditors assure that the benefits of their work are realized.

b. Known system deficiencies and recommendations from prior audits are summarized in the Contractor's Organization and Systems section of the audit report (see 10-210.7). The auditor should follow-up on those deficiencies that affect the scope of audit, determine whether the contractor has taken timely and appropriate corrective action, and report the status of uncorrected deficiencies.

2-305 Fraud, Illegal Acts, Violations of Provisions of Contracts (GAGAS 6.13 – 6.14)

a. In planning examination-level contract audits, auditors are required to design the audit to provide reasonable assurance of detecting fraud, illegal acts, or violations of provisions of contracts or grant agreements (including applicable laws and regulations, e.g., FAR, CAS, TINA) that could have a material effect on the subject matter of the audit. Auditors should assess the risk of possible effects of material fraud, illegal acts, or violations of provisions of contracts or grant agreements on the subject matter of the audit. When risk factors are identified, auditors should document those factors, the auditors' response to those factors individually or in combination, and the auditors' conclusions.

b. Auditors are not expected to provide assurance of detecting potential fraud, illegal acts, or violations of provisions of contracts or grant agreements for review-level or agreed-upon procedure level engagements. Instead, if during the engagement, information comes to the auditors' attention indicating that such acts or violations that could have a material effect on the subject matter may have occurred, auditors should perform procedures as necessary to determine if such acts or violations are likely to have occurred and, if so, determine their effect on the results of the engagement.

c. To comply with this standard, the auditor is responsible for determining whether contractors have complied with contractual costing and pricing requirements (e.g., FAR, CAS, TINA). As a general rule, audit files should contain details concerning the laws and regulations pertinent to the Government contracts under audit. Additionally, liaison between the auditor and the administrative contracting officer should provide the information necessary to keep the files current.

d. In determining the nature, timing, and extent of the audit steps and procedures to test for compliance, the auditor should assess and document the risk of noncompliance with laws and regulations occurring and having a direct and material effect on the results of contract audits. The auditor should assess the risk that the entity did not comply with those laws and regulations and the risk that the entity's control structure to ensure compliance with laws and regulations might not prevent or detect that noncompliance.

e. Cost Accounting Standards (48 CFR Chapter 99) are issued to achieve:

(1) an increased degree of uniformity in cost accounting practices among Government contractors in like circumstances, and

(2) consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time.

Increased uniformity and consistency in accounting improve understanding and communication, reduce the incidence of disputes and disagreements, and facilitate equitable contract settlements. FAR 30.202-6c and 30.202-7b outline the basic functions of the contract auditor in the implementation of the Cost Accounting Standards. The broad base of CAS coverage on DoD contracts, coupled with the number and scope of the standards promulgated, have had a substantive effect on DCAA audit procedures and responsibilities.

2-306 Internal Control (GAGAS 6.10 – 6.12)

For examinations, GAGAS requires the auditor to obtain a sufficient understanding of the internal controls material to the subject matter to plan the audit and design procedures to achieve the objectives of the audit. This understanding should include knowledge of the contractor's control environment, information and communication methods, risk assessment processes, monitoring processes, and relevant control activities (see 5-102).

a. The control environment represents the collective effect of management's philosophy and operating style, the entity's organizational structure, the functioning of the board of directors and its committees, the methods of assigning authority and responsibility, management's control methods for monitoring and following up on performance, management's attitude toward internal and external audit, the entity's personnel policies and practices, and various other external influences that affect an entity's operations and practices. Judgments about the control environment may positively or negatively influence audit judgments about specific control activities.

b. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report accounting transactions, and to maintain accountability for the related assets and liabilities. An effective accounting system identifies and records all valid transactions, describes transactions in sufficient detail to permit proper classification for financial reporting, measures the value of transactions in a manner that permits proper monetary recording, records transactions in the proper accounting period, and presents transactions properly in the financial statements or other financial representations.

c. At major and larger nonmajor contractors, the control environment and accounting system is a combination of interrelated accounting and management systems (see 5-102d).

d. Control activities are the policies and procedures that management has established to provide reasonable assurance that specific objectives will be achieved. Such control activities are classified as safeguarding controls and controls over compliance with laws and regulations, and are integrated into specific components of the accounting and management systems.

(1) Safeguarding controls relate to the prevention or timely detection of unauthorized transactions and unauthorized access to assets. Such safeguarding controls might include:

- Proper authorization of transactions and activities.
- Segregation of duties that reduces the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and files.

(2) Controls over compliance with laws and regulations provide for:

- Design and use of adequate documents and records to help ensure the proper recording of transactions and events.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, comparison of assets with recorded accountability, computer-programmed controls, and user review of computer-generated reports.

(3) The Agency's standard audit programs for Internal Control Audits and the related Internal Control Matrices (available on the DCAA Intranet and the APPS) identify specific control objectives, likely control activities for accomplishing those objectives, and audit procedures for evaluating the contractor's control activities.

2-306.1 Procedures to Obtain Understanding

The audit team should perform procedures to obtain sufficient understanding of the contractor's internal controls (i.e., control environment, information and communication methods, risk assessment processes, monitoring processes, and relevant control activities) that are material to the subject matter of audit to plan the audit and design procedures to achieve the objectives of the audit. At major contractors, the procedures to gain this understanding are normally performed and documented in separate audits of the contractor's systems, and summarized on the internal control audit planning summary (ICAPS) forms in permanent files or the Internal Control Review System (ICRS) database (see 3-300 and 5-100). To the extent that this prior audit work does not provide the audit team with an understanding of internal controls material to the subject matter sufficient to plan the audit and design procedure to achieve the objectives of the audit, the scope of the current audit must be expanded to gain and document that understanding.

2-306.2 Assessing Control Risk and Designing Substantive Audit Tests

a. Control risk is the likelihood that a material misstatement or noncompliance in an account or area subject to audit will not be prevented or detected on a timely basis by the contractor's internal controls. Assess this risk by gaining an understanding and evaluating the effectiveness of the control environment, information and communication methods, risk assessment processes, monitoring processes, and relevant control activities. The lower the assessed risk and materiality, the less evidence needed from substantive tests (i.e., detailed testing and analytical procedures) to form an opinion.

b. Control risk may not be assessed below maximum unless the effectiveness of the internal controls have been tested and found effective. The auditor may choose not to perform the tests of controls needed to assess control risk below maximum when planning substantive audit tests because the contractor's internal controls are unlikely to be effective, or because it would be inefficient to evaluate their effectiveness.

c. Use the understanding of the internal control structure, the assessed level of control risk and consideration of inherent risk (see 2-302.1c) and materiality (see 2-309) to design substantive tests for auditing the contractor's cost estimates or representations. When the internal controls have been tested and determined to be effective, the auditor should rely on them and reduce the amount of substantive testing in the applicable audit area.

2-307 Working Papers/Documentation (GAGAS 6.20 – 6.26)

a. Auditors must prepare attest documentation in connection with each engagement in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand from the documentation the nature, timing, extent, and results of procedures performed; and the evidence obtained and its source; and the conclusions reached. Working papers should also include evidence that supports the auditor's significant judgments and conclusions.

b. The auditor should prepare documentation that contains support for findings, conclusions, and recommendations before they issue the report. Documentation provides the principal support for:

- The statement in the report that the auditors performed the attestation engagement in accordance with GAGAS, and
- The auditors' conclusion.

c. GAGAS requires auditors to also document the following:

- The objectives, scope and methodology.
- The work performed to support significant judgments and conclusions, including descriptions (identification) of transactions and records examined. The information pro-

vided should be sufficient for an experienced auditor to examine the same transactions and records.

- Evidence of supervisory reviews of the work performed before the report is issued.
- The auditor's consideration that the planned procedures be designed to achieve the objectives of the engagement when evidence obtained is dependent on computerized information systems, that evidence is material to the objectives, and the auditor is not relying on the effectiveness of the internal controls over those computer systems that produced the evidence (see 5-111.1d).
- The auditor's departure from any applicable GAGAS requirements (due to law, regulation, scope limitations, restriction on access to records, etc); the impact on the engagement and on the auditors' conclusions. These circumstances would generally require a modified GAGAS statement (see 2-403).

d. When the timeliness of an audit report is critically important to a customer, it may be appropriate for an FAO to issue its report before completing its non-critical working papers; i.e., those working papers that do not impact the sufficiency of the documented audit evidence supporting the auditor's findings, conclusions, and recommendations. This would generally be administrative working papers. In these situations, the audit team should:

(1) issue its audit report,

(2) ensure the customer's immediate need for the audit report is documented in the working papers, and

(3) complete any remaining non-critical working paper documentation as soon as possible.

In no case will the auditor issue an audit report when working papers supporting the audit findings, conclusions or recommendations are incomplete. Significant revisions to the audit working papers after the audit report is issued are allowed only under specific circumstances and conditions described in 4-409.

e. Additional guidance concerning the sufficiency of audit evidence and working papers is presented in 3-104.14 and 4-400.

2-308 Developing Elements of Findings (GAGAS 6.15 – 6-19)

Audit findings may involve deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. The elements needed for a finding depend entirely on the engagement objectives. Thus a finding or set of findings is complete to the extent that the engagement objectives are satisfied. When auditors identify deficiencies, auditors should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the engagement objectives. The elements of a finding are criteria, condition, cause, and effect or potential effect.

2-309 Materiality (GAGAS 6.28)

a. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of a subject matter or an assertion, while other matters are not important. In performing the engagement, matters that, either individually or in the aggregate, could be material to the subject matter are a primary consideration.

b. In engagements performed in accordance with GAGAS, it may be appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS engagements because of the public accountability of Government entities and entities receiving Government funding, various legal and regulatory requirements, and the visibility and sensitivity of Government programs.

2-400 Section 4 --- Reporting Standards

2-401 Introduction

The Generally Accepted Government Auditing Standards (GAGAS) for attestation engagements incorporate the AICPA attestation engagement reporting standards, unless specifically excluded or modified by GAGAS, and prescribe additional standards. This section explains how GAGAS reporting standards are integrated with contract audit field work guidance.

2-402 AIPCA Reporting Standards for Attestation Engagements (GAGAS 6.30)

The four AICPA reporting standards that apply to all levels of attestation engagements are discussed below.

2-402.1 Subject and Character of Engagement

The auditor must identify the subject matter or the assertion being reported on and state the character of the engagement in the report. The statement of the character of the engagement includes a description of the nature and scope of the work performed and a reference to the governing professional standards (GAGAS). Guidance on implementing this standard in general is in 10-210.1. Other sections of Chapter 10 provide additional guidance applicable to particular types of reports.

2-402.2 Conclusion

The auditor must state the conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was evaluated in the report. Guidance on implementing this standard in general is in 10-210.5. Other sections of Chapter 10 provide additional guidance applicable to particular types of reports.

2-402.3 Significant Reservations

The auditor must state all of the significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report.

a. Reservations about the engagement refer to any unresolved problem the auditor had in complying with applicable GAGAS requirements (e.g., the auditor was not able to perform all the procedures that he or she considers necessary in the circumstances) or, in an agreed-upon procedures engagement (AUP), the specific procedures agreed to. This type of reservation results in either a qualified or disclaimer of opinion (see 2-102.2) and requires a modified GAGAS statement (see 2-403). In addition, the reservations are discussed in the scope section of the report. The presentation of this discussion in the report will vary slightly depending on the type of engagement and the type of opinion expressed. For examinations where the reservations about the engagement result in a qualified opinion, the circumstances are discussed under the subheading “Qualification” (see 10-210.4). However, if an adverse opinion is being expressed (because there is also a reservation about the subject matter – see paragraph b below), the subheading “Scope Restriction” rather than “Qualification” should be used (see 10-210.4i). If the omitted procedures are so significant that a disclaimer of opinion is expressed the section title “Scope of Audit” should be changed to “Scope Restriction” (see 10-210.3b). For AUPs see 10-1008.

b. Reservations about the subject matter or the assertion refer to any unresolved reservation about the conformity of the subject matter with the criteria, including the adequacy of the disclosure of material matters (e.g., the assertion is incomplete or inaccurate or there are noncompliances with FAR or CAS). In DCAA audits, this type of reservation generally results in reported findings such as questioned costs, deficiencies, noncompliances, etc. These reservations are generally discussed in the audit report exhibits and explanatory notes or statement of conditions and recommendations, etc. Under the attestation standards, reservations about the subject matter or assertion result in either a qualified or adverse opinion depending on the materiality of the departure from the criteria (see 2-102.2). This type of reservation does not require a modified GAGAS statement unless the circumstances also result in a reservation about the engagement. For example, a contractor's denial of access to records may result in both reservations about the engagement and reservations about the subject matter.

2-402.4 Restrictions on Use of Report

a. The auditor must state in the report that the report is intended for use by specified parties under certain circumstances; e.g., when the criteria used to evaluate the subject matter are appropriate for or available to only limited or specified parties.

b. Restrictions on the use of a report may result from a number of circumstances, including; the purpose of the report, the criteria used in preparation of the subject matter, the extent to which the procedures performed are known or understood, and the potential for the report to be misunderstood when taken out of context in which it was intended to be used. For example, the purpose of the restriction on the use of the agreed-upon procedures report is to restrict its use to only those parties that have agreed upon the procedures performed and taken responsibility for the sufficiency of the procedures. See 10-212.1 for guidance on restrictions included in DCAA reports.

2-403 Reporting Compliance with Generally Accepted Government Auditing Standards (GAGAS 6.32 and 1.12)

a. When auditors comply with all applicable GAGAS requirements, they should include a statement in the report that they performed the engagement in accordance with GAGAS.

b. If the auditor did not follow all the applicable standards during the audit the GAGAS compliance statement should be modified as follows depending on the significance of the departure from GAGAS (see 2-402.3a).

(1) To state that the auditor performed the engagement in accordance with GAGAS, except for specific applicable requirements that were not followed, or

(2) To state that because of the significance of the departure(s) from the requirements, the auditor was unable to and did not perform the engagement in accordance with GAGAS.

(c) When auditors use a modified GAGAS statement, they should disclose in the report the applicable requirement(s) not followed, the reason for not following it, and how not following the requirements affected, or could have affected the audit and the assurance provided. In DCAA audit reports, this information is generally included in the "Scope of Audit" section under the subheading "Qualifications" for cases covered in (1) above (see 10-210.4) or under the "Scope Restrictions" section for cases covered by (2) above (see 10-210.3b).

2-404 Reporting Deficiencies in Internal Controls, Fraud, Illegal Acts, Violations of Provisions of Contracts (GAGAS 6.33 – 6.38)

a. For attestation engagements performed under GAGAS auditors should report, as applicable to the objectives of the engagement and based on the work performed:

(1) significant deficiencies in internal control, identifying those considered to be material weaknesses (see 2-404g and h);

(2) all instances of fraud and illegal acts unless inconsequential (however, see paragraph c below); and

(3) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the subject matter of the engagement.

b. To comply with these requirements, audit reports should either:

(1) describe the scope of the auditor's testing of compliance with applicable laws and regulations and testing of internal control (if performed) and present the results of those tests; or

(2) refer to separate reports containing that information (see 5-100 and 10-400).

In presenting the results of those tests, the auditor should report all violations of provisions of contracts that are material, other material noncompliances, and significant deficiencies/material weaknesses in internal control applicable to the subject matter, or assertion of the engagement.

c. When fraud or suspected irregularities are discovered, DCAA policy is for the auditor to prepare a Form 2000 (see 4-700) instead of including the issue in the audit report. There is no requirement for the auditor to prove the existence of fraud or other contractor irregularities to submit a DCAA Form 2000. The auditor is merely reporting the suspicion of irregularities to the appropriate investigative agencies.

d. GAGAS also requires the reporting of abuse that is material to the subject matter. Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of contracts. CAM Sections 4-803 and 4-804 address audit responsibilities relating to suspected abuse or unsatisfactory conditions.

e. When auditors report separately on compliance and internal control, audit reports of other related audits should reference those additional reports and state that the separate report is an integral part of the audit and should be considered in assessing the results of audit (see 10-210.3f and 10-210.7).

f. Auditors should report deficiencies in internal controls and noncompliances that are material to the subject matter or assertion on a "real time basis" using a flash report (see 10-413 and 10-808). For internal control deficiencies, the auditor should also establish a separate limited scope audit assignment to review the control activities related to the applicable control objective. The limited scope audit assignment should be completed as soon as possible after the condition is identified.

g. With respect to Government contracting, a significant deficiency is an internal control deficiency, or combination of deficiencies that

(1) adversely affects the contractor's ability to initiate, authorize, record, process, or report Government contract costs in accordance with applicable Government contract laws and regulations,

(2) results in at least a reasonable possibility that unallowable costs will be charged to the Government, and

(3) the potential unallowable cost is not clearly immaterial.

h. A material weakness is a significant deficiency (or combination of significant deficiencies) that results in or could result in <u>material</u> unallowable costs being charged to the Government.

i. Since DCAA only performs internal control audits on systems that are material to Government contract costs, significant deficiencies identified in DCAA audits will gener-

ally be those considered to be material weaknesses (i.e., the impact or potential impact to Government contract costs is material). Therefore, all internal control deficiencies that result in or could result in unallowable costs being charged to the Government should be reported as significant deficiencies and be considered material weaknesses, unless the potential unallowable cost is clearly immaterial.

2-405 Reporting Views of Responsible Officials (GAGAS 6.44 – 6.50)

If the auditors' report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts, or abuse, auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions. In instances of suspected irregularities DCAA guidance is to issue a Form 2000 and auditors should follow guidance in 4-700 regarding discussions with the contractor.

2-406 Reporting Confidential or Sensitive Information (GAGAS 6.51 – 6.55)

If certain pertinent information is prohibited from public disclosure or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary. DCAA audit reports generally include sensitive and confidential information that is subject to regulatory or statutory restrictions. As a result, DCAA reports are restricted from the release (see 2-402.4).

2-407 Distributing Reports (GAGAS 6.56)

Audit organizations in government entities should distribute reports to those charged with governance, to the appropriate entity officials, and to the appropriate oversight bodies or organizations requiring or arranging for the engagement. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations, and to others authorized to receive such reports. Auditors should document any limitations on report distribution. DCAA normally submits the audit report to the contracting officer responsible for acting on the audit recommendations. The contracting officer provides the report to the contractor at their discretion.

2-408 Application of the Reporting Standards

DCAA has developed reporting guidance (see Chapter 10) which complies with all aspects of the GAGAS, including the AICPA standards and requirements for attestations.

2-500 Section 5 --- Field Work Standards for Operations Audits (Performance Audits)

2-501 Introduction (GAGAS 7.01 – 7.02)

In the contract audit environment, performance audits are more commonly described as operations audits. Those audits seek to determine if the contractor is operating in an economical and efficient manner. Economy and efficiency relate to the reasonableness of costs charged to Government contracts, but also impacts areas such as program schedules. Inefficient operations can result in schedule slippages and contract overruns. Examples of operations audits performed by DCAA include; labor and facilities utilization, and materials inventory management. Chapter 7 of the Yellow Book establishes the field work standards and guidance for performance audits and apply to operations audits performed by DCAA. The fieldwork standards for performance audits relate to planning the audit; supervising the staff; obtaining sufficient, appropriate evidence, and preparing audit documentation. The concepts of reasonable assurance, significance, and audit risk form a framework for applying these standards.

2-501.1 Reasonable Assurance (GAGAS 7.03)

Operations audits that comply with GAGAS provide reasonable assurance that evidence is sufficient and appropriate to support findings and conclusions. The sufficiency and appropriateness of evidence needed and tests of evidence will vary based on the audit objectives, findings, and conclusions. Audit objectives for operations audits range from narrow to broad and involve varying types and quality of evidence. In some audits, sufficient, appropriate evidence is available, but in others, information may have limitations. Professional judgment assists auditors in determining the audit scope and methodology needed to address the audit objectives, while providing the appropriate level of assurance that the obtained evidence is sufficient and appropriate to address the audit objectives.

2-501.2 Significance in a Performance (Operations) Audit (GAGAS 7.04)

The concept of significance assists auditors throughout an operations audit, including when deciding the type and extent of audit work to perform, when evaluating results of audit work, and when developing the report and related findings and conclusions. Significance is defined as the relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors. Such factors include the magnitude of the matter in relation to the subject matter of the audit, the nature and effect of the matter, the relevance of the matter, the needs and interests of an objective third party with knowledge of the relevant information, and the impact of the matter to the audited program or activity. Professional judgment assists auditors when evaluating the significance of matters within the context of the audit objectives.

2-501.3 Audit Risk (GAGAS 7.05)

Audit risk is the possibility that the findings, conclusions, recommendations, or assurance may be improper or incomplete, as a result of factors such as evidence that is not sufficient and/or appropriate, an inadequate audit process, or intentional omissions or misleading information due to misrepresentation or fraud. The assessment of audit risk involves both qualitative and quantitative considerations. Factors such as the complexity or sensitivity of the work, size of the program operations in terms of dollar amounts, and adequacy of the audited entity's systems, and access to records, also impact audit risk. Audit risk includes the risk that auditors will not detect a mistake, inconsistency, significant error, or fraud in the evidence supporting the audit. Audit risk

can be reduced by taking actions such as increasing the scope of work, adding experts, additional reviewers and other resources to the audit team; changing the methodology to obtain additional evidence, higher quality evidence, or alternative forms of corroborating evidence; or aligning the findings and conclusions to reflect the evidence obtained.

2-502 Planning (GAGAS 7.06 – 7.15)

a. Auditors must adequately document the planning of the work necessary to address the audit objectives. Auditors must plan the audit to reduce audit risk to an appropriate level to provide reasonable assurance that the evidence is sufficient and appropriate to support findings and conclusions. This determination is a matter of professional judgment. In planning the audit, auditors should assess significance and audit risk and apply these assessments in defining the audit objectives and the scope and methodology to address those objectives. Planning is a continuous process throughout the audit. Therefore, auditors may need to adjust the audit objectives, scope, and methodology as work is being completed.

b. Adequate planning for operations audits should include evaluation of internal audit reports, capital budgets, consideration of the results of previous performance and attestation audits that could affect the current audit objectives, and other contractor information related to the prospective audit. The criteria for assessing performance should be established. Sufficient staff and specialists with adequate collective profession competence should be assigned and other resources needed should be identified. The auditors should gain an understanding of applicable legal and regulatory requirements and contracts provisions, potential fraud or abuse (see 2-504) that are significant within the context of the audit objectives. Auditors should also obtain an understanding of internal control as it relates to the specific objective and scope of the audit and determine whether it is necessary to evaluate information systems (see 2-505).

c. Written audit programs are essential to conducting audits efficiently and effectively and should be prepared for each audit. Audit programs provide:

(1) A description of the audit methods and suggested audit steps and procedures to be conducted to accomplish the audit objectives.

(2) A systematic basis for assigning work to supervisors and staff.

(3) The basis for a summary record of work.

d. Auditors should communicate an overview of the objective, scope, and methodology, and timing of the audit and planned reporting (including any potential restrictions on the report) to contractor management; including those with sufficient authority and responsibility to implement corrective action in the program or activity being audited and the individuals contracting for or requesting the audit services.

2-503 Supervision (GAGAS 7.52 – 7.54)

a. The audit supervisors or those designated to supervise auditors must properly supervise the audit staff. Audit supervision involves providing sufficient guidance and direction to staff assigned to the audit to address the audit objectives and follow applicable standards, while staying informed about significant problems encountered, reviewing the work performed, and providing effective on-the-job training. The nature and extent of the supervision of staff and the review of audit work may vary depending on a number of factors, such as the size of the audit organization, the significance of the work, and the experience of the staff.

b. Supervisory reviews of audit work and the report should be timely and must be performed and documented in the working papers before the report is issued. Supervisory reviews of the work conducted should include verification that:

(1) the auditors conformed to the auditing standards,

(2) the audit programs are followed, unless deviation is justified and authorized,

(3) the working papers adequately support findings and conclusions (see 2-507 for the GAGAS on documentation),

(4) the working papers provide adequate evidence to prepare a meaningful report, and

(5) the audit team accomplished the audit objectives.

2-504 Legal and Regulatory Requirements, Fraud and Abuse (GAGAS 7.28 – 7.35)

a. Auditors should determine which laws, regulations and provisions of contracts are significant within the context of the audit objectives and assess the risk that violations could occur. Based on that risk assessment, the auditor should design and perform procedures to provide reasonable assurance of detecting instances of violations of legal and regulatory requirements or contract provisions that are significant in the context of the audit objectives.

b. The assessment of audit risk may be affected by such factors as the complexity of the laws, regulations, and provisions of contracts. The assessment of audit risk also may be affected by whether the entity has controls that are effective in preventing or detecting violations of laws, regulations, and provisions of contracts. If auditors obtain sufficient, appropriate evidence of the effectiveness of these controls, they can reduce the extent of their tests of compliance.

c. In planning the audit, auditors should assess risks of fraud occurring that is significant within the context of the audit objectives. Team members should discuss fraud risks, including factors such as incentives or pressures to commit fraud, the opportunity for fraud to occur, and rationalizations or attitudes that could allow individuals to commit fraud. Auditors should gather and assess information to identify risks of fraud that are significant within the scope of the audit objectives or that could affect the findings and conclusions. For example, auditors may obtain information through discussion with officials of the audited entity or through other means to determine the susceptibility of the program to fraud, the status of internal controls the entity has established to detect and prevent fraud, or the risk that officials of the audited entity could override internal control. An attitude of professional skepticism in assessing these risks assists auditors in assessing which factors or risks could significantly affect the audit objectives.

d. When auditors identify factors or risks related to fraud that has occurred or is likely to have occurred that they believe are significant within the context of the audit objectives, they should design procedures to provide reasonable assurance of detecting such fraud. Assessing the risk of fraud is an ongoing process throughout the audit and relates not only to planning the audit, but also to evaluating evidence obtained during the audit.

e. When information comes to the auditor's attention indicating fraud that is significant within the context of the audit objectives may have occurred, auditors should extend the audit steps and procedures, as necessary, to (1) determine whether fraud has likely occurred and (2) if so, determine its effect on the audit findings. If the fraud that may have occurred is not significant within the context of the audit objectives, the auditors may conduct additional audit work as a separate engagement, or refer the matter to other parties with oversight responsibility or jurisdiction (see 4-700).

f. Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider a reasonable and necessary business practice given the facts and circumstances. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of contracts. If during the course of the audit, auditors become aware of abuse that could be significant to the program under audit, auditors should apply audit procedures specifically directed to ascertain the potential effect on the area under audit. After performing additional work, auditors may discover that the abuse represents potential fraud or illegal acts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse (see 4-800).

g. When investigations or legal proceedings are initiated or in process, auditors should evaluate the impact on the current audit. In some cases, it may be appropriate for the auditors to work with investigators and/or legal authorities, or withdraw from or defer further work on the audit or a portion of the audit to avoid interfering with an investigation (see 4-702.5).

2-505 Considering Internal Controls (GAGAS 7.16 - 7.22)

a. Auditors should obtain an understanding of internal controls that are significant within the context of the audit objectives. For internal controls that are significant within the context of audit objectives, auditors should assess whether the internal controls have been properly designed and implemented. For those internal controls that are deemed significant within the context of the audit objectives, auditors should plan to obtain sufficient, appropriate evidence to support their assessment about the effectiveness of those controls. Information systems controls are often an integral part of an entity's internal control. Thus, when obtaining an understanding of internal control significant to the audit objectives, auditors should also determine whether it is necessary to evaluate information systems controls.

b. An assessment should be made of applicable internal controls when necessary to satisfy the audit objectives. The assessment should include a survey of management policies, procedures, practices, and internal controls applicable to any aspect of the activities in which the auditor attempts to judge whether existing practices can be made significantly more efficient or economical. The audited entity is responsible for establishing effective internal controls. Auditors may modify the nature, timing or extent of audit procedures based on the assessment of internal controls and the results of internal control testing.

c. The following discussion of the principal types of internal control objectives is intended to help auditors better understand internal controls and determine whether or to what extent they are significant to the audit objectives.

(1) Effectiveness and efficiency of operations: Controls over operations include policies and procedures that the audited entity has implemented to provide reasonable assurance that the operation meets its objectives, while considering cost-effectiveness and efficiency. Understanding these controls can help auditors understand the program operations.

(2) Relevance and reliability of information: Controls over the relevance and reliability of information include policies, procedures, and practices that officials of the audited entity have implemented to provide themselves reasonable assurance that operational and financial information they use for decision making and reporting externally is relevant and reliable and fairly disclosed in reports. Understanding these controls can help auditors assess the risk that the information gathered by the entity may not be relevant or reliable and design appropriate tests of the information considering the audit objectives.

(3) Compliance with applicable laws and regulations and provisions of contracts or grant agreements: Controls over compliance include policies and procedures that the audited entity has implemented to provide reasonable assurance that program implementation is in accordance with laws, regulations, and provisions of contracts or grant agreements. Understanding the relevant controls concerning compliance with those laws and regulations and provisions of contracts or grant agreements that the auditors have determined are significant within the context of the audit objectives can help them assess the risk of illegal acts, violations of provisions of contracts or grant agreements, or abuse.

d. Costs result from implementation of management policies and decisions. Accordingly, the evaluation of these policies and decisions, and the effectiveness of management controls over their implementation, will also significantly influence the scope and nature of the audit. Ideally, management policies and decisions should be geared toward prudent, effective, and economical operations, and reflect adequate consideration of the interests of both the contractor and the Government. Ideal conditions are seldom found. As an illustration, the retention of a large engineering staff during periods of significantly declining sales volume may well serve the contractor's interest in terms of maintaining a capability to expand efforts in bidding for new business. However, unless the auditor questions the increased overhead rate that re-

sults from such a decision, the costs of current Government contracts will be inflated, thereby adversely affecting the Government's interest. Where management policies and decisions are motivated by contractor interests that are not compatible with those of the Government, the examination of questionable cost areas should be intensified.

2-505.1 Information Systems Controls (GAGAS 7.23 – 7.27)

Understanding information systems controls is important when information systems are used extensively throughout the program under audit and the fundamental business processes related to the audit objectives rely on information systems. An organization's use of information systems controls may be extensive; however, auditors are primarily interested in those information systems controls that are significant to the audit objectives. Information systems controls are significant to the audit objectives if auditors determine that it is necessary to evaluate the effectiveness of information systems controls in order to obtain sufficient, appropriate evidence. Auditors should obtain a sufficient understanding of information systems controls necessary to assess audit risk and plan the audit within the context of the audit objectives.

2-506 Obtaining Sufficient, Appropriate Audit Evidence (GAGAS 7.55 – 7.71)

a. Auditors must obtain sufficient, appropriate audit evidence to provide a reasonable basis for their findings and conclusions.

b. Appropriateness is the measure of the quality of the evidence that encompasses its relevance, validity and reliability in supporting audit objectives and related findings. In assessing the overall appropriateness of evidence, auditors should assess whether the evidence is relevant, valid, and reliable.

(1) Relevance refers to the extent to which evidence has a logical relationship with, and importance to, the issue being addressed.

(2) Validity refers to the extent to which evidence is based on sound reasoning or accurate information.

(3) Reliability refers to the consistency of results when information is measured or tested and includes the concepts of being verifiable or supported.

c. Sufficiency is a measure of the quantity of evidence used to support the findings and conclusions related to the audit objectives. In assessing the sufficiency of evidence, auditors should determine whether enough evidence has been obtained to persuade a knowledgeable person that the findings are reasonable.

d. Evidence may be categorized as physical, documentary, and testimonial. (See 3-104.14 for more details on evidence.)

e. In assessing evidence, auditors should assess whether the evidence taken as a whole is sufficient and appropriate for addressing the audit objectives and supporting final audit findings and conclusions.

2-507 Working Papers/Audit Documentation (GAGAS 7.77 - 7.84)

a. Auditors must prepare audit documentation related to planning, conducting, and reporting for each audit. Working papers should contain sufficient detail to enable an experienced auditor, having no previous connection to the audit, to understand from the working papers the nature, timing, extent, and results of procedures performed and the evidence obtained and its source and the conclusions reached, including evidence that supports the auditor's significant judgments and conclusions. Audit documentation should contain support for findings, conclusions, recommendations before auditors issue their report.

b. Auditors should design the form and content of audit documentation to meet the circumstances of the particular audit. The audit documentation constitutes the principal record of the work performed in accordance with standards and the conclusions reached. The quantity, type, and content of audit documentation are a matter of professional judgment.

c. Audit documentation is an essential element of audit quality. The process of preparing and reviewing audit documentation contributes to the quality of an audit. Audit documentation serves to:

(1) Provide the principal support for the auditors' report,

(2) aid auditors in conducting and supervising the audit, and

(3) allow for the review of audit quality.

d. GAGAS requires auditors to document:

(1) The objectives, scope, and methodology of the audit;

(2) The work performed to support significant judgments and conclusions, including descriptions of transactions and records examined;

(3) Evidence of supervisory review, before the audit report is issued, of the work performed that supports findings, conclusions, and recommendations contained in the audit report; and

(4) The auditor's departure from any applicable GAGAS requirements (due to law, regulation, scope limitations, restriction on access to records, etc.) and the impact on the audit and on the auditors' conclusions. These circumstances would generally require a modified GAGAS statement (see 2-603e).

2-600 Section 6 --- Reporting Standards for Operations Audits (Performance Audits)

2-601 Introduction

Chapter 8 of the Yellow Book establishes reporting standards and provides guidance for performance audits conducted in accordance with GAGAS. This section discusses the form of the report, report contents, and report issuance and distribution. The reporting standards explained in this section apply only to DCAA operations audits. Section 10-400 provides reporting guidance for DCAA operations audits that fully complies with these reporting standards.

2-602 Reporting (GAGAS 8.03 – 8-07)

Auditors must issue audit reports communicating the results of each completed performance (e.g., operations) audit. The form of the audit report should be appropriate for its intended use and should be written or in some other retrievable form.

a. The purposes of the audit reports are to:

(1) Communicate the results of audits to those charged with governance, the appropriate officials of the audited entity, and the appropriate oversight officials (usually the contracting officer);

(2) make the results less susceptible to misunderstanding; and

(3) facilitate follow-up to determine whether appropriate corrective actions have been taken.

b. If an audit is terminated before it is completed, and no report is issued, auditors should document the results of the work to the date of termination and why the audit was terminated (see 4.403f). The auditor should also communicate the reason for terminating the audit to contractor management, and the requestor, preferably in writing.

c. If after the report is issued, the auditors discover that they did not have sufficient, appropriate evidence to support the reported findings or conclusions, they should communicate with those charged with governance, the appropriate officials of the audited entity, and the appropriate officials of the organizations requiring or arranging for the audits, so that they do not continue to rely on the findings or conclusions that were not supported. The auditors should then determine whether to conduct additional audit work necessary to reissue the report with revised findings or conclusions.

2-603 Report Contents (GAGAS 8.08 – 8.42)

Auditors should prepare audit reports that contain the objectives, scope, and methodology of the audit; the audit results, including findings, conclusions, and recommendations, as appropriate; a statement about compliance with GAGAS; a summary of the views of responsible officials; and if applicable, the nature of any confidential or sensitive information omitted.

a. Objectives, Scope, and Methodology (GAGAS 8.09 – 8.13): The report should include the objectives in a clear, specific, neutral and unbiased manner that includes relevant assumptions including the purpose of the audit and report. The report should describe the scope of the work performed and any limitations, including issues that would be relevant to likely users, so that they could reasonably interpret the findings, conclusions, and recommendations in the report without being misled. The audit report should also include information on any significant constraints imposed by information limitations or scope impairments, including denials of access to certain records or individuals. In reporting audit methodology, auditors should explain how the completed audit work supports the audit objectives, including the evidence gathering and analysis techniques, in sufficient detail to allow knowledgeable users of the report to understand how the auditor addressed the audit objectives.

b. Audit Findings (GAGAS 8.14 – 8.18): The report should present sufficient, appropriate evidence to support the findings in relation to audit objectives. Clearly developed findings assist the governing agency and the contractor's management in understanding the need for taking corrective action. The findings should be in perspective by describing the nature and extent of the issues reported and the extent of the work performed that resulted in the finding. To give the reader a basis for judging the prevalence and consequences of these findings, auditors should, as applicable, relate the instances identified to the population or the number of cases examined and quantify the results in terms of dollar value, or other measures, as appropriate.

c. Audit Conclusions (GAGAS 8.27): Auditors should report conclusions, as applicable, based on the audit objectives and the audit findings. Report conclusions are logical inferences about the contractor's operations based on the auditor's findings, not merely a summary of the findings. The strength of the conclusions depends on the sufficiency and appropriateness of the evidence supporting the findings and the soundness of the logic used to formulate the conclusions. Conclusions are stronger if they lead to the auditors' recommendations and convince the knowledgeable user of the report that action is necessary.

d. Recommendations (GAGAS 8.28): Auditors should recommend actions to correct problems identified during the audit and to improve programs and operations when reported findings and conclusions substantiate the potential for improvement in programs, operations, and performance. Effective recommendations encourage improvements in the conduct of programs and operations. Recommendations should flow logically from the findings and conclusions, seek to resolve the cause of identified problems, and clearly state the actions recommended.

e. Reporting Compliance with GAGAS (GAGAS 8.30 – 8.31): When the auditor complies with all applicable GAGAS requirements, GAGAS 8.30 requires that the report include specific language which represents an unmodified GAGAS statement. That language is included in the operations audit report shells delivered by APPS. When the audit does not comply with all applicable GAGAS requirements, the report should include a modified GAGAS compliance statement (see 2-403).

f. Fraud, Illegal Acts, Violations of Provisions of Contracts, and Abuse (GAGAS 8.21 – 8.23): Under GAGAS when auditors conclude, based on sufficient, appropriate evidence that fraud, illegal acts, significant violations of provisions of contracts, or significant abuse either has occurred or is likely to have occurred, they should report the matter as a finding. However, when fraud or suspected irregularities are discovered, DCAA policy is for the auditor to prepare a Form 2000 (see 4-700). When auditors detect violations of provisions of contracts or abuse that are not significant, they should communicate those findings in a separate letter to officials of the audited entity (or in a separate appendix of the audit report) unless the findings are clearly inconsequential, considering both qualitative and quantitative factors. If the auditors have communicated instances of violations of provisions of contracts or abuse in a separate letter to officials of the audited entity, they should refer to that letter in the audit report.

g. Internal Controls (GAGAS 8.19 – 8.20): The audit report should include (1) the scope of work on internal control and (2) any deficiencies in internal control that are significant within the context of the audit objectives and based upon the audit work performed. When auditors detect deficiencies in internal control that are not significant to the objectives of the audit, they may communicate those deficiencies in a separate letter to appropriate officials of the audited entity unless the deficiencies are clearly inconsequential considering both qualitative and quantitative factors. If the auditors have communicated deficiencies in a separate letter to officials of the audited entity, they should refer to that letter in the audit report.

h. Views of Responsible Officials (GAGAS 8.32 – 8.37): Providing a draft report with findings for review and comments by the responsible officials of the audited entity helps the auditor develop a report that is fair, complete, and objective. Including the views of responsible officials results in a report that presents not only the auditors' findings, conclu-

sions, and recommendations, but also the perspectives of the responsible officials of the audited entity and the corrective action they intend to take. Written comments are preferable, but oral comments are acceptable.

i. Privileged and Confidential Information (GAGAS 8.38 – 8.42): If certain information is prohibited from general disclosure due to the confidential or sensitive nature of that information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that makes the omission necessary.

j. Report Quality Elements (GAGAS A8.02): The auditor may use the report quality elements of timely, complete, accurate, objective, convincing, clear, and concise when developing and writing the report as the subject permits.

(1) An accurate report is supported by sufficient, appropriate evidence with key facts, figures, and findings being traceable to the audit evidence.

(2) Objective means that the presentation of the report is balanced in content and tone.

(3) Being complete means that the report contains sufficient, appropriate evidence needed to satisfy the audit objectives and promote an understanding of the matters reported.

(4) Being convincing means that the audit results are responsive to the audit objectives, that the findings are presented persuasively, and that the conclusions and recommendations flow logically from the facts presented.

(5) Clarity means the report is easy for the intended user to read and understand.

(6) Being concise means that the report is not longer than necessary to convey and support the message.

(7) To be of maximum use, providing relevant evidence in time to respond to officials of the audited entity, and other users' legitimate needs is the auditors' goal. Likewise, the evidence provided in the report is more helpful if it is current. Therefore, the timely issuance of the report is an important reporting goal for auditors. During the audit, the auditors may provide interim reports of significant matters to appropriate entity officials. Such communication alerts officials to matters needing immediate attention and allows them to take corrective action before the final report is completed.

2-604 Report Distribution (GAGAS 8.43)

Under GAGAS, auditors should submit audit reports to those charged with governance, the appropriate officials of the audited entity, and to the appropriate oversight bodies or organizations requiring or arranging for the audits. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. DCAA normally submits the audit report to the contracting officer responsible for acting on the audit recommendations and a copy of the report is provided to the contractor through the contracting officer. Chapter 10 and 4-300 specify disclosure restrictions applicable to contract audits performed by DCAA.

2-S10 Supplement. Description of DCAA Quality Control System

2-S101 INTRODUCTION

DCAA's quality program is based on the precepts of Total Quality Management (TQM). DCAA's quality control program is an important subset of the Agency's overall quality program. TQM emphasizes "prevention" as a means for reducing errors and rework. However, to further ensure that quality is being achieved, it also provides for an adequate level of monitoring and inspection. As an agency that provides professional services, DCAA has a responsibility to establish and conform to professional standards. To meet this responsibility, DCAA has established standards based on generally accepted government auditing standards which incorporate the standards of the American Institute of Certified Public Accountants. To ensure that it provides professional services that conform with its professional standards, DCAA is required to have a system of quality control and, indeed, maintains such a system. The authority for and descriptive details of this system can be found in the various official pronouncements and Agency publications, including the DCAA Charter, Instructions, Manuals, and other DCAA directives. A summary description of the system follows.

2-S102 PHILOSOPHY, ORGANIZATION, AND APPROACH TO PROVIDING QUALITY SERVICES

2-S102.1 Philosophy

DCAA is an independent audit agency within the Department of Defense (DoD) with a mission to perform contract audits and provide all the necessary accounting and financial advisory services for the DoD, and other agencies, as appropriate. In accomplishing this mission, the Director of DCAA has fully committed the Agency staff to attain the highest level of integrity, competence, and customer satisfaction. This is best explained through our vision statement set forth as the Agency's Commitment to Excellence, which says:

"In support of the National Interest, we are dedicated to providing timely and responsive audits, reports, and financial advisory services to the Department of Defense contracting officers and other customers.

Our aim is to be THE audit organization with the foremost reputation for competence, integrity, and customer satisfaction by:

- Creating an environment of teamwork, open communication, trust, and mutual respect, and
- Developing highly qualified employees dedicated to the concept of continuous improvement."

Good working relationships and open communications with customers will minimize potential conflicts between the customer's needs and the Agency's requirement to perform contract audits that conform with generally accepted government auditing standards.

2-S102.2 Organization

DCAA's basic system of quality control encompasses the Agency's organizational structure, as detailed in the DCAA Organization Manual (DCAAM 5110.1), and outlined below.

a. Headquarters

(1) Office of the Director. DCAA's Director reports to the Under Secretary of Defense (Comptroller) and exercises worldwide direction of the Agency in performing all contract audits for DoD and other agencies upon request. The Director's staff includes a Deputy

Director, three Assistant Directors, a General Counsel, an Executive Officer, and a Special Assistant for Quality Management. The Director is the senior management official responsible for establishing policies and procedures for the management control program in conjunction with the Federal Managers' Financial Integrity Act (FMFIA). The Executive Officer (DX) serves as the focal point for developing regulations and guidance, accumulating information, and drafting the Director's annual statement required under the FMFIA. DX monitors tests of critical management controls performed by others as reported through the FMFIA process. DX also advises the Director and Deputy Director on any sensitive matters disclosed by quality or management control reviews reported through the FMFIA process. The Special Assistant for Quality Management (DQ) serves as the Agency focal point for the TQM program.

(2) Assistant Directors.

(a) Operations. Responsible and accountable for providing technical guidance and direction to the Agency for field contract audit operations. This includes directing the development of Agency audit objectives, activities, operational schedules, and priorities to assure effective accomplishment of field contract audit operations.

(b) Policy and Plans. Responsible and accountable for directing the formulation and development of DCAA contract audit policy and for the coordination, issuance, and integration of this policy. Assigned divisions include: Accounting and Cost Principles (PAC), Auditing Standards (PAS), Policy Programs (PPD), Special Projects (PSP), and Quality Assurance (PQA).

(c) Resources. Responsible and accountable for formulating, directing, and executing plans, programs, policies, and procedures related to the management of DCAA resources including financial management, personnel management and administration, information resources management, management analysis, security, and general administration activities.

b. Regional Offices and Field Detachment

(1) Office of the Regional Director. DCAA presently has five Regional Directors who are individually responsible and accountable to the Director for planning, managing, and accomplishing the Agency's mission in assigned geographical areas. This includes directing the overall management of DCAA personnel and resources assigned to the individual Regional Offices and to the various Field Audit Offices (FAOs) and suboffices within the regions. Each Regional Director's staff includes a Deputy Regional Director, several Regional Audit Managers, a Special Programs Manager, a Resources Manager, a Special Assistant to the Regional Director (RQ), and a Regional Quality Assurance (RQA) Chief.

(2) Director, Field Detachment. The Director of DCAA's Field Detachment is responsible and accountable for the overall planning, management, and execution of worldwide DCAA contract audits of compartmented programs and for managing all of the resources and staff assigned to the Detachment. The Director's staff includes a Deputy Detachment Director, several Detachment Audit Managers, a Special Assistant to the Field Detachment Director, and a Quality Assurance (QA) Chief.

(3) Field Audit Offices (FAOs).

(a) Resident Offices. Are established at contractor facilities whenever the amount of audit workload justifies the assignment of a permanent staff of auditors and support elements. Resident Offices, which can be made up of several suboffices of components within the same company, are responsible and accountable for planning and executing a comprehensive, integrated audit program to carry out DCAA's audit mission. Resident offices are responsible for implementing a sound quality control program based on Headquarters and regional directives.

(b) Branch Offices. Are established to plan and execute a comprehensive audit program to carry out DCAA's audit mission at those contractor locations, within a general geographical area, which individually do not have sufficient workload to justify establishing a Resident Office. Branch Offices are generally organized to cover their smaller contractors from one central office on a mobile basis. Larger contractors are often cov-

ered from suboffices. Branch offices are responsible for implementing a sound quality control program based on Headquarters and regional directives.

- c. Executive Steering Committee

The Executive Steering Committee (ESC) includes the Director, Deputy Director, Assistant Directors, General Counsel, Regional Directors, and Director, Field Detachment. The Executive Officer and Special Assistant for Quality Management provide staff support to the ESC. The ESC is responsible for:

- establishing the vision and strategic goals for the Agency and monitoring attainment of the goals,
- providing overall management and direction for the Agency, and
- identifying, evaluating, and making recommendations on Agency-wide policy and improvement projects.

- d. Participative Work Teams

Participative Work Teams (PWTs) are in place at all DCAA field offices. Audit PWT members include the supervisory auditor and his/her assigned auditors. PWTs hold regularly scheduled meetings to share information and complete PWT-related responsibilities. Among these responsibilities are:

- coordinating with customers,
- establishing and monitoring realistic team audit plans,
- establishing and monitoring team goals,
- scheduling and assigning team workload,
- using the zero-based budgeting technique on audit assignments,
- performing peer reviews, and
- identifying potential audit process improvements.

e. Quality Assurance (QA)

DCAA's Quality Assurance (QA) organization is responsible for the management and execution of the quality assurance program. The QA organization is comprised of a Headquarters division (PQA) and six Regional/Field Detachment divisions (RQA/FDQA). The Headquarters QA division routinely teams with the regional and Field Detachment divisions to plan and execute the Agency's quality assurance program. The QA team performs:

- formal internal QA reviews based on guidelines adapted from those established by the President's Council on Integrity and Efficiency (PCIE) and
- QA-related review projects on both an Agency-wide and regional basis.

The PCIE guidelines are used by various IG organizations when conducting their external peer group reviews required by the Government Auditing Standards. In performing both the PCIE-based internal reviews and QA projects, the QA team assesses compliance with applicable auditing standards and audit policy and procedures, assesses the need for new or enhanced audit policy guidance, and identifies best practices for Agency-wide use.

2-S102.3 Approach

Auditing in accordance with generally accepted government auditing standards is the principal work of the Agency. To promote the quality accomplishment of this work, DCAA auditors are initially guided to take steps to develop a thorough knowledge of the contractual matters and circumstances affecting their audits. These steps entail:

- Developing an "intelligence base" on a contractor's operations and contracting environment in order to assess the events and conditions that affect the contractor actions and the Government's cost impact.
- Identifying the audit universe and documenting interrelationships between a contractor's organization and operations so that all significant auditable activities which affect the costs of Government contracts are identified.

- Accurately assessing the strengths and weaknesses of a contractor's internal controls, accounting and management systems, and methods of operation, in order to: (1) identify the relative risk in selecting or deferring a contractor system for audit evaluation in the current period; (2) evaluate the Government's exposure to potential fraud, waste, and mismanagement; and (3) tailor audit programs for specific assignments. It is DCAA's policy that each accounting or management system at major contractor segments that have significant flexibly-priced contract work be reviewed on a cyclical basis and the results of these reviews be recorded on an Internal Control Audit Planning Summary (ICAPS) form.
- Accomplishing certain basic, core audit requirements before rendering an opinion on contract costs incurred and before relying on incurred costs in any other review or evaluation. If no weaknesses are disclosed, the satisfaction of these core requirements provides a basic level of assurance that a contractor's incurred cost representations are reliable. If weaknesses are disclosed, audit procedures must be extended accordingly.
- Determining that contractor systems for estimating prices are adequate and in compliance with applicable regulations.
- Assuring that all laws, regulations, and authoritative technical guidance for the accounting and auditing professions (including those issued by DCAA) are followed.
- Continually assessing progress on individual assignments and program areas in order to react timely and positively to changed conditions within the industry, acquisition, and audit environments. DCAA, for example, continually assesses the increased use of information technology and its impact on Agency audits.

2-S103 ELEMENTS OF DCAA'S QUALITY CONTROL SYSTEM

2-S103.1 Independence, Integrity, and Objectivity

a. Objective.

To provide reasonable assurance that all DCAA employees:

- maintain the level of independence required by the Agency's standards of conduct and by the generally accepted government auditing standard on independence;
- perform their professional responsibilities with integrity; and
- maintain objectivity in performing their professional responsibilities.

b. Policies and Procedures.

(1) General Requirements. DCAA employees at all organizational levels must adhere to the requirements on independence as stated in the GAGAS independence standard, DCAA Instructions, Contract Audit Manual (CAM), and Personnel Management Manual (PMM). Guidance on the GAGAS independence standard is incorporated in 2-203, which prescribes the DCAA auditor's responsibilities for independence when performing contract audits.

(2) Organizational Placement. DCAA has been organizationally positioned within DoD to ensure independence from the various DoD departments and agencies involved in the acquisition process. This provides the independent environment necessary for DCAA to accomplish its contract audit mission. Refer to the preceding section on Organization and 1-1S1 for further details.

(3) Audit Impairments. Occasionally, factors external to DCAA may restrict the audit or interfere with the auditor's ability to form independent and objective opinions and conclusions. When a limitation is identified, every effort should be made to remove the limitation or, failing that, report the limitation. DCAA expects each auditor to exercise prudent judgment in establishing audit scope, auditing procedures, and appropriate reporting of results.

(4) Personal Impairments. DCAA employees must maintain a high level of moral character and observe a high standard of ethical and professional conduct. Consistent with this responsibility, employees are required to refrain from any private business or professional activity which conflicts, or gives the appearance of conflicting, with official duties.

(5) Policies and Procedures. The following procedures must be followed to identify personal and external impairments and assure compliance with GAGAS independence requirements (see 2-203).

- Mandatory annual training sessions will be conducted to ensure understanding of the GAGAS auditor independence requirements.
- Upon completion of the annual independence training, all DCAA auditors will complete a Statement on Independence form (see Figure 2-S10-1) to document compliance with this GAGAS standard. This form is also to be completed by newly hired auditors prior to beginning any audit work. Individuals who are either not able to sign this statement or experience a situation after signing where they believe their independence and/or objectivity is or may be impaired should notify, in writing, the official who reviews their Statement on Independence form of their situation. Supervisors/FAO managers should coordinate with regional offices to eliminate any personal impairments of independence and/or resolve any outstanding concerns relating to independence. The supervisor/FAO manager's resolution of any impairment should be documented. If not resolved at the regional level, regions should elevate the independence issue to DCAA Headquarters, Policy and Plans, Attn: PAS.
- GAGAS also requires all auditors to be aware of and comply with applicable Government ethics laws and regulations. The standards of conduct for DCAA employees are set forth in the provisions of DoD Directive 5500.7, "Standards of Conduct," and DoD Regulation 5500.7R, "Joint Ethics Regulation." Supervisors/FAO managers shall contact the Designated Agency Ethics Official or Alternative Designated Agency Official at DCAA's General Counsel (DL) if they have questions concerning these standards of conduct. The Ethics Official will work with the supervisor/FAO manager to address the Government ethics questions. When a question also relates to an independence issue, the manager must separately resolve the independence issue by using the guidelines and procedures contained in this section. PAS will coordinate with the Ethics Official when both the Joint Ethics Regulations and the GAGAS standards provide guidance on the independence or ethics issue under concern.
- Each auditor is responsible for notifying his or her supervisor of any actual or potential personal and/or external impairment in writing. No auditor with a personal impairment will be permitted to work on any assignment that is affected by the impairment. Employees may be reassigned or rotated without change in grade to assure audit independence, integrity, and objectivity.
- Deviations from the above policies and procedures are subject to appropriate disciplinary action in accordance with the DCAA Personnel Management Manual, Chapter 50.

2-S103.2 Personnel Management

a. Objective.

To provide reasonable assurance that:

- those hired possess the appropriate characteristics to enable them to perform competently;
- work is assigned to auditors having the degree of technical training and proficiency required in the circumstances;
- auditors participate in continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned and satisfy the GAGAS continuing professional education requirements; and
- personnel selected for advancement have the qualifications necessary to fulfill the responsibilities of the position they will assume.

b. Personnel Hiring Policies and Procedures.

(1) General. DCAA's policy is to make use of all available resources to assure that the Agency is fully staffed with qualified and competent auditor and administrative personnel.

Recruiters must be carefully selected for their ability to represent the Agency effectively and to carry out this policy. The procedural guidance and specific responsibilities for implementing DCAA's recruitment program are contained in PMM, Chapter 11. This guidance covers the candidate sources and criteria for source selection, the college recruitment program, recruitment for intermediate- and senior-level positions, and candidate selection procedures.

(2) Qualifications. The Office of Personnel Management (OPM) establishes the required qualifications for Accountant and Auditor positions, GS-5 through 12. Qualifications for DCAA's administrative positions are found in the OPM Qualification Standards Handbook X-118 governing the particular occupational series.

(3) Informing Applicants and New Hires. During orientations conducted by the Personnel Office and FAO management, applicants and new hires are informed of Agency policies and procedures relevant to them. A recruitment brochure is also available to any interested person or college recruitment office.

(4) Employee Retention. As an extension of the recruitment process, DCAA invokes a probationary period. If, during this period, an employee is determined to lack the skills and character traits necessary for satisfactory performance as a career employee, his or her appointment will be terminated. Details on completing an Auditor Probationary Appraisal Report and the procedures relating to actions required by supervisors of new employees in the probationary period are covered in PMM, Chapter 19.

c. Personnel Assignment Policies and Procedures.

(1) General. Headquarters is responsible for providing the strong, central direction necessary for development and maintenance of a competent, professional staff and for effective utilization of this staff. Staffing positions are established and personnel are assigned at each organizational level to provide an optimum balance among mission needs, economy and efficiency of operations, and effective employee utilization. The Agency's personnel policies and procedures relating to position classification and position management are contained in PMM, Chapter 6. These policies and procedures are compatible with and fully support all affirmative social action programs. Refer to the preceding section on Organization for the general responsibilities of all principal DCAA organizational elements.

(2) Staff Qualifications. DCAA auditors and specialists (see Consultation below) must collectively have the skills necessary to accomplish all aspects of DCAA's audit mission. This requires detailed knowledge of:

- accounting and auditing theory, principles, procedures, and practices;
- organizations and contracts subject to audit;
- Government contracting policies and regulations; and
- management principles and skills.

Update and maintenance of the required skills is accomplished through DCAA's continuing education program (see Professional Development below).

(3) Staff Requirements and Distribution. DCAA's staff requirements are determined based on estimates of the workload and the time required to perform this work in accordance with generally accepted government auditing standards. Appropriate consideration in calculating these estimates must be given to such factors as Government financial risk and vulnerability to fraud, waste, and abuse. Guidance for determining staffing requirements is provided annually through issuance of a Headquarters Planning and Staff Allocation Document (PSAD). This memorandum contains specific Agency direction for determining staffing requirements for the coming year.

The distribution of available personnel within DCAA is based on an evaluation of total Agency workload and priorities, and is made in consonance with the respective workloads of the five DCAA Regions, the Field Detachment, and Headquarters. Regional offices make distributions to Field Audit Offices (FAOs). A DCAA office is established when sufficient workload exists to justify a separate audit unit without unnecessarily duplicating administrative support requirements (see Organization).

The general guidelines used by DCAA for organizing staff, programming audits, scheduling performance of audit segments, and analyzing progress are contained in the Audit Planning Guide, available on the Intranet, which covers management of mobile audit workload and management of resident audit offices. Detailed programming objectives and guidance are set forth in the annual PSAD.

(4) FAO Assignments. The Field Audit Office or FAO is DCAA's base level organizational unit responsible for providing financial services and planning and performing contract audits for the DoD and other Government agencies. Accordingly, FAO managers have primary responsibility for the assignment of field office personnel while audit supervisors (see Supervision below), reporting to the FAO managers, generally direct the actual planning and performance of the individual audits.

The FAO supervisors, together with the FAO managers, are responsible for considering and weighing many variables and factors when assigning personnel. They must ensure the auditor possesses the necessary knowledge, skills, and abilities to perform the audit. They must also consider the technical difficulty, timing requirements, specialized expertise needed, and availability of personnel for each assignment. Under the direction of the supervisory auditor, the GS-13 Technical Specialists assigned to an FAO are responsible for the technical management and performance of the most complex audits in their specific program areas. Examples of these program areas are the Cost Accounting Standards, post award audits, terminations, claims, incurred costs, internal controls, compensation, universities and not-for-profits, and financial capability.

(5) Reassignment/Rotation. Employees are reassigned to different positions and locations as necessary to accomplish the Agency's mission. In fact, the Agency encourages employees to be mobile in the interest of broadening their experiences and increasing their qualifications. Specific procedures covering employee reassignment/rotation to satisfy Agency objectives are contained in PMM, Chapter 37.

d. Professional Development Policies and Procedures.

(1) General Guidelines & Requirements. It is DCAA's policy to systematically plan for and provide all of the training and development necessary for its auditors to:

- meet the GAGAS continuing professional education requirements,
- maximize their performance proficiency, and
- assure they remain current in the contract audit environment.

Individual organizational elements are responsible for establishing adequate plans and controls to ensure that all training and employee development activities are accomplished economically, effectively, and on a timely basis, in consonance with the Agency's training and development program. This program encompasses:

- on-the-job training and skill development through carefully planned and progressively more complex employee assignments;
- formal training, including courses given by the Defense Contract Audit Institute (DCAI);
- self-development courses, developed or approved by DCAA personnel and administered by the Regions or DCAI;
- professional continuing education programs;
- attendance at short-term training courses on specific subjects offered by other sources; and
- self-development through attaining professional certification (e.g., Certified Public Accountant) and advanced degrees (including the Director's Fellowship Program in Management).

Specific procedures and responsibilities for carrying out the Agency's professional development program at all organizational levels are contained in the following PMM chapters:

Chapter 16	Career Management Program
Chapter 17	Performance Management System
Chapter 21	Training and Development
Chapter 30	Professional Activities Outside DCAA

PMM, Chapter 21 presents DCAA's Master Training and Development Plan for Auditors. This plan identifies the formal technical and management training, by type and course, which is essential or desirable for progression from one audit career level to another within DCAA.

The knowledge and skills that are required by contract auditors at various grade levels to effectively perform their assigned tasks are detailed in Chapters 16 and 17 of the PMM. These chapters also provide guidance on assessing individual performance and identifying individual training and education needs. As an integral part of its overall training and development program, DCAA also requires that specific evaluations be performed to assess the extent to which training sources are achieving stated objectives.

(2) Defense Contract Audit Institute (DCAI). The DCAI is responsible for developing the Agency's training program and courses. Courses provided at the Institute are designed and periodically updated to enable DCAA's auditors and managers to gain the knowledge and skills they need to perform their assigned tasks in carrying out DCAA's audit mission. The courses are also designed to improve performance weaknesses and to prepare employees for higher responsibilities.

(3) Specialization. Training needs are continuously reviewed and updated to meet present and anticipated Agency needs in specialized areas such as information systems and cost accounting for pensions and insurance. This specialized training is accomplished through the same basic training sources described in the General paragraph above, or derived from working with Agency specialists from Headquarters, Regional Offices, or DCAA's Technical Support Branch (see Consultation).

(4) On-the-job Training. This form of training is an integral part of the Agency's overall training and development program and is one of the most important responsibilities of all DCAA supervisors. It provides employees with the opportunity to participate in all types of audit assignments at progressively higher levels of complexity and in different contract audit environments.

e. Advancement Policies and Procedures.

(1) Required Qualifications. The qualifications necessary for the various levels of auditor responsibility within DCAA can be stated in terms of the progressive growth in an individual's technical competence and professional ability. This concept of career development is delineated in PMM Chapter 16. The accounting and auditing knowledge and skills that are essential for the contract auditor at various grade levels to effectively perform the assigned tasks are stated in Chapter 16, appendix B, and Chapter 17, appendix D, of the manual.

(2) Criteria for Evaluating Performance. The performance of most DCAA personnel is evaluated in accordance with Office of Personnel Management (OPM) regulations. In many instances, these OPM regulations have been implemented by DoD directives and instructions. The objectives of DCAA's performance appraisal system include identifying the job elements of each position, establishing performance standards relative to the elements, informing employees of the job elements and the performance standards for their positions, and conducting a periodic formal review and discussion of the quality of each employee's work performance in relation to the established performance standards. These objectives and associated DCAA appraisal policies and procedures are presented in the PMM, Chapter 17.

(3) Advancement Decisions. Selections for promotions are made from among the best qualified candidates, based solely on their relative knowledge, skills, and abilities. Advancement selections to auditor positions GM-13 and above are made in accordance with

DCAA's Career Management Program policies (see below). Positions GS-12 and below are filled non-competitively (without using vacancy announcements) by career ladder promotions, as employees demonstrate their ability to perform higher level duties. Agency guidance on advancement decisions is contained in PMM, Chapter 36, Merit Promotion.

(4) Career Management and Career Boards. DCAA managers and supervisors at all organizational levels are responsible for aiding subordinates in defining career objectives and implementing career plans and for making advancement recommendations (or decisions, when authorized) regarding employees under their supervision. Employees, in turn, are encouraged to familiarize themselves with the operation of the merit promotion program, provide complete and accurate information needed for consideration under the merit promotion program, and periodically review and update their experience records and other personal data maintained by the Personnel Office. Individual careerists must further provide the initiative and energy necessary for development of the skills required in their career field and recognize the advantages of mobility to themselves and the Agency.

A DCAA Career Development Board (CDB) is established at Headquarters with responsibilities for providing policy guidance and monitoring DCAA's career management planning and programming activity. The CDB consists of senior Headquarters executives who:

- recommend for the Director's approval the establishment or revision of employee development activities which may be expected to improve the operation of the career management program and
- review lists of candidates for filling all auditor and administrative positions at grade GM-14 and above to determine those best qualified for referral to the Director, who is the selecting official.

Regional Directors are accountable for the effective functioning of their respective Region's career management programs and Career Management Boards (CMBs). Each CMB consists of senior regional managers who recommend any needed revisions in the program to the Regional Director and who periodically evaluate the region's career management programs.

2-S103.3 Acceptance of Engagements/Assignments

a. Objective.

To provide reasonable assurance that:

- DCAA undertakes only those engagements/assignments that can be completed with professional competence,
- the risks associated with providing professional services in particular instances are appropriately considered, and
- an understanding is reached with the customer regarding the services to be performed.

b. Policies and Procedures.

(1) General Requirements. It is DCAA's mission to perform all necessary contract audits for DoD (and other agencies as appropriate) and provide accounting and financial advisory services regarding contracts and subcontracts to those responsible for procurement and contract administration. If a requested audit service appears to be outside the mission of DCAA, the request is referred to the Agency Director for a determination as to whether DCAA will perform the requested service. Only those engagements that can be completed with professional competence are undertaken by DCAA.

(2) Understanding the Services to be Performed. During the planning phase of an assignment, it is essential that auditors coordinate with the customer or contracting official to obtain an understanding of the:

- purpose of the audit;
- contractual, regulatory, or other factors pertinent to the review; and
- nature of the audit services to be performed.

Auditors should determine the scope of audit based on the overall risk.

2-S103.4 Engagement Performance

a. Objective.

To provide reasonable assurance that work performed by personnel meets the applicable professional standards, regulatory requirements, and the Agency's standards of quality. Audit assignments must be adequately planned, performed, supervised, reviewed, documented, and communicated in accordance with the GAGAS.

b. Engagement Design & Execution Policies and Procedures.

(1) Planning of Field Work. Adequate planning requires that appropriate consideration be given to the assignment of personnel. Consideration should also be given to report format and content. Likewise, coordinating the audit with cognizant contractor and Government procurement representatives both prior to and during the audit is important. Although aspects of audit planning are presented throughout CAM, Chapter 3 specifically covers this critical element of quality control.

In planning and managing audits, regions and FAOs are directed to:

- ensure that quality performance is emphasized and
- implement the total audit concept technique (TACT).

While the techniques of TACT are geared to audits of major contractors, the TACT principle (managing audit activities on the basis of an integrated totality) applies equally to audits of smaller contractors. Certain TACT techniques are required and performed annually as part of DCAA's planning process. These include use of the internal control audit planning summary for major contractors and the internal control questionnaire for other contractors.

(2) Performance of Field Work. Every auditor assumes the duty to exercise professional judgment in the performance of his/her audits. Professional judgment requires auditors to perform their audits in accordance with generally accepted government auditing standards (GAGAS). Auditors should ensure that the nature, timing and extent of audit procedures performed are consistent with the risk assessments made and audit plan established. The CAM provides detailed audit guidance for the different audits/procedures performed.

(3) Supervision of Field Work. Supervisors are responsible for assuring that the necessary auditing procedures and tests are properly designed and systematically laid out so that they can be understood by the assigned audit staff. The extent of supervision and review required varies with the audit circumstances and depends on such factors as complexity of the work, the qualifications of the persons performing the work, and the extent of consultation available and used. The level of detail in a supervisor's instructions must be tailored to the auditor's experience, so that all elements necessary to performing a quality audit are addressed. Sufficient care must be exercised in supervising auditors and in reviewing their work throughout the audit. Findings and audit exceptions should be clearly described and well supported, and recommendations should be responsible and appropriate to the conditions described. Although aspects of audit supervision are presented throughout CAM, Section 2-302.2 specifically covers this critical element of quality control.

(4) Review of Working Papers and Reports. Supervisory review of working papers and reports is required to ensure that:

- the auditor conforms to auditing standards,
- audit programs are followed unless deviation is justified,
- the working papers conform to standards and adequately support the reported audit findings,
- the auditor accomplishes the audit objectives,

- the report is prepared in accordance with CAM, and
- the needs of the customer are understood and considered.

Documentation of supervisory reviews must be prepared and retained. A technical specialist or GS-12 senior auditor who has been properly delegated to act for a GS-13 supervisory auditor has the same authority as the supervisor to approve/initial-off on all audit working papers and final draft report, unless otherwise prohibited by the supervisor or FAO manager. Copies of delegations of authority must be maintained in the FAO permanent files under file code 205.9, Delegations of Authority.

Supervisors must assure that each auditor is fully aware of the GAGAS auditing and reporting requirements implemented in CAM. FAO supervisors are also responsible, along with their FAO and regional managers, for implementing all Headquarters policy guidance memorandums. Headquarters updates pro forma audit programs and reports as new policy guidance is issued. Audit programs are expected to be tailored to the specific assignment and approved by the supervisor.

The full performance level for DCAA auditors is the GS-12 senior auditor position. Experienced GS-12s may be called upon to give onsite work direction to trainees as long as it does not preempt the supervisor's responsibility or unduly interfere or prevent the GS-12 from the timely accomplishment of his/her principal work. Some GS-12s may be asked to furnish advice and instructions on specific audit programs, tasks, and techniques; plan and review individual work assignments within the scope of the total audit assignment; maintain the status and progress of work assignments; and provide on-the-job training to trainees.

(5) Documentation of Audit Performance. The auditor's work should be documented and retained in the form of working papers. Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain that the evidence supports the auditor's significant conclusions and judgments. The auditor should obtain sufficient, competent and relevant evidence to support a reasonable basis for his/her conclusions. CAM Section 4-400 contains detailed guidance for the preparation, format, contents and retention of audit working papers.

(6) Communication of Audit Results. Audit reports are the principal means of communicating the audit results to our customers. Auditors must exercise professional judgment in preparing, reviewing, and processing reports to provide reasonable assurance that the reports are accurate, complete, clear, and prepared in accordance with the GAGAS reporting standards. CAM Chapter 10 contains detailed guidance for the preparation and distribution of DCAA audit reports. FAO managers should review and sign significant or sensitive reports as prescribed in DCAA Regulation 5600.1. This Regulation also establishes the requirements for delegating supervisors authority for signing certain audit reports and related audit documents.

c. Consultation Policies and Procedures.

The auditor is responsible for obtaining sufficient evidence to express an opinion. Since the advice of technical specialists can constitute a significant part of this evidence, auditors must first recognize when areas of an assignment extend beyond their expertise and then obtain assistance from individuals who have the skills needed to evaluate those areas. CAM Appendix D contains detailed guidance on assessing the need for technical specialist assistance, requesting technical assistance and reporting the use of the assistance. When specialists are used, the auditor is responsible for satisfying himself or herself as to their professional qualifications and reputation by inquiry or other procedures. Refer to AICPA Standards of Field Work, "Using the Work of a Specialist," for this and other considerations in determining the need for consultation.

(1) Sources for Consultation. DCAA auditors may consult with either specialists in a particular field or auditors with specialized experience and training. This includes personnel with specialized technical skills who are assigned to Government procurement activities and to attorneys assigned to the Defense Legal Services Agency. Other sources include DCAA employees assigned to Headquarters, Regional Offices, and Field Audit Of-

fices (FAOs). An example of a Headquarters source is the Technical Support Branch (see below), whose employees have specialized experience and training in such areas as information systems, computer assisted audit techniques, and quantitative methods.

To further support the audit mission, reference libraries with assorted technical and professional publications and other material are maintained in accordance with DCAAR 5000.1. New audit approaches, guidance, and techniques are investigated, developed, and implemented, as required, through research and evaluation conducted by Headquarters and Regional Offices.

(2) Technical Support Branch (OTST). The OTST has been specifically established under the DCAA Assistant Director, Operations, to operate as a focal point for applications research and development activities, and as a source of expertise which is available to field elements engaged in both traditional audits and nontraditional audits. Staffed by computer specialists, engineers, CPAs, and other professionals having the expertise needed to support DCAA's mission, the OTST provides assistance in the areas of advanced information systems, computer assisted audit techniques (CAAT), operations audits, and special programs.

(3) Requests for Consultation. DCAA's goal is to minimize the number of reports in which auditors have to express a qualified audit opinion because of a lack of specialized knowledge or skills. DCAA's evaluations of price proposals frequently require specialized technical assistance from the cognizant procurement or contract administration activities. Therefore, with few exceptions, requests for this type of assistance are routinely handled. That is, when determined necessary, they are made orally or in writing to the cognizant servicing activity (9-103.1). With regard to requests for technical assistance to perform an incurred cost audit or operations audit, it is DCAA policy that the auditor will request the assistance from the contract administration activity responsible for the contractor being audited (2-202a). Requests for specialized assistance from Regional Offices, Headquarters, or from the Defense Legal Services Agency are accomplished through Regional Office channels.

(4) Results of Consultation. The results of a technical review performed by a specialist are expected to be sufficiently detailed for the auditor to satisfy his or her reporting requirements and to include in a final consolidated audit report. To ensure that the results are correctly reported, the auditor must:

- examine them in light of all known facts,
- understand the methods and assumptions used by the technical specialist, and
- attain assurance that the technical findings are appropriately applied in relation to the contractor's financial representations.

Where the results do not appear to be correct or complete, the situation is discussed with the specialist, and any remaining significant differences of opinion are elevated to the Regional Office. Issues that cannot be resolved by the Regions are forwarded to Headquarters in a timely manner. Especially difficult accounting or cost principle issues that cannot be answered using existing regulations and reference sources are referred by Headquarters to the responsible authoritative body for clarification or other appropriate action. All appropriate files documenting the resolution of any significant differences of opinion are required to be maintained for reference and research purposes.

2-S103.5 Monitoring

a. Objective.

To provide reasonable assurance that the policies and procedures established by DCAA for each of the elements of quality control described above are suitably designed and are being effectively applied. Monitoring involves an ongoing consideration and evaluation of the:

- relevance and adequacy of DCAA's policies and procedures;
- appropriateness of DCAA's guidance materials;
- effectiveness of professional development activities; and

- compliance with DCAA's policies and procedures, including appropriate follow-up of quality related issues.

b. Policies and Procedures.

(1) General. Direct responsibility for quality control in all audit and resource management functions is vested in the line and staff managers and supervisors at all levels of DCAA. As stated above, the Executive Officer is responsible for preparing the Director's annual statement certifying that DCAA's system of internal accounting and administrative control provides a reasonable assurance that management controls are in place and operating effectively as required under the Federal Managers' Financial Integrity Act (FMFIA). As reported through the FMFIA process, the Executive Officer monitors tests of critical management controls performed by others and advises the Director and Deputy Director on any sensitive matters disclosed by quality or management control reviews. In addition, the Special Assistants to the Regional Director coordinate periodic management control reviews in accordance with FMFIA.

(2) Relevance and Adequacy of DCAA's Policies and Procedures. Quality control review planning considers the universe of all audit and resource management functions at all organizational levels. Areas for review are prioritized on the basis of periodic full-scale vulnerability assessments, supplemented by data monitoring at the Headquarters level and continual input of any other indicators from any source. The assessments consider the coverage and results of external audits and oversight reviews such as those by the Government Accountability Office; the Department of Defense; Office of the Inspector General; Office of Personnel Management; the Information Security Oversight Office; the Office of the Secretary of Defense; and the Office of Government Ethics; to avoid duplication. Depending on its nature, the area to be reviewed may be covered by:

- onsite visits to lower-tier offices by Headquarters or Regional Office program managers or functional specialists;
- fact-finding by cognizant line or functional staff managers or supervisors using such tools as centrally directed survey instruments and checklists for gauging audit performance;
- Headquarters desk reviews of sample transaction/event packages called in from Field Audit Offices (for example, audit reports or working papers);
- onsite review of internal systems by DCAA specialists who normally support our contract audit function, such as IT staff; or
- review by peers from outside the organization being reviewed, including outside DCAA if required.

The quality control program provides timely feedback to all levels of management on the state of compliance with the Agency's objectives, policies, and procedures. It also provides appropriate focal points for tracking the implementation of corrective action plans established by management to address issues of noncompliance disclosed by external reviews or internal quality control activities. All significant review results and associated plans affecting Agency-wide operations are reported to the Agency's Executive Steering Committee (see Organization above).

(3) Appropriateness of DCAA's Guidance Materials. DCAA produces and maintains a substantial amount of audit guidance, audit management guidance, and administrative guidance in the form of regulations, instructions, manuals, pamphlets, and memoranda. DCAA's guidance publications/issuances are routinely posted to and readily accessible on the Agency's Intranet. DCAA's Headquarters, regional, and Field Detachment staffs continually assess the need for new or revised guidance. For example, the Auditing Standards Division (PAS) of the Headquarters Policy and Plans Directorate periodically posts changes to the Agency's online Contract Audit Manual and republishes a printed Manual on a semi-annual basis. On a continuous basis, PAS updates DCAA's standard audit programs, working papers, and shell audit reports. Guidance revisions arise from many sources, including the issuance of new professional standards, decisions of DCAA's Executive Steering Committee, input from Headquarters, regional and field personnel.

(4) Effectiveness of Professional Development Activities. The Defense Contract Audit Institute (DCAI) is responsible for managing the Agency's professional development and training program. The DCAI staff evaluates on an ongoing basis the effectiveness of the Agency's professional development program (For additional information on DCAI's monitoring procedures see the Professional Development section under the Personnel Management quality control element above).

(5) Compliance with GAGAS and DCAA's Audit Policies and Procedures and Follow-up of Quality Related Issues. Compliance is monitored on a daily basis by regional staff personnel, field audit office (FAO) management, and the members of the participative work teams at the individual FAOs. The QA organization within DCAA (see Organization above) assesses the state of auditor compliance on completed audit assignments. It does this by performing:

- QA-related review projects on both an Agency-wide and regional basis; and
- continuous rounds of internal reviews that follow the guidelines and use the checklists adapted from the President's Council on Integrity & Efficiency (PCIE) External Quality Review Guide.

The objectives of the PCIE-based reviews are to:

- Evaluate the effectiveness of DCAA's quality control system as it relates to the selected audits and determine whether the FAOs and audits satisfactorily complied with the applicable GAGAS and Agency policies;
- Identify the Agency's audit policies, or elements thereof, that contribute to specific instances of noncompliant activity disclosed by the review;
- Identify the areas where improvements are needed in the level of FAO compliance with the GAGAS and DCAA's related audit policies; and
- Significantly facilitate the implementation of Agency-wide process improvements.

A key component of monitoring is timely and effective follow-up of action taken by DCAA's audit and policy management to address/correct quality related issues identified by other elements of DCAA's quality control system. Timely and effective follow-up often involves the need for new or enhanced Agency policies and procedures, as well as the development and implementation of corrective action plans by Regional management (i.e. Regional Directors, Regional Audit Managers, FAO Managers, or Supervisors) to address specific issues or deficiencies. Headquarters Policy and Plans Directorate is responsible for revising Agency policies and procedures when inadequacies in guidance are identified. When deficiencies are identified in the level of field auditor compliance with policies and procedures or GAGAS, Regional management is responsible for developing appropriate corrective action plans to address the deficiencies/noncompliant practices. Regional management is also responsible for:

- assuring that the corrective actions are implemented in a timely and effective manner, and
- following-up on the actions taken on an "as needed" basis to assure that they achieve the intended results.

One of the tools available to regional management to monitor working paper compliance with GAGAS and Agency policy is the DCAA Quality Checklist for Review of Audit Working Papers. This checklist can be used for the purposes of auditor self-assessment, a peer review, or a supervisory review of the audit working papers. The checklist is maintained by Headquarters – PQA, and can be found in the APPS and on the DCAA Intranet.

2-S104 ADMINISTRATION OF DCAA'S QUALITY CONTROL SYSTEM

a. Objective.

To provide reasonable assurance that the Agency's quality control system achieves its objectives. In so doing, appropriate consideration must be given to the:

- assignment of quality control responsibilities,
- means by which quality control policies and procedures are communicated, and
- extent to which the Agency's policies and procedures and compliance therewith should be documented.

b. Policies and Procedures.

(1) Assignment of Responsibilities. All quality control procedures discussed above are designed and maintained by the staff elements of DCAA's Headquarters, regions, or Field Detachment. All employees are responsible for complying with the procedures.

(2) Communication of Quality Control Policies and Procedures. The Agency's quality control policies and procedures are contained in various Agency publications, including the DCAA Charter, Instructions, Manuals, and other DCAA directives. Most Agency publications are contained on the DCAA intranet and are accessible to all auditors. The majority of the quality control procedures are contained in the CAM. The CAM is updated continuously and available to all personnel on the DCAA Intranet. It is printed semiannually and provided to all personnel.

(3) Documentation of DCAA's Quality Control Policies and Procedures. A strong, well-documented internal quality control system has been in place within DCAA since its inception. Key elements of the system are described throughout this manual and summarized in this section. The system is further documented in the Agency's charter, regulations, instructions, personnel management manual, etc. The Agency also documents its system of quality control for the Department of Defense, Inspector General (DoDIG) through completion of the form entitled (DCAA's) Audit Quality Control Policies and Procedures. The form is part of the President's Council on Integrity & Efficiency (PCIE) External Quality Control Review Guide.

The attention given to improving the Agency's quality system and its documentation over the years is evidence of the strength of the system. The Agency's implementation of the Federal Managers' Financial Integrity Act (FMFIA) and related DCAA internal management control system requirements (DCAA Regulation No. 5010.7) are key examples of the continuous improvement of the system and its documentation. FMFIA implementation, in particular, served to consolidate various elements of the system and restructure the system's documentation.

As noted under 2-S102.2.a.(1), the Executive Officer (DX) is responsible for drafting the Director's annual statement required by the Federal Managers' Financial Integrity Act (FMFIA). The statement documents that:

- The Director recognizes the importance of management controls,
- DCAA has conducted an annual evaluation of the Agency's system of accounting and administrative control, which covered the management controls within that system,
- The annual evaluation was conducted in a conscientious and thorough manner, and that
- The results of the annual evaluation show that the management controls are in place and operating effectively.

The broadly termed system of accounting and administrative control noted in the FMFIA statement encompasses DCAA's system of audit quality control. The enclosure supporting the annual statement documents in detail the audit quality control system and the monitoring and evaluation of that system.

(4) Documentation of Auditor Compliance with DCAA's Quality Control Policies and Procedures. As mentioned above, the enclosure supporting the annual FMFIA statement documents in detail the monitoring and evaluation of DCAA's audit quality control system. It covers the monitoring and evaluation done by regional management and

staff personnel and by the management and personnel assigned to the various Headquarters elements. The Assistant Director for the Headquarters Policy and Plans Directorate has the greatest responsibility for:

- assuring that Agency auditors are performing audits in accordance with the GAGAS, and
- documenting the Directorate's work that provides the appropriate level of assurance.

The Policy Directorate fulfills its responsibilities through the work of its Divisions (see Organization above) and staff of program managers, and through the general management and oversight of DCAA's Quality Assurance (QA) function.

The management and oversight of the QA function and the documentation of the Agency's QA review efforts are accomplished through the Policy Directorate's Quality Assurance Division in the manner outlined above under Organization – Quality Assurance and Monitoring -- Compliance with GAGAS and DCAA's Audit Policies and Procedures. The documented results of the QA reviews are routinely provided to the Agency's Executive Steering Committee and to its external reviewers – the DoD Office of Inspector General.

Figure 2-S10-1
Defense Contract Audit Agency
Statement on Independence

Background: Generally Accepted Government Auditing Standards (GAGAS), address Auditor Independence. Section 3.03 of GAGAS states that in all matters relating to the audit work, the audit organization and the individual auditor, whether Government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence. Personal Impairments are defined in Sections 3.07 through 3.18, and external impairments are defined in Sections 3.19 through 3.20. These requirements are discussed in detail in CAM 2-203 and 2-S10.

Instructions: This form, which documents compliance with this GAGAS standard, is to be completed annually by all DCAA auditors and other Agency specialists providing audit support. This form is also to be completed by newly hired auditors prior to beginning any audit work. Individuals who are either not able to sign this statement or experience a situation after signing where they believe their independence and/or objectivity is or may be impaired should notify, in writing, their immediate supervisor of the situation. DCAA's Ethics Officer is also available for consultation.

Statement: I have read and understand DCAA guidance in CAM 2-203 and 2-S10 (2-S103.1 Independence, Integrity and Objectivity), which provide coverage of GAGAS Sections 3.07 through 3.18, Personal Impairments, and Sections 3.19 through 3.20, External Impairments. I have also read and understand the guidance in CAM 1-800 Section 8 --- Auditor Participation on Contractor and Government Process Action Teams (PATs); Integrated Product Teams (IPTs); Management Councils; and Related Streamlined Acquisition Initiatives.

I state that I have neither personal nor external impairments that will keep me from objectively planning and conducting my assignment(s) and reaching independent conclusions based on the evidence. I will reevaluate my independence whenever my assignment is changed and whenever my circumstances change. If changes affecting either my independence or my objectivity occur subsequent to the completion of this form, I will promptly notify my immediate supervisor in writing of the situation.

Signature: _____ Date: _____

Printed Name: _____

Supervisor's Signature: _____ Date: _____

Printed Name: _____

CHAPTER 3

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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 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 2 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 NASA contractors.

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

3-101 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.

3-102 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.

3-103 The Audit Program

3-103.1 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

3-103.2 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 supervisor will determine 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.

3-103.3 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 or in a separate working paper 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.

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.

3-103.4 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 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 or on the audit program itself, as appropriate, and modify the audit program based on the

interim discussion. If the Agency's standard audit programs are revised while the audit is in process, the summary of revisions issued with the quarterly APPS update will identify which, if any, of these revisions must be incorporated into audits in process.

b. During the audit, reference each audit step to the working paper(s) where the step was accomplished. 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).

3-104 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 3-104.1 through 3-104.19 below.

3-104.1 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 4-103 for guidance on coordinating and communicating with our audit customer.

3-104.2 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.

3-104.3 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).

3-104.4 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.

3-104.5 Direct Costs

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

3-104.6 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.

3-104.7 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.

3-104.8 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.

3-104.9 Indirect Cost Allocation Bases

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

3-104.10 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.

3-104.11 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.

3-104.12 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.

3-104.13 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.

3-104.14 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 sev-

eral 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 Appendix B 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. (See Appendixes E and F.)

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).

3-104.15 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.

3-104.16 Mandatory Annual Audit Requirements (MAARs) Accomplishment

A general discussion of MAARs appears in 6-100; 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 3-1S2), reports filed with regulatory bodies, such as the Securities and Exchange Commission (SEC) (see 3-1S1), 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 3-104.14.

3-104.17 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; guidance is in Appendix B.

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 (Appendix E). The manual 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 3-104.14 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.

3-104.18 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 3-200 for further guidance on reviewing RFP/RFQ and contract provisions.

3-104.19 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.

3-1S1 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.

3-1S2 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.

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)).

3-200 Section 2 --- Briefing of Contracts and Requests for Proposals

3-201 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.

3-202 Contract Briefing System

3-202.1 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 priced contracts and final voucher audits, other incurred cost audits or reviews for cost type contracts, and defective pricing audits.

3-202.2 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 3-202.3 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 3-2S1.

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 3-204.1. 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.

3-202.3 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 (3-205), 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 3-2S1 to determine adequacy. (For guidance on provisions impeding contract administration see 3-204.) 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.

3-203 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 (3-205) are required, promptly inform all DCAA personnel who may be affected.

3-204 Reporting on Provisions Impeding Effective Contract Audit or Administration

3-204.1 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.

3-204.2 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.

3-204.3 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 manager. 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.

3-205 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.

3-2S1 Supplement --- Special Considerations in Audits of Selected Contract Types

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
1. FAR Citations		
FAR 52.216-7	FAR 52.232-7	FAR 52.232-16, 32.5, 42.7
Accrued Versus Paid Cost		
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.
For purposes of interim reimbursement. 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.
For final vouchers. 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.
Delinquent Payments		
For interim vouchers. 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.
Unallowable Cost		
Billed costs do not include unallowable costs.	Same as cost reimbursable for the ODC and material portions of the contract.	Same as cost reimbursable.
Pensions, etc.		
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		
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.	Same as cost reimbursable.	Not applicable.
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.	Same as cost reimbursable.	Same as cost reimbursable.
See also 11-100 for guidance on the limitation of cost clause.	Not applicable.	See also 11-100 for guidance on the Limitation of Payments Clause. Progress Payment and Liquidation rates are specified in the contract.
3. Cost Sharing Arrangements		
Contracts may identify percentages or absolute values in excess of which the Government will not reimburse costs.	Not applicable.	Not applicable.
4. Retentions and Withholds		
Patent Rights and Technical Data Withholds. 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 27.305-3(3) 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 which states that the Government may withhold payment until a reserve not exceeding $50,000 or 5 percent of the amount of the contract, whichever is less has been set aside. Similarly, the clause in	Not applicable.	Not applicable.

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
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.		
Fee Withholds. 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.	Not applicable.	Not applicable.
Not applicable.	Hours Withhold. 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 subcontract 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).	Not applicable.

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
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.		
Interim Vouchers. 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 only once a month, unless otherwise approved by the contracting officer.	Vouchers may be submitted only once a month.
Final vouchers on completed contracts. Completion vouchers should be submitted promptly upon completion of the work, but no later than one year (or longer, as the contracting officer may approve in writing) from the completion date per FAR 52.216-7(h)(1). 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.
Final vouchers on terminated contracts. 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 (2) billing other direct costs (ODCs); direct mate-	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
	rials 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).	
For interim payments. 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 3 above.) However, Award fees are generally the subject of a special contract modification and the specific amount to be billed is given.	Profit is billed as part of the rate.	Contract line items are billed at price unless progress payments or advance payments are allowed.
For final vouchers. The fee is calculated in accordance with the terms of the contract.	Profit is billed as part of the rate.	Contract line items are billed at price less any credit for liquidating progress payments.
7. Forms and Documentation Requirements		
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.	Same as cost reimbursable.	For progress payments the SF 1443 is used. Instructions for the SF 1443 are on the back of the form.
The contract generally identifies the cognizant DCAA office responsible for processing vouchers.	Same as cost reimbursable.	Not applicable.
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.		
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	Same as cost reimbursable.	A fixed price contract requires specific delivery dates for item.

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
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 data stated in the contract, or in excess of contract limitations.		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		
Overtime Premium. 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.
Other. 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.		
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

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
		for progress payments.

3-300 Section 3 --- Internal Control Audit Planning Summary (ICAPS)

3-301 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.

3-302 Background Information

a. As discussed in 3-100, 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.

3-303 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.

3-304 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 contactors 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.

3-305 Preparation of the Internal Control Audit Planning Summary

Figure 3-3-1 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.

3-305.1 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 Contractor 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 con-

tractor'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.

3-305.2 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 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.

3-305.3 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 inadequate 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.

3-305.4 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)).

3-306 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 3-3-1
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

	Control Risk			Reference to Support Assessment
Control Objectives	Low	Moderate	High	Report No./Date
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: _____

Figure 3-3-1

IV. IMPACT ON THE SCOPE OF OTHER AUDITS

Audit Areas	Required Substantive Testing Minimum	Increased	N/A	Reference to Continuation Sheet that Describes the General Scope of Required Substantive Testing
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 3-305.4c). 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 repairability 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 7-600).
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.

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CHAPTER 4

4-000 General Audit Requirements

4-001 Scope of Chapter

This chapter presents general guidance and basic auditing concepts and techniques to assist the auditor in accomplishing the objective of contract auditing. Amplification of this guidance will be found in later chapters and appendixes.

4-100 Section 1 --- FAO Coordination with Contract Administration Personnel

4-101 Introduction

This section presents guidance on general coordination with procurement and contract administration personnel.

4-102 Coordination with Contractor and Government Contract Administration Personnel

a. The maintenance of effective communications and interface with the people with whom DCAA is involved in day-to-day operations is an important aspect of the audit function and is referenced in various sections of CAM dealing with operational auditing matters.

b. Periodic visits are made to various field audit offices by DCAA regional personnel (RD, DRD, RAM) in conjunction with reviews of the adequacy and status of audits performed by such FAOs. Occasional visits are also made to FAOs by members of the DCAA Headquarters staff in connection with their assigned duties. In view of the importance of effective communication, regional and Headquarters personnel should, during visits to FAOs, make a reasonable attempt to arrange for meeting with appropriate contractor and Government contract administration officials. The primary purpose of such meetings is to provide contractor and Government representatives with an opportunity to express their views on relationships with DCAA and any significant developments or problems where DCAA may be involved or be able to provide assistance. In addition, it is expected that significant audit matters and problems requiring the cooperation or assistance of contractor or Government contract administration personnel would be discussed at these meetings. Discussions should be informal and conducted with an objective of mutual benefit.

c. In the case of visits to branch offices, it is contemplated that contacts would ordinarily be limited to contractor representatives at suboffices visited and Government contract administration offices in the same locality as the branch offices or suboffices visited.

4-103 Acknowledgment/Notification Letter

a. Correspondence with our audit customers is critical to coordinate and communicate our services effectively. Correspondence at the beginning of an audit should reflect our understanding of the customer's specific needs and summarize the audit services we intend to perform. The FAO should electronically transmit an acknowledgment letter in a timely manner in response to requests for audit services received from a customer. An example acknowledgment letter is included in Figure 4-1-1. Requirements for acknowledgements of agreed-upon procedures engagements are discussed in paragraph 4-103d., below. The FAO should also electronically transmit notification letters to the planned recipient(s) of our audit reports for audits which have not been requested (e.g., incurred cost audits,

postaward audits, and internal control system audits). An example notification letter is included in Figure 4-1-2.

b. The suggested contents for acknowledgment/notification letters are as follows:

- Assignment Identification. Identify DCAA's assignment number for the audit and information to identify the customer's request for audit, in the case of a requested audit, or the contractor's submission, when the audit is not based on a customer request.
- Audit Scope. Briefly describe the scope of audit and list the audit objectives and/or key audit procedures in bullet format.
- Opportunity for Interaction. Invite the customer to contact DCAA if the audit scope will not fully meet his/her objectives.
- Technical Assistance. If technical assistance is needed to perform a complete audit, incorporate the request into the letter (following the guidance in Appendix D) - See Figure 4-1-1 for an example.
- In-process Communications and Report Date. Provide the planned completion date for the audit and inform the customer that we will keep him/her informed of significant issues that may arise during the audit.

c. The acknowledgment/notification letter will usually be issued after the risk assessment/preliminary review section of the audit is completed. In the case of customer requested audits, this should be performed as quickly as possible after receipt of the audit request (a rule of thumb is five days). Should the auditor be unable to prepare the acknowledgment letter within a short time after receipt of the audit request, DCAA should issue a brief acknowledgment of the request and follow this up with an expanded letter, containing the elements in 4-103b, as quickly as possible.

d. Agreed-upon procedures: Before issuing the acknowledgement letter, follow the guidelines in 14-1002.3, Establishing an Agreement on the Terms of the Engagement. The following information should be included in the acknowledgement letter:

- Nature of engagement (i.e., an application of agreed-upon procedures).
- Identification of the subject matter or assertion (usually a contractor submission) to which agreed-upon procedures are to be applied and the fact the contractor is responsible for the subject matter or assertion.
- Identification of the specified users of the report.
- Confirmation of requestor's responsibility for the sufficiency of procedures.
- DCAA's responsibility to complete the engagement in accordance with applicable professional standards.
- Listing of agreed-upon procedures, including the criteria to be used.
- (If applicable) Any materiality limits for reporting purposes agreed to by the auditor and the requestor.
- (If applicable) Assistance to be provided to DCAA by requestor.
- (If applicable) Involvement of any specialists from outside of DCAA.
- Disclaimers expected to be included in the report.
- Restrictions on use of report.

Figure 4-1-3 is an example of an acknowledgment letter for agreed-upon procedures. In addition, a pro forma acknowledgement letter for agreed-upon procedures (OAG – DCAA Acknowledgement Letter – Agreed-Upon Procedures.doc) is available in APPS under Other Audit Guidance.

Figure 4-1-1
Example Acknowledgment Letter

October 26, 20XX

MEMORANDUM FOR CONTRACTING OFFICER, DEPARTMENT OF THE AIR FORCE
AIR LOGISTICS CENTER, 123 ROAD
CITY, STATE 12345-6789

SUBJECT: Request for Audit of ABC Company
Prime Contract Proposal for Systems Support

Reference is made to RFP No. WAFB12-XX-R-0097. We have received your request for audit services dated October 21, 20XX, for an audit of ABC Company's proposal, dated September 27, 20XX, submitted in response to RFP No. WAFB12-XX-R-0097. This is a firm-fixed-price proposal in the amount of $11,443,450. We have established assignment number 1234-20XXB21000001 to audit this proposal.

The scope of our services will be based on auditor judgment, risk assessment and your specific needs, as we discussed on October 22, 20XX. During this examination we will perform the following procedures:

- Compare proposed labor hours to current plant-wide labor standards and evaluate the reasonableness of the proposed improvement curve applications.
- Evaluate the proposed labor rates.
- Verify that the proposed direct labor and indirect expense rates compare favorably with our recent audit of the forward pricing rates.
- Evaluate the contractor's cost analysis of the major subcontractor's proposal and request any needed assist audit.

As discussed with Ms. Molly Wilson, Industrial Engineer, on October 22, 20XX, we need technical assistance to help us evaluate proposed manufacturing hours. In estimating this cost element, the contractor used plant-wide labor standards adjusted by a productivity factor resulting from experience on the XYZ contract. The contractor then judgmentally applied a 20 percent complexity factor to reflect the impact of this newly proposed product. We request that an engineer review the reasonableness of the 20 percent complexity adjustment factor.

The contractor also proposed 3 new labor standards, as follows:

- Item 1 -- Set up 1.097; Run 453.301
- Item 2 -- Set up 212.5; Run 63.511
- Item 3 -- Set up 312.4; Run 75.551

We also request the engineer review the reasonableness of these standards.

We would appreciate receiving the engineer's review results by November 15, 20XX.

We will notify your office of any significant issues as they arise during our audit. Our audit is scheduled to be issued no later than November 20, 20XX. If you require additional audit services other than those cited, please contact Dain Williams, Senior Auditor, or Danica Wells, Supervisory Auditor, at (703) 111-1111 or fax (703) 111-2222. Our e-mail address is dcaa-faoxxxx@dcaa.mil.

LINDA BELL
Branch Manager

Figure 4-1-2
Example Notification Letter

October 26, 20XX

MEMORANDUM FOR ADMINISTRATIVE CONTRACTING OFFICER
ADDRESS
CITY, STATE 12345-6789

SUBJECT: Audit of ABC, Inc.
Fiscal Year 20XX Incurred Cost Proposal

We are planning to begin the subject audit on November 12, 20XX. The scope of our audit will be based on a detailed risk assessment and auditor judgment. As we discussed last week, your office is concerned about the reasonableness of material requirements charged to Government contracts. We will address your concern during the audit. If you have any other input on this audit or concerns which you believe should be addressed by this audit, please discuss them with us at the number listed below.

During the audit, we plan on evaluating the following:

- labor and material cost transfers (the allowability of recorded labor costs were evaluated during the concurrent floor checks performed during FY 20XX)
- material requirements
- indirect expenses with focus on executive compensation, depreciation, public relations and advertising, and employee morale
- interdivisional cost transfers

At this time, we do not foresee a need for technical assistance from your office. However, should a need arise during the audit, we will notify your office and request specific assistance.

We will notify your office of any significant issues that arise during the audit. Our audit report is scheduled to be issued on or before January 15, 20XX. If you have any questions, please contact Dain Williams, Senior Auditor, Danica Wells, Supervisory Auditor, or myself at (703) 555-1233 or fax at (703) 555-1234. Our e-mail address is dcaa-faoxxxx@dcaa.mil.

LINDA BELL
Branch Manager

Figure 4-1-3
Example Acknowledgement Letter
Application of Agreed-Upon Procedures

In reply refer to:

2441-20XXA17900027 March 15, 20XX

MEMORANDUM FOR CONTRACTING OFFICER, U.S. NAVAL AIR SYSTEM COMMAND, PATUXENT RIVER, MARYLAND

ATTENTION: Contracting Officer (T.P. Hunt)

SUBJECT: Request for Agreed-Upon Procedures
New Corporation, Alexandria, VA

Reference is made to Case No. xxx-xx-xxx We have received your request for DCAA services dated March 12, 20XX to apply agreed-upon procedures to the New Corporation (NC)'s September 20XX invoice for Contract No. N00019-0X-D-0001, Task Order No. 3. NC is responsible for the submitted invoice. We have established assignment number 2441-20XXA17900027 to perform the agreed-upon procedures engagement.

Your office will use our report on application of agreed-upon procedures to assist you in determining if NC paid its employees the Davis-Bacon Act rates per Contract No. N00019-0X-D-0001, Task Order No. 3, for the work performed at the U.S. Naval Air Station, Patuxent River, Maryland. Based on your written request and subsequent discussion with Ms. Jordan of this office, the U.S. Naval Air Systems Command is solely responsible for the sufficiency of the procedures agreed upon to accomplish this engagement. DCAA is responsible for completing this engagement in accordance with applicable government auditing standards for agreed-upon procedures.

The agreed-upon procedures are as follows:

- Using NC's September 20XX invoice for Contract No. N00019-0X-D-0001, Task Order No. 3, compare the cumulative labor dollars and hours billed to the amounts recorded in NC's September 20XX job cost ledger and report any differences.
- Compare the direct labor rates recorded in NC's September 20XX labor distribution report for Contract No. N00019-0X-D-0001, Task Order No. 3 to the hourly rates paid to employees per NC's payroll report for September 20XX and report any differences.
- Compare the hourly rates paid to employees for Contract No. N00019-0X-D-0001, Task Order No. 3 per the September 20XX labor distribution report to the Davis-Bacon Act hourly rate stated in Contract N00019-0X-D-0001 and report any differences.

Our report will pertain only to the application of the agreed-upon procedures to NC's September 20XX invoice for Contract No.N00019-0X-D-0001, Task Order No. 3. We were not engaged to, and will not, perform an audit, the objective of which would be the expression of an opinion on the subject matter of the report. Accordingly, we will not express such an opinion. Additional procedures, if applied, could bring other matters to our attention that would be reported to you. The report will be prepared using the procedures identified above and any other procedures which may later be agreed upon with you. The information included in our report is intended solely for your use, and should not be used

by you or by others for any purpose other than that for which the procedures are established.

We will notify your office of any significant issues as they arise during our application of agreed-upon procedures. Our report is scheduled to be issued no later than April 12, 20XX. If you require additional services beyond those cited, please contact Sam Sharp, Senior Auditor, or Isobel Jordan, Supervisory Auditor, at (703) 123-4567 or fax (703) 123-4568. Our e-mail address is dcaa-faoxxxx@dcaa.mil.

James Mack
Branch Manager

4-104 Negotiation Memorandum and Findings on Appeals

a. FAR provides that the contracting officer shall forward to the cognizant DCAA auditor one copy of the negotiation agreement (e.g., price negotiation memorandum (PNM) (FAR 15.406-3(b)), Memorandum of Disposition of Post-award Audits (FAR 15.407-1(d)), and Final Determinations on Contractor Appeals to DCAA Forms 1. In order to be timely and fully responsive to the needs of DoD management in providing information on audits, negotiations, etc., all field audit offices will establish formal follow-up procedures to ensure that copies of these contracting officer advices are timely received and promptly reported in the status reports required by Headquarters. For a contract awarded under competitive negotiation procedures, a PNM may not be prepared, but the information required by FAR 15.406-3(a) should be reflected in the evaluation and selection document, to the extent applicable, and forwarded to the cognizant audit office that provided assistance.

b. If the negotiation agreement (e.g., PNM) provided for by FAR 15.406-3(b) is not received by the auditor within 90 days following issuance of the audit report, and negotiations are known or expected to be completed (for price proposals, questioned costs should exceed $500,000 to warrant follow-up unless the pricing action has been selected for a defective pricing audit), the field audit office will take follow-up action requesting a copy of the document directly from the cognizant procurement or administration activity with a copy of the request to the FLA. If necessary, the field audit office should issue a second follow-up request, identified as such, within 90 days of the first follow-up request for the PNM. Upon receipt of the second follow-up request, the FLA will become responsible for all further follow-up until the contracting officer distributes the PNM. Where the FLA encounters a continuing problem with timely distribution of PNMs, and corrective action is not effected, the FLA should elevate the matter for resolution by the region with its counterparts in the acquisition or administration activity.

c. Those activities with FLAs are listed in the FLA Locator on the DCAA Intranet site.

d. Auditors at subcontractor locations also require similar information relating to prime contractor or higher tier subcontractor negotiations with subcontractors. This information is needed for postaward auditing, assessing performance, and reporting purposes. The auditor at the prime contractor or higher tier subcontractor location should ensure that maximum support is given to subcontract auditor requests. In the event a contractor refuses to release the information for use outside its organization, it will be necessary for the auditor at the prime contractor or higher tier subcontractor sites to review the subcontract file and report pertinent information to the subcontract auditor.

e. Follow-up is required for copies of Final Determination on Contractor Responses to DCAA Forms 1. 6-908c states that the auditor must have received a copy before a resubmission voucher can be processed.

4-200 Section 2 --- Coordination with Contractor Internal and External Auditors

4-201 Introduction

This section discusses requirements for maintaining effective relationships with contractor internal and external auditors.

4-202 Relationships with Contractor Internal and External Auditors

4-202.1 Coordinated Audit Planning

a. The auditor's evaluation of a contractor's internal controls, pursuant to 5-100, may disclose, particularly at a major defense contractor location, that a contractor maintains a highly professional internal audit staff. In addition, the majority of larger contractors also engage an external public accounting firm to conduct an audit of their financial statements. While these internal and external auditors' final audit objectives are not the same as DCAA's, the means of achieving these differing objectives often overlap. This frequently results in duplicative audit procedures. Whenever there are multiple audit organizations involved, consideration should be given to coordinated audit planning. Such a program must, of course, be predicated upon the contractor's agreement to make available to DCAA relevant internal and/or external audit working papers and reports (see 4-1000). Since the external auditor's working papers do not belong to the contractor, there must be agreement between the contractor and the external auditor to provide access to DCAA. This may be accomplished in the engagement letter. Also, before communicating directly with an external auditor regarding contractor information, a letter should be obtained from the contractor indicating that there are no objections to such communication.

b. Coordinated audit planning is a voluntary process wherein DCAA and the contractor's internal and external auditors consider each other's work in determining the nature, timing, and extent of auditing procedures. Coordinated audit planning considers the extent to which reliance can be placed upon work performed by the other auditor to minimize duplication of audit effort. In addition, this process strengthens the evaluation of internal control systems.

c. The primary benefit of coordinated audit planning is that it promotes contractor self-governance, enabling organizations to better develop and maintain strong systems of internal controls. Coordinated audit planning also helps identify and eliminate duplicative audit effort, thus saving resources for all parties. It is an efficient and effective means for conducting oversight and it provides contractors with better visibility into and understanding of Government oversight criteria. This promotes communication, cooperation, and respect among the various auditors.

d. The specifics of a contractor’s participation in coordinated audit planning should be discussed at the annual planning meeting between FAO management and contractor executives. SEC registered public companies are subject to additional certification and reporting requirements as a result of the Sarbanes-Oxley Act of 2002. These companies are required to certify to the financial and other information contained in the quarterly and annual reports filed with the SEC, and are also to include with their annual filing, a report of management on the company’s internal control over financial reporting. They are also required to include with the annual report the independent auditor’s attestation report on management’s assessment of the company’s internal control over financial reporting. As a result, public companies and their independent auditors may now perform additional audit effort to support the certification and reporting requirements. Auditors should be aware of the potential for increased opportunities in planning and performing audits in coordination with the external and internal auditors to avoid duplication and reduce overall costs of audits to the company and the Government. As a means towards reducing our planned audit effort on internal controls, auditors should discuss with corporate management the relevance and availability of documented audit work used in support of the SEC required certifications and in developing management’s report on internal control over financial reporting.

e. If the contractor elects to participate in coordinated audit planning, or if the auditor intends to rely upon any work performed by internal auditors, the FAO should update permanent files annually to document the continued organizational independence of the internal audit department and their objectivity in conducting audits.

f. The coordinated effort may be accomplished either through the adoption of complementary audit programs for separate performance by the respective audit staffs or through joint audits. The sharing of overall annual audit plans or participation in such programs as the Contractor Risk Assessment Guide does not constitute a joint audit. A joint audit is one in which the Government and the contractor have mutually assessed risk, developed an audit program, and conducted field work in the audit of a particular area. When audit steps are performed jointly, each audit organization will maintain supervisory responsibility over its respective audit staff.

g. In some instances, for reasons such as limitations imposed on the scope of the contractor's internal audit activities or the sensitivity of the audit area, it may not be feasible or desirable to adopt a joint audit approach. However, even in such instances, the work of the contractor's internal and external auditors should be considered in assessing risk and in establishing audit scope. Areas particularly appropriate for consideration include tests of the overall accuracy of computations, accounting records, compliance with established internal controls and procedures, material and inventory pricing, payroll preparation, labor distribution, and accounts payable. To reduce the extent of audit work that would otherwise be performed by the DCAA auditor, reliance should be placed on the contractor's internal and external audit activities commensurate with the nature, scope, and effectiveness of work performed. See 4-1000 for documentation requirements when relying upon the work of others.

h. At contractors where internal and/or external working papers and reports are made available to DCAA, the FAO should make arrangement to receive reports impacting DCAA audit work when the audits are completed. The FAO should review the report shortly after receipt to determine if there are any reported items that need follow-up or affect in-process, planned audits, or the annual audit plan. The FAO should also request annually a listing of reports issued and perform a reconciliation to ensure all reports have been received. When a report indicates significant audit deficiencies or major problems with billings to the Government, the auditor should conduct a timely fact finding of all issues and communicate the findings to the proper Government personnel. All oral communications should be confirmed in writing on a timely basis (see 1-403.3).

4-202.2 Access to DCAA Working Papers

a. Under a coordinated audit planning program the contractor's internal or external auditors are authorized access to most relevant DCAA working papers. However, contractors' internal and external auditors are not authorized access to the following:

(1) DCAA Form 2000 and associated working papers.

(2) Audit reports and associated working papers when reports have a contingent release statement (see 10-212.2). These may be released with permission of the contracting officer.

(3) Government technical reports and price negotiation memorandums. These may be released with permission of the originator.

(4) Reports or information on subcontractors. This information may be released if authorized by the subcontractor.

(5) Administrative forms or appraisal evaluations.

(6) Classified working papers.

(7) Working papers discussing unsatisfactory conditions on the part of Government personnel (see 4-803.2b).

(8) Sensitive materials related to DoD Hotline issues.

b. DCAA working papers are considered Government property and, as such, DCAA must maintain physical custody. To the extent practical, the other auditors should satisfy the evidence requirement by reference to, or notes and extractions from, DCAA working papers. Copies should generally be made only when referencing notes or extraction would not be practical. If copies are required, the other auditor should provide a list to the DCAA auditor who in turn will arrange for reproduction. A list of the documents provided will be retained in the DCAA working papers.

4-202.3 Coordinated Audit Matrix

At those contractors participating in coordinated audit planning, a coordinated audit matrix should be prepared at the beginning of the year. This matrix should identify the areas of audit coverage for the coming year, the parties responsible for performing the specific audit work, and milestone dates. There should be ongoing status and program evaluation meetings to assess progress on the coordinated audit plan and to discuss audit results.

4-203 DCAA Response to Accounts Receivable Confirmation Requests from CPA Firms

a. Auditors occasionally receive requests from CPA firms to confirm the amounts represented by their clients as receivables due from the Government. These requests normally apply to contracts where provisional approval for interim payment of costs incurred to date is DCAA's responsibility. Confirmation of receivables is a generally accepted auditing procedure whereby the CPA seeks to verify the existence and accuracy of the dollar amounts reported as accounts receivable on the contractor's financial statement. Under Government contracting, it may be expected that the CPA will request positive rather than negative confirmation; in either case, it is DCAA policy to acknowledge each request.

b. Contractors usually establish a receivable under cost-reimbursement type contracts, in the amount of a public voucher, at the time it is submitted to the auditor. However, we cannot reasonably determine the exact timing of contractor payment by the disbursing office or the total amounts unpaid at any prior point in time. Furthermore, public vouchers represent claims for interim payments which are provisional in nature and subject to retroactive adjustments at any time prior to approval and payment by the Government of the contractor's completion voucher. Therefore, the auditor is not in a position to issue an unqualified confirmation of accounts receivable amounts, and could not issue a qualified confirmation of outstanding billings without the disbursing office coordination.

c. A confirmation request may also include contract billings which are not subject to audit approval, such as for progress payments, economic price adjustments, or deliveries under fixed-price type contracts. It is not appropriate for DCAA to expend any effort attempting to confirm such billings.

d. Because of the above considerations, auditors will not attempt to confirm amounts claimed by contractors as due from the Government. Tactfully and promptly acknowledge a CPA's confirmation request by letter, with a brief statement as to why we are not in a position to confirm a contractor's accounts receivable. Also provide, if available, the name and address of the Government disbursing office where additional information may be pursued if the firm so desires. For example, the acknowledgment might read:

"We acknowledge receipt of your confirmation request dated August 15, 20XX, concerning amounts represented by the XYZ Company as due from the Department of the Army as of July 31, 20XX."

"Until completion of a cost-reimbursement type contract and later final settlement of the costs, we are not in a position to confirm that amounts claimed by a contractor are payable under the contract. Also, under any type of Government contract, we cannot

determine the unpaid billed amount at any prior point in time because we do not maintain records of payments made. If you wish to pursue confirmation of the outstanding billed amounts, we suggest that you address your inquiry to the Army Finance Office, (address)."

4-300 Section 3 --- Conferences With the Contractor (Entrance, Interim, and Exit) on Audit Plans and Results

4-301 Introduction

a. This section provides guidance on audit conferences with the contractor. It states the basic requirements for and the extent and nature of discussions during entrance, interim, and exit conferences in general and under each type of audit assignment.

b. Additional guidance on program plan and risk assessment conferences with the contractor is contained in the DCAA Management Information System (DMIS).

c. Regarding contractor conferences in the mobile audit environment, see supplementary guidance as follows: (1) supervisory auditor participation (see 2-302.2), (2) branch manager participation (see 2-302.2).

d. Special guidance on preliminary conferences after a contract termination (before the contractor submits a settlement proposal) is in 12-205.

e. Special guidance on preliminary conferences when performing concurrent incurred cost audits is contained in 6-404.

f. Conduct all discussions with contractors with objectivity and tact in a forthright, professional manner.

4-302 Contractor Conferences - Entrance

4-302.1 General Procedures for Entrance Conferences

a. Except as provided in 4-302.4, hold an entrance conference with the contractor's designated representative(s) at the start of each separate audit assignment (or each group of assignments to be covered in a single field visit). Document the date, participants' names and titles, and primary discussion points, including specific identification of requested data to control what was requested and provided during the audit. The significance or sensitivity of the assignment will dictate the level and number of audit personnel who should attend the conference.

b. As a minimum, explain the purpose of the audit, the overall plan for its performance including the estimated duration, and generally the types of books, records, and operations data with which the auditor will be concerned. If applicable, the following matters should be handled during or shortly after the entrance conference:

(1) Make arrangements for any necessary work space and administrative support. Primarily, this applies to mobile assignments; however, auditors in a resident office or suboffice may also need temporary space in a particular operating location to expedite an audit with budgeted hours of a month or more, such as a system audit.

(2) Ask the contractor to designate primary and alternate officials with whom audit matters are to be discussed during the course of the assignment. However, make it clear that such an arrangement does not preclude access to other knowledgeable contractor personnel as needed during the audit. Also make it clear that these arrangements should not cause delays or extra audit work (hence the advisability of having named alternate officials to expedite the audit should the primary official be unavailable). Complex, detailed, and time consuming procedures, such as requiring all data requests be written and/or funneled through a single individual only, are an obstruction to efficient audit operations. Contractor representatives' actions which unreasonably restrain, restrict, or delay the audit should be processed using the denial of access to records procedures set forth in 1-504.3.

(3) Discuss, or obtain a briefing on, the contractor's proposal(s) or other cost representation(s) to clarify any preliminary questions, understand the basis of each submitted cost element, and learn the nature and location of supporting data.

(4) Visit all office and/or plant operating areas used in performing current and proposed contract(s).

(5) Arrange to review the planning documents, working papers, and audit reports of the contractor's internal and external auditors for any audits or reviews performed or planned that may curtail the planned scope of work. See 4-202 for guidance on coordinated efforts with the contractor's auditors.

(6) Arrange for any needed IT audit assistance (see 4-500).

(7) When the assignment involves a subcontractor's cost representation(s), resolve any restrictions on release of audit findings and report information to higher-tier contractor(s) per 9-106.4.

(8) Do not enter into written agreements with contractors, or affix concurrence signatures to contractor letters, which contain procedural arrangements that inhibit and/or delay the audit performance or restrict the reproduction of necessary supporting evidential matter.

4-302.2 Special Considerations for Entrance Conferences on Major Operations Audits

a. Hold a planning meeting with the contract administration office technical specialist(s) in advance of the joint entrance conference with the contractor, whenever technical assistance is being provided or a joint review/audit is being conducted. The technical specialist(s) should help develop the entrance conference agenda, such as identifying necessary data to be requested from the contractor. Also invite the specialist(s) to participate actively in the conference itself.

b. Notify the contractor's management several weeks before starting an operations audit or other system audit. This notice may be oral or in writing depending on resident working arrangements (4-302.4).

c. As applicable, mention the following matters during the initial contact before the entrance conference, and follow up during the entrance conference on each major system in addition to those matters common to all assignments (4-302.1).

(1) Request the cooperation of the contractor's top management and operating area management to expedite the audit.

(2) Give the contractor's management personnel an opportunity to explain how they have discharged their responsibilities to establish and maintain adequate internal accounting and administrative controls in the area being audited.

(3) Request the contractor to identify all reports and analyses used by any management level to evaluate and control the effectiveness, economy, and efficiency of the audit area.

(4) Request the contractor to provide an informational briefing on the organization and operations involved in the area to reduce the audit time. Such briefings may cover: organizational assignments affecting the area; system descriptions and/or flowcharts of transaction flows and system controls; and any identified problems and planned corrective actions or other planned changes in the area.

(5) Invite the contractor to participate actively in the evaluation.

(6) Explain in advance the DCAA procedures for submitting draft statements of conditions and recommendations, and establish time frames for the contractor's written responses (see 4-304.5b).

4-302.3 Confirming Letter on Certain Major Assignments

Issue a letter to the contractor on major system audits confirming the arrangements made and significant matters discussed at the entrance conference. Keep the letter's tone courteous and express appreciation for the arrangements made. At the FAO's discretion, use a similar letter for other major audit assignments to help maintain good working relations with the contractor. However, make it clear that the arrangements should not in any way restrict access to records or personnel necessary to the audit performance. Predeterminations of all records, facilities, contractor personnel, etc. that may be needed before starting an audit are not possible.

4-302.4 Resident Working Arrangements for Entrance Conferences

a. Where auditors are assigned full time at the contractor site, it is usually desirable to establish local working arrangements for entrance conferences with the contractor. For example, some contractors may require that the auditor contact certain key personnel before starting specific types of audits (see 4-302.1b.(2)). The contractor may designate a permanent Government liaison representative for audits of a general nature, or the contractor's controller as the contact point for any financial system or compliance type audit and the chief of estimating as the principal contact for price proposal audits. A contractor might also desire a formal entrance conference only on major or nonrecurring audits while price proposal audits or other recurring audits are handled in a prearranged manner.

b. Working arrangements should be established only upon full mutual concurrence of the contractor and the FAO manager. They should not be permitted to restrict access to records or otherwise limit the audit scope. They should expedite the audit and not become so cumbersome as to cause delays or extra work.

c. Do not sign agreements for local working arrangements. If documentation is necessary, a confirming letter may be issued by the contractor, subject to cancellation or revision at any time upon the auditor's request. Make it clear that the auditor will bypass the arrangements anytime that they impede the audit. Additionally, do not enter into written agreements or affix concurrence signatures to contractor letters containing any access to records provisions. Understandings with contractors on reasonable conditions and procedures for the conduct of an audit shall not prejudice DCAA's access rights to perform audits and shall not be formalized in written agreements signed by DCAA representatives.

d. As a minimum, the resident auditor or resident AIC will hold periodic conferences, usually more than one a year, with the contractor's designated representative at the controller or higher level position. At such conferences, discuss any audit matters that need special management attention and advise the contractor of any changes in audit plans by major audit segment. Document such discussions.

4-303 Contractor Conferences - Interim

4-303.1 General Procedures for Interim Conferences

a. Throughout each audit assignment, discuss matters with the contractor as necessary to obtain a full understanding of the basis for each item in the contractor's pricing data or other cost representation, or each aspect of the area being audited. Disclose to the contractor any factual duplications, omissions, or other mistakes noted in the contractor's submission, records, or supporting data. As the audit progresses, conduct further discussions as needed to gain assurance that audit conclusions will be based on a complete understanding of all pertinent facts. Document all discussions in the working papers, including date, participants' names and titles, and primary discussion points. If warranted, the discussions should be confirmed in writing to the contractor, and if necessary, a copy should be sent to the ACO.

b. In the interest of equitable dealings with the contractor and in the proper discharge of official duties, apprise the contractor of any significant understatements noted in price proposals, reimbursement vouchers, or other cost representations when such understatements are clearly the result of obvious and unintentional oversight, bookkeeping or arithmetic errors, etc. Such cases may include mathematical errors in using improvement curve and other computational analysis techniques.

c. If apparent understatements of estimated costs in price proposals or related submissions do not meet the criteria stated above, do not discuss the auditor's conclusions with the contractor unless the negotiating contracting officer so requests. (See 4-304.2.)

d. Handle errors on reimbursement vouchers as set forth in 6-1008e.

e. Communicate major audit problems encountered to contractor officials authorized to make a decision. The notification should be made at the earliest possible time, with written confirmation to the contractor of any oral discussions, and if necessary a copy to the ACO. Do not wait until the final exit conference or the issuance of the audit report. Document any oral discussions with appropriate memorandums or notations in the working papers. Major audit problems include:

(1) Denial of access to records, including but not limited to:

(a) Unavailability of contractor personnel,

(b) Failure of contractor personnel to complete audit schedules on a timely basis,

(c) Unreasonable delays by management in permitting the commencement of the audit or in providing needed information.

Follow procedures in 1-504.3 when denial of access is encountered.

(2) Items that impact the reliability of the contractor's books and records, including major internal control weaknesses,

(3) Significant differences concerning the application of generally accepted accounting principles,

(4) Conclusions regarding the reasonableness of estimates used in developing forward pricing/bidding rates,

(5) Any other items that may affect audit performance.

4-303.2 Incurred Cost Proposals

Promptly discuss significant system deficiencies found during performance of incurred cost audits with the contractor. Equally important is the timely written notification to the ACO of these deficiencies. Significant deficiencies are those with significant dollar impact on existing or future contracts or which require that the contractor take corrective action(s). Normally discuss the deficiencies during each system (material, labor, indirect expenses, etc.) audit. Oral discussions with the contractor should be followed up in writing to prevent any misunderstanding of the deficiencies found, and to solicit the contractor's plan of corrective action.

4-303.3 Operations Audits – Interim Conferences

a. During the audit, keep the contractor's designated representative informed of any problems encountered and interim results of completed phases. If necessary for the efficiency of the audit, a written follow up of the discussions should be sent to the contractor as soon as possible.

b. If contract administration personnel are assisting or participating in the audit, fully coordinate interim findings and recommendations with them before discussing deficiencies with the contractor. Joint reviews require especially close coordination to assure team members' consensus and complete understanding of the findings by the contract administration office. Also coordinate with contract administration technical personnel when the findings involve their area of expertise, but their assistance could not be provided during the audit. Discussions with the technical personnel in such cases can help clarify and/or support the findings when presented to the contractor.

4-304 Contractor Conferences -- Exit

4-304.1 General Procedures for Exit Conferences

a. Upon completion of the field work on each separate assignment or field visit, hold an exit conference with the contractor's designated representative and summarize the audit results as provided in succeeding paragraphs. Even when there are no questioned or unsupported costs, noncompliances, system deficiencies, or cost avoidance to be reported, the exit conference is a minimum courtesy to the contractor and is an impor-

tant part of sound contractor relations. Exceptions may arise when the audit is performed in support of litigation (4-304.7), investigations (4-702.5), or voluntary disclosure verifications (4-707.3).

b. Confirm or follow up on requests for the contractor's reaction to any audit exceptions on incurred costs (4-304.4), operations audits (4-304.5), and CAS adequacy and compliance audits (4-304.6) for inclusion in the audit report.

c. If applicable (especially on mobile audits), inform the contractor that the audit findings, conclusions, and recommendations are subject to normal DCAA review by the auditor's office before the audit report is issued, and that the contractor will be advised if any significant changes are made.

d. Document the exit conference in the working papers, including date, participants' names and titles, and specifically discussed items and associated contractor's reaction, if any. This provides the information to be included in the audit report, required by 10-210.5e.(1).

4-304.2 Price Proposals

a. This category includes contractor proposals to establish:

(1) initial prices under all types of negotiated contracts;

(2) successive target prices and interim prospective prices under FPR- and FPI-type contracts;

(3) price changes for contract change orders;

(4) other contract price adjustments and Contract Disputes Act (CDA) claims including those for alleged delay and disruption and requests for extraordinary contractual relief;

(5) forward pricing rate agreements; and

(6) special rates.

Treat the incurred cost portion of final FPR/FPI price redetermination proposals, equitable adjustment proposals and CDA claims as an incurred cost proposal (4-304.4) and the projected portion under this paragraph.

b. Discuss any factual differences found during the audit with the contractor and obtain a reaction for further analysis or inclusion in the audit report. However, pursuant to FAR 15.404-2(c)(1)(i), do not disclose to the contractor the audit conclusions and recommendations on projected costs or rates that are subject to contracting officer negotiation, except as specifically requested by the negotiating contracting officer. (Discussion of actual cost submissions, even if subject to negotiation, is covered in 4-304.4.) As an example, a labor cost estimate proposed by the contractor may reflect a learning or improvement trend different from the contractor's prior cost experience, with no apparent justification. In this example, you would discuss with the contractor the factual aspects of the prior cost experience and inquire why the experienced trend was not considered appropriate to project future costs. You would not, however, discuss your audit conclusions or disclose the amount of proposed labor costs to be questioned, if any, in the audit report.

c. Discuss with the contractor any discrepancies noted in the cost or pricing data, as defined in FAR 2.101, whether they increase or decrease the contract price. As part of these discussions, inform the contractor of any cost or pricing data found to be inaccurate, incomplete, or noncurrent. Confine the discussions to factual aspects of the data, and do not attempt to influence the contractor to change the proposal. Any changes in the proposal should be based on the contractor's own initiative by formal written submission to the contracting officer.

d. Advise the contractor of any costs to be reported as unsupported (see 10- 304.8c).

e. Discuss with the contractor any other CAS and FAR noncompliances found during the audit and, as appropriate, provide details for the contractor's analysis and reaction.

4-304.3 Postaward Audits of Cost or Pricing Data for Possible Defective Pricing

a. Discuss any factual indication that cost or pricing data may have been defective to afford the contractor an opportunity (normally 30 days) to review the matter and provide any additional information for the auditor's consideration. A draft copy of the report exhibit(s) and accompanying footnotes normally should be provided to the contractor. Final determination as to the existence and extent of defective pricing remains the responsibility of the contracting officer.

b. The contracting officer should also be provided the draft report exhibit(s) and accompanying footnotes on apparent defective pricing issues and given the opportunity to provide comments. See 14-122 regarding discussions of the audit findings with the contracting officer. The auditor should discuss the findings throughout the course of the audit rather than only at the end.

c. The contractor may contend that there were understated estimates offsetting any potential price reduction that would result from a contracting officer's defective pricing determination. For contracts entered into on or before February 15, 1987, request specific supporting data for audit evaluation and inclusion in the audit report. For contracts entered into after February 15, 1987, request the contractor provide appropriate certification and specific data supporting the offsets for audit evaluation and inclusion in the audit report (see 14-118 and 10-606.5d).

d. Although the auditor should not expend resources examining uncertified contractor offsets, the auditor should objectively disclose all of the facts known. Therefore, apparent offsets discovered during the postaward audit should be disclosed to the contractor for its analysis and offset submission if the contractor deems appropriate. (Refer to 14-118 for treatment of offsets in the audit position on recommended price adjustments).

e. Coordination and discussion of the findings by all parties before the audit report is issued can minimize delays in the resolution process. Postaward audit reports should not be issued until the initial findings have been properly coordinated.

4-304.4 Incurred Cost Proposals

a. This category includes cost reimbursement vouchers and contractor representations of incurred costs to establish:

(1) final prices on all types of completed negotiated contracts,
(2) final indirect cost rates,
(3) contract termination settlements, and
(4) equitable adjustment proposals and CDA claims.

Contractor requests for progress payments authorized by the contract will be treated under this paragraph even though projected costs are involved in the calculations. Proposals to establish special rates and interim changes in contract prices are covered in 4-304.2.

b. Discuss all audit conclusions with the contractor's designated official and try to reach agreement on any questions of conformity with generally accepted accounting principles, applicable cost accounting standards, and other cost principles incorporated in the contract(s). If there are audit exceptions to be reported, request the contractor's official reaction for inclusion in the audit report or in the notice of costs suspended or disapproved.

c. See 6-902c and d for special discussion procedures on costs to be suspended or disapproved under cost-reimbursement-type contracts.

d. As discussed in 6-902e, the auditor should notify the ACO of developing issues which may result in the issuance of a DCAA Form 1 as follows:

(1) Provide the ACO with written documentation of the audit results which were discussed with the contractor at the exit conference, unless the contractor immediately agreed to all audit exceptions and the written report will be issued within the next 30 days. The written documentation may be in the form of a memorandum to the ACO, a copy of a memorandum for the file setting forth the results of the exit conference, copies of a draft re-

port exhibit and/or notes, or copies of working paper exhibits and/or supporting working papers. In other words, provide the ACO with whatever information or subset thereof that was provided to the contractor at the exit conference.

(2) Provide the ACO a copy of the contractor's written rebuttal to the audit findings immediately upon receipt.

(3) Discuss significant unresolved issues with the ACO at any mutually agreeable time. Such discussions may result in the introduction of additional data or information which could support or modify audit findings.

(4) The ACO should not ordinarily participate in the formal exit conference. However, if the auditor wishes (or the ACO so requests), the auditor may have the ACO attend discussions with the contractor subsequent to the formal exit conference, if, in the auditor's opinion, this would facilitate the resolution of contested issues. In arriving at this decision, consider factors such as the likelihood of issuing DCAA Forms 1, ongoing relationships with the ACO, and duplication of effort which may result if joint discussions are not conducted.

4-304.5 Operations Audits – Exit Conferences

a. This paragraph covers evaluations of contractor's operations for economy and efficiency and financial compliance, including audits of internal controls, major system surveys, and joint reviews under DFARS Subpart 242.70.

b. After full discussion of each matter requiring contractor action, provide the contractor a draft statement of the condition(s) and recommendations. Carefully design the discussions and drafts to elicit contractor concurrence with recommended system improvements and/or cost avoidance. Request an official written response for inclusion in the audit report, and establish a time frame for the contractor's response. Allow ample time for the contractor to consider the audit presentations, and be receptive to alternatives the contractor may suggest that will satisfy the audit objectives.

c. If the contractor does not agree with the audit recommendations and provides a response, the auditor should provide in the report comments specifically on the contractor's response. If specialist or technical assistance is required in evaluating those alternatives, the auditor should obtain the assistance. Do not merely restate or amplify a position already stated.

d. If the evaluation results in cost avoidance recommendations, make the contractor aware that, effective immediately, any impact of such recommendations will be reflected as questioned costs in reports on price proposal evaluations when applicable (in accordance with the criteria in 9-308).

e. See further guidance on discussion of audit findings as part of a team review in 5-1302 (contractor's purchasing system review team), 5-1303 (contractor's insurance/pension review team), and 5-1200 (surveys of contractor estimating systems).

4-304.6 Cost Accounting Standards Audits

a. This paragraph covers CAS disclosure statement adequacy audits, compliance audits (including audit reports on CAS noncompliance), and cost impact proposal audits.

b. Discuss the results of adequacy audits with the contractor. If one or more disclosures are considered inadequate, provide the contractor a draft copy of the audit report for its comments. The letter transmitting the draft audit report should solicit the contractor’s specific comments on the adequacy issues and advise that the comments will be included in the audit report if received by a specified date. Provide the contractor a reasonable period of time to respond to the draft audit report. Do not delay issuing the report, however, if the comments are not provided in sufficient time to permit their inclusion by the established report due date.

c. Thoroughly discuss apparent CAS noncompliances with the contractor to establish that the audit findings are based on a proper understanding of the issues and that all pertinent facts have been considered. Do not state that the auditor is making a determination of noncompliance, since the contracting officer makes this determination. Provide the contractor a draft copy of the audit report for its comments. The letter transmitting the draft audit report should solicit the contractor's specific comments on the compliance issues and advise that the comments will be included in the audit report if received by a specified date.

d. Discuss the results of cost impact proposal audits with the contractor to establish that the audit findings are based on a proper understanding of the issues and that all pertinent facts have been considered. Provide the contractor a draft copy of the audit report for its comments. The letter transmitting the draft audit report should solicit the contractor’s specific comments on the audit exceptions and advise that the comments will be included in the audit report if received by a specified date.

4-304.7 Litigation Support

a. Audit work is privileged when performed at the request of Government litigation counsel in support of ongoing or anticipated litigation (see 15-503). If there is reason to believe that the audit has been requested in support of litigation, the auditor should ask the requestor to state whether the audit will be covered by the attorney work product privilege. If so, an exit conference could compromise the privilege. When audit work is covered by the attorney work product privilege, the auditor should explain the importance of the exit conference in resolving audit issues and avoiding errors, and attempt to obtain permission to hold an exit conference. However, to prevent inadvertent compromise of the attorney work product privilege, an exit conference must not be held without litigation counsel’s written consent and coordination on the matters to be discussed.

b. Litigation support should not be confused with investigation support (see 4-702.6). In litigation support, audit access arises from contractual requirements.

4-400 Section 4 --- Audit Working Papers

4-401 Introduction

This section contains guidance for the preparation, format, contents, and filing of audit working papers, whether prepared manually or using computers. The preparation of working papers assists the auditor in accomplishing the objectives of an audit assignment and serve as the principle support for the conclusions in the audit report. They also provide a record of the work performed; evidence of adequate supervision; are used as supporting data during negotiations, appeals, and litigations; and provide a basis for any other quality assurance reviews.

4-402 General

a. Extensive copying of contractor records for inclusion in working papers is unnecessary. It is generally sufficient to reference the records and source documents examined during the course of the audit. However, where audit exceptions are found and reported, the working papers should include copies of the evidential material examined, including contractor source documents.

b. Auditors should prepare and maintain audit working papers on a current basis. Working papers should reflect the progress of the audit, ensure continuity of audit effort, and permit reassignment of auditors without significant loss of time.

c. The audit report is not a working paper. It summarizes and reports the Agency's final conclusion on the Subject of Audit, based on the data and analysis documented in the working papers. The working papers must support the final conclusion(s) reached. Auditors should follow 4-403f, which discusses superseded and extraneous working papers, for guidance on the treatment of working papers that do not support the final report conclusion(s). Only the final report and the final cross-referenced draft should be retained in the original file.

d. The nature of working papers requires that proper control and adequate safeguards be maintained at all times. Working papers frequently reflect information considered confidential by the contractor, marked "For Official Use Only," or classified for Government security purposes.

e. E-mail is used to routinely communicate audit related information within DCAA. When sending e-mail within DCAA, the use of compression software is recommended for anything in excess of 500KB in size. In addition, auditors should ensure recipients have enough information in the subject and body of the e-mail to efficiently identify the subject matter (typically, without opening the attachments). Items that should be considered for inclusion (as appropriate) are as follows:

(1) audit assignment number (if not already in an attached filename),

(2) if inter-FAO correspondence, consider using the assignment number established by the requesting FAO, which is more meaningful to them,

(3) contractor name,

(4) assignment subject.

See 10-203.10(c) for guidelines on preparation of e-mails to customers, including use of compression software.

4-403 Format and Contents of Working Papers

a. Standardization in design, content, and arrangement of working papers is desirable because it facilitates the audit, the supervisory auditor's review, and report preparation. This section provides guidance on the Agency's standard working paper format.

b. Conditions and circumstances vary with each audit. The nature, timing and extent of audit documentation require the exercise of professional judgment. A constant awareness of the purpose and use to be made of working papers is helpful in determin-

ing their content. See guidance in 4-409 and 10-214.1d on revisions to audit working papers after the audit report is issued.

c. Working papers can consist of electronic files, such as spreadsheets, word-processing files, graphical images, etc., as well as hardcopy documents when electronic files are not practical. Auditors should strive to use electronic working papers, to the extent possible, to capture the efficiencies provided by information technology, such as storage, search functions, accuracy, and processing speed.

d. Two types of working papers are generated during the audit -- administrative working papers and audit working papers.

e. Administrative working papers are those that do not document field work or audit procedures. Administrative working papers contain elements that result from or lead to field work activities, such as notes/correspondence with Government representatives and/or the contractor. The administrative working papers also contain information and documentation that is used internally by the Agency, such as DMIS data entries (including computations of dollars audited and cost savings), and information to update the permanent files. Although the audit report is not a working paper, it is filed with the administrative working papers. Figure 4-4-2 contains an outline of the Agency standard administrative working papers. Each audit working paper package will include an index of the Administrative Working Papers(4-403 l (2)).

f. Audit working papers are generated during the field work portion of the audit to document the significant conclusions and judgments of the auditor. They should contain descriptions of the transactions and records examined, and the objectives, scope, and methodology (audit procedures) used to develop the conclusions. The audit working paper file consists of current working papers and, if applicable, superseded working papers. A description and discussion of current, and superseded working papers and working papers for cancelled assignments follows.

(1) Current working papers. Current working papers should be relevant to the audit assignment and support the report conclusions. In preparing current file working papers, the auditor should not unnecessarily duplicate information contained elsewhere in the same audit assignment or located in the permanent file. Frequently, the most expeditious method is to reference the permanent file data to the current file (see 4-405.1 for information pertaining to permanent files). GAGAS field work standards on audit documentation require that working papers be appropriately detailed and organized to provide a clear link to the findings, conclusions, and recommendations contained in the report. When a revision in audit scope occurs, the working papers that document the audit field work, and conclusions based on the revised scope, are classified as current working papers because they are relevant to the reported audit conclusion (also see 4-403f(3)(c)). An increase or decrease in audit scope should be adequately documented as part of the “revised scope” working papers. If the revision in the audit scope is significantly different from the working paper B risk assessment, the auditor should also make a notation in this section as well. The documentation, in all cases, should briefly describe the original audit scope and the reason for the revision in scope.

Working papers should also contain evidence of supervisory review of the work performed. Figure 4-4-1 contains an outline of the Agency's standard working paper format and the indexing protocol for audit working papers. Each audit working paper package will include an index of Audit Working Papers (4-403 l (2)).

(2) Superseded working papers. Superseded working papers should be clearly identified as such and include any working papers prepared during the course of the audit that do not support or are not relevant to the conclusions in the audit report. This will include, for example, working papers changed due to revisions in audit methodology that are not relevant to the audit conclusions. Superseded working papers will also include those resulting from differences of opinion within the audit team regarding audit issues.

(3) Documenting unreconciled differences of opinion. Special procedures and documentation (as a part of superseded working papers) are required for unreconciled differences of opinion between the auditor and the supervisor or higher levels of management

that could materially affect audit conclusions. This includes, for example, a significant change in questioned costs, a change in audit opinion from qualified or adverse to unqualified, or a change in audit opinion from inadequate to adequate or vice versa.

(a) Every effort should be made to reconcile differences of opinion regarding audit issues between the auditor and the supervisor or higher levels of management before an audit report is issued. If the auditor and supervisor are unable to reconcile a difference of opinion that could materially affect audit conclusions, the issue should be elevated to the FAO manager for a decision. Discussions with the FAO manager of such differences should include both the auditor and the supervisor. If differences of opinion exist between the supervisor and FAO manager, they should be elevated to the regional audit manager (RAM). Employees should elevate differences of opinion on audit issues to the Deputy Regional Director if they are unable to reach a resolution through the supervisor, FAO manager and RAM.

(b) If the difference of opinion cannot be reconciled and the draft audit results are changed by the supervisor or higher level management, both the auditor and the supervisor should document the disagreement as a part of the superseded working papers. This documentation must fully address the resolution of the unreconciled difference of opinion to ensure that the facts and circumstances are ascertainable at a later date. This would include, for example, the specific basis for changing the audit opinion and adequate support for that decision (e.g., why conditions that the auditor considered deficiencies are not deficiencies). This documentation is generally only required when the difference of opinion could materially affect the audit conclusions. However, auditors and/or supervisors may document in the superseded working papers any unreconciled difference of opinion on audit issues. The name of an auditor who has documented an unreconciled difference of opinion on audit issues may be excluded from the DCAA Personnel section of the applicable audit report if the auditor so chooses (10-211). The documentation requirements for unreconciled difference of opinion on audit issues must be followed even if an assignment is cancelled (4-403f(4)).

(c) The current working papers must adequately document and support the final audit opinion. For example, the auditor concludes that the contractor's claimed consultant costs are unallowable. The supervisor believes that the auditor's conclusion is based on insufficient audit procedures. The current working papers must document the additional work performed to determine whether the contractor's claimed consultant costs are allowable and provide sufficient evidence to support the final opinion.

(4) Working papers for cancelled assignments. Working papers for all cancelled assignments will be retained and filed in LiveLink regardless of the number of hours charged. GAGAS field work standards require documentation when an engagement is terminated before it is completed and a report is not issued. Therefore, for assignments cancelled with 8 or more hours, auditors should prepare a MFR to fully document the audit work performed and why the assignment was cancelled. Auditors and supervisors should generally use judgment in deciding whether to prepare a MFR for cancelled assignments with less than 8 hours. However, documentation requirements for unreconciled difference of opinion must always be followed even when the assignment is cancelled (4-403f(3)).

g. The following is a description of the major audit working paper sections:

(1) W/P Section A -- Summary working paper section contains:

- The summary of audit results, executive summary, and subject of audit to be forwarded into the draft audit report (see Chapter 10)
- The customer's special requests and requirements (if any)
- The audit criteria (e.g., FAR, DFARS, CAS)
- Initial supervisory guidance and audit objectives
- Concluding audit steps
- Interim/final supervisory guidance and review

(2) W/P Section B -- Risk assessment and preliminary review working paper section contains:

- A summary of the risk assessment and the impact the risk assessment has on the substantive testing required to accomplish the audit objectives
- The audit report note on the assessment of control risk (see 5-109)
- Documentation on the examination of internal controls (Internal Control Audit Planning Summaries (ICAPS) or the Internal Control Questionnaire (ICQ), as appropriate) and the impact of this assessment on the audit
- Documentation on the evaluation of materiality and sensitivity factors, and the impact of this evaluation on the audit
- Documentation on the evaluation of reliance on computer based data and the impact of this evaluation on the audit
- Documentation on the evaluation of inherent and other risk factors (e.g., permanent files, prior findings, contract mix, Government participation, audit lead sheets), and the impact of this evaluation on the audit
- Accomplishment of other preliminary audit steps that do not relate to auditing a specific cost element/area
- Assessment of need for technical assistance and/or assist audit(s) and the related request(s)

(3) Lead working papers contain:

- The lead schedule for each cost element/area being evaluated (e.g., schedule of proposed and questioned amounts, schedule of control objectives audited and the results)
- The tailored audit steps for the evaluation of that cost element/area.
- The structured audit report note (see 10-210.6), for inclusion in the audit report, which describes the work performed for the cost element/area being audited.

The structured note format should be used even if the cost element/audit area will be excluded from the audit report. The structured note will address the following topics:

(a) Summary of Conclusions
(b) Basis of Contractor's Costs
(c) Audit Evaluation
(d) Contractor's Reaction
(e) Auditor's Response

Another form of the structured note is the Statement of Condition and Recommendation. This format is used for internal control examinations, operations audits (refer to 10-409) and CAS audits (refer to the appropriate Results of Audit section in 10-800). If there are no findings, for these activities provide a narrative summary of the audit area, the audit work performed and a conclusion indicating no exception was taken.

(4) Detailed working papers contain:

- The supporting data, information, schedules, and computations for the audit steps on the applicable lead working paper
- The on-page notes that document accomplishing the tailored audit steps, support the significant audit judgments and conclusions, and describe the transactions and records examined. These notes will address the following:
- Purpose – state the specific purpose of the working paper on each working paper or the first page of a group of related working papers. Avoid using general phrases such as “Review Labor” or “Review Material.” Include enough information so that the rea-

son the working paper was created will be evident. The wording of the purpose should align with the audit program steps that the working paper will satisfy.

- Source of Information – identify the source of data or information shown on each working paper. The statement should include the name, title, and department of the individual who provided the information. If beneficial, also provide the date the information was provided. If the information comes from a contractor generated report, provide the name and date of the report. Also, if the data was obtained from the contractor's systems, indicate how the information was obtained so as to facilitate another auditor obtaining the same type of information at a later date. If the information came from the FAO permanent file, the auditor should provide specific information regarding the source of the information, not merely referencing "permanent file." Generalized statements, such as "contractor's accounting records," or "Jane Doe" are not sufficient.
- Scope of Analysis – provide a detailed description of the scope of the audit work performed to create the working paper. Include appropriate explanations when the scope has been limited or unusually expanded. It should also include the criteria (e.g., FAR, CAS) used to make the judgments and conclusions. Avoid using generic phrases, such as "reviewed the rates."
- Auditor's Conclusions and Recommendations – state the conclusions and recommendations on the working paper as soon as a determination is made. For a group of related working papers, a single conclusion on the first page of the group is acceptable. The conclusion should not duplicate, but should relate to, the information included in the purpose (e.g., if the purpose of the working paper is to determine the acceptability of costs, the conclusion should state whether or not the costs were acceptable).
- When selecting items for transaction testing, regardless of the method of selecting the items, the following should be documented in the working papers. (See B-203 for additional documentation requirements for statistical sampling.)
  1. A description of the universe from which the items are selected, including specific source information (e.g., contractor's January 1, 20XX bill of material totaling $2.5 million).
  2. Identification of the items to be tested (e.g., material parts with an extended value over $50 thousand) and the attributes to be tested.
  3. An explanation that supports the judgmental selection results in adequate audit coverage of the universe to meet the audit objectives (e.g., the 30 items with an extended value over $50 thousand represent 90 percent of the total bill of material value of $2.5 million).

h. Auditors are to prepare working papers in electronic format to the maximum extent possible. The APPS incorporates working paper templates and audit report shells that must be used for most audit activity codes. If use of the APPS is not mandatory for a particular activity code, it will be indicated next to the assignment number in the APPS tab when entering the assignment in DMIS.

i. Naming Conventions:

(1) To simplify the indexing process in an electronic environment, DCAA has adopted a standardized file naming convention. This convention also establishes standardized pro-

cedures for storing in-process electronic working papers, as follows (see 4-407e. for naming conventions related to closing actions):

- Each auditor should have a folder named "Audit Working Papers" on the hard drive of his or her primary computer.
- For each assigned audit, the APPS software will establish a new folder within the Audit Working Papers folder. This new folder is assignment specific and will be given the actual assignment name, such as: 02441_2005B21000001. All in-process electronic working papers will be stored within the appropriate electronic assignment folder. DCAA electronic working paper software supports this naming and storing convention.

(2) Auditors should name each file beginning with the actual working paper reference, such as A-01, B-02a, T-04, etc. This will be followed with a brief description or actual title of the working paper, such as Evaluation of Engineering Labor Rates or Determination of Current Labor Rates. The combined result will make the identification of electronic working papers much clearer. An example of the file naming convention is shown below:

W/P	Description
A	A Audit Summary XYZ Proposal.doc
D-02	D-02 Detailed Evaluation of Labor Rates.doc
D-02a	D-02a Determination of Current Labor Rates.xls

To make it easier to find documents, auditors should make use of longer, more descriptive file names.

j. Working papers should contain the following information:

(1) Heading. Head each working paper with the name of the contractor, the assignment number, and a title or description. The title or description should convey the purpose of the working papers. Most working papers generated using the Agency electronic working paper application will collect and automatically generate the appropriate headings based on user-supplied input.

(2) Auditor's and Supervisor's Initials and Date. The requirement for the auditor's and supervisor's initials and dating applies to both hardcopy documents and electronic working papers. The work of all auditors contributing to the working paper content, including that of technical specialists, should be identified to the individual work product. The auditor who prepares or completes a working paper should place his or her initials and the month, day, and year the work was performed or completed on each sheet. If the auditor verifies a multiple-page, contractor-prepared document (e.g., bill of material), the auditor should place his or her initials and the date on only the first page of such document. To facilitate the use of electronic tools and provide a standard location for reviewers, the auditor normally identifies his/her work by initialing in the lower right corner of the audit working paper. When the software is not conducive to this location (e.g., spreadsheets) working paper attributes (e.g., assignment number, initials, date) should be placed in a prominent location. When preparing or completing electronic working papers, the auditor's initials will be typed in by the auditor using the bold italic font, which will set the auditor's initials out from the text of the working papers.

An acceptable example:

W.H.R.
12/16/03

Color fonts may also be used to further distinguish initials and dates; however, care should be taken in selecting colors that are easy to read, even when printed on a non-color printer. It is not necessary for supervisors to indicate their review and approval on each working paper; however, supervisory guidance, review, and approval must be evident in the working papers. As a minimum, to indicate final review and approval of the work, supervisors should initial and date the lead working papers, the top page of the

summary working paper section, the top page of the risk assessment/preliminary review section, and the top page of the draft audit report. As with the auditor's initials, the supervisor's initials on electronic working papers should be in the bold italic font to easily distinguish the supervisor's initials from the audit working paper text. APPS provides space for auditor initials and date in the lower right corner of audit working papers, as appropriate. Space is also provided for supervisory approvals. Initialing these documents is evidence that the working papers have been reviewed to the extent necessary for the supervisor to ensure the audit objectives have been accomplished and there is adequate evidential matter to support the audit findings (also see 2-S103.4b(4)).

(3) References. The working paper reference scheme should follow a "top-down" approach. Avoid referring from lower level working papers (i.e., detailed working papers) to higher level working papers (i.e., lead and summary working papers). As a minimum, reference the following:

- All significant judgments, findings, conclusions, and recommendations that are included in the draft report. This includes: summary results and notes to the summary and lead working papers; the report scope section on how the contractor's internal control systems affected the scope of audit; all report qualifications; and if applicable, the *Other Matters* section of the report.
- Information in the summary working papers to the related lead working papers.
- Risk assessment/preliminary review working papers to the related detailed working papers.
- The lead working papers to the detailed working papers.
- The detailed working papers to the next lower level of supporting working papers.

Audit working papers may follow the top-down approach using any one of the following examples:

- See W/P K-02a
- Source W/P K-02a
- W/P K-02a

All are acceptable, provided they clearly direct the auditor to the appropriate source working paper. It may be preferable to provide a more detailed reference, such as: "See W/P L-1, line 45, column B." The level of reference detail is subject to individual auditor judgment and to any supervisory or FAO specific preferences.

Electronic working papers can complicate the referencing process. Windows based software packages allow for electronic references to source data. Specifically, such functions as hyperlinks, copy and paste, linked objects, embedded objects, etc., increase the auditor's ability to manipulate data within and between working papers. Auditors are encouraged to make use of this technology; however, it is essential to maintain the requirement to specifically annotate the appropriate working paper reference.

k. Stated References. Electronic working papers and the draft audit reports that are electronically referenced must also include a stated reference. A stated reference is an actual working paper reference, such as A-01, B-02a, T-04, etc. Maintaining a stated reference within the electronic working paper is a sound business practice. It may be needed if the working paper is printed at a later date. Hyperlinks are excellent navigational aids, but the electronic links can be severed, making the stated reference the only navigational aid to the supporting documentation. Similar to the designation of auditor and supervisory initials, working paper references should be distinguished using the Bold Italic font. Color fonts may also be used to further distinguish working paper references; however, care should be taken in selecting colors that are easy to read when printed. There are APPS Tools (Quick Links) available to aid auditors when developing hyperlinks that take advantage of using stated references. These tools will also apply the desired attributes (bold, color, italics).

l. Indexing.

(1) Index each working paper as it is prepared. The Agency standard indexing protocol is described in Figure 4-4-1. In practice, auditor working paper packages can consist entirely of electronic files or include a mix of electronic files and hardcopy working papers. Each audit working paper package, whether in electronic or hardcopy form, will follow the standard indexing structure.

(2) Every audit working paper package should include an index of the Administrative and Audit Working Papers. The required index is provided by APPS as working paper 00 Working Paper Index. It automatically generates a listing of all electronic documents in the assignment folder within the Audit Working Papers folder, organized in accordance with the Agency standard indexing protocol as described in Figure 4-4-1. It also provides entries for the standard administrative working papers as described in Figure 4-4-2. If there is an electronic version for a particular administrative working paper entry, the index removes the entry and lists the electronic file. Hard copy working papers should be added to this index and noted in the description column. If the assigned file name does not adequately describe the electronic file, additional narrative should be provided in the description column. Entries for any unused administrative working papers with no electronic file should be removed at the conclusion of the audit using the index's function for that purpose so that it is clear that those working papers are not a part of the working paper package.

m. When the audit report has been electronically transmitted to the customer, the exact same file transmitted must be included in the working paper package (see 4-407e.(2)). An electronic copy of the draft audit report, cross-referenced to the working papers, and an electronic version of the acknowledgment letter must be retained in the audit working paper package.

Figure 4-4-1
Standard Working Paper Format and Indexing

Summary Working Paper, which includes:	A
• Audit Summary	
• Executive Summary	
• Results of Audit	
The following working papers are also required:	
• Planning Document, which includes:	A-01
• Subject of Audit	
• Initial Supervisory Guidance/Audit Objectives	
• Concluding Audit Steps	
• Interim Guidance/Corrective Actions	A-02
• Final Review Comments	A-03
Risk Assessment/Preliminary Review Working Paper	B
• Summary of Risk Assessment	
The following working papers are also required:	
• Audit Planning Considerations/Preliminary Audit Steps	B-01
• Documentation of Risk and Assessment of Internal Controls	B-02
• Assessment of Need for Technical Assistance/Assist Audit	B-03
Lead Working Papers	C, D, etc.
• Tailored Audit Steps for the Cost Element/Area Being Audited	C-01, D-01, etc.
• Detailed Working Papers	C-02, D-02, etc.
• Supporting Working Papers	C-02a, D-02a, etc.

Note: Electronic indexing of page numbers should be done using currently available means within the software application in which the work is performed. Hard copy indexing of page numbers should be done using the format: A (1/3), A (2/3), A (3/3).

Figure 4-4-2
Administrative Working Papers

Following are the contents of the Agency administrative working papers section and their sequence:

01	AUDIT REPORT
01a	Cumulative Allowable Cost Worksheet (CACWS)
02	Computation of Dollars Audited & Cost Savings
03	Defective Pricing Lead Sheets
04	
05	Audit Leads (check if positive)
	CORRESPONDENCE
06a	Entrance Conference Notes
06b	Exit Conference Notes
07	Government Notes / Correspondence
08	Contractor Notes / Correspondence
09	Technical Report
10	Assist Audit Reports
11	Acknowledgment / Notification Letter (Original / Revised)
12	Request For Audit (Original / Revised)
	PERMANENT FILE UPDATE WORKING PAPERS
13	ICAPS/ICQs Sections
14	Contract Briefs
	AGENCY ADMINISTRATIVE WORKING PAPERS
15	Livelink Setup Sheet
16a	Closing Actions
16b	Tick Marks Legend
	FAO SPECIFIC WORKING PAPERS
17	
18	
19	
20	
21	
	CONTRACTOR'S SUBMISSION, DATA, ETC.
22	Contractor's Submission, Data
23	Revised Contract Submission / Data
30	Other Audit Guidance (or worksheets)
31	Activity Code Specific Policy Guidance (or worksheets)

4-404 Working Papers - Agenda Sheet

During the assignment, matters may arise that are not settled immediately either because the information is not available or the auditor wishes to avoid interrupting the work at hand. The auditor should develop a separate agenda sheet or "To Do" sheet listing matters for further examination as the audit proceeds. Before completion of the audit, each

item on the agenda sheet should be resolved. Items which may be placed on the agenda sheet include:

(1) Differences to be investigated.
(2) Items to be discussed with contractor personnel.
(3) Additional audit steps to be performed after preparation of an analysis or schedule.
(4) Unavailable contractor records to be examined later.
(5) Follow-up on partially completed transactions.
(6) Items requiring discussion with or approval of the contracting officer or technical or supervisory personnel.

4-405 Permanent File

a. The permanent file on each contractor is a central repository of information gathered during audits that has continuing value and use to subsequent audits expected to be performed at the same contractor. Permanent files are useful in preparing the audit program and in determining the appropriate scope of subsequent audits. They also provide ready means for auditors to become familiar with the contractor's operations and any existing audit problems or contractor system weaknesses. While summary information on the contractor's organization, financial structure, and policies and procedures may sometimes be included in permanent files for smaller contractors, such information on large contractors with continuing audit activity is generally maintained in the field audit office at a central reference library.

b. The third mandatory annual audit requirement (MAAR) is to maintain and update permanent files for new or changed contractor organizations, operations, policies, procedures, internal controls, software programs, and accounting methods that influence the nature, level, and accounting treatment of costs being charged or to be charged to Government contracts. This also includes the update to documentation on the contractor’s contract briefing system or auditor-prepared contract briefs. This mandatory annual audit requirement ensures that any of the above type information gleaned from current audit work is summarized or referenced where it is likely to have a continuing value to subsequent audit work. It is not necessary to establish separate audit assignments to gather organizational or procedural manual changes, and to file such information in the permanent files when it has no immediate or obvious influence on future audit assignments. In distinguishing between what is needed and all other information, the auditor must exercise judgment. Additional guidance for both major and nonmajor contractors is in the DCAA Management Information System (DMIS).

c. Auditors often refer to prior current audit working paper files as the permanent files. This is especially true with indirect cost audit files that contain audited contract cost information. Accordingly, when prior audit files contain information that would likely be useful in the performance of future audits, and it is not practical to transfer the data to a separate permanent file, the auditor should maintain and properly reference the prior audit file as part of the permanent file. Steps should be included in each current audit to identify the types of information that should be placed in the permanent file (see 4-405f). Auditors using the permanent file during a current audit are also expected to identify permanent file information that is outdated or no longer considered useful for future assignments. The auditor should submit recommendations to the supervisory auditor for removal of such data from the permanent file.

d. The permanent files should be maintained in a convenient, accessible manner. The Electronic Contractor Permanent File (ECPF) system is the Agency’s standard tool for maintaining contractor permanent file records. During field visits to contractor locations, auditors are encouraged to obtain information electronically, if possible, to facilitate storage and maintenance of records in the ECPF system.

e. The structure of the ECPF uses a folder with the contractor name and DUNS number, and includes 13 primary folders subordinated to it. The primary folders are lettered A through M, as follows:

A-General Contractor Information
B-Audit Planning
C-Financial Capability
D-Financial Information
E-EVMS
F-Contract Information
G-Correspondence
H-ICAPS/ICQ
I-CAS
J-Forward Pricing
K-Incurred Cost-Indirect rates
L-Operations Audits
M-Miscellaneous

The primary folders also contain numerous subfolders, and there are versions available for both contractors with ICAPS and contractors with ICQs. Filing can be performed at any level within the system of folders. Depending on the size and complexity of the contractor, filing can be accomplished in as simple or complex a fashion as required. Instructions and tools related to the creation, implementation, and use of the ECPF are located in the File Libraries on the DCAA Intranet.

f. The following items would logically be included in the permanent file as having continuing value in future audit assignments:

(1) Internal control audit planning summary (ICAPS) sheets.

(2) Internal control questionnaires (ICQ).

(3) MAARs control log.

(4) Disclosure statement and revisions in accordance with CAS rules and regulations.

(5) CAS planning and cycling documentation.

(6) CAS compliance and noncompliance tracking.

(7) DMIS CAS Tracking of Issued Noncompliance (19200) Report (After FY 1991).

(8) Audit lead sheets.

(9) Internal control system planning and cycling documentation.

(10) Historical pension cost information. At a minimum include the following information for each defined benefit plan by fiscal year:

(a) For contractors not separately calculating pension costs by segment – total costs incurred, the contractor's established allocation base to allocate pension costs to segments, and the Government's participation in the allocation base, even if no pension costs were incurred for the year.

(b) For contractors calculating pension costs by segment – for each segment: total costs incurred, the portion of the costs allocated to contracts subject to CAS and FAR Cost Principles, and the year-end pension asset balance (market value), even if no pension costs were incurred for the year.

(11) Cumulative Allowable Cost Worksheet (CACWS).

4-406 Copies of Contractor Data in Working Papers

a. When considering the extent of the contractor's data that should be copied and retained in the working paper files, the auditor should use the following guidelines:

(1) The audit file should contain copies of the contractor's records as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed, the evidence obtained and its source, and conclusions reached. The auditor should consider the continuing availability of source documents and contract data retention requirements when deciding whether to reference or reproduce contractor source documents.

(2) Where a particularly sensitive or material audit conclusion hinges on key source documents and referencing would not provide sufficient evidence of the content, copies

should be included in the working papers. This same consideration applies when the audit results can give rise to a Government claim against the contractor, such as an assertion of defective pricing or an allegation of CAS noncompliance. In these situations, the contractor data should be retained in the working paper files for consideration by the contracting officer in his/her decision making processes. More routine audit conclusions may be sufficiently documented by reference and extraction of pertinent information.

(3) The auditor should recognize contractor concerns about reproducing copies of sensitive financial or other operating information. Instead of making copies, the auditor should take notes or extracts if this will satisfy the Government Auditing Standards (see above) and the needs of the contracting officer can be accomplished with a reasonable expenditure of audit effort.

b. The contractor must provide reasonable access to all records and corroborative documentary evidence necessary to achieve the audit objective. Auditors who are precluded from performing procedures considered necessary and material in the circumstances, including reproducing contractor records and documents, should follow Agency access to records guidance (see 1-504).

c. Scanned Documents. The decision to transfer hardcopy documentation to electronic form (scanning) is a matter for auditor judgment. When presented as evidence in litigation, the courts will treat a document reproduced from electronic format as an original. Documents which might be scanned include correspondence, invoices, travel vouchers, quotes, and similar records. Special care must be taken to avoid any alteration or appearance of alteration of the data. DCAA scanner software will default to saving scanned documents as image files, which cannot readily be modified. The software also has the capability to convert a scanned document to Optical Character Recognition (OCR) form. OCR scans are subject to transcription error and may easily be changed in word processing and spreadsheet programs.. Agency policy requires scanned documents to be saved in PDF image format.

4-407 Computer-Aided Working Papers

Agency standard naming conventions (see 4-403i) should be carried throughout the audit working paper package, including storage of the completed assignment official records and the corresponding audit report. As with any audit assignment, the integrity of our audit working papers must be maintained; this is vital with electronic audit files. During an audit, many interactions take place between an auditor, other team members, technical specialists, the supervisory auditor, and the FAO manager. The following requirements apply to the audit workflow process and incorporate standard procedures to protect working paper integrity, specifically the integrity of the official electronic working papers.

a. Working Paper Creation: In order to obtain the latest available guidance, the auditor must first set up an assignment in DMIS and then generate working papers using the APPS functionality in DMIS.

b. Work-In-Process Procedures (Interim): During the performance of an audit, working papers should be generated using the APPS User Interface. In particular, the report shell initially generated should be used as a starting point for drafting reports. In addition, the auditor must coordinate his/her work with the audit supervisor. This includes interim guidance as well as obtaining supervisory review and approval of individual working papers. This requires that electronic files be accessible to audit supervisors and others. Although there are many methods of transmitting electronic files between parties (common drives, physical delivery, e-mail, intranet, etc.), the primary methods facilitated by the APPS software are the use of the common LAN X: drive and e-mail for “off-line” connectors. The APPS software incorporates import and export functions to facilitate the transfer of files between personnel. When electronic audit files are returned to the auditor after supervisory review, the auditor is responsible for ensuring that only the most current audit files, i.e., the reviewed files, are included in the audit package. The APPS software facilitates this goal when the export/import

functions are used, but it is still possible to overwrite a newer file with an older version in other software applications (e.g., Windows Explorer). In addition to the daily backup, the backup function should be performed just prior to performing an export. This provides a temporary backup, until the approved file is returned. In most cases, work should cease until the next import is initiated. However, if work must be performed, it should be tracked, approved, and updated after the file is imported.

c. Work-In-Process Backup: The most important computer proficiency discipline is the daily backup of current work in-process files. Files can be lost or destroyed, hard drives fail, and entire computers are sometimes stolen. Such occurrences could result in loss of the entire in-process electronic working paper package. To minimize such disruptions, the following procedures should be followed.

(1) A backup copy of in-process electronic audit files will be made at least daily. The APPS software utility functions allow auditors to easily backup their work to a location of their choosing (i.e., common drive, removable medium, etc.). The utility notifies the user when there are three or more backup files detected in the backup location for the selected audit. If the user chooses to view the list, a window is displayed with the list of backup files that can be selected to delete. Since two backups should be more than adequate, particularly if they are stored to a LAN drive, auditors should normally delete any backups that are older than the two most current backups.

(2) Auditors using portable laptops must ensure that backup files are not stored with the laptop computer (i.e., in the carrying bag) to avoid both being concurrently lost. The backup copy(s) should be stored in a location where loss or damage is unlikely to occur.

(3) An in-process backup set of all assignment audit files will be maintained until the entire audit and review is completed and the final electronic working papers have been stored and backed up.

d. Preparing the Completed Working Paper Package for Final Supervisory Review: The auditor should perform the following procedures when an audit has been completed and the working papers are ready for final supervisory review.

(1) A hardcopy folder will be established to consolidate and store assignment working papers. Working papers include electronic media, as well as hardcopy working paper documents that are not practical to store electronically. The hard copy folder will house the official hard copy files and the final backup electronic files on CD. In making a decision whether or not it is practical to scan hardcopy items, rather than maintain paper copies, the following factors should be considered: how long it will take to scan the hardcopy items; how often the item will be used; and any scanning preferences or guidance provided by the supervisor, FAO, or region.

(2) Electronic files should be maintained in efficient formats. As audit working files are backed up or archived, individual files and sizes comprising the backup can be viewed using WinZip. When creating the final backup, the auditor should use WinZip to identify files appearing inordinately large compared to their content. The intent of this review is to identify and remedy poor file creation techniques that contribute to unnecessarily large overall file size. The supervisory auditor should perform a similar review as part of the final review process. To aid in this review process, a File Size Review Tool is available on the DCAA Intranet as part of Other Audit Guidance. Files that directly support audit conclusions should never be removed from a backup or archive simply because they are large.

(3) All electronic working papers will be backed up just prior to performing the export for supervisory review. The APPS software removes original files from the personal computers and places them on the LAN X: drive for importing and eventual archiving. The auditor will maintain the backup files until a final permanent backup is created from the original files during the closing actions (4-407e), after which all interim backup files should be deleted.

(4) The electronic files on the LAN X: drive are the official audit working papers; any copies of these files maintained on the auditor's hard drive or on LAN drives accessible by the FAO staff must be renamed or otherwise designated as back up or nonofficial copies.

(5) The auditor is responsible for populating the title, author, and keywords fields of the file properties in the audit report. File properties are only necessary for the audit report/memorandum and not for all other files contained within the APPS exe file.

(6) The package is then exported, and notification is provided to the supervisory auditor/FAO manager for final review and completion of the associated audit report.

(7) Only the final audit report and the final cross-referenced draft should be retained in the official file.

(8) Printed copies of electronic working papers and the audit report are not required for inclusion in the package and should be rare. In cases where a determination has been made (and documented) to maintain hard copy when an electronic version is available, the hard copy included in the package must match the electronic version.

e. Closing Actions: The final closing actions should be completed as soon as possible after report issuance and, except for very unusual situations, within ten working days of report issuance. Each FAO must have written closing action procedures to ensure that appropriate Agency software is used to save and back up all final electronic working papers. The procedures should identify what types, if any, of electronic working papers will be made available for routine unofficial use and when they will be deleted, and should ensure the backup copy (copy stored on CD in the hard copy folder) is included with the working paper package when it is sent to storage. The procedures should also include the following elements.

(1) The final electronic version of the draft audit report (containing all changes to the draft, except removal of the cross references and final spelling and format changes) must be cross-referenced (see 4-403j.(3) & 4-403k.) to the working papers and included in the working paper package. A table at the top of the cover sheet is provided for inserting supervisory approval. Previous versions of draft audit reports are extraneous and should not be retained in the current audit working paper file.

(2) The final audit report electronic file must be stored with the working papers. An additional copy should be stored uncompressed with the executable file (in Livelink) and on the backup CD) for easy reference. The APPS software generates a copy of the draft audit report for final processing. The copy created by APPS is named “01 DCAA Report [RORG-ASSIGNMENT NO.]-Draft.doc.” This file is processed to accept/reject tracked changes, remove the table at the top of the cover sheet, remove cross-references and comments, remove hyperlinks to other documents, unlink document variables, and make final formatting changes before the signature page of the report is printed out and signed. Once an audit report is signed, the electronic document should immediately be modified to indicate who signed it, and it should be password protected. There is no need to document the password in the working papers since its only function is to prevent inadvertent changes, and it does not prevent using the document contents in a new document that can accept changes. The electronic file should then be renamed to uniquely identify that file as the official report according to the convention “01 DCAA Report [RORG-ASSIGNMENT NO.]-Final.doc” and changed to a read-only file. For audits closed with documents other than reports, replace “Report” with the type of document issued (i.e., MFF, MFR, Letter, etc.) as appropriate for the draft and final. For supplements or revisions, add the designator –S1 or –R1 after the –Final designator, as appropriate. Only this file should be stored, transmitted, or otherwise used for official purposes.

(3) Scanning the signed signature page is required for all DCAA audit reports and memorandums distributed outside the Agency. The signed signature page should be scanned in accordance with applicable Agency or regional scanning instructions. For audit packages, the scanned signature page should be named “01 DCAA Report RORG-ASSIGNMENT NO-Final-sig.pdf.” For supplements or revisions, add the designator –S1 or –R1 after the –sig designator as appropriate. The scanned image of the signature page should be included separately in the Livelink folder and on the backup CD; however, there is no requirement to make the file a part of the APPS generated executable file. Signed documents (other than the report or memo, e.g., SF 1408) maintained in the

audit working papers should be scanned, saved as .pdf files (.tif if there is a need to embed the file as an image), and incorporated into the electronic audit report document.

(4) For reports sent to customers via e-mail, the transmission e-mail must be retained in the official files (see 10-203.10(c) for e-mail content). For audit packages, the transmission e-mail should be named "RORG-ASSIGNMENT NO-email.txt." The transmission e-mail should be included separately in the Livelink folder, as well as on the CD containing the APPS-generated executable file. To eliminate another copy of the report in the working paper package, the transmittal e-mail should be saved in a .txt format. For supplements or revisions, add the designator –S1 or –R1 after the –email designator as appropriate.

(5) The following copies of the final electronic working papers (which should include the APPS generated executable file, a separate uncompressed copy of the final audit report, the transmission e-mail, and the scanned signature page) are required:

(a) The Official Working Paper Electronic Files (compressed as required, read-only, and self-extracting) will be stored in Livelink under the appropriate file code. A separate folder will be created for each assignment. Official copies of revised/supplemental working papers and revised/supplemental reports will be stored in the same Livelink folder as the original files. The file naming convention for the Official Working Paper Electronic Files is encoded by the Archive function in the APPS software using an 8-digit date format (e.g., 01701_2003A10100001_Archive_20080927.exe). APPS does allow for a custom label at the end of the naming convention. Since the file name is already 40 characters long, this function should be used sparingly in conjunction with the archive function. However, the custom label function can and should be used for valid descriptors (e.g., cancelled) on archive files. It can also be used routinely to distinguish multiple copies of backups. For supplements, the designator S1 should be placed after the six digit date. The S1 can be added using the custom label function.

(b) The FAO Backup Working Paper Electronic files will be stored on a single session CD in the hard copy folder. The backup copy of the electronic working paper files must be maintained as long as the original. This copy is to be used only if the original files in Livelink become lost or damaged. The naming convention for the backup copy should match exactly the Official copy.

(6) Any temporary files (recognized by the "~$" or "~WRL" characters that begin the file name) and concatenated audit programs (working paper B-99) in the audit working paper package must be deleted during the closing actions. These files are duplicates which are used for recovery and review purposes. Saving them in the final audit working paper package could confuse personnel that use or review the work in the future.

(7) The following process shall be used to create the archive copies:

- The end user accesses the audit working paper files using APPS. This could be any member of the DCAA work force. It is critical that whoever is assigned this responsibility be appropriately trained, including training in APPS.
- Select the Utilities Function within APPS and use the Import Utility to import the selected assignment to the local machine.
- Use the Backup Utility to backup the file before proceeding. This file should be saved in a temporary location until the archive function is complete.
- Use the Export Utility Function (select "Archive" as the Type of Review) to export the selected assignment to the LAN X: drive. This will create the final official executable file (e.g., 01701_2003A10100001_Archive_20093003.exe) that is stored in Livelink and backed up in the hard copy audit folder on a CD. After the official file is created, complete (a), (b) and (c) below.

(a) Collect all the files created in the closing process (APPS generated executable file, a separate uncompressed copy of the final audit report, the transmission e-mail and the scanned signature page) in the assignment subdirectory on the X: drive.

(b) Follow the instructions in the Livelink User Guide to file all the appropriate official files in Livelink in a separate folder under the appropriate file code.

(c) Copy all files from the LAN X: drive to a temporary location on the C: drive to prepare for the CD burning process. Make a copy of the APPS generated executable file (*.exe), final audit report file, transmission e-mail, and the scanned signature page file on a single session CD-ROM (type CD-R). Using the CD writing software, assure that the files are burned in the "Data CD" format, data is tested as it is recorded, and that the CD is closed at the end of the session. This will be the Backup Electronic File. After the electronic working paper backup copy is created, it must be opened and read to ensure it was not corrupted during the copying or compressing process. This test must be performed on another machine. Label the CD with, at a minimum, the following information:

- The word "tested" and the initials of the person who performed the test.
- The complete assignment number.
- A brief assignment description, such as:

Tested: XXX
2441-2004B21000001
Audit of XYX Proposal for Multicolored Widgets

Note: At the discretion of the FAO, additional copies may be created and made available for routine unofficial purposes.

(8) Ensure the backup electronic files (stored on single session CD-ROM's) are securely enclosed in the working paper hard copy folder. The use of sleeves or other appropriate techniques should be employed to ensure the final electronic files are not separated or lost from the working paper package and the copies are kept in good condition. Each FAO should ensure strong controls are in place to protect the integrity of the official records/files as well as their physical security. The completed folder will be then be stored consistent with standard FAO procedures.

(9) If the auditor receives documents/correspondence (e.g., price negotiation memorandum) that are directly related to an assignment that has already been finalized, stored and archived, the auditor should use compression software when appropriate and create appropriately named files (e.g., "RORG-Assignment No.–PNM Data ") to incorporate into the official and backup files. Newly created files should then be:

(a) filed in Livelink in the same folder with the official files and

(b) stored on a new single-session CD and placed with the backup CD in the hard copy folder.

The auditor should not re-open the original APPS file to add this supplemental documentation.

(10) Records discovered to be missing, lost, or destroyed prior to the date that they are eligible for destruction (and which cannot be recreated) must be reported in accordance with DCAAM 5015.1, Chapter 4, paragraph C.

f. Sensitive Audits: Sensitive audits include, but are not limited to, classified work, suspected irregular conduct, hotline or DCAA Form 2000 related files. These audits will not be filed in Livelink at this time. The two CD storage methods will be used to create an official and a backup copy. For storing sensitive audits skip (7)(a) above and repeat (7)(b) twice, using the file naming conventions that follow. The naming convention in APPS 5.0 should be used for both copies. For the official file copy, the designator "_Official" should be placed after the eight digit date (YYYYMMDD). This can be done using the custom label function in the APPS User Interface. For the backup copy, the official file can be copied and the file name changed to "_Backup" in place of "_Official". The Official electronic files must be stored in the hard copy folder. The Backup copy for sensitive audits must be stored separately from the Official Working Paper Electronic Files, in a controlled or locked file. With the exception of classified work, the hard copy folder should be marked "SENSITIVE AUDIT-OFFICIAL ELECTRONIC FILES ENCLOSED".

4-408 Computer-Aided Audit Applications

a. A computer-aided audit application is any audit task that has been automated using a software program. Any application that is developed must be tested before it is used. The extent and type of testing should be based on the complexity of the application and the inherent risk when relying on the results generated.

b. Audit applications done with a computer must fully satisfy the requirements of 2-307 and 4-402b. Thus, working papers prepared with the aid of a computer should be documented in the same manner as those prepared manually. They should clearly describe the data and procedures employed in the computer application.

c. The amount of documentation will vary depending on the particular computer application employed; however, the data and procedures used in the application must be sufficiently documented and properly retained to satisfy the requirements of 4-402b and to facilitate the re-creation of the application. Examples of matters that may need to be documented to fully explain the computer-aided audit work are:

(1) the basis for formulas used in spreadsheet-type applications or in calculated columns of tabular schedules,

(2) detailed schedules supporting summary schedules, and

(3) the input data if it is not shown in the output.

Depending on the application, the required documentation may be in the form of supplementary printouts from the computer application program or explanatory annotations by the auditor.

d. Proper training, planning, and testing are important factors in ensuring that computers are effectively used and in minimizing the risk of generating inaccurate results. However, just learning about proper design methods and good construction techniques in developing an audit application provides no guarantee that the results will be error-free. Adequate control features need to be identified, designed, and incorporated into the documentation, data entry, processing, and output portions of an audit application. For example, the following control activities could be used for spreadsheet applications, where appropriate:

(1) Retain a listing of the formulas and their relationships.

(2) Attach instructions and identification data with the spreadsheet application.

(3) Create back up files.

(4) Use the software protection/locking features to protect formulas and overall structure.

(5) Use record counts, data totals, hash totals, or other control totals.

(6) Calculate key balances using two alternative methods and then compare the results to make sure they are equal.

(7) Use range and reasonableness check numbers to confirm totals.

(8) Run test data and review the output for accuracy.

e. Store the data supporting a computer-aided audit application on reliable computer media (i.e., single session CD-ROM, magnetic tape, etc.) labeled with the appropriate audit assignment number. Take necessary precautions to adequately store and protect the electronic files.

f. Auditors should not create electronic files that are so large that they are difficult to store, e-mail, or otherwise handle. When scanning or otherwise obtaining electronic files, the auditor should obtain and retain only necessary data, and should properly prepare audit reports and working papers. When it is necessary to retain electronic copies of contractor data or documents (see 4-406), it should be in an efficient format. Pages scanned in accordance with Agency guidance will usually be less than 100 kilobytes in file size; however, if the settings are incorrect, a single page can take up several megabytes (e.g., when saved as a .BMP file rather than a .PDF file). A document saved in an .RTF format can be several times larger than the same document saved in a .DOC format. All overly large files should be reviewed to ensure they are in the most efficient format and do not contain unnecessary images or data. Significant amounts of data can be embedded or imported into a

document or spreadsheet without realizing the significant impact on file size. Images may be pasted into a document as a .BMP file which can make the document very large, but which may not be easily identified because they are embedded in the document and the auditor cannot see the portions that are in the .BMP format. Similarly, Excel spreadsheets should generally not be embedded into audit reports (see 10-203.15), although that process can be used in working papers. When issuing audit reports, a good rule of thumb is that the file size should be about 50 to 100 kilobytes per page. If the report is significantly larger, it should be checked. There is a File Size Review Tool available on the DCAA Intranet to assist auditors and supervisors in identifying files with size problems. Regional RSA staff can provide assistance if needed.

g. Supervisory review to ensure compliance with the auditing standards applies to computer-aided audit applications, just as it applies to any other type audit application. The reviewer must evaluate each application based upon its objectives and the relative sensitivity of the audit conclusions.

4-409 Supplemental Revisions to the Audit Working Papers after the Audit Report is Issued

a. Audit documentation in the current file must not be deleted or discarded after the report issuance date. However, circumstances may require additions to audit documentation after the report release date. In all cases, the original file must be left intact. Under the AICPA auditing standards, additional audit procedures and supplemental working papers may be necessary after audit report issuance when, subsequent to the date of the audit report:

(1) The auditor concludes that one or more procedures considered necessary at the time of the audit, in the circumstances then existing, were omitted.

(2) The auditor becomes aware that additional facts regarding the subject of audit may have existed at the report date, and such facts might have affected the report.

(3) Relevant and material developments or events have occurred (e.g., final determinations or resolutions of contingencies or other matters disclosed in the audit report or which had resulted in a departure from the auditor's standard report). See 10-214.1 for guidance on supplemental audit reports in this situation.

The auditor should update working papers and issue a supplemental report only when necessary under circumstances 1 through 3 listed above, or if a supplemental report would be useful to the requestor or other likely report users. For example, the audit issues are still outstanding/being negotiated or there is a possibility that the audit may be used to settle disputes. When working papers are supplemented, they should contain a concise explanation of the circumstances, and resolution of the issues involved. Guidance on supplemental audit reports is contained in 10-214.

b. When additional audit procedures and/or supplemental working papers are needed after the audit report has been issued due to application of previously omitted procedures, additional facts, or to address subsequent events, the auditor should take prudent measures to ensure that the update will not be mistaken for part of the original working paper package. The auditor should ensure that the update:

- is clearly distinguished from the original content;
- fully documents the circumstances leading to the additional effort;
- contains a lead schedule summarizing the cost elements/areas evaluated;
- contains structured notes or on-page notes as appropriate (see 4-403.g), and
- properly reflects who performed the additional procedures and the dates that the additional procedures were performed. Working papers must meet Agency documentation standards discussed in 4-403.

W/P A and the lead schedules for the changed cost elements/areas evaluated should be annotated with the updated recommendations/conclusions, if any, and cross-referenced to the working papers supporting the update.

c. Consideration of Omitted Procedures After the Report Date.
Additional audit procedures are necessary when an auditor concludes that a procedure considered necessary at the time of the audit in the circumstances then existing was omitted.

(1) The auditor should assess the importance of the omitted procedure to his/her present ability to support the previously expressed opinion or conclusions regarding the audit taken as a whole. The following procedures may be helpful in making an assessment of the importance of the omitted audit procedures:

- review the working papers
- discuss the circumstances with the personnel involved in the audit (i.e., supervisory auditor, requestor, contracting officer), and others; and
- reevaluate the overall scope of the audit. For example, the results of other procedures that were applied may tend to compensate for the procedure omitted or make its omission less important. Also, subsequent audits may provide audit evidence in support of the previously expressed opinion.

(2) If the auditor concludes that the omission of a procedure considered necessary at the time of the audit report in the circumstances then existing:

- impairs his/her present ability to support the previously expressed opinion or conclusions regarding the audit, and
- the auditor believes there are persons currently relying, or likely to rely, on the report, the auditor should promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for the opinion or conclusions.

(3) If the previously omitted procedure or alternative procedures cannot be applied, the auditor should discuss this matter with the supervisor and/or FAO manager to determine an appropriate course of action concerning responsibilities to the requestor, contracting activities, or other individuals who may rely on the report.

(4) If the additional procedures disclose that the report opinion, conclusions, or recommendations must be updated, follow the reporting guidance in 10-214. If no report revision is necessary, annotate the working papers to explain why this is the case.

d. Subsequent Discovery of Information Affecting the Audit Report Results.

(1) If, subsequent to issuance of an audit report, the auditor becomes aware of facts or events that would have been evaluated during the course of the audit, had they been known at the time, the auditor should promptly:

- undertake to determine whether the information is reliable, and
- assess whether its impact may be material.

The information at issue may have come into existence either before or after the audit report date. In any case, the auditor should discuss the matter with the contractor at any management level deemed appropriate, and request cooperation in whatever evaluation may be necessary.

(2) When the subsequently discovered information is found to be reliable, the auditor should take action in accordance with the procedures described in the subsequent paragraphs if the nature and effect of the matter are such that:

(a) the report would have been affected if the information had been known at the date of the report and had not been reflected in the audit; and

(b) the auditor believes there are persons currently relying or likely to rely on the audit report who would attach importance to the information.

Consideration should be given, among other things, to the time elapsed since the audit report was issued. When the auditor has concluded, after considering (a) and (b) above, that action should be taken to amend the opinion, conclusions, or recommendations in the original report, a supplemental report should be issued in accordance with 10-214.

(3) If the effect on the audit report of the subsequently discovered information cannot be determined without a prolonged evaluation, the issuance of a supplemental audit report

will necessarily be delayed. When it appears that the information will require a supplemental report, appropriate disclosure would consist of notification to the requestor and any other persons who are likely to rely on the audit report that supplemental work is being performed and a supplemental report will be issued upon completion of the evaluation.

4-500 Section 5 --- Using Information Technology (IT) in Contract Auditing

4-501 Introduction

a. This section describes how IT can assist in audit of contract costs being estimated and/or incurred by contractors (to include internal control audits), and ways available to obtain related audit assistance. It includes policy and procedural guidelines for using both DCAA and non-DCAA IT resources for technical audit applications.

b. Sections 5-400 and 5-1400, along with the Information Systems (IS) Auditing Knowledge Base, available on DCAA's Intranet, include general background and orientation material on IT, Information Systems (IS), and related terminology. More specific guidance on contract audit objectives related to IS includes:

(1) Evaluating IS General Internal Controls (5-400).
(2) Evaluating IS Application Internal Controls (5-1400).
(3) Auditing the economy and efficiency of contractor IT operations (C-400).

4-502 Policy on Use of IT

4-502.1 General Criteria for Using IT in Audit Applications

a. Auditors are capable of performing many audit tasks using IT, and DCAA strives to take full advantage of this capability. The growing cost and scarcity of auditor time, coupled with increasing economy and efficiency of IT, can make the choice of using it increasingly cost-effective.

b. IT resources available to DCAA auditors include any computer system and software from:

(1) the contractor that has submitted the data,
(2) DCAA regional and field audit offices, and
(3) the Technical Support Branch (OTST) of the Technical Audit Services Division in Memphis, TN.

If the data is written or copied to any electronic media, it can be accessed by any one of a number of data manipulation software tools. Due to the transportability of data, processing can take place at the contractor site or at any other processing site available to DCAA. Assistance in requesting and obtaining contractor data is available from regional and OTST computer specialists.

c. Documents used to enter information into the computer for processing, certain computer files, or other evidential matter required by the auditor may exist only for a short period or only in electronic form. In some computer systems, input documents may not exist at all because information is directly entered into the system. A contractor's data retention policies may require the auditor to request retention of some information for his/her evaluation or to perform audit procedures when the information is available. In addition, certain information generated by the computer for management's internal purposes may be useful in performing analytical tests (e.g., system management facilities and statistical analysis system data).

d. Using IT may also provide an opportunity to apply certain procedures to an entire population of accounts or transactions rather than performing sampling. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control activities without using IT resources.

e. When performing an audit, the auditor should employ an appropriate combination of both manual and IT related audit techniques. In determining whether to use IT, the auditor should consider such factors as:

(1) the auditor's expertise, knowledge and experience with IT,
(2) the availability of suitable IT resources,
(3) the efficiency and effectiveness of using IT related techniques over manual ones,
(4) time constraints,
(5) integrity of the contractor's information system and IT environment, and

(6) level of audit risk.

f. Certain planning steps should be taken in preparing for the application of selected IT related audit techniques such as:

(1) setting objectives for using IT,

(2) determining the accessibility and availability of IT resources and data,

(3) defining the procedures to be taken (e.g., statistical sampling, recalculation, confirmation, etc).,

(4) defining output requirements,

(5) determining resource requirements, and

(6) documentation of IT used including objectives, high-level flowcharts, and any operating instructions.

g. Data files, such as detailed transaction files, are often retained for only a short period of time; therefore, the auditor should make arrangements for the retention of the data covering the appropriate audit time frame. If the auditor plans to access the contractor's IT resources and data, arrangements should be made well in advance of the needed time period in order to minimize the effect on the contractor's IT environment. The auditor should also assess the effect that any changes to the IT environment may have on the use of IT in any audit applications. In doing so, the auditor should consider the effect of these changes on the integrity and usefulness of IT, as well as the integrity of any data used.

h. The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of IT through appropriate planning, design, testing, processing and evaluation of documentation. This should be done before reliance is placed upon the IT. The nature, timing and extent of testing is dependent on the availability and stability of any IT resources used.

i. The use of IT should be controlled to provide reasonable assurance that the audit objectives and the detailed specifications of the IT related audit activity have been met. Certain tests should be performed such as:

(1) a reconciliation of control totals,

(2) a review of output for reasonableness,

(3) a review of the logic, parameters or other characteristics of the IT, and

(4) a review of the contractor's IT general controls which may contribute to the integrity of the IT (e.g., program change controls and access to system, program, and/or data files) before the auditor relies upon system outputs.

j. Use of IT for audit applications should be sufficiently documented to provide adequate audit evidence. Specifically, workpapers should include a description of the IT related audit activity, its planning and execution, and any output produced along with conclusions reached.

4-502.2 Use of Contractor IT

a. With some computerized applications, access to contractor IT and data may be clearly essential for proper audit of costs incurred or proposed.

b. When possible, meet audit needs through adjustments to normally scheduled contractor computer runs rather than by special runs solely for contract audit purposes. Consider using reports or other records that are otherwise available before requesting special reports. This requires knowledge of the usefulness of available contractor output. Be receptive to suggestions of the contractor's personnel, so long as audit objectives are achieved effectively and efficiently.

c. In many applications the value of the audit benefit received will far exceed the net cost to the contractor. Often, added IT costs are more than justified by benefits accruing to the contractor, such as accelerated cash flow resulting from timely processing of progress payment requests or public vouchers, greater assurance of the accuracy of records, and reduced administrative support to contract audit requirements. Sample selections, cost reconciliations, and special analyses requested by the auditor often save the contractor other significant audit support efforts; and the audit data can often be used by the contractor's operating personnel to improve performance of their assigned tasks.

4-502.3 Cooperation with Internal and Independent Auditors

Obtaining cooperation from the contractor's internal audit staff and/or independent auditors can facilitate the use of IT in auditing contract costs. These groups normally perform reviews of the company's IS and the data processed. They may often be aware of computer listings and/or general purpose computer programs within the system which will provide the specific information needed by the auditor. Obtain and use this assistance following the guidelines in 4-202 and 4-1000.

4-503 Organizational Support of Auditing Using IT

DCAA maintains a complete network of regional and Headquarters resources to help the field auditor determine the feasibility of using IT resources for audit applications and implementing those that are appropriate. (These resources are, for the most part, the same as are available to assist the field auditor plan and/or perform the types of audits noted in 4-501b.)

4-503.1 Regional IS Auditors and Computer Specialists

One or more auditors in the regional special programs offices are responsible for coordinating the overall implementation of auditing using IT policy and programs within the regions. These auditors provide technical guidance and assistance in performing audits using IT resources.

4-503.2 Technical Support Branch

a. OTST provides guidance and assistance for audit applications using IT resources. In addition, OTST is responsible for coordination and control of computer program development to ensure adequate dissemination of new and/or refined IT audit techniques

b. OTST provides technical guidance, support, and assistance for all aspects of audit applications using IT including internal control evaluations, information access, retrieval, displaying, and reporting; capacity planning; computer performance evaluation; and system tuning. OTST also provides direction and assistance in using generalized data management and data manipulation software packages (both commercially available and OTST developed) such as SAS, FOCUS, SQL, MSAcess, and VisualBasic.

c. OTST provides guidance and assistance involving statistical sampling, correlation analysis, and improvement curves (EZ-Quant); use of economic data; Flexible Progress Payments; and Financial Accounting Standard Board (FASB) Statement 13. In addition OTST provides onsite and written directions for complex applications of statistical sampling (Appendix B), correlation analysis (Appendix E), and improvement curves.

4-503.3 IT Related Training

DCAA's general auditor training and career development plan includes courses designed to provide a basic understanding of Information Systems and Information Technology and the audit concerns associated with this environment. The courses are offered through the Defense Contract Audit Institute (DCAI) and conducted by OTST. More specialized courses, offered through both Government and non-government sources, are available on an as-required basis.

4-504 IT Audit Tools

4-504.1 Generalized Audit Software

Generalized audit software is a computer program or series of programs designed to perform certain automated functions. These functions include reading computer files, selecting data, manipulating data, sorting data, summarizing data, performing calculations, selecting samples, and printing reports or letters in a format specified by the auditor. This technique includes software acquired or written for audit purposes and software embedded in information systems. When using generalized audit software, the auditor should take appropriate steps to protect the integrity of the contractor's data.

4-504.2 Application Software Tracing and Mapping

Application software tracing and mapping is the technique of using specialized tools to analyze the flow of data through the processing logic of the application software and document the logic, paths, control conditions, and processing sequences. Both the command language or job control statements and programming language can be analyzed. This technique includes program/system: mapping, tracing, snapshots, parallel simulations, and code comparisons. When using application software tracing and mapping, the auditor should confirm that the source code being evaluated generated the object program currently being used in production. The auditor should be aware that application software tracing and mapping only points out the potential for erroneous processing; it does not evaluate actual data.

4-504.3 Audit Expert Systems

Audit expert systems or decision support systems are tools that can be used to assist auditors in the decision-making process by automating the knowledge of experts in the field. This technique includes automated risk analysis, system software, and control objectives software packages. When using audit expert systems, the auditor should be thoroughly knowledgeable of the operations of the system to confirm that the decision paths followed are appropriate to the given audit environment/situation.

4-504.4 Test Data

Test data are simulated transactions that can be used to test processing logic, computations and controls actually programmed in computer applications. Individual programs or an entire system can be tested. This technique includes Integrated Test Facilities (ITFs) and Base Case System Evaluations (BCSEs). When using test data, the auditor should be aware that test data only point out the potential for erroneous processing; this technique does not evaluate actual data. The auditor also should be aware that test data analysis can be extremely complex and time consuming, depending on the number of transactions processed, the number of programs tested, and the complexity of the programs/system. Before using test data the auditor should verify that the test data will not affect the contractor's live system.

4-504.5 Utility Software

Utility software is a computer program often provided by a computer hardware manufacturer or software vendor and used to support running the system. This technique can be used to examine processing activity; test programs, system activities, and operational procedures; evaluate data file activity; and analyze job accounting data. When using utility software, the auditor should confirm that no unplanned interventions have taken place during processing and that the utility software has been obtained from the appropriate system library. The auditor should also take appropriate steps to protect the integrity of the organization's system and files since these utilities can easily damage them.

4-600 Section 6 --- Audit Sampling

4-601 Introduction

This section states the procedures for audit sampling on a statistical or nonstatistical basis. Detailed guidance is in Appendix B, Statistical Sampling Techniques.

4-602 Sampling

Audit sampling can be classified into the two main categories of estimation and acceptance sampling. The sampling method used depends on desired audit objectives.

a. Estimation sampling provides an answer to the question of either how many or how much, and can be further classified into sampling for attributes and sampling for variables. The purpose of attributes estimation sampling is to estimate the frequency with which items fall into certain categories (how many), such as compliance with internal controls. The purpose of variables estimation sampling is to provide an estimate of average or total value (how much), such as the total questioned amount in a bill of materials. Estimation sampling provides a point estimate of the actual frequency (in attributes sampling) or value (in variables sampling) that exists in the universe or stratum. It also enables the auditor to assess the sample's reliability, thereby helping the auditor determine how much reliance to place on the point estimate. This feature, consisting of an estimate of the sampling error, shows how far the point estimate might be from the value obtainable from total review.

b. Acceptance sampling, which can also be subdivided into attributes or variables sampling, differs from estimation sampling in that its purpose is simply to either accept or reject a statement of condition. In this case, consideration of sampling error is incorporated in the acceptance criteria. Acceptance sampling is not intended to provide information regarding how good or bad a statement or representation might be, though at times it might serve that ancillary purpose.

c. Throughout this manual the auditor is advised to "test check" a procedure, to make verifications "on a selective basis" or to review a "representative number" of transactions or items. These instructions recognize that a complete review of all the transactions which support a proposal, claim, or other form of financial representation generally is unnecessary or impractical. Review of all representations may be required when a few transactions or items of large amounts are involved or when it is necessary to develop detailed information devoid of sampling error, such as in the case of support for legal action. In most instances, however, it is possible to support a professional opinion regarding a contractor's representation by reviewing a limited number of transactions on a sampling basis.

d. It is usually more efficient to group or stratify items to be tested into two or more categories, one group or stratum to be reviewed in its entirety and the remaining groups or strata to be reviewed on a sampling basis. When an item has been selected for review, the review must be completed, regardless of difficulty, to provide statistical integrity of sample results. When initial examinations disclose excessive misrepresentations or frequency of error, it may be appropriate to discontinue the review, abandon statistical interpretation of sample results, and issue an opinion on the basis of the strength of the evidence provided by the initial examinations. In the case of acceptance sampling, the auditor might develop a sampling plan that provides for curtailment of sampling when no significant error appears in a preliminary sample, as explained in the material on the use of preliminary samples in Appendix B.

4-603 Scope and Degree of Testing

The scope and degree of testing is a matter of judgment by the auditor. The decision will be influenced by prior experience, materiality, sensitivity, and other factors, including recognition of the important factor that only a statistical sample can be defended as truly objective. In selecting the items to be tested, and in determining the extent of the examination, the following guidelines should be considered:

(1) All large transactions should be considered for examination (the meaning of "large" will vary; thus, a $1,000 item in a $10,000 claim would deserve attention, but the same item would not be "large" in a $10 million indirect cost pool in which the Government shares a small percentage).

(2) All transactions of an unusual or sensitive nature should be reviewed.

(3) More extensive tests may be necessary in areas where procedures or internal controls are known to be weak or where deficiencies were disclosed in previous audits, where errors or items of a questionable nature are more likely to occur in certain departments or in records produced by certain categories of employees, during certain periods of reorganization, or where personnel are assigned unfamiliar tasks.

(4) The lapse of time since previous tests should be considered.

(5) Special attention should be given to those areas where incorrect charges would have the greatest effect on the costs to the Government.

(6) Trend information from previous audits should be considered.

(7) Other transactions should be tested where the total amount may be significant in the aggregate.

4-604 Method of Selecting Sample Items

a. The method of selecting the sample items affects the interpretation of the results. The results of a randomly selected sample can be objectively applied to the stratum from which the sample is drawn because the sample items are drawn without regard for their possible outcome upon review. Nonstatistically selected samples lack this feature because it cannot be indisputably demonstrated that some items in the strata are not favored for selection over others on the basis of their possible outcomes. Furthermore, only with random sample selection can the reliability of the sample results be determined.

b. A randomly selected sample, often referred to as a statistical sample because statistical principles can be applied to it, is one in which each item in a stratum has an equal probability (or chance) of being selected. More broadly, a statistical sample is one for which each item in the stratum has a determinable chance of being selected. The manner of selection of the items must preclude any personal influence as to which items are included in the sample. Judgment and knowledge of the subject area, however, are necessary in defining the sampling unit and what constitutes an error or deficiency, in deciding where to stratify, and in designing the sampling plan. There is no limit on the amount of judgment that is used, provided it is not allowed to influence the selection of sample items. Random sample selection procedures are discussed in Appendix B.

c. Statistical sampling for variables (estimation sampling) can be performed in two ways, depending on selection probabilities for individual sampling units. With physical unit sampling, each item (physical unit) in a stratum has an equal chance of being selected. With dollar unit sampling (DUS), known outside the audit context as probability proportional to size sampling (PPS), each item has a selection probability that is proportional to its dollar (absolute value) size. This translates to an equal chance of selection for each dollar in a stratum. DUS is sometimes referred to as monetary unit sampling (MUS), reflecting the fact that the sample selection method is adaptable to any measure of size. Except for the option of a stratum for total review, the need for stratification based on physical unit magnitudes is eliminated in DUS. The appropriate use of these two methods is discussed in Appendix B.

d. A nonstatistical sample is one in which individual judgment has influenced the selection of sample items. Although nonstatistical sampling results cannot be used to make totally objective inferences regarding conditions of the entire stratum or universe, they might be adequate in some circumstances to form an audit opinion. For example, if a nonstatistical sample reveals a high degree of inaccuracy in a price proposal, the entire proposal may be rejected. Although a nonstatistical sample may be acceptable, there is no way of estimating the reliability of the results or guaranteeing their objectivity. Such qualities are available only through statistical sampling or total review of the stratum or universe.

4-605 Sampling Policy

a. Statistical sampling is the preferred method for sampling because it allows auditors to express an opinion regarding the entire universe of transactions from which the sample selection was made.

b. Where audit sampling or other quantitative methods are used, a comment to that effect should be made a part of the auditor's explanation of the individual cost elements involved. The audit report must disclose whether the auditor used either a nonstatistical or statistical sample as a basis for the audit conclusions. The report must also include details concerning the sample universe, the sampling method, and sampling unit. The report will state whether the statistical sampling results were projected to the sampling universe. In expressing an opinion as to the results of statistical sampling for variables (estimation sampling), only one projected value or amount will be used, (i.e., the point estimate). Audit reports with projections will also include the confidence level and confidence interval boundary amounts. If the results were not projected, the report should explain the reasons why the results could not be projected.

c. For audit purposes, items stratified for detailed or more intensive examination will not be considered a part of the sample area (universe); hence, the results will be appraised separately from the statistical evaluation of the sample result.

d. Where appropriate, the statistical sample result should be projected to the universe from which the sample was selected.

e. Computer systems will be used to the maximum in the stratification, random selection of sample items, and statistical evaluation of sample results. See 4-606 for a description of sampling software.

4-606 Sampling Software

There are a number of computer software packages available to assist the auditor in data retrieval and in stratifying, selecting, and appraising the results of a sample. EZ-Quant is a collection of quantitative methods for which software has been written for use on microcomputers to perform quantitative analyses such as statistical sampling, correlation analysis, and improvement curves. Specific operational guidance is given in the EZ-Quant software "help" documentation.

4-700 Section 7 --- Responsibilities for Detection and Reporting of Suspected Irregularities

4-701 Introduction

This section covers procedures, audit guidance, and responsibilities relating to fraud, other unlawful activity, and anticompetitive practices. For unsatisfactory conditions not covered by this section see 4-800.

4-702 Suspected Fraud and Unlawful Activity --- General

4-702.1 General

a. When auditing a contractor's records in accordance with government auditing standards, auditors may encounter, or receive from other sources, information constituting evidence or causing suspicion of fraud or other unlawful activity. (Examples of other unlawful activity include violations of the Anti-Kickback Act, anticompetitive (antitrust) practices, and illegal political contributions.) Sources for such information may include company employees, disgruntled participants, or others making allegations by letter, telephone, personal visit, or through a third party. Such information may pertain to acts of:

(1) military personnel or civilian employees of the Government in their relations with the Government.

(2) military personnel or civilian employees of the Government in their relations with individuals or firms.

(3) individuals or firms in their business relations with the Government.

(4) individuals or firms in their business relations with other individuals or firms doing business with the Government.

b. Definition. For purposes of this chapter, the term "fraud" or "other unlawful activity" means any willful or conscious wrongdoing, including, but not limited to, acts of cheating or dishonesty which contribute to a loss or injury to the Government. Some examples are:

(1) falsification of documents such as time cards or purchase orders.

(2) charging personal expenses to Government contracts.

(3) submitting false claims such as invoices for services not performed or materials not delivered.

(4) intentional mischarging or misallocation of costs.

(5) deceit by suppression of the truth.

(6) bribery.

(7) corrupt payments which violate the Foreign Corrupt Practices Act.

(8) theft.

(9) a Government employee acquiring a financial interest in or seeking employment with a contractor over whom the employee exercises oversight.

(10) kickbacks.

(11) any unlawful or fraudulent acts resulting from accounting classification practices designed to conceal the true nature of expenses, e.g., classifying unallowable advertising or entertainment costs as office supplies.

(12) product substitution or false certification that tests were performed.

(13) any attempt or conspiracy to engage in, or use, the above devices.

4-702.2 Auditor Responsibilities for Detecting and Reporting Fraud

a. The assessment of the risk of material misstatement due to fraud is a cumulative process that:

(1) includes a consideration of risk factors individually and in combination, and

(2) should be ongoing throughout the audit. In determining contractor compliance with laws and regulations, government auditing standards require auditors to design audit steps

and procedures to provide reasonable assurance of detecting errors, irregularities, abuse, or illegal acts that could:

- have a direct (or indirect) and material effect on contractor financial representations or the results of financial-related audits, or
- significantly affect the audit objectives.

Auditors should also exercise:

- due care in planning, performing, and evaluating the results of audit procedures, and
- a proper degree of professional skepticism to achieve reasonable assurance that material unlawful activities or improper practices are detected.

Under the concept of professional skepticism, an auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, an auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine if contractor financial representations are free of material misstatements. Many aspects of a DCAA auditor's responsibilities, particularly as set forth in Chapters 6 and 9, require constant alertness to the possibility of fraudulent activities. This alertness, combined with a contractor's internal controls and the auditor's normally programmed tests of procedures and transactions, should provide a reasonable degree of assurance for disclosing fraud or other unlawful activity. (See also 4-702.3.)

b. Auditors are not trained to conduct investigations of illegal acts. This is the responsibility of investigators or law enforcement authorities. Auditors are responsible for being aware of fraud indicators, vulnerabilities, and potentially illegal expenditures and acts associated with an audit area (see 4-702.3a. and b.). When an auditor obtains information that raises a reasonable suspicion of fraud or other unlawful activity that has not been previously disclosed to the Government, an investigative referral should be initiated (see 4-702.4).

c. Issuance of an investigative referral should not be deferred until completion of the audit. Neither should it necessarily take place as soon as the auditor is confronted with a fraud indicator. The auditor should follow up on fraud indicators until he or she is satisfied either that an innocent explanation of the irregularity is not likely or no further relevant information can be generated through audit techniques. This is similar to the manner in which a tentative decision to question costs would be followed up. The auditor must avoid the appearance of conducting an investigation. If the auditor is in doubt about the propriety of a proposed audit step, guidance should be requested from the supervisor or FAO manager. Audit support to investigations is covered in 4-702.6 and 4-702.7.

d. The following guidance applies when suspected irregularities are discovered by either Government or contractor auditors during joint audits. Joint audits are discussed in 4-202.1e.

(1) As soon as there is a discovery of a suspected irregularity during the conduct of a joint audit, both the Government and contractor participants in the audit should be notified. The contractor will have 30 days from the date of the discovery to make a contractor disclosure to the DoD Inspector General.

(2) Audit tasks from the joint audit plan pertaining to the suspected irregularity will normally be suspended until the 30-day time period has elapsed, or until the contractor notifies the Government it does not intend to make a disclosure. Upon such notice, audit activities in the area will be subject to 4-702.4 procedures for determining whether a referral is required. Work on other tasks in the joint audit plan may continue.

(3) If the contractor makes a disclosure to the DoDIG, it will be permitted to conduct an independent internal investigation of the suspected irregularity. Audit tasks from the joint audit plan pertaining to the disclosure will be suspended until that investigation is completed.

e. Suspected irregularities, whether discovered through audit steps and procedures; discovered by an auditor inadvertently, as in a conversation overheard; or disclosed to an auditor, either in person or through an anonymous tip, shall be recorded in the audit working papers and reported promptly to FAO management. It is not necessary to establish that

the Government has been defrauded before alerting investigators. Proving that an unlawful act has occurred is the responsibility of investigators and prosecutors.

4-702.3 Fraud Indicators and Audit Procedures for Uncovering Fraud

a. Auditors should be familiar with specific fraud indicators. Examples of fraud indicators are included in the following publication issued by the DoDIG: Handbook on Fraud Indicators for Contract Auditors (IGDH 7600.3, APO, March 31, 1993).

In addition to the indicators shown in the publication, specific fraud indicators, risk factors, audit tests, and procedures for the detection of fraud appear in the standard audit programs and in the listed CAM sections for the following audit areas:

Audit Area	CAM Reference
General	Figure 4-7-3
Internal Control Audits	5-100
Physical Observations	5-108a
Accounting for Material Cost	6-305
Storing and Issuing Materials	6-312
Labor Cost Charging and Allocation	6-404.6
Floor Checks	6-405.2/.3
Overtime	6-409.2
Consultant Costs	7-2105.1
Defective Pricing Audits	14-121
IT System Audits	5-400
Financial Capability	14-304

b. The auditor should specifically assess the risk of material misstatement due to fraud and should consider that assessment in designing the audit procedures to be performed. Effective audit risk assessments and audits of internal controls are useful procedures for assessing risk of fraud against the Government. Proper execution of audit programs together with adequate tests of contractor internal control systems should provide reasonable assurance that significant fraudulent and other unlawful practices are detected (see Chapters 5, 6, 7, and the Information Systems (IS) Auditing Knowledge Base on DCAA's Intranet).

The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. The extent of the procedures applied should reflect the assessment of the risk of material misstatement due to fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate. Application of auditor judgment and applicable coordination with the supervisor is important to assure that any added steps are value added, are an efficient use of audit resources, and will specifically address the added risk of material misstatement due to fraud or error.

c. Treat as a possible audit lead any allegation received from outside sources, such as telephone calls, anonymous letters, and contractor employees. If there is further evidence available at the FAO to support the allegation and a reasonable basis to suspect fraud or other unlawful conduct, report the suspicions in accordance with 4-702.4. If the allegation provides a reasonable basis to suspect fraud or other unlawful conduct, but there is no further corroborating evidence, relay the allegation using the DoD Hotline (4-702.4a(1)).

4-702.4 Procedures for Referring Suspicions

a. There is no requirement for the auditor to prove the existence of fraud or other contractor irregularities in order to submit a referral. Upon encountering or receiving information which raises a reasonable suspicion of fraud, corruption, or unlawful activity (see 4-702.3) relating to a Government contract:

(1) Promptly prepare a DCAA Suspected Irregularity Referral Form (DCAAF 2000), or utilize the DoD Hotline toll-free telephone number (800/424-9098) or the mailing address (Defense Hotline, The Pentagon, Washington, DC 20301-1900). If the irregularity does not affect DoD contracts, the matter may be reported to the inspector general of the agency most at risk.

Use of the DCAAF 2000 is the preferred method for forwarding this information. It specifies the information needed by investigators and provides for appropriate consideration of audit impact. A copy of the DCAAF 2000 is included as Figure 4-7-2. The latest version of the DCAAF 2000 is available on the DCAA Intranet and the APPS.

(2) If the DCAAF 2000 is to be used, it should be obtained from either the DCAA Intranet or the APPS. Fully describe the fraudulent condition to be reported and reference the procurement regulations or statutes that were allegedly violated. Include information on contractor efforts to hinder or obstruct audit work which uncovered the suspected fraud (see 4-708). The auditor may submit the completed referral directly, or has the option to submit through your immediate supervisor for review. Management reviews of the DCAAF 2000 prior to formal submission to Headquarters should be limited to that necessary to ensure clarity. No attempt should be made to dissuade an auditor from completing and submitting a DCAAF 2000.

(3) Care should be taken to avoid unnecessary use of legal terminology or proliferation of enclosures beyond those necessary to explain the problem. The purpose of the DCAAF 2000 is to alert an investigator to a possible irregularity, not to establish that the reported irregularity is a violation of the law. The auditor's obligation to protect the contractor's records from unauthorized access requires that the distribution of documents which appear to provide evidence of impropriety be restricted. Evidentiary material should be made available to the investigator at the earliest opportunity after an investigation has been opened, preferably during the investigator's initial visit to the FAO.

(4) Place a reference to the draft DCAAF 2000 in the audit working papers to establish a record of events leading up to the decision to make a referral. The referral itself should be secured separately in a locked receptacle to prevent inadvertent disclosure (see 4-702.5d).

(5) Continue with assigned duties and pursue development of factual information as appropriate or indicated by 4-702.5. Coordinate any continuing evaluation with your supervisor or FAO manager.

b. Instructions for referring suspicions are contained in the DCAA Instruction on "Reporting Suspected Contractor Fraud and Other Contractor Irregularities" (DCAAI 7640.16).

4-702.5 Audit Activities Subsequent to Referral --- Continuing Audits

a. Following a referral, or after notification of the initiation of an investigation, take no actions that would compromise the investigation. Do not attempt to establish wrongdoing (an investigative responsibility) nor inform the contractor that a fraud referral has been made. Audit scope may, after consultation with the investigative organization, be expanded to determine the impact of the suspected fraud or other unlawful activity on audit objectives. Do not expand audit scope for the sole purpose of gathering additional information to support an investigation. If audit activities relate to an area under investigation or litigation, coordinate with the cognizant investigative or prosecutive organization before taking any final administrative action. An example of such an audit activity is the issuance of final audit-determined indirect cost rates. Audit activities outside the area of investiga-

tive interest will continue unless the investigative organization requests in writing they be deferred or suspended. If it is believed the requested deferral will cause financial harm to the Government or unnecessarily impede the audit mission, elevate the matter for management resolution between the respective organizations. Before any decision is made to defer or suspend an audit, coordinate the matter with Headquarters (OTS).

b. Furnish a copy of any resulting audit report to the appropriate investigative organization. Also, furnish any information developed later, relating to the suspected wrongdoing or similar misconduct, directly to the responsible investigative agency without filing a separate DCAAF 2000. Reference all future correspondence and/or updates with the DCAA case number assigned by OTS, and, if available, the case control number assigned by the investigative agency. In order that current, complete, and accurate information is available to the Department of Justice (DOJ), furnish the DCAA Justice Liaison Auditor (JLA), DCAA's representative to the DOJ, a copy of all unclassified audit reports or memorandums prepared in support of an investigation or similar customer requested assignment. The address is:

DCAA Justice Liaison Auditor
Attn: OTS
8725 John J. Kingman Rd., Suite 2135
Fort Belvoir, VA 22060-6219

c. Suspicions of fraud or other unlawful activity may be so serious as to prevent the issuance of an unqualified audit report or lead to a recommendation that contract payments be halted pending resolution. If additional time is required to develop factual information for an audit impact determination, the final audit report can usually be delayed for DCAA-initiated assignments. (See 4-702.5a. and e. before issuing a report.) Examples of such assignments are operations audits, estimating system surveys, or postaward audits. However, when an audit report is scheduled for issuance within a specified time frame (e.g., a report on a price proposal audit) the suspected condition may have a serious impact on the auditor's ability to meet the due date. When this occurs:

(1) Consult the regional office.

(2) Contact the Plant Representative/ACO or the representative of a non-DoD agency, as appropriate, to explain the condition and arrange for an extended report due date. Do not do this, however, if the contracting representative may be involved in the suspected unlawful activity.

(3) Qualify the report if a due date cannot be extended, and inform the requestor by separate letter of the circumstances affecting the situation (but see 4-702.5a. and e.).

(4) Question any costs improperly claimed as a result of the suspected wrongdoing (but see 4-702.5a. and e.).

d. Carefully protect and strictly control all information related to the suspicion of fraud or other unlawful activity. This is to protect the reputations of innocent persons and ensure that information is not prematurely or inadvertently disclosed to persons suspected of wrongdoing. Premature or inadvertent disclosure could compromise the Government's efforts to gather needed evidence. Mark the DCAAF 2000 and all related DCAA reports and correspondence "FOR OFFICIAL USE ONLY" (unless a security classification is required). Control and protect all such information as follows:

(1) During normal duty hours, keep the documents in an out-of-sight location if the work area is accessible to nongovernment personnel (e.g., contractor personnel).

(2) After duty hours, place the documents in locked receptacles such as file cabinets, desks, or bookcases.

(3) When such information is being disseminated outside DCAA, hand carry reports and correspondence between appropriate officials whenever practicable, or otherwise transmit them in a manner which will prevent inadvertent release to unauthorized persons.

e. Do not issue an audit report on any part of a representation containing a fraudulent claim without first notifying and coordinating with the cognizant investigative agency (see 4-702.5a). Normally there is no need to withhold an audit report unless it can be demonstrated that its issuance would hinder an investigation or prosecution. Before a decision is

made to withhold an audit report, the FAO or region should coordinate the matter with Headquarters (OTS). Unless otherwise instructed, send the original audit report to the responsible contracting officer/ACO along with a separate cautionary transmittal memorandum regarding the suspected unlawful activity. See Figure 4-7-1 for an example. Do not make reference in the audit report to suspected irregular conduct or a referral for investigation, and do not send copies of the transmittal memorandum to other parties. In circumstances where Government contracting representatives may be involved in the suspected unlawful activity, do not use the transmittal memorandum if, per discussion with the cognizant investigative agency, the information contained therein would interfere with a pending investigation.

f. It is DCAA policy that information relating to a matter referred for investigation will be protected and not released or disclosed to a contractor, or a contractor's employee, representative, or attorney. This policy is based on the need to avoid the disclosure of information which might impede or compromise an investigation. A regional director or head of a principal staff element may make a case-by-case exception to this policy after consultation with the cognizant investigator and OTS.

g. Representatives of a contractor seeking protected information might take unusual measures to contact the auditor away from the workplace. Such measures could include telephoning or making an unannounced visit to the auditor's home. Whether the contact occurs at the workplace or elsewhere, do not discuss any aspect of a matter referred for investigation. Any contractor contacts, whether related to an investigation or normal audit activity, should occur at the auditor's or contractor's place of business during normal duty hours. If an attempt to contact the auditor outside normal working hours or workplace occurs, notify the region, OTS, and the cognizant investigative organization.

h. Since the information on the DCAAF 2000 is obtained from the performance of our normal audit activities, it is documented in existing working papers for those assignments. Therefore, it is the information from those working papers that can be used when planning the scope of future audits (e.g., Working Paper B).

4-702.6 Investigative Support Responsibilities

The auditor's responsibility for detecting fraud ends with the submission of a Form 2000 or Hotline referral. DoD IG Joint Policy Memorandum No. 2 (JPM-2), which is referenced in DCAA Regulation (DCAAR) 7640.15, makes the investigative agency responsible for directing, monitoring, and reporting on the status of fraud investigations. Audit support to DoD investigative organizations is authorized by DoD Instruction 7600.02, "Audit Policies," dated April 27, 2007. Specific guidelines concerning audit support of fraud investigations are contained in JPM-2. The provisions of JPM-2 were carefully developed to encourage cooperation between DoD investigators and auditors, and to clearly define the responsibilities of each organization. Offices furnishing support to investigative activities should be thoroughly familiar with the contents of this memorandum. Following are some of the regional, FAO, and auditor investigative support responsibilities:

a. Regions are to establish procedures, documented by regional instructions, which provide for regional oversight of the timeliness and quality of audit support to investigators.

b. Auditors should support formally constituted investigations when the investigators have submitted a written request for assistance to the cognizant FAO. Auditors will treat requests for investigative support as customer requested assignments and schedule them for completion on that basis. Such requests should include a list of the audit tasks needed to support the investigation. If requested, the FAO will assist the investigative organization in framing the list of audit tasks being requested. This list may be amended periodically, depending on investigative developments or as deemed necessary by the auditor to properly fulfill his or her mission or function. A formally constituted investigation is one which:

(1) has progressed beyond the preliminary inquiry stage,

(2) has been assigned an investigative case number, and

(3) has resolved all issues regarding notification of the contractor under investigation.

It is the investigator's responsibility to notify the contractor that it is under investigation and that DCAA auditors are assisting. This should be done before DCAA provides support to a criminal investigation requiring access to contractor personnel or records located at the contractor’s facility .

c. Auditors will provide prompt and effective support to investigators consistent with the auditor's role in the acquisition process. Auditors assigned to assist investigators will remain under the operational control and supervision of DCAA management. Auditors are not to perform clerical or other tasks outside the normal function of the auditing profession on behalf of investigators and are not to assume the role of an investigator.

(1) Auditors assigned to support an investigation are not required to meet contractor employees or other witnesses in situations where their safety may be threatened. If such unsafe conditions are expected, auditors may be asked to develop questions, but are not required to accompany the investigator. Requests for the use of DCAA resources to assist covert or clandestine investigations or operations must be elevated to DCAA Headquarters, ATTN: OTS.

(2) Investigators have authority (through inspector general or grand jury subpoenas and search warrants) to obtain documents not normally available to DCAA in performing its mission. When assigned to support an investigation, auditors will not have investigators use their authority to obtain, for DCAA's use, information or documents not related to the investigation. Conversely, auditors will not use DCAA's authority to obtain for investigators information or documents not related to the investigation.

(3) Auditors assigned to a criminal investigative team will not, directly or indirectly, state or indicate that their presence at the auditee's premises is for any purpose other than to assist in a criminal investigation. To do otherwise could result in audit-obtained information being deemed inadmissible in court.

(4) When supporting an investigation, it may be necessary to audit companies that are not the target of the investigation. An example is the audit of a subcontractor to confirm or refute information provided by a prime contractor. If a company is not the target of an investigation, do not inform the company of the investigation or of the investigative nature of the audit.

d. Auditors will;

(1) provide Government investigators and prosecutors ready access to applicable DCAA working paper files, including contractor-generated material contained therein,

(2) list in the working papers or DCAAF 2000 file copies of working papers and other data provided to investigators, and

(3) document in the working papers or DCAAF 2000 file meetings with members of governmental investigative agencies (see 1-405).

See 4-702.5c., d., e., f., and g. for guidance on the protection of information relating to investigations.

e. If, within the course of exercising its existing authority, DCAA obtains custody and control of original documents (including contractor records) reflecting indicators of fraud or other unlawful activity, DCAA must immediately inform the cognizant criminal investigative organization so appropriate measures can be taken for the Government to maintain custody and control over such documents.

f. Grand jury proceedings are criminal investigations officially conducted by the Department of Justice or an assistant U.S. attorney (AUSA) rather than a DoD investigative organization. An AUSA or DOJ attorney may also conduct a civil investigation into suspected contract fraud. In many cases, the trial attorney obtains services from an investigative agency such as the FBI. The investigator will then obtain DCAA audit assistance. Although JPM-2 does not address DOJ trial attorneys, AUSAs or the FBI, it

is DCAA policy that the obligations of the requestor and auditor are the same as those specified in JPM-2.

g. Audit services to non-DoD agencies are furnished under agreements that provide for interagency billings. Although future agreements will provide for investigative support services, existing agreements may not specifically list investigative support as a covered audit service. To ensure consistency, handle requests from non-DoD agencies for investigative support using the guidelines in JPM-2. Investigative support to non-DoD agencies other than the Department of Justice (DOJ) and the FBI is reimbursable, and this should be confirmed with the requesting agency before such services are rendered. Investigative support to DOJ and the FBI is reimbursable only to the extent that DOJ or FBI contracts are affected. DCAA may provide investigative support to DOJ or FBI for other non-DoD contracts only when reimbursed by the contracting agency. Investigative support may be only partially reimbursable when the contractor has a mix of DoD and non-DoD contracts.

h. Audit support of investigations may consist of completing routine overhead audits or defective pricing audits of special interest to investigators. In these situations, report audit results using standard audit reports (see 4-702.5e., 4-702.8, and Chapter 10). However, certain requests for investigative support require effort not fitting the pattern of established audits. In these circumstances, consider the information needs of the requestor in conjunction with the guidance in 10-1200 when issuing reports or memoranda in response to investigative support requests. Do not release results of these audits, including draft condition statements or recommendations, to the contractor before consulting with and obtaining the approval of the investigator. Discuss factual matters with the contractor only to the extent necessary to ensure accuracy. These procedures are necessary to prevent premature release of audit results which could compromise Government actions regarding the condition under investigation.

4-702.7 Control of Documents Obtained Under Inspector General or Grand Jury Subpoenas and Civil Investigative Demands

For criminal investigative purposes, documents may be obtained under either an Inspector General (IG) or a grand jury subpoena. The civil investigative equivalent of a grand jury subpoena is referred to as a civil investigative demand (CID). DCAA subpoenas will not be used in connection with investigations. When an investigative office obtains documents under an IG subpoena, it is the custodian of the documents. When the documents are obtained under a grand jury subpoena, the grand jury is the custodian and the Government prosecutor or the investigator acts as the grand jury's agent or representative. Similar custodial requirements exist for CIDs. Requirements for safeguarding grand jury materials or CIDs are more stringent than for IG subpoenas.

a. Auditor responsibility for safeguarding contractor records is discussed in 1-507. The auditor is not relieved of responsibility simply because the records in question have been obtained under subpoena or because the contractor itself should be excluded from access to the subpoenaed records. When auditors are assigned to assist an investigation, they should be aware of their responsibility to exercise due care and be mindful that removal of original documents from the designated workplace could result in both significant embarrassment to the Agency and penalties to the auditor.

b. If an auditor is to work directly with an investigator or trial attorney, the acknowledgment of the request for audit services should state that, while the auditor will exercise due professional care, neither the auditor nor the Agency can assume responsibility for the completeness of subpoenaed documents that are not inventoried upon receipt and maintained under appropriate security thereafter.

c. If unsatisfactory conditions are encountered, the cognizant manager or supervisor should advise the head of the investigative agency of the situation in writing. The matter should then be left to the discretion of the investigative office. It is highly unlikely that security problems will arise under a grand jury subpoena; however, in that case,

notice of unsatisfactory conditions should be furnished to the trial attorney with a copy to the investigator.

4-702.8 Audit Reports Involving Alleged Subcontractor Fraud

a. Most fraud statutes provide for measurement of total cost impact to the Government for damages resulting from subcontractor fraud or false statements. For example, a second-tier subcontractor may make a false statement to a first-tier subcontractor resulting in a $1 million defective pricing. If the first-tier subcontractor and the prime contractor rely on the defective data, the impact to the Government would exceed $1 million after adding the two additional levels of overhead, G&A, and profit. In this example, the second-tier subcontractor would be liable for the entire cost impact to the Government (plus penalties) even though its gain was only $1 million. This situation differs significantly from a non-fraudulent defective pricing case where the Government would seek recovery of the entire cost impact from the prime contractor. In non-fraudulent subcontractor defective pricing cases, the audit report procedures described in 10-602b. apply (i.e., subcontract audit reports are provided to the prime contract auditor who issues a consolidated report to the procurement authority).

b. In subcontract fraud matters, auditors at subcontractor locations are usually requested by investigators or attorneys to determine the total cost impact to the Government. In such cases, the auditor supporting the investigation of the subcontractor should assume full responsibility for coordinating all audit activity necessary to respond to the request. Accordingly, the subcontractor investigative support auditor should request audit assistance from FAOs with audit cognizance over any higher-tier contractors and incorporate the results into a single consolidated report or memorandum to the requestor. Use this procedure regardless of the number of higher-tier contractors. As part of this process, the subcontractor investigative support auditor should identify information needed from the higher-tier locations and supply the higher-tier auditors with any data necessary to assist them in their work. In acknowledging the request from the investigators or attorneys, the cognizant investigative support auditor should inform the requestor of arrangements being made for the submission of reports on any:

(1) technical analysis or

(2) evaluations of intracompany or higher-tier contractor additive factors.

c. Resolve any disputes between regions on administrative procedures or technical accounting matters that arise during assist audits in accordance with 6-807.

4-703 Suspected Contractor Provision of Improper Gifts/Gratuities to Government Personnel

a. The Standards of Ethical Conduct for the Executive branch (5 C.F.R. Part 2635, Subpart B) state that federal employees shall not accept gifts/gratuities directly or indirectly which are given because of the employee's official position or which are given to the employee by a prohibited source. "Direct or indirect acceptance" includes gifts to an employee's parent, sibling, spouse, child or dependent relative given because of the employee's relationship to that other person. "Prohibited sources" are any person or legal entity that:

(1) seeks official action from the employee's agency;

(2) does business or seeks to do business with the employee's agency;

(3) conducts activities regulated by the employee's agency;

(4) has interests that may be affected by the performance or nonperformance of the employee's duties; or

(5) is an organization, a majority of whose members fall within any one or more of the prior four categories.

b. The Standards of Ethical Conduct for the Executive branch are found at Chapter 2 of DoD's Joint Ethics Regulation (JER), DoD 5500.7R. Additionally, 18 U.S.C. 203 makes it a crime for a Government employee to receive compensation for his or her duties as a Gov-

ernment employee from anyone other than the Government. It also makes it a crime for someone to pay such compensation to a Government employee.

c. A violation of 18 U.S.C. 203 or DoDD 5500.7 may become the subject of an investigation and can result in disciplinary action. DCAA auditors do not have a designated mission to monitor compliance with either the Standards of Ethical Conduct or the statute; consequently, audit programs do not contain specific steps to detect noncompliance. However, any apparent noncompliance coming to your attention, regardless of the length of time since the suspected event occurred, is referable. Be aware, however, that there are exclusions from the definition of a gift and a number of listed exceptions to the gift prohibition including a blanket exception for gifts valued at less than $20 per occasion and $50 per calendar year. The exclusions and exceptions are found on pages 2-7 through 20-14 of Chapter 2 of the JER. A regulatory change [August 20, 1996] by the Office of Government Ethics provides greater authority for Federal agency ethics officials to permit the gift of free attendance to a "widely attended gathering" to be accepted by a Federal official when there is agency interest in that employee's participation in the event [e.g. a conference, dinner, reception, etc.] Therefore, be sure to evaluate these exceptions before making a referral. Guidance on the "widely attended gatherings" exception can be obtained from the DCAA General Counsel's office pending inclusion of that guidance in a revised or republished JER available in the field. Forward suspected offers or acceptances of gratuities even though no recipient can be identified or no investigative lead is apparent. The requirements for referral of personnel from other Federal agencies who have accepted gifts, gratuities, loans, favors, or entertainment are the same as those for DoD employees (see 4-704).

(1) The referral (DCAAF 2000 may be used) must contain as much information as is available. Such information includes the identity of the offeror and recipient (names, position titles, and agency/department or contractor), type of gratuity, range in dollar value of the gratuity or benefit detected, estimated total dollar value, the records reviewed, whether access to any records was denied, and why the auditor suspects that a gratuity was offered or received. Also, state whether the contractor is aware of the condition and, if so, include comments on the nature of corrective action taken or contemplated, including the adequacy of any repayments to the Government.

(2) Do not forward with the referral many copies of essentially duplicative documents from the contractor's records, such as expense vouchers. Instead, forward one or two representative samples of such records along with a listing of pertinent information such as names, dates, and amounts extracted from the records. All copies should be legible. If it is not possible to obtain a legible copy, state this fact in the referral and briefly describe the document.

(3) Send the referral to Headquarters, ATTN: OTS, with copies to the regional director. OTS will review the referral for possible forwarding to the appropriate investigative agency.

4-704 Suspected Violations of the Anti-Kickback Act (41 U.S.C. 51 to 58)

4-704.1 General

a. The Anti-Kickback Act (4-7S1) prohibits providing, attempting to provide, or offering to provide any kickback; soliciting, accepting, or attempting to accept any kickback; or including, directly or indirectly, any kickback in the contract price charged by a subcontractor to a prime contractor or a higher-tier subcontractor or in the contract price charged by a prime contractor to the Government.

b. Kickback is defined as any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.

4-704.2 Examples of Questionable Practices

Questionable practices under the Anti-Kickback Act may take such form as: payments of commissions to prime contractor personnel; entertainment provided for prime contractor personnel; loans to prime or higher-tier contractor personnel that may not be repaid and may be later recorded as an expense on the subcontractor's records; and expensive gifts or preferential treatment to particular subcontractors.

4-704.3 Audit Responsibilities

Ascertain that contractors have informed:

(1) their personnel who award or administer subcontracts or purchase orders and

(2) their subcontractors and suppliers about the provisions of the amended Anti-Kickback Act and questionable practices thereunder.

If such action has not been taken by a contractor, recommend that the contracting officer require such action. In addition, cooperate to the extent necessary to ensure that the contractor's procurement personnel are aware of the provisions of the Act.

4-704.4 Referral Requirements

Because Public Law 99-634, "Anti-Kickback Enforcement Act of 1986," imposes a duty on the contractor to promptly report the possible violation in writing to the Inspector General of the contracting agency, to the head of the contracting agency if the agency does not have an Inspector General, or to the Department of Justice, the contractor has a statutorily imposed duty to self-report. Therefore, suspected kickbacks are ineligible for inclusion in the Voluntary Disclosure Program. When there is reason to believe that a violation of the Act has occurred, and the cognizant Defense criminal investigative organization has not been notified, the auditor shall promptly prepare a DCAA Form 2000. The Form 2000 will state all known details of the transaction. Coordinate and forward the Form 2000 in the same manner as those on suspected fraud (see 4-702.4).

4-705 Suspected Anticompetitive Procurement Practices

a. Anticompetitive procurement practices are those designed to eliminate competition or restrain trade. They include those practices or events listed in FAR 3.303(c). They do not include bona fide sole-source procurement actions, violations of the Competition in Contracting Act by the procuring activity, or buying-in by a contractor.

b. If information received from any source indicates suspected anticompetitive procurement practices by a contractor or subcontractor, determine, by appropriate audit techniques, whether sufficient evidence exists to indicate an improper practice. If the anticompetitive procurement practice involves exclusive teaming arrangements, see 4-705c. For all other anticompetitive procurement practices, promptly submit a referral using the procedures set forth in 4-702.4.

c. When auditing a contractor’s records, auditors may encounter, or receive from other sources, information constituting evidence or causing suspicion of an anticompetitive exclusive teaming arrangement. Because of the complexity of antitrust laws, the existence of an exclusive teaming arrangement does not necessarily mean an anticompetitive situation exists. An example of an anticompetitive exclusive teaming arrangement is when one company teams exclusively with another company which other potential offerors consider essential for contract performance. The potential for an antitrust violation is present only if one or a combination of the companies participating in an exclusive teaming arrangement is the sole provider of a product or service that is essential for contract performance, and the Government’s efforts to eliminate the exclusive teaming arrangement are unsuccessful. Therefore, if the information received from any source indicates an anticompetitive exclusive teaming arrangement, the auditor should promptly notify the contracting officer. If the auditor believes

the contracting officer's efforts to resolve an anticompetitive exclusive teaming arrangement are not successful, the auditor will consult with DCAA Headquarters General Counsel for further guidance.

4-706 Suspected Illegal Political Contributions

4-706.1 The Statute

a. Title 2 U.S.C. 441c, in essence, prohibits any firm or person contracting with the United States from making a contribution to or expenditure for a political party, committee, candidate for public office, or any person, for a political purpose or use. The statute applies only at the national level, not the state and local levels.

b. The term "contribution" includes:

(1) any gift, subscription, loan, advance, or deposit of money or anything of value made by any person for the purpose of influencing any election for Federal office; or

(2) the payment by any person of compensation for the personal services of another person which are given to a political committee without charge for any purpose.

4-706.2 Methods of Channeling Inappropriate Expenditures

Corporations that make illegal political contributions may use several means to channel such payments to the intended recipient. Be alert to such methods as:

a. Bonus payments to contractor personnel passed on by the employee as a personal contribution or returned to the company to make the contribution. These payments usually cover taxes paid by the employee. Review carefully any bonus payments which might be based on a formula designed to cover taxes due.

b. Payments to outside consultants or other professional contacts. Such payments may be too high for the service received or there may be no services received at all. Scrutinize high or unusual professional and consultant service expenses for inappropriate expenditures. Such scrutiny involves a comprehensive review of supporting documentation, which should state the extent of services provided.

c. Padding or falsifying expenses paid to employees. Such expenses may include travel, dues, memberships and subscriptions, training, educational expenses, or any expenses where the contractor makes payment based on an invoice from an employee or a close, outside associate.

4-706.3 Audit Responsibilities

It would be impractical to perform the audit effort necessary to disclose every illegal political contribution. However, government auditing standards require auditors to design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, abuse, illegal acts, or other unlawful activity that could significantly affect the audit objectives or results of audit (see 4-702.2a).

4-706.4 Referral Requirements

When a violation of the statute is suspected, submit a report describing all known details of the transaction to Headquarters, ATTN: OTS, for possible referral to the Federal Election Commission. The DCAAF 2000 may be used for this purpose. "Early alerts" are not required when reporting this suspected misconduct.

4-707 Reserved

4-708 Obstruction of Audit

a. The Anti-Drug Abuse Act of 1988 (P.L. 100-690) added section 1516 to Title 18, U.S.C., which contains an obstruction of audit provision. This provision makes it a crime for a person or corporation to endeavor to influence, obstruct, or impede, with the intent to deceive or defraud the Government, a Federal auditor in the performance of official duties. The purpose of the provision is to punish acts designed to prevent an auditor from discovering or reporting fraud or deceit against the Government. The provision does not make it a crime to deny an auditor access to records unless the purpose of the denial is to prevent such discovery. Therefore, do not report a suspicion of fraud or other unlawful activity solely on the basis that access to records was denied. Pursue access to records problems in accordance with 1-504.5.

b. If there is a reasonable basis to suspect fraud or deceit against the Government, and you believe a denial of access to records is an attempt to prevent an auditor from discovering or reporting this fraud or deceit, include this information in a suspected fraud referral (see 4-702.4). The mere denial of access to records, however, is not by itself a reasonable basis to suspect fraud.

c. When reporting suspicions of fraud or other unlawful activity (see 4-702.4), include any information on suspected contractor efforts to influence, obstruct, or impede an auditor with the intent to deceive or defraud the Government.

4-709 Qui Tam Actions Under the False Claims Act

Qui tam actions are civil, not criminal, actions, which are brought under the authority of the False Claims Act. In such a suit, the plaintiff brings the action on behalf of the Government. A qui tam suit is filed under seal. The defendant contractor is not provided with a copy of the filing nor is it to be told the contents of the filing while the action is under seal. The Government is furnished a copy of the filing and has 60 days in which to make a decision on whether it will join in the suit. To assist its deliberations, the DOJ will frequently seek information about the defendant contractor from DCAA. Information in our files and working papers is to be made readily available to the attorney handling the case as well as any DoD personnel supporting the attorney. Any requests for additional audit support will be treated as a customer requested assignment. The contractor is not to be informed of the source of these requests without the approval of the requesting attorney. At the same time, the FAO should determine if the attorney has any objections to providing the results of the audit to the contracting officer. If there are none, a report should be sent to the contracting officer. However, the report will caution that the audit was conducted in connection with a qui tam suit and that before any contractual action is taken on the matter, permission must be obtained from the responsible attorney.

4-710 Defense Hotline

a. The Defense Hotline is an element of the DoD Inspector General Office of Investigations which receives and reviews audit and investigative leads. The Defense Hotline operates to ensure that allegations of fraud and mismanagement are properly evaluated, substantive allegations are examined, appropriate administrative, remedial or prosecutive actions are taken and administrative procedures are in place and maintained in order to properly manage Hotline allegations. It receives allegations from Government entities such as DoD, from private individuals both inside and outside the Government, and from the GAO. The Hotline assigns review of these leads to the audit or investigative agency it believes is best qualified to determine their validity; monitors the progress of the examination; reviews and analyzes all interim and final reports to determine that the examinations are conducted properly and the appropriate corrective measures were recommended and/or taken; and tabulates and reports case dispositions. DoD instructions

pertaining to the Defense Hotline program are discussed in DoDD 7050.1. DCAA responsibilities for reviewing Hotline referrals are set out in DCAAR 7600.1.

b. In accordance with DoD IG Joint Policy Memorandum Number 95-2 dated May 26, 1995, the DoD Hotline reviews will only be performed by individuals and organizations who are independent. Accordingly, non-government employees and/or organizations, including contractor internal audit groups or external auditors, will not perform any work in relation to any DoD Hotline review because of their inherent lack of independence.

c. The Hotline and the Agency are obligated to protect the anonymity of sources. The Headquarters, DCAA transmittal of a sensitive Hotline referral will make specific reference to nondisclosure requirements in its opening paragraph. Hotline documents arising from such a source are clearly marked. In order to evaluate a Hotline referral, it may be necessary to advise a contractor that an audit lead has been received. However, the auditor should strive to reveal only the minimum amount of information necessary to conduct a proper and thorough review. The Hotline should not be identified as the source of the lead. Under no circumstances may Hotline documents be released outside the Government. Hotline documents may be released within Government channels only to agencies/employees involved in the Hotline review.

d. At its discretion, the Hotline may determine that an allegation lacks significant detail or significant subject matter to warrant formal inquiry. Such a matter will be classified as an information referral. All other referrals are action referrals which are assigned a due date. Hotline referrals are reviewed in Headquarters, OTS, and are forwarded to the cognizant regional office for information or response. The regional office may further delegate responsibility. Delegation of the decision to conduct a field review of an information referral does not convert the status of that referral to an action referral. However, if a field audit is undertaken, results must be reported to the Hotline.

e. All Hotline referrals which have been assigned due dates, either by the Hotline or by Headquarters, are to be treated as customer requested assignments. If a due date cannot be met, an extension should be requested by filing a Hotline Progress Report (DCAAR 7600.1). The Hotline has suggested that six month extension requests reduce unnecessary proliferation of progress reports. It is the responsibility of the Regional Office to assure that Hotline progress and completion reports are issued in the specified format.

f. When a field audit of a Hotline referral involving alleged fraud is undertaken, allegations are to be treated as audit leads and followed up through audit in accordance with 4-702.2c. If a reasonable suspicion of fraud or other unlawful activity remains after performing the appropriate risk assessment and audit steps, arrangements should be made for transfer of the matter to an investigative agency. The responsible field element should discuss the case with the investigative office to which it would have sent a DCAAF 2000 had the allegation arisen through audit. (However, matters first reported through the Defense Hotline are deemed to be known to the Government, and therefore ineligible for reporting on the DCAAF 2000.) Case responsibility may be transferred by submitting a Hotline Completion Report (DCAAR 7600.1) to Headquarters, Attention OTS, setting out the results of audit, the reason(s) for transfer, and the investigative office to which the matter should be transferred.

g. Audit procedures and reporting following transfer of a Hotline referral to an investigative agency should be carried out in accord with 4-702.5. If a transfer is not made, audit findings should be pursued and reported in accord with normal procedures. If available, audit reports containing findings and recommendations which arose from a Hotline referral should be submitted as an enclosure to the Hotline Completion Report.

h. When a referral makes allegations of a technical nature, the assistance of a Government technical evaluator should be obtained. Occasionally it becomes apparent that the technical evaluator's agency should assume responsibility for the referral, with audit support as needed. When this happens, transfer of responsibility should be formalized similarly to investigative transfer.

4-711 Evaluating Contractor Compliance with Administrative Suspension and Debarment Agreements

a. Background. Contractors found to have committed fraud or other misconduct sometimes enter into suspension and debarment agreements to avoid being suspended or debarred from obtaining Government contract awards or to be removed from the listing of suspended or debarred companies. These agreements usually require the contractor to implement ethics and fraud prevention programs and strengthen internal controls over the areas where the fraud or other misconduct occurred. Often, the agreements require the contractor to maintain a Hotline for employees to report fraud or other irregularities. Sometimes the costs incurred by the contractor to comply with these agreements are unallowable under FAR 31.205-47. Each Service and the Defense Logistics Agency has suspension and debarring officials or designees who are responsible for monitoring contractor compliance with the agreements.

b. Responsibilities. The suspension and debarring officials or designees will request DCAA audit support to evaluate contractor compliance with any provisions of the agreement that relate to DCAA's audit mission. For example, the auditor will generally be requested to perform an audit if the contractor is identifying and segregating the unallowable costs being incurred to comply with the agreement. If the agreement also provides for the contractor to make improvements to its internal control systems, the auditor will generally be requested to determine if the improvements have been made. The suspension and debarring officials or designees are responsible for assessing overall contractor compliance with the agreement.

c. Briefing of the Agreement and Coordination. At those contractors with suspension and debarment agreements, the FAO should obtain a copy and brief the agreement to identify provisions that fall within DCAA's areas of responsibility. The FAO should then discuss with the responsible suspension and debarring official or designee and the contracting officer the audit services needed to assist in evaluating contractor compliance. Any differences of opinion between the FAO and the suspension and debarring official or designee or any difficulty in arranging a meeting should be communicated through the Regional Office to PAS for resolution. The results of this coordination should be documented in the FAO's audit planning files.

d. Audit Planning. The FAO normally will not have to establish special audits to provide the needed audit support. The audit steps needed to assist the suspension or debarring official or designee in determining compliance with the provisions of the agreement can be usually performed as part of the FAO's regularly scheduled audits; e.g., the FAO's planned audits of internal controls relating to the identification and segregation of unallowable costs. However, if the compliance officer requests a special audit because of his scheduled responsibilities, the FAO should provide the requested services.

e. Corporate Offices. Settlements at the corporate level affecting two or more segments should be coordinated by the corporate auditor or CAC. After the briefing, the corporate auditor or CAC will disseminate the agreement to the segment auditors with an assist audit request (if applicable) on any services needed to assess compliance with the relevant parts of the agreement.

f. Reporting. The FAO should communicate in writing all noncompliances or other concerns with the agreement to the ACO cognizant of the contractor with a copy to the suspension and debarring official or designee. All applicable DCAA audit reports should contain comments on any contractor actions required by a suspension/debarment agreement until the contractor fully implements or complies with the agreement.

g. Excluded Parties Listing. The General Services Administration (GSA) maintains an "Excluded Parties Listing System" on the Internet at http://www.epls.gov, which provides data on all suspended and debarred parties. The site allows data searches via various search criteria, makes available a number of reports in different formats, and provides other useful data. This information is updated continuously on a real time basis. This site is the only source that should be used when checking the suspensions and debarment status of a contractor.

4-7S1 Supplement - Public Law 99-634, "Anti-Kickback Enforcement Act of 1986"

An Act to prohibit kickbacks relating to subcontracts under Federal Government contracts.

Section 1. This Act may be cited as the "Anti-Kickback Act of 1986."

Section 2. As used in this Act:

(1) The term "contracting agency," when used with respect to a prime contractor, means any department, agency, or establishment of the United States which enters into a prime contract with a prime contractor.

(2) The term "kickback" means any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.

(3) The term "person" means a corporation, partnership, business association of any kind, trust, joint-stock company, or individual.

(4) The term "prime contract" means a contract or contractual action entered into by the United States for the purpose of obtaining supplies, materials, equipment, or services of any kind.

(5) The term "prime contractor" means a person who has entered into a prime contract with the United States.

(6) The term "prime contractor employee" means any officer, partner, employee, or agent of a prime contractor.

(7) The term "subcontract" means a contract or contractual action entered into by a prime contractor or subcontractor for the purpose of obtaining supplies, materials, equipment, or services of any kind under a prime contract.

(8) The term "subcontractor"

(A) means any person, other than the prime contractor, who offers to furnish or furnishes any supplies, materials, equipment, or services of any kind under a prime contract or a subcontract entered into in connection with such prime contract; and

(B) includes any person who offers to furnish or furnishes general supplies to the prime contractor or a higher tier subcontractor.

(9) The term "subcontractor employee" means any officer, partner, employee, or agent of a subcontractor.

Section 3. It is prohibited for any person ---

(1) to provide, attempt to provide, or offer to provide any kickback;

(2) to solicit, accept, or attempt to accept any kickback; or

(3) to include, directly or indirectly, the amount of any kickback prohibited by clause (1) or (2) in the contract price charged by a subcontractor to a prime contractor or a higher tier subcontractor or in the contract price charged by a prime contractor to the United States.

Section 4. Any person who knowingly and willfully engages in conduct prohibited by section 3 shall be imprisoned for not more than 10 years or shall be subject to a fine in accordance with title 18, United States Code, or both.

Section 5. (a).

(1) The United States may, in a civil action, recover a civil penalty from any person who knowingly engages in conduct prohibited by section 3. The amount of such civil penalty shall be --

(A) twice the amount of each kickback involved in the violation; and

(B) not more than $10,000 for each occurrence of prohibited conduct.

(2) The United States may, in a civil action, recover a civil penalty from any person whose employee, subcontractor or subcontractor employee violates section 3 by providing,

accepting or charging a kickback. The amount of such civil penalty shall be the amount of that kickback.

(b) A civil action under this section shall be barred unless the action is commenced within 6 years after the later of (1) the date on which the prohibited conduct establishing the cause of action occurred, and (2) the date on which the United States first knew or should reasonably have known that the prohibited conduct had occurred.

Section 6. (a) A contracting officer of a contracting agency may offset the amount of a kickback provided, accepted, or charged in violation of section 3 against any moneys owed by the United States to the prime contractor under the prime contract to which such kickback relates.

(b)(1) Upon direction of a contracting officer of a contracting agency with respect to a prime contract, the prime contractor shall withhold from any sums owed to a subcontractor under a subcontract of the prime contract the amount of any kickback which was or may be offset against that prime contractor under subsection (a).

(2) Such contracting officer may order that sums withheld under paragraph (1) -

(A) be paid over to the contracting agency; or

(B) if the United States has already offset the amount of such sums against that prime contractor, be retained by the prime contractor.

(3) The prime contractor shall notify the contracting officer when an amount is withheld and retained under paragraph (2)(B).

(c) An offset under subsection (a) or a direction or order of a contracting officer under subsection (b) is a claim by the Government for the purposes of the Contract Disputes Act of 1978.

(d) As used in this section, the term "contracting officer" has the meaning given that term for the purposes of the Contract Disputes Act of 1978.

Section 7. (a) Each contracting agency shall include in each prime contract awarded by such agency a requirement that the prime contractor shall have in place and follow reasonable procedures designed to prevent and detect violations of section 3 in its own operations and direct business relationships.

(b) Each contracting agency shall include in each prime contract awarded by such agency a requirement that the prime contractor shall cooperate fully with any Federal Government agency investigating a violation of section 3.

(c)(1)(A) Whenever a prime contractor or subcontractor has reasonable grounds to believe that a violation of section 3 may have occurred, the prime contractor or subcontractor shall promptly report the possible violation in writing.

(B) A contractor shall make the reports required by subparagraph (A) to the inspector general of the contracting agency, the head of the contracting agency if the agency does not have an inspector general, or the Department of Justice.

(2) In the case of an administrative or contractual action to suspend or debar any person who is eligible to enter into contracts with the Federal Government, evidence that such person has supplied information to the United States pursuant to paragraph (1) shall be favorable evidence of such person's responsibility for the purposes of Federal procurement laws and regulations.

Section 8. For the purpose of ascertaining whether there has been a violation of section 3 with respect to any prime contract, the Government Accountability Office and the inspector general of the contracting agency, or a representative of such contracting agency designated by the head of such agency if the agency does not have an inspector general, shall have access to and may inspect the facilities and audit the books and records, including any electronic data or records, of any prime contractor or subcontractor under a prime contract awarded by such agency.

Figure 4-7-1
Pro Forma Cautionary Transmittal Memorandum

FOR OFFICIAL USE ONLY

MEMORANDUM FOR (name and address of requestor)

SUBJECT: Cautionary Statement Related to Audit Report (audit report number, date and subject, and the contractor's name and location)

The attached audit report addresses certain matters which have raised a suspicion of potential fraud on the part of (indicate the name of the company involved). Specifically, those matters are (describe the suspected fraudulent conduct). We are willing to discuss these matters with you, your counsel, and representatives of the cognizant criminal investigative organization in an effort to reach a proper disposition of these issues in light of the requirements of DoD Instruction 7050.05, Coordination of Remedies for Fraud and Corruption Related to Procurement Activities.

(Signature)
Branch Manager

FOR OFFICIAL USE ONLY

Figure 4-7-2
Suspected Irregularity Referral Form

(Use full size form or APPS Version for reporting)

DCAA CASE NO.: _____

SUSPECTED IRREGULARITY REFERRAL FORM

Follow enclosed guidance and DCAA Instruction 7640.16 when providing the following information:

1. Name, FAO, RORG number, telephone and FAX numbers, and e-mail address of the auditor preparing the referral.

2. Contractor's name, division, and address. Identify if the contractor is a small/disadvantaged (8a) firm.

3. Government entities (e.g. Navy, DOE, HHS, etc.) affected by irregularity. If possible, identify contract(s), types, amounts, and major program(s) affected.

4. Classification of irregularity (See the enclosed instructions)

5. Prepare, on a separate page, a concise description of the irregularity. Include the following criteria: **who, what, where, when, how, how much**. If possible, identify regulatory provisions and/or statutes violated. Attach documentation (appropriately cross-referenced) as necessary.

6. Reason for treating this as other than normal questioned costs (e.g.; if suspected fraud, where is the **material statement**, which is **false**, and why do you think it is **known** by the maker to be false?)

7. Estimated loss or impact to the Government. Explain basis and any reasons for limited current visibility of total losses.

8. Signature of Auditor and date (must be signed and dated).

   _____ _____
   Auditor Date

9. Distribution: Headquarters OTS, ACO/PCO, and Cognizant Investigator
   (See Appendix 1 of DCAAI 7640.16). Identify all addressees.

DCAAF 2000
March 2009

INSTRUCTIONS FOR PREPARATION OF FORM 2000

GENERAL:

Information which suggests a reasonable basis for suspicion of fraud, corruption, or unlawful activity affecting Government contracts must be reported **promptly**. For reporting purposes, **fraud** is defined as: a **material statement** of fact which is **false**, and **known** to be false. Other reportable irregularities include Kickbacks, Gratuities, Illegal Political Contributions, Foreign Corrupt Practices Act violations, and Agreements in Restraint of Trade. Activities **not** reportable on the Form 2000 include matters such as (1) those already known by the Government, (2) Contractor Disclosures, and (3) unsatisfactory conditions (CAM 4-800).

An effective referral requires close communication between auditors, supervisors and FAO Managers. You may also coordinate with your Regional Investigative Support Division (RSI) if there are any questions about whether or not to refer the matter, keeping in mind the need for **promptness**. Follow instructions in CAM 4-700 and DCAAI 7640.16 in preparing the Form. Use continuation pages as necessary, especially for question 5, keeping in mind the need for **conciseness**.

Classification of Irregularity (Form 2000, Item 4):

To assist the investigator in evaluation of the material presented, indicate in item 4 which of the following classifications best fits the matter being referred (more than 1 classification may apply):

1. Defective Pricing a. Pattern of Activity b. Other (explain)	5. False Claims/Certifications a. Equitable Adjust. Claims b. Termination Settlements c. Indirect Cost Certification d. Other (explain)	8. Ethical Violations a. Kickbacks b. Gratuities c. Political Contributions d. Foreign Corrupt Practices Act e. Bribery f. Restraint of Trade g. Other (explain)
2. Billing Irregularities a. Progress Payments b. Public vouchers c. Other (explain)	6. Consultants/Subcontractors a. Consulting Irregularities b. Subcontract Irregularities	
3. Labor Irregularities a. Timekeeping b. IR&D/B&P Mischarges c. Other (explain)	7. Materials a. Product Substitution b. MMAS c. Other (explain)	9. Other Irregular Activity a. Conspiracy b. Obstruction of Audit (see CAM 4-708) c. Other (explain)
4. Accounting Mischarging a. FAR 31/CAS 405 Violations b. Improper Transfers c. Unallocable Costs d. Other (explain)		

DCAAF 2000
March 2009

Figure 4-7-3
Examples of Characteristics and Types of Activity Associated with Illegal Expenditures and Acts for Specific Audit Areas

Audit Area	Indicators
Labor	Unexplained changes to timecards transferring hours from commercial firm-fixed-price contracts to Government cost-type contracts.
	Employee time charged differently from associated travel costs.
	Diverting labor from firm-fixed-price contract by reclassifying employees as indirect who provide direct labor to firm-fixed-price contracts.
Material	Significant material requirements charged to Government cost-type contracts where follow-up work shows that the material was not needed.
	Using inferior material on Government contracts that does not meet contract specifications.
	False certification of inspection test results.
Subcontracts	Intercompany profit claimed and billed for an intercompany affiliate that the contractor represented to the Government was an unrelated subcontractor.
Indirect Cost	Overrun contract costs charged to indirect expenses for allocation to other contracts.
	Expressly unallowable costs recorded in accounts that are generally allowable such as small tools and supplies.
	Improper transfers, or recording, of costs to indirect accounts for direct contract costs that are not allowed to be charged under the terms of the contract.
Defective Pricing	See 14-121.2 for listing.
All Audit Areas	Alterations to documents that would result in improper costs claimed for Government contracts.
	Evidence showing that payments were not actually made for the amounts shown on the document.

4-800 Section 8 --- Special Reporting of Unsatisfactory Conditions

4-801 Introduction

This section contains guidance and procedures on special reporting requirements on unsatisfactory conditions noted by contract auditors that are not reportable under section 7 of this chapter.

4-802 Voluntary Refunds for "Windfall Profits"

4-802.1 Introduction

DFARS Subpart 242.7100 expresses DoD policy and general procedures on the solicitation or acceptance of voluntary refunds from contractors or subcontractors.

4-802.2 Audit Responsibility – Voluntary Refunds

When the contract auditor reaches a conclusion pursuant to 4-802.3 that it may be appropriate to seek a voluntary refund, the auditor should observe DFARS Subpart 242.71 carefully, and inform the cognizant administrative contracting officer, in writing, of this conclusion and its basis, either in an audit report or otherwise.

4-802.3 Audit Procedures

On audits of any type, auditors should be alert to situations where the Government was overcharged under a contract; was inadequately compensated for the use of Government-owned property, or in the disposition of contractor inventory; and where the contractor's or subcontractor's retention of the amount in question would be contrary to good conscience and equity. If any of these situations are disclosed and it is due, at least in part, to the fault of the contractor or subcontractor, the Government may request a voluntary refund or credit, provided the adjustment is not otherwise required by contractual terms or statutory requirements such as 10 U.S.C. 2306a.

4-802.4 Audit Reports

a. Prepare reports on situations involving voluntary refunds in a narrative format pursuant to 10-1200. A decision to seek a voluntary price adjustment must be approved by the head of the contracting activity, or as provided in department/agency regulations. Therefore, the report or letter should contain sufficient information to permit adequate consideration of the facts and to support a decision at that level.

b. Address a report or letter involving a subcontractor to the contracting officer and forward it through the office which has audit cognizance of the prime contractor. Where audit cognizance has not been established for the prime contract and the prime contractor is not otherwise subject to audit by another audit office, transmit the report directly to the contracting officer in the same manner as if it involved a prime contract.

4-803 Unsatisfactory Conditions (Serious Weaknesses, Mismanagement, Negligence, etc.) on the Part of Contractors

4-803.1 Introduction

a. Unsatisfactory conditions, such as repeated and significant deficiencies in accounting or estimating practices, mismanagement or negligence, and failure to comply with acquisition regulations may result in significant monetary loss or cost to the Government, or frustrate public policy.

b. Unsatisfactory conditions are not to be reported on the DCAAF 2000. Denial of access to records (DCAAI 7640.17) is an unsatisfactory condition for which a specific remedy (the DCAA subpoena) is available. Neither suspected irregular conduct nor denial of access to records is reportable under this section.

c. Unsatisfactory conditions related to a Government official are discussed in 4-804 below.

4-803.2 Examples of Questionable Practices

Examples of unsatisfactory conditions in contractor operations include, but are not limited to, the following:

(1) An estimating system and related practices so deficient that price proposals are consistently unreliable, resulting in widespread defective pricing.

(2) Significant and chronic violations of Cost Accounting Standards.

(3) Internal control weaknesses of a magnitude that could cause significant monetary loss to the contractor and excessive cost to the Government.

(4) Excessive or premature contractor reimbursement because of inappropriate application or review of economic price adjustment provisions.

(5) Failure to pay the minimum wages required by the Davis-Bacon Act, Walsh-Healey Public Contract Act, or the Service Contract Act.

4-803.3 Audit Responsibilities

a. Serious weaknesses causing major audit problems encountered during audit performance should be discussed with the contractor, the principal cognizant ACO, and the CAC as soon as possible so as to expedite the resolution process. The auditor should not wait until the final exit conference or the issuance of the audit report to convey such findings. All such discussions should be documented by appropriate memorandums or notations in the working papers and a separate audit report issued using the procedures in 10-400, 10-800, or 10-1200.

b. When an unsatisfactory condition is called to the FAO manager's attention in writing, the FAO manager may:

- determine that no action is required;
- take appropriate action to resolve the condition; or
- determine that the condition cannot be resolved at the FAO level and request regional assistance.

The FAO manager should prepare a memorandum for record documenting judgments and conclusions supporting the choice of alternative. A copy should be furnished to the originator, with an information copy to the RAM, and the original report and the resulting MFR should be retained within an appropriate FAO file.

4-803.4 Headquarters Reporting Requirements

a. When an FAO encounters unsatisfactory conditions in contractor operations and the issue cannot be resolved at the FAO level, the FAO should involve the regional office promptly.

b. If the condition is not or cannot be corrected after all FAO and regional office efforts have been exhausted, the regional office will prepare a Headquarters report describing the condition along with the actions taken to correct it and submit it to Headquarters, ATTN: P and DL. Before the report is submitted, the regional director will assure that it contains all pertinent facts, including the FAO's original report and a comprehensive explanation of all actions taken to resolve the matter. Wherever determinable, it should include the monetary amount involved.

4-804 Unsatisfactory Conditions (Mismanagement, Negligence, etc.) Related to Actions of Government Officials

4-804.1 Introduction

Unsatisfactory conditions include actions by Government officials that appear to reflect mismanagement, a failure to comply with specific regulatory requirements or gross negligence in fulfilling his or her responsibility that result in substantial harm to the Government or taxpayers, or that frustrate public policy. Most unsatisfactory conditions should be handled by the region/FAO elevating the issues through the Government official's management chain. However, for some unsatisfactory conditions an independent assessment is necessary due to the sensitivity or significance of the matter. DCAA will report such conditions to the Department of Defense Inspector General (DoDIG) for appropriate action.

4-804.2 Audit Responsibilities

a. Auditors should discuss unsatisfactory conditions they encountered with the FAO management and the FAO manager should assess the issues and take the appropriate actions. The FAO manager may be able to resolve some unsatisfactory conditions at the local level. For example, the FAO manager may resolve an issue related to the contracting officer by elevating it to the head of the local procurement office. For unsatisfactory conditions addressed at the FAO level, the FAO manager should take the necessary actions and prepare a memorandum for record (MFR) documenting the relevant facts, including judgments and conclusions supporting the actions taken. A copy should be furnished to the originating auditor for filing in the appropriate FAO file, with an information copy furnished to the RAM.

b. If the FAO's efforts to resolve the issue are unsuccessful or it is determined that the unsatisfactory conditions should not be handled at the FAO level due to the sensitivity or significance of the matter, the FAO manager should discuss the unsatisfactory conditions with the regional office. Based on these discussions, the region/FAO will determine whether to (1) attempt to resolve the issues at the regional level by elevating the issues through the Government official's management chain, or (2) forward the unsatisfactory conditions to Headquarters for forwarding to the DoDIG for resolution. If the region/FAO determine that the region should attempt to resolve the issue and those regional efforts fail, the issue will be forwarded to Headquarters.

c. Any unsatisfactory conditions forwarded to Headquarters, either for resolution at the Headquarters level or forwarding directly to the DoDIG, will be accompanied by a report prepared by the FAO describing the condition. Before the region submits the report to Headquarters, ATTN: Policy and Plans, the regional director will ensure that it contains all pertinent facts and a comprehensive explanation of all actions taken to resolve the matter, if applicable. Headquarters will either attempt to resolve the issue at the Government official headquarters level or, if an independent assessment is needed, forward the submission to the DoDIG for appropriate action.

d. This special reporting to the DoDIG applies only to the most significant and sensitive issues. Less significant/sensitive matters should be handled at the local level, elevating the issue to the next higher level of management authority within the Government official's chain of command for appropriate resolution. Examples of the types of unsatisfactory conditions that may warrant an independent assessment by the DoDIG include, but are not limited to, the following:

(1) A contracting officer purposely excludes DCAA from performing or completing an audit to avoid a negative report (e.g., audit report with an adverse opinion).

(2) A contracting officer takes an action grossly inconsistent with procurement law and regulation; e.g., awards a contractor unreasonable or excessive costs and/or profit.

e. Contracting officers have wide authority to make decisions regarding contract matters. DCAA auditors act as advisors to contracting officers. Simple disagreement

between the audit position and the contracting officer's decision is not reportable as an unsatisfactory condition.

f. Suspected irregular conduct, e.g., violations of criminal and penal statutory provisions, such as those implemented by the Joint Ethics Regulation, should be reported on the DCAAF 2000 and not as unsatisfactory conditions.

4-900 Section 9 --- Requesting Audit Guidance -- Regional Offices and Headquarters

4-901 Introduction

a. This section states policies and procedures for processing requests to regional offices and Headquarters for expert advice, assistance, and guidance on significant auditing and accounting issues. Requirements for feedback to Headquarters on the application of guidance received are also included.

b. The policies and procedures in this section generally do not apply to requests for informal guidance. Informal guidance represents quick comments on an issue without a detailed analysis performed by the regional/Headquarters staff and with no or little management review of the guidance.

4-902 Obtaining Guidance

4-902.1 Definition

For purposes of this paragraph, auditing and accounting issues mean any questions involving interpretation of the FAR and DFARS cost principles, Cost Accounting Standards (CAS), Generally Accepted Government Auditing Standards (GAGAS), Generally Accepted Accounting Principles (GAAP), or other applicable laws and regulations relating to the conduct of audits or allowability, allocability, or reasonableness of costs charged to Government contracts.

4-902.2 Background and General Responsibilities

a. On occasion, field auditors require assistance and advice to help resolve new, unique, complex, or controversial auditing and accounting issues. Before issues are elevated to the region for assistance, the FAO will research the issue by reviewing relevant guidance in CAM, open MRDs, and regulations (e.g., FAR and CAS). FAOs should not research and analyze court cases or regulatory history. When the FAO's research does not adequately resolve the issue, a request for assistance should be submitted to the regional office. The region should thoroughly research the issue using the regional library (except for requests meeting the criteria for the streamlined approach (see 4-902.2.c).)

b. When the region’s research does not adequately resolve the issue, the region should submit an audit guidance request with supporting documentation to Headquarters, DCAA, ATTN: P, using the following format:

(1) SUBJECT. Always start the subject line with the following: "Request for Headquarters Guidance on ..."

(2) Program Area. Identify the major operational area; for example, FAR Cost Principles, CAS, Forward Pricing, Defective Pricing, Comprehensive Labor, etc.

(3) Problem/Issue Identification. Provide:

(a) background information regarding what generated the request;

(b) a clear and succinct statement of the problem/issue, with sufficient information to clearly explain the issue, as well as all relevant facts related to the specific circumstances; and

(c) specific questions that the region would like addressed in the guidance.

(4) Regional Staff Evaluation. Explain the nature and extent of, and the sources used in, the regional evaluation prior to submission to Headquarters. (Exclude this section when the streamlined approach is used.)

(5) Regional Alternatives. List and explain any alternatives that the regional office may have identified for resolving the issue, including the pro(s)/con(s) of each alternative. (Exclude this section when the streamlined approach is used.)

(6) Regional Recommendation. Identify the solution recommended by the region with the supporting rationale. (Exclude this section when the streamlined approach is used.)

(7) Use of Guidance. Explain how the guidance will be used; e.g., in draft audit report on [*subject*]; to rebut contractor's response to draft audit report on [*subject*].

(8) Regional Contact. Identify the regional focal point, telephone number, e-mail, and FAX number.

(9) Regional Working Paper File. Provide with the request the region's electronic assignment file containing working papers and other documents used during its research (as well as any relevant hard copy documents that are not available electronically). This will eliminate the need for Headquarters to duplicate research already performed by the region and should reduce the time and effort required by Headquarters to respond. Applicable working papers and other documents should be referenced in the other sections of the region's request. When the streamlined approach is used (see 4-902.2.c) relevant background documents and other documentation needed to clearly understand the facts should be submitted with and referenced in the request.

c. Streamlined Approach.

(1) For certain types of issues, the region may not be required to perform research prior to submitting its audit guidance request to Headquarters; e.g., where a legal opinion is required; there is an urgent need for Headquarters guidance; there is no current policy covering the issue; or where external agency coordination is required.

(2) Issues that the region believes may be appropriate for the streamlined approach should be discussed with the appropriate Headquarters division as soon as the region has sufficient facts to adequately understand the issue.

(3) If it is determined that the streamlined approach is appropriate, the region should submit a request as outlined in 4-902.2.b, except that only items (1) through (3) and items (7) through (9) need to be included.

d. Headquarters will research Federal laws and regulations, FAR, DFARS, and CAS case history files, decisions of courts and boards of contract appeals, authoritative accounting literature, etc. to develop guidance. When appropriate, legal and/or technical input from outside experts or specialists will be obtained.

e. The proposed guidance will be coordinated with elements of the Office of the Secretary of Defense (OSD), when appropriate.

f. The feedback required by 4-902.4 below will be used to evaluate whether further guidance is needed.

4-902.3 Requesting Guidance For Use Of Legal Citations

Audit guidance is based on generally accepted accounting principles, applicable Government regulations, and rulings of Boards of Contract Appeals and Federal courts. Often the authoritative source of the guidance (e.g., a board or court case) is cited in CAM and/or specific audit guidance provided by Headquarters in support of the recommended audit conclusion. The guidance stated in CAM and specific audit guidance, including relevant legal citations, should be employed in the audit and explained in the audit report to the extent necessary to support the audit conclusions. When the auditor believes it is necessary to include in the audit report a legal citation not discussed in CAM or Headquarters guidance, the use of the citation must be formally coordinated, through the region, with Headquarters, Policy and Plans Directorate. The Headquarters division responsible for the audit issue will coordinate with our legal advisors and the FAO to ensure that the citation is relevant and properly applied.

4-902.4 Requirements for Feedback to Headquarters

a. When a guidance memorandum is issued to one region, applicable to a specific issue at a particular FAO, the region should advise the Headquarters division that issued the guidance, of the application of the guidance by forwarding to the appropriate Headquarters

division copies of audit reports, memorandums to contracting officers or others, or letters to contractors or others which reflect application of the Headquarters guidance. When a region issues a guidance memorandum to an FAO without Headquarters guidance, the FAO should submit the information listed above to the regional office.

b. Regional offices will also forward to the appropriate Headquarters division copies of any resulting contractor rebuttals, contracting officer comments, related legal opinions, or other comments received that:

(1) could have an impact on the guidance previously provided; or

(2) could lead to the issuance of a general memorandum to all regions and FAOs concerning the issues and related audit guidance.

4-1000 Section 10 --- Relying Upon the Work of Others

4-1001 Introduction

This section provides guidance for relying upon the work of others, except for Government technical specialists. For guidance on relying upon the work of Government technical specialists, see D-302.

4-1002 General

a. An auditor's work includes the examination or development of sufficient, competent, and relevant evidence to afford a reasonable basis for his/her conclusions and recommendations. In examining or developing evidence, auditors may rely upon the work of others to the extent feasible once they satisfy themselves of the quality of the other's work by appropriate tests or by other acceptable methods. Work performed by another DCAA auditor is to be presumed of sufficient quality based on DCAA's managerial controls.

b. Documentation of work performed and evidence acquired or examined is maintained or referenced in the form of working papers. Working papers are the link between field work and the audit report. They should be complete and accurate; provide support for findings, judgments, and conclusions; and demonstrate the nature and scope of the work performed (see 2-302.3 and 4-400).

4-1003 Work Performed by Others

a. An important source of evidence is work performed by other DCAA or Government auditors, contract administration office staff, independent public accountants, contractor internal auditors and nonauditors. It is important to maintain effective communications with these groups, to understand their responsibilities, and to know when it is appropriate to request their assistance or rely upon their work. Coordinating with these groups can often provide additional audit evidence and avoid the duplication of effort. Following is a partial list of other sources of reliance:

(1). Labor audits, floor checks, operations/IT/financial control audits, systems surveys, etc., performed by regional or other special DCAA audit teams.

(2). Assist audits performed by other DCAA audit offices on subcontracts, offsite labor, etc., or on costs which are allocated from, or records which are maintained at, home offices, other divisions, segments, cost centers, etc.

(3). Reviews performed by contract administration office staff on special cost-related subjects, procurement and inventory systems, etc.

(4). Contractor internal audits and other self-governance functions (see 4-202 and 4-302.1b.(5)).

(5). Reviews performed by the Government Accountability Office or the Inspector General.

(6). Reviews performed by independent public accountants (e.g., internal control audits conducted in conjunction with financial statement audits; see 4-302.1b.(5)).

b. The results of audits performed by foreign auditors under reciprocal agreements should not be incorporated into DCAA audit reports (see 4-1007).

4-1004 Deciding Whether to Rely on the Work of Others

4-1004.1 General Evaluation Criteria

a. Relying on the work of others reduces the amount of work necessary to accomplish audit objectives. The evaluation of the others' work is dependent on the exercise of sound professional judgment. The work of others has to be adequate to provide reasonable assur-

ance that the DCAA audit objectives were accomplished. Care should be taken not to dismiss the work of others for some noncritical deficiency. In deciding whether to rely on the work of others, the DCAA auditor must first evaluate the competence, independence, and objectivity of the external and internal auditors, and the nonauditor. The DCAA auditor must then evaluate the individual work product for sufficiency. The DCAA auditor should also provide feedback to the contractor/external auditors on the results of our evaluations and the extent of our reliance.

b. Under self-governance programs, contractor personnel who qualify neither as auditors nor experts may be performing oversight functions in a given area. Such activities are part of the contractor's system of internal controls which should be assessed in planning the audit scope.

4-1004.2 Evaluation of Competency, Independence, and Objectivity

a. An initial assessment must be made of the professional competence, independence, and objectivity of the external and internal auditors and nonauditors. The results of this evaluation and documentation will be included in the permanent file, and should be updated as conditions change.

b. In order to eliminate duplicate inquiries, Headquarters will monitor the following national accounting firms regarding their professional reputations, qualifications, and independence:

(1) BDO Seidman LLP;
(2) Deloitte & Touche LLP;
(3) Ernst & Young LLP;
(4) Grant Thornton LLP;
(5) KPMG LLP;
(6) McGladrey & Pullen LLP; and
(7) PricewaterhouseCoopers, LLP.

This is not an exclusive list of public accounting firms that meet the Government Auditing Standard's criteria of professional reputation, qualifications, and independence. Rather it is an alphabetical listing of firms likely to be engaged by major DoD contractors. Regions and Field Audit Offices will be notified by Headquarters if problems with any of these firms are encountered. This Headquarters assessment does not alleviate the requirement for the DCAA auditor to evaluate the external auditor's work product and document that evaluation as discussed in 4-1004 and 4-1005. If reliance is to be placed on the external auditor's work, access is needed to the external auditor's working papers to perform the evaluation and documentation procedures. For other external auditors, determine that they possess the necessary competence and independence by obtaining a representation from the firm that they are:

(a) members of the AICPA and/or state society in good standing and
(b) that the firm is independent under the requirements of the AICPA.

c. When an entity's internal audit department has adopted the standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors, the entity's internal auditors are likely to possess the requisite independence, competence and objectivity. The Standards include specific criteria for assessing independence, competence, and objectivity. A summary of the standards follows:

- Independence - Internal auditors should be independent of the activities they audit.
- Professional Proficiency - Internal audits should be performed with proficiency and due care.
- Scope of Work - The scope of the internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal controls and the quality of performance in carrying out assigned responsibilities.
- Performance of Audit Work - Audit work should include planning the audit, examining and evaluating information, communicating results, and following up.

- Management of the Internal Auditing Department - The Director of Internal Auditing should properly manage the internal auditing department.

Whether or not the entity's internal auditors have adopted these standards, the auditor should apply appropriate procedures to document that the internal audit department is competent, independent, and objective. Evidence should be readily available for review in the internal audit department.

d. Where appropriate, the CAC should coordinate an assessment of adherence to the above standards for the corporate managed internal audit function.

e. In determining whether an entity's internal audit department is competent , independent, and objective, the auditor should consider the following guidance:

(1) When assessing the internal auditors' competence, the auditor should obtain information about such factors as the educational level and professional experience of internal auditors, professional certification and continuing education; audit policies, procedures, and checklists; and supervision and review of internal auditors' activities.

(2) When assessing the internal auditors' independence and objectivity, the auditor should obtain information about such factors as the organizational status, including whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors. In addition, review policies to maintain internal auditors' objectivity about the areas audited, including policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.

f. The assessment of the internal auditor's independence, competence and objectivity should be used in determining:

(1) whether reliance can be placed on the internal auditor's work, and

(2) if so, the extent of testing needed to evaluate the internal auditor's work product (i.e., less testing is needed if no deficiencies exist; increased testing is needed if deficiencies exist). In any case, the contractor should be notified of any deficiencies and the impact of those deficiencies on DCAA's ability to place reliance on the internal auditor's work.

g. For nonauditors (consultants, experts, specialists, etc.), other than those assisting in the audit, the auditor should consider:

(1) the professional certification, license, or other recognition of the competence of the specialist in his field, as appropriate,

(2) the reputation and standing of the specialist in the views of his peers and others familiar with his capability or performance, and

(3) the relationship, if any, of the specialist to the client.

4-1004.3 Evaluation of Work Product

a. To satisfy certain of the requirements discussed in subsections b through d below, access to working papers is required. Accordingly, make arrangements to ensure that working papers will be available. Evaluation of the work product should be based on a comparison of the audit steps the DCAA auditor believes are necessary to those which were performed. If the DCAA auditor concludes that audit program steps essential to developing evidence to support an unqualified opinion have not been performed, those additional steps must be performed by the auditor before issuing an audit report.

b. When evaluating the work of external auditors, consider whether to conduct additional tests and procedures, such as reviewing the audit procedures they followed and the results of audits they conducted (including their assessment of control risk). The auditor should review their audit programs and/or working papers, tests of compliance, and conclusions reached. The auditor may review the documentary evidence in the external auditors' working papers or make supplemental tests of the work conducted.

c. In evaluating the work of internal auditors, the DCAA auditor should examine, on a test basis, documentary evidence of the work performed by the internal auditors. He or she should consider such factors as whether the scope of the work is appropriate,

audit programs are adequate, working papers adequately document work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed. The DCAA auditor should also perform tests of some of the work of internal auditors. The extent of these tests will vary depending on the circumstances, including the type of transactions, their materiality, results of prior audits; and the independence, objectivity, and competence of the internal audit organization as discussed in 4-1004.2 above. These tests may be accomplished by either:

(1) examining some of the transactions or balances that internal auditors examined or

(2) examining similar transactions or balances but not those actually examined by internal auditors.

The DCAA auditor should compare the results of his tests with the results of the internal auditors' work in reaching conclusions as to whether DCAA can place reliance on their work.

d. In evaluating the work of nonauditors, consider whether to:

(1) conduct additional tests and procedures (e.g., reviewing the procedures followed and the results of the work conducted),

(2) review the work program,

(3) review the working papers,

(4) make supplemental tests of the work conducted, and

(5) consider the methods or assumptions used.

4-1005 Documentation Requirements

a. Whenever reliance is placed upon the work of others, documentation is required. Reliance must be based upon specific knowledge of the actual work performed and the results obtained. It is not to be based merely upon the assumption or general knowledge that work is to be performed by others.

b. The extent of documentation needed is a matter of auditor judgment. However, there should be sufficient documentation to describe the scope of work performed, the period and costs/audit area covered, the nature and extent of audit procedures applied, the evidence obtained and analyzed, and the audit results. The documentation may include copies of working papers, audit programs, reports, third party confirmations, and DCAA auditor prepared summaries of the work performed. The documentation should also describe the extent of reliance that will be placed upon the work of others.

c. In rendering an audit opinion, consider all work performed, including that performed by others. If work of others is not sufficient in scope and as a result an unqualified opinion cannot be rendered, take steps to obtain additional evidential matter. Where the scope of work performed by other government representatives does not appear to be sufficient in scope, consult with the organization involved to obtain clarification or any additional information available. If reliance still cannot be placed on the work, advise the contractor of the need for additional audit work, how it relates to the work already performed by the other organization, and why it will not duplicate prior Government audits. If additional evidential matter cannot be obtained, then render either a qualified or adverse opinion. See 9-211.2 and 9-211.3.

d. In determining the extent of documentation to be included in the working paper file, the auditor should apply the guidance contained in 4-406. To the extent possible, document reliance on the work of others by reference, notes, or extractions. Where a particularly sensitive or material audit conclusion hinges on other auditors' working papers and referencing/extraction would not be practical, include appropriate copies in DCAA working papers.

4-1006 Referencing the Work of Others in Audit Reports

4-1006.1 Technical Specialists

As indicated in D-300, refer to and give effect to technical findings and opinions when relied upon. See 10-210.3a and 10-304.10 for suggested audit report comments when incorporating the results of technical review.

4-1006.2 Part of an Audit Performed by Other Auditors

a. The DCAA mission includes providing all contract auditing for the DoD, and providing accounting and financial advisory services to all DoD procurement and contract administration activities (see 1-102). Because DCAA has the ultimate responsibility to express an opinion on contract audit issues, judgments about assessments of inherent and control risk, materiality, sufficiency of tests, and other matters affecting the opinion must be judgments of the DCAA auditor. Recognition of the contractor's participation in self-governance should be included in the DCAA audit report in a manner which does not imply a limitation of scope or a qualification of opinion.

b. Ordinarily you need not make reference to work performed by another auditor if:

(1) the other auditor works for an organization associated with your organization (e.g., another DCAA office (see 4-1002a)) and whose work is acceptable to you based on your knowledge of the professional standards and competence of that organization; or

(2) the other auditor is retained by DCAA and the work is performed under DCAA guidance and control; or

(3) you take steps necessary to satisfy yourself with the other auditor's work; or

(4) the work performed by the other auditor is not material to the opinion being expressed.

c. Once field work is complete, a report using the applicable format in Chapter 10 will be used. In addition, if another auditor’s work provides relevant information to promote adequate understanding of matters being reported, the report may include:

(1) In the “Results of Audit” section, in additional comments:

- information on another auditor's work, including a brief statement on the purpose, scope, and a summary of results;
- a statement indicating if the other auditor's report has been provided to the PCO/ACO or is attached to the report;
- expression of appreciation for the participation of non-DCAA personnel in the audit effort (see 10- 210.5d.(6)).

(2) A reference in the explanatory notes accompanying the report exhibits, schedules, and appendixes to the other auditor's scope and findings as they relate to the DCAA reported conclusions. Based upon the complexity and/or the nature of the findings, it may be appropriate to include the other auditor's report as an appendix. However, this should not be done without first obtaining authorization from the other auditor.

4-1007 Audits Performed by Foreign Auditors Under Reciprocal Agreements

a. The United States Department of Defense (DoD) has agreements with the Governments of certain foreign countries to provide contract audit services and other contract administration services without charge. Under these agreements, DCAA performs audits of U.S. companies performing or bidding on contracts of the foreign country. In return, the auditors of the foreign country perform audits of the foreign companies performing or bidding on U.S. Government contracts. The U.S. currently has reciprocal audit agreements with five countries; Canada, United Kingdom, France, Netherlands, and Germany. Audits of foreign companies in countries not covered by reciprocal audit agreements will be performed by the appropriate FAO (e.g. Pacific Branch Office, European Branch Office).

b. When audits are performed by foreign auditors under reciprocal agreements, performing the procedures required by auditing standards to allow incorporation of the foreign auditors' results into DCAA audit reports is generally not possible because access needed to perform the procedures is generally precluded by terms of the agreements and restrictions on disclosing proprietary information to the purchasing government. Therefore, the results of audits performed by foreign auditors are not to be incorporated into DCAA audit reports.

c. When requested to audit a contractor submission (e.g., incurred cost or forward pricing proposal) that includes costs requiring audit by foreign auditors under a reciprocal agreement, the FAO should coordinate with the contracting officer. The FAO should advise the contracting officer that DCAA is unable to perform the procedures required by auditing standards to allow incorporation of the foreign auditors' results into the DCAA audit report and that the report opinion will not address those portions of the contractor's submission that are subject to coverage by the foreign auditors. The FAO should recommend that the contracting officer use the procedures outlined in the applicable reciprocal agreement to request that a separate audit of the foreign company's costs be performed by the foreign auditors and that the foreign auditor's report be sent directly to the contracting officer.

d. For example, if DCAA were requested to audit a contractor's forward pricing proposal which includes foreign subcontract costs requiring audit by foreign auditor under a reciprocal agreement, the FAO would audit only the parts of the proposal under DCAA's cognizance using activity code 27000. (See CAM 9-104.2 for guidance on advising the contracting officer on the need for subcontract assist audits.) A similar "parts of submission" approach should be used for incurred cost audits that include foreign subcontract costs. In such cases, the standard subject of audit paragraph should be modified to indicate that the FAO examined the contractor's proposal and related books and records, except for the foreign subcontract costs and provide information sufficient to clearly identify the costs not audited.

e. In situations where the costs audited by the foreign auditors cannot be readily separated and therefore a "parts of submission" approach cannot be used (e.g., audits of incurred cost submissions including indirect flow-down costs from a foreign company), the audit report will clearly identify those costs that the FAO did not audit and will be appropriately qualified.

f. In the event the FAO receives the audit report from the foreign auditors, it should be immediately forwarded to contracting officer. The foreign country's audit report should not be incorporated into the DCAA audit report.

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CHAPTER 5

5-000 Audit of Policies, Procedures, and Internal Controls Relative to Accounting and Management Systems

5-001 Scope of Chapter

This chapter provides audit guidance on implementing Government Auditing Standards---the second standard of fieldwork and SAS No. 55 as amended by SAS No. 78, Considerations of Internal Control in a Financial Statement Audit in performing audits of contractor accounting and management systems and related internal controls.

5-100 Section 1 --- Obtaining an Understanding of a Contractor's Internal Controls and Assessing Control Risk

5-101 Introduction

a. This section outlines the auditor's fundamental requirements and responsibilities for obtaining and documenting an understanding of a contractor's internal controls and for assessing control risk as a basis for planning related audits.

b. These fundamental requirements and responsibilities apply to each of the contractor's accounting and management systems (see 5-300 through 5-1200) that are used to propose, charge or bill significant costs to Government contracts.

c. The audit guidance discussed in sections 5-102 to 5-110 applies primarily to major contractors. This guidance can also be adapted for use at nonmajor contractors who have controls over some of the systems listed in 5-102d below and where audit effort to evaluate those systems is expected to be offset by reduced audit effort on other related audits. The guidance for auditing internal controls at nonmajor contractors is discussed in 5-111.

5-102 Background Information

a. Government Auditing Standard 6.13 requires the auditor to obtain a sufficient understanding of the contractor's internal controls and to assess control risk to plan the audit and to determine the nature, timing, and extent of tests to be performed. DCAA has chosen to incorporate the requirements of SAS 55 as amended by SAS 78 for attestation audits. The attestation standards (AT 101.45), under the planning standard, require the auditor to make preliminary judgments about attestation risk (control risk and inherent risk). (See 2-306)

b. It is important to remember that contractor management is responsible for establishing and maintaining adequate internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control activities. Internal control, as defined by SAS No. 78, is “a process effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.”

c. A contractor's internal controls consist of five interrelated components:

- Control environment -- sets the tone of an organization, influencing the control consciousness of its people
- Risk assessment-- the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed
- Control activities -- the policies and procedures that help ensure that management directives are carried out

- Information and communication -- the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities
- Monitoring -- the process that assesses the quality of internal control performance over time

d. Elements of these components are designed into an entity's accounting and management systems to help ensure that management objectives are achieved as effectively and efficiently as possible. The relevant accounting and management systems in the contract audit environment and their respective CAM sections are listed below:

Control Environment and Overall Accounting System	5-300
General IT System	5-400
Budget and Planning System	5-500
Purchasing System	5-600
Material System	5-700
Compensation System	5-800
Labor System	5-900
Indirect and ODC System	5-1000
Billing System	5-1100
Estimating System	5-1200

e. The auditor should consider the contractor's control environment and overall accounting controls when assessing control risk for individual accounting and management systems (see 5-300). In addition, the auditor should consider the adequacy of general IT System controls (see 5-400) as they affect the operational effectiveness of control activities in other significant systems.

f. The components of internal control and the relevant control objectives identified with the accounting and management systems listed above apply to every contractor and should be considered in the context of the following:

- the contractor's size
- the contractor's organization and ownership characteristics
- the nature of the contractor's business
- the diversity and complexity of the contractor's operations
- the contractor's methods of transmitting, processing, maintaining, and accessing information
- applicable legal and regulatory requirements

Nonmajor contractors may have less formal internal controls that accomplish these control objectives (see 5-101c).

g. With a sound understanding of the critical aspects of each system, the auditor can more effectively and efficiently develop the audit procedures necessary to audit compliance with laws and regulations in other related audits.

h. SAS 70, as amended by SAS 78 and SAS 88, has been incorporated into the Government Auditing Standards. SAS 70 requires that the auditor gain an understanding of a service organization's controls when:

(1) the service organization is part of the user organization's information system,

(2) the service organization's controls are significant to the user organization's internal controls (i.e., controls are relevant to user cost objectives and costs affected by the service organization's controls are material), and

(3) the degree of interaction between internal controls at the user organization and at the service organization is low (i.e., the service organization may initiate transactions or otherwise affect the user organization's accounting records without prior approval of the user organization).

This understanding is necessary in order to assess control risk to plan the audit and to determine the nature, timing, and extent of tests to be performed. If the auditor needs to ob-

tain this understanding but is unable to, the auditor will have to qualify the report or disclaim an opinion due to a scope limitation.

5-103 General Audit Policy

5-103.1 Internal Control Audit Policy and Approach

a. It is DCAA's policy that each relevant accounting or management system that has a significant impact on Government contract costs be audited on a cyclical basis, (i.e., every 2 - 4 years) based on a documented risk assessment. If past experience is favorable and current audit risk is considered to be low, an audit may be performed on a less frequent basis (however, no less frequently than 4 years). If the audit risk is considered to be medium or high, the auditor should work with the ACO and the contractor to correct the deficiencies. When the contractor changes the system, the auditor should give a high priority to the audit of the system change as a basis for relying on the system. In conjunction with Mandatory Annual Audit Requirement (MAAR) 1, Internal Control Audit Planning Summary and/or Internal Control Questionnaire (ICQ), at major contractors, the auditor should meet annually with top contractor representatives, such as senior management, internal auditors, audit committee members, or others during the annual planning coordination process (see DMIS User Manual, Planning Process, Other Considerations) to obtain information regarding any significant changes in accounting policies and procedures affecting internal control systems listed in 5-102d. The auditor should request and review for any audit leads a copy of the management representation letter provided to the contractor’s external auditors, in conjunction with the audit of the company’s financial statements. At large, multi-segment contractor locations, the management representation letter should be requested by the corporate auditor and/or the CAC. Corporate auditors should provide any relevant information from the management letter to auditors at the affected segments.

b. FAR or DFARS establishes specific requirements for certain system audits--- compensation, estimating, purchasing, and material management accounting systems. See the individual Chapter 5 sections for guidance on the timing of these audits and the procedures for obtaining waivers if the system is considered low risk.

c. In determining the significance of a system, the auditor should carefully consider the relationship of the system to Government contracts. For example, if a contractor incurs a significant amount of labor costs which are assigned to Government contracts, the contractor's compensation and labor systems would be considered significant. Likewise, if a contractor does not purchase significant amounts of materials for Government contracts, the contractor's purchasing and material systems would not be considered significant. (See 3-305.1)

d. The auditor’s evaluation of the contractor's internal controls and assessment of control risk is documented in the permanent files on the Internal Control Audit Planning Summary (ICAPS) working papers for each significant system (see 3-300). After preparing the initial ICAPS, individual ICAPS forms will be updated whenever subsequent audit work indicates that revisions are necessary (3-305). The scope paragraph of every audit report must comment on the internal control work performed and the assessment of control risk (see 10-210.3f). In addition, the adequacy opinion, assessment of risk, and the nature and extent of related audit effort that is summarized on the ICAPS form is described in the Contractor Organization and Systems section (see 10-210.7c) and integrated into the planning and reporting of other attestation audits (see 10-410).

e. When a contractor that participates in self-governance programs furnishes the FAO with an initial internal control evaluation and compliance test plan, the FAO should establish a current audit assignment to update the audit of related internal controls. The objective is not to complete an internal control audit, but rather to coordinate with the contractor on the relevant control activities and compliance testing described in the related internal control audit program.

f. SEC registered public companies are required to follow additional reporting requirements as a result of the Sarbanes-Oxley Act of 2002, such as including in their annual reports filed with the SEC, management's report on internal control over financial reporting. Furthermore, the external auditors are required to attest to management's assessment of the company's internal controls over financial reporting. Auditors may be able to rely on work performed to support the information in the SEC filings when conducting internal control audits provided the requirements of 4-1000 "Relying Upon the Work of Others" is followed. Auditors should consider the potential opportunities for increased coordination with the contractor when planning and performing audits (see 4-202.1d).

g. Audits of internal control systems will be coordinated in writing with the ACO (see 4-103).

5-103.2 Coordinated Internal Control Auditing Process at Multi-Segment Contractor Geographical Locations

a. Auditing internal control systems at multi-segment contractors requires cognizant auditors to identify audit responsibilities at each geographical location to ensure appropriate audit coverage when contractor locations share components of an internal control system, such as policies and procedures, common technologies (e.g., software), or common management. The following should be considered as part of this coordinated process.

(1) The Contract Audit Coordinator (CAC) or Corporate Home Office Auditor (CHOA) cognizant of a multi-segment contractor is responsible for maintaining a current Responsibility Matrix (a copy of this EXCEL workbook is in APPS, Other Audit Guidance). This matrix serves as a tool to collect information on the multi-segment contractor's internal control system (as well as information on incurred cost, CAS, EVMS, Washington Area Offices and offsite locations). The Responsibility Matrix contains a worksheet for each of the ten accounting and management systems (5-102d). These worksheets identify the contractor locations that have the primary management responsibility for each system. In addition, the individual system worksheets identify the contractor locations that share common system aspects/components (policies and procedures, software) with other locations and where significant control activities are performed.

(2) To initiate the coordinated audit process, the lead FAO cognizant of the contractor segment responsible for the design and maintenance of the shared system should coordinate with other cognizant FAOs to gain an understanding of the contractor's internal control system to determine the extent of common or shared aspects of the system. This understanding includes identifying where the key control activities are performed. The lead FAO should use the ICAPS Responsibility Matrix worksheets for the respective internal control systems to document (i) where the common aspects exist, (ii) where the control activities are performed, and (iii) the FAO(s) responsible for performing the specific internal control audit procedures. FAOs cognizant of segment locations should initiate assist audits from off-site locations as necessary. FAOs cognizant of off-site locations should not self-initiate audits of internal controls.

(3) All draft reports should be provided to the CAC or CHOA to ensure consistency of audit recommendations. (See 5-110 for guidance on reporting on internal control audits relating to multi-segment contractors.)

5-104 Audit Objectives

a. The purpose of each internal control audit is to gather sufficient evidence to express an opinion on the adequacy of the contractor's relevant accounting and management sys-

tems and the related internal controls for compliance with applicable laws and regulations and contract terms.

b. The objective in performing internal control audits is to assess control risk to determine the degree of reliance that can be placed on the contractor's internal controls in relevant accounting and management systems as a basis for planning the scope of other related audits.

c. In those cases where the auditor can rely on the contractor's system to record, process, summarize, and report in a manner consistent with Government contract laws and regulations, control risk would be considered low. In these cases the auditor should be able to minimize substantive testing.

d. In those cases where the contractor's internal control system(s) are inadequate, expanded testing in other related audits is often needed.

e. If a system has not been audited or a report on the full system (i.e., not a follow-up audit) has not been issued within the past four years, control risk should be assessed as "high" and an audit of the system should be scheduled as soon as possible. In the interim, substantive testing should be increased in related audits to compensate for the inability to rely upon internal controls.

f. At those contractors with outstanding internal control deficiencies, the auditor should recommend actions to the ACO to encourage the contractor to correct the deficiencies (e.g., suspension of costs, disapproval of system). When the contractor corrects the deficiency or changes the system, the auditor should give a high priority to the audit of the system change as a basis for placing reliance on the system.

g. While the discovery of fraud or other unlawful/improper activity is not the primary objective of any audit, the auditor should be attentive to any condition which suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with 4-700.

5-105 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size and the amount and type of Government business (materiality and sensitivity), the scope of the internal control audit should include:

- gaining an understanding of the contractor's internal controls, including both manual and automated (IT) activities, which provide reasonable assurance that Government contract costs are allowable, allocable, and reasonable in accordance with contract terms, and that material misstatements are prevented or detected and corrected in a timely manner;
- documenting the understanding of the contractor's internal controls in the working papers and permanent files;
- testing the operational effectiveness of the system's internal controls;
- assessing control risk as a basis for designing substantive tests for related audit effort;
- reporting on the understanding of the internal controls, the assessment of control risk, and the adequacy of the system for Government contracts; and
- adjusting the audit scope of related audits based on the internal control strengths and/or weaknesses of the contractor accounting and management system audited.

b. In establishing the scope of audit effort, the auditor should carefully consider the nature and extent of documentation available from prior system audits, related audit effort, and permanent files. Once a comprehensive audit of a contractor's accounting or management system has been performed, it should serve as a baseline for establishing the scope of subsequent audits of that system. Subsequent audits should cover major system changes and other areas identified as high risk. They should also include tests of key internal controls over selected transactions to ensure that the controls are in place and operating effectively. The tests of the key controls need to be performed every two to four years irrespec-

tive of whether they were tested in the prior comprehensive audit of a contractor's accounting or management system.

c. The results of prior IT general internal control audits and applicable system audits should be evaluated for related system deficiencies. The following elements should be considered when auditing internal controls related to individual application systems (see the IS Auditing Knowledge Base available on DCAA's Intranet):

- The contractor's representation of the application system's internal controls should include a description of system operation and the identification of all related system policies, practices, and procedures.
- The number of employees having access to system data should be reasonable and based on need. Adequate security controls (logical and physical) should be incorporated to limit access to data input, review, and change authorizations. Authority to make changes to data, files, and programs should be limited, logged, and closely monitored.
- Current system flowcharts should describe data input characteristics, internal control points, internal control tables, and output reports. System operation should be verified to the policies, practices, procedures and flowcharts.
- Tests of system internal controls should trace the flow of significant transactions from the original source documents through data entry, through their interim and final processing stages. Any differences must be resolved with the contractor. Consider using CAATs to expedite the process.

d. Contractor management has a responsibility to establish and maintain effective internal controls. As part of the preliminary audit effort, the contractor should be requested to explain how their system operates, what controls are in place to achieve the control objectives identified with the system (5-102b), and what methods are used to monitor and evaluate their continued operation. The auditor should rely to the maximum extent possible on the contractor's self-assessment, monitoring and testing efforts (see 4-1000, Reliance on the Work of Others).

e. The following paragraphs contain general guidance for evaluating contractor accounting and management systems. This guidance is intended to provide the auditor with a framework for performing an internal control examination. However, this framework is not a substitute for professional judgment. Consequently, the auditor should adapt the guidance to respond to unusual or unique situations encountered in their individual audit circumstances.

5-106 Obtaining an Understanding of the Contractor Accounting and Management Systems

a. The first step in evaluating the contractor's internal controls is to obtain an understanding of the accounting or management system being audited. This understanding will serve as the foundation for evaluating related internal controls and will allow the auditor to design more effective and efficient audit procedures.

- To acquire a basic understanding of the accounting or management system being audited, the auditor should:
- Review the control objectives and audit procedures listed in the appropriate section of Chapter 5, the respective audit program, and the internal control matrix (available on the DCAA Intranet, and the APPS) for the accounting and management system to be audited.
- Review the contractor's system explanation and related documentation; e.g., system policy and procedure manual.
- Review relevant working papers from the permanent files and prior audits.
- Make inquiries of appropriate contractor management, supervisory, and staff personnel.
- Inspect relevant documents.

- Observe actual contractor operations.

b. In addition, the auditor should request that the contractor explain selected aspects of the system to help confirm the auditor's understanding. The auditor should walk-through the system---tracing one or more transactions from initiation through the various processing steps to inclusion in related cost estimates, reports, or billings on Government contracts. The auditor should observe actual processing activities and examine related documents to validate the understanding of the system. Selective transaction walk-through to confirm the auditor's understanding are an important part of the audit process and should be performed for significant aspects of the system. If the auditor already has a sufficient understanding of the system as a result of prior audit experience, this procedure may not be necessary.

c. The extent of audit effort expended in gaining an understanding of the contractor's accounting and management systems is a matter of auditor judgment. Characteristics that should be considered include:

- the size and complexity of the contractor;
- level of previous experience with the contractor;
- nature and extent of systems documentation;
- the significance of costs proposed, charged, or billed to the Government by the system; and
- materiality judgments for specific accounts and transactions handled by the system.

d. Once the auditor has gained an adequate understanding of the contractor's accounting and management systems, that understanding should be documented in the audit working papers and related permanent files. This documentation will typically take the form of system flowcharts, narrative descriptions, and copies of relevant documents and reports. The method(s) used and extent of documentation required are a matter of professional judgment. However, the documentation should provide sufficient information to communicate the auditor's understanding in a clear and summarized manner.

5-107 Determining if Relevant Control Objectives and Related Control Activities Exist

a. The auditor should identify those control objectives which, if achieved, would provide reasonable assurance that material errors or misstatements would be prevented or detected in a timely manner. Control objectives can be classified into the three general areas:

(1) financial reporting control objectives which are concerned with ensuring the preparation of reliable financial statements,

(2) operational control objectives which are concerned with ensuring that the contractor's resources are being used effectively and efficiently, and

(3) compliance control objectives which are concerned with ensuring that the contractor complies with applicable laws and regulations.

While control objectives in each of these areas can have an impact on contract costs, DCAA auditors generally focus on operational and compliance controls.

b. Relevant control objectives for each contractor accounting and management system are discussed in this section, the specific section in Chapter 5 and the standard audit program for the individual system. The auditor should become familiar with all relevant control objectives for the accounting and management system to be reviewed prior to initiating the audit.

c. The auditor should also identify the control activities designed and implemented by the contractor to achieve each relevant control objective. Examples of control activities the contractor may have implemented to achieve the control objectives are available in the internal control matrix (available on the DCAA Intranet, and the APPS) for the accounting and management system to be audited. Controls may be either manual or automated. In many instances, control activities will be integrated into the contractor's IT system. As

needed, an IT audit specialist can assist the auditor in identifying and understanding IT related controls.

d. Once the auditor has obtained an adequate understanding of the contractor's system, a determination should be made as to whether relevant internal control activities exist and whether the effort to test and evaluate those controls would be justified by an equal or greater reduction in related substantive testing. For example, the auditor should expect that the costs to test and evaluate the contractor's labor accounting controls should be more than offset by the benefits of reduced labor substantive testing (e.g., floor checks).

e. If the auditor determines that relevant internal control activities do not exist or that the effort to perform tests of those controls is not justified, no control testing will be performed and control risk would be assessed at the maximum (High). This control risk assessment and its background rationale should be documented in the audit working papers.

f. If the auditor determines that relevant internal control activities can be identified and that the effort to perform tests of those controls is justified, the auditor should plan and perform appropriate tests of those controls.

5-108 Testing Controls

a. Testing controls involves selecting a sample of transactions and evaluating whether they were executed in accordance with established policies and procedures. GAAS and GAGAS require that tests of controls be performed to provide reasonable assurance that a contractor’s internal control system is functioning as prescribed. The auditor also performs substantive tests to determine the validity and the propriety of accounting transactions and balances. SAS-55 (Consideration of Internal Control Structure in a Financial Statement Audit) provides that although the objectives of tests of controls and substantive tests are different, both objectives are often achieved simultaneously through the tests of details (substantive tests other than analytical review). The testing of details would be dual-purpose testing (AU319.64), because it not only relates to the specific transaction, but also covers the entire system. That is, the auditor may design a sample that will be used for dual purposes: assessing control risk and testing whether the recorded monetary amount of transactions is correct. Such tests determine if controls are adequately designed and operating effectively to prevent or detect material misstatements in a timely manner. The testing of the controls should be done at least every three years. The guidance in Sections 3 through 12 of Chapter 5 should be reviewed before determining what testing should be done. Tests of controls are necessary to support a control risk assessment other than high.

b. To obtain evidence of the effectiveness of particular internal control activities, the auditor should perform physical observations, inquiries of appropriate personnel, or inspection of relevant documents. No one specific test is always necessary, applicable, or equally effective in every circumstance. In fact, a combination of these types of tests is often required to provide the necessary level of assurance that controls are working effectively. Selected transactions must be tested, and audit evidence gathered to ascertain that there are no potential weaknesses. The type of audit procedures selected depends upon the nature of the control to be tested and the available evidence to review the control. Auditors should use the standard audit programs and the internal control matrixes available on the DCAA Intranet and the APPS and tailor their audit procedures to fit their individual circumstances.

c. The nature of the control influences the type of evidential matter that is available to review the control. For example, if the control provides documentary evidence, the auditor may decide to inspect the documentation. For other controls, such documentation may not be available or relevant. For example, segregation of duties controls generally do not provide documentary evidence. In such circumstances, the auditor may obtain evidential matter about the effectiveness of operation through observation or inquiry.

d. The timing of audit effort and the period covered by the audit should also be considered in selecting the appropriate audit procedures for testing controls. The evidential matter should relate to the audit period and, unless it is documentary evidence, should be obtained during the audit period when sufficient corroborative evidence is most likely to be available. When the evidence relates only to a specific point in time, such as evidence obtained from physical observation, the auditor should obtain additional evidence that the control was effective during the entire audit period. For example, the auditor may observe the control in operation during the audit period and use inquiry and inspection of procedures manuals to determine that the control was in operation during the entire period.

e. After determining the nature of audit procedures to be used to test controls, the auditor should determine the extent of testing to be performed. This determination is a matter of auditor judgment taking into consideration:

- the information gathered in developing an understanding of the internal control structure,
- the nature of the control to be tested,
- the nature and availability of evidential matter, and
- the contractor's monitoring and testing efforts.

The extent of testing is also significantly impacted by the FAO's total audit experience with the contractor. For instance, the extent of required testing of the estimating system is influenced by the current experience on forward pricing audits. In most instances, where there is significant proposal activity, the auditors have gained a great deal of knowledge of the estimating system controls during proposal audits.

f. When identified control activities are accomplished as part of the contractor's IT operations, the auditor should consider the use of Computer Assisted Audit Techniques (CAATs), such as DATATRAK, SAS, and FOCUS when performing tests of controls. In some instances, the assistance of IT specialists may be required to perform tests of controls. In these cases, auditors should contact their regional offices to obtain the necessary expertise.

5-109 Assessing Control Risk

a. Control risk is the probability that the contractor's internal controls will not prevent or detect a material error, irregularity, or misstatement in a timely manner. In assessing control risk, the auditor considers the effectiveness of established control activities to accomplish stated control objectives. The more effective the control activities, the lower the control risk.

b. The auditor should assess control risk for each relevant control objective. If the auditor concludes that the relevant internal controls do not exist or that other related audits could be more efficiently performed by expanding substantive testing, then control risk should be assessed at the maximum (High). (see 5-111.2)

c. If the auditor has been able to identify relevant internal control policies and procedures and performed tests of those controls, the auditor should assess control risk as follows:

- High: The relevant control activities do not exist or they do exist but because of inadequate design or operation, they rarely accomplish the control objective.
- Moderate: The relevant control activities exist but, because of deficiencies, the control objective is not consistently accomplished.
- Low: The contractor's control activities consistently accomplish the control objective.

The assessment of control risk for each control objective is summarized on the system's ICAPS working paper (3-300) and translated to needed audit effort on other related audits.

d. When internal controls have been audited and tested, assessments of moderate or high risk should be tied to specific significant deficiencies/material weaknesses. A deficiency is a significant deficiency/material weakness when additional audit procedures are

needed in related audits to protect the Governments interest because the contractor's internal controls are unlikely to accomplish an applicable control objective. The details would be described on the ICAPS working paper (see 3-305.4). The appropriate audit opinion for any system with a single significant deficiency/material weakness is inadequate (see 10-408.2a).

e. Significant deficiencies should be discussed with the ACO and the contractor immediately---do not wait until the final exit conference or until the final report is issued to start the resolution process (see 5-110c and 10-400). When possible, significant deficiencies should also be linked to relevant historical data that are available or can be reasonably developed. For example, if the auditor can link estimating system deficiencies to questioned costs on proposal audits or positive findings on postaward audits, the importance of correcting the deficiency is more apparent.

f. Assessments of low risk for specific control objectives mean the auditor can rely on the contractor’s internal controls and can reduce testing in other related audits to analytical procedures or minimum transaction tests. The details would be described on the ICAPS working paper (3-305.4)

5-110 Internal Control Reporting

Reporting on internal controls relative to individual accounting and management systems and on compliance with laws and regulations must be made in all audit reports. This includes audit reports on functional areas as well as those related to specific proposals, claims, or other financial representations.

a. The internal control audit report for each relevant accounting and management system should follow the general guidance in 10-200 and 10-400. The following are the major highlights of the reporting guidance.

(1) The Subject of Audit section should state that the objective for auditing the specific contractor system and its related internal controls is to determine the adequacy of the system and the contractor’s compliance with the relevant internal controls (see 10-405b).

(2) The Executive Summary and the Results of Audit sections should present an overall opinion of the system (i.e., adequate or inadequate). The executive summary should briefly summarize the deficiencies and their cost impact. When the audit opinion on a contractor’s estimating and/or purchasing system is inadequate, the executive summary should also include a recommendation for disapproval of the system or portions of the system affected by the deficiencies (see 10-406). Detailed explanations in a condition/recommendation format will be included in the results of audit section. The results of audit section should also state the auditor’s control risk assessment and describe the impact this assessment will have on the nature and extent of audit effort on other attestation audits, e.g., "As a result of control risk assessments, our audit effort in the following areas will be [increased/decreased]." Identify the affected audit areas and describe the additional audit effort required (see 10-408).

(3) The Scope of Audit section should explain that the internal control audit includes obtaining an understanding of the internal controls, determining if the controls are adequate and in operation, and assessing control risk to use as a basis for planning the testing necessary in other attestation audits. This section should also identify the system’s control objectives covered by the audit and refer to the Contractor Organization and Systems section that describes the current status of the system along with any needed background information (see 10-407).

(4) If significant deficiencies are noted during the audit, they should be discussed with the contractor and the ACO during the course of the audit and corrective action should be underway before the final audit report is issued. The Statements of Condition and Recommendations in the audit report should comment on the contractor’s efforts to correct the deficiencies (see 5-110c).

(5) The status of the contractor's corrective action on prior recommendations should be detailed in the Results of Audit section and summarized in the Contractor Organization and Systems section.

b. Reports for other attestation audits, (e.g., forward pricing proposals, progress payment requests, and annual incurred cost audits) should follow the general guidance in Chapter 10. The report should refer to the relevant accounting and management systems internal control report(s) used to plan the audit.

(1) At those contractors with defined internal controls, the Scope of Audit section should:

(a) list the system(s) that provide for compliance with laws and regulations for the specific audit area,

(b) describe how assessed system(s) control risk was considered in determining the scope of audit (It is not necessary to define the degree of risk as low, moderate or high but it may be used for emphasis.), and

(c) refer to the Contractor Organization and Systems section that describes the current status of the system(s).

(2) The Contractor Organization and Systems section should:

(a) reference the last internal control audit report and the current opinion on the overall system,

(b) show the current assessment of control risk, and

(c) list any outstanding internal control deficiencies and the current status of those deficiencies.

(3) At nonmajor contractors that do not have defined internal controls or those where it was not beneficial to audit the controls, the auditor would assess control risk as "high". The scope paragraph should state that the audit tests performed to provide a basis for opinion considered the auditor's assessment of control risk. (It is not necessary to define the degree of risk as "high" in the scope paragraph. The "assumed degree of risk" for the sake of audit expediency is not a reportable condition.)

c. Significant internal control weaknesses identified during an audit require immediate action intended to expedite the resolution process and to protect the Government.

(1) If a significant internal control deficiency is encountered during an internal control audit:

- Discuss the deficiency with the contractor, the cognizant ACO, and the CAC as soon as possible so as to expedite the resolution process. Do not wait until the final exit conference or the issuance of the audit report to convey such findings.
- The internal control audit report should describe the deficiency, its estimated cost impact, the contractor's efforts to correct the deficiency and increased audit effort in other related audits needed to mitigate the internal control weakness.

(2) If a significant or likely to be significant internal control deficiency is encountered during other related audits, a separate flash report should be issued (10-413). The flash report should, whenever possible, include a general statement (and estimate when possible) on the cost impact of the internal control weakness.

(3) As soon as practical, the deficiency(ies) cited in the flash report should be followed-up in an appropriately-scoped systems audit in which an audit opinion (versus disclaimer) is given. It is expected that most follow-ups will be initiated within 90 days. If initiation of a follow-up requires additional time due to conditions beyond the control of the FAO, the FAO manager should document the need for additional time and establish a definite date for the follow-up audit to begin.

(4) The auditor should work with the ACO and the contractor to correct the deficiency rather than performing expanded testing in a particular audit area. When the contractor corrects the deficiency, the auditor should give high priority to the audit of the system change as a basis for placing reliance on the system.

(5) If the contractor does not take timely corrective action to resolve the deficiency, the auditor should take appropriate steps to protect the Government's interest. The auditor

should coordinate with the ACO and notify the contractor of the intent to suspend or disapprove costs related to the weakness. For example, reports on price proposals should question the related costs and contain an appropriate opinion and/or recommendation (see 9-200). If internal control deficiencies affect billings to the Government, the auditor should suspend any appropriate costs on public vouchers (see 6-900) or recommend to the ACO reductions on progress payment requests (see 14-206). DFARS 242.7502 provides procedures which the ACO should take upon receipt of an audit report identifying significant internal control deficiencies.

(6) If the contractor has contracts requiring an approved Earned Value Management System (EVMS), provide an assessment of whether any deficiencies are likely to have a material effect on the reliability of the contractor's EVMS (10-1204.5b). The auditor should immediately evaluate the impact of deficiencies which may have a material effect on reports submitted for specific contracts requiring an approved EVMS and provide the details in EVMS surveillance reports (11-210).

d. At nonmajor contractors, the lack of formal internal controls is not, in itself, a significant deficiency. Contractor reactions to internal control recommendations should be considered, and may be paramount, in assessing control risk – absence of a sufficient level of control consciousness within the organization may be a separate reportable condition.

e. For multi-segment contractor locations, generally, the following three types of reports may be issued:

- A report on the shared or common aspects;
- A report on the overall system adequacy and operational effectiveness; or
- A report on the testing of specific control activities.

(1) A separate report on the shared or common aspects should be issued to the cognizant ACO for resolving audit issues related to the common aspects of the system. Copies of this report should be provided to the auditors at the segments who will rely on the work performed when expressing an opinion on the overall system at their segment. Any weaknesses on the common aspects of the system must be assessed by each segment FAO to determine the impact on the audit opinion at the segment level. For example, a corporate office may have determined that the contractor’s policy on travel does not comply with FAR 31.205-46. A segment FAO performing an Indirect/ODC internal control audit at a location that does not have significant travel costs may conclude that the deficiency on the shared aspects of the system (policy and procedures) has limited impact at that location and, therefore, no impact on the audit opinion on the system adequacy at that segment. However, alternatively, if a corporate office review of company-wide labor practices disclosed that the labor system allows for undocumented changes to employee time charges, this condition would likely render the system inadequate at all locations using that system to record significant labor costs.

(2) Typically, reports on overall system adequacy and operational effectiveness should be issued at the segment level. Generally, reports on system adequacy should not be issued at an offsite/plant location. The segment level report will incorporate (i) assist audits performed at offsite locations where significant control activities are performed and (ii) the report on the shared/common aspects of the system.

(3) Assist audit reports will not express an overall opinion on the system, but only provide an opinion on the elements or activities tested at the specific location.

(4) The segment level report should identify all locations where testing of controls was performed. The locations that did not participate in the testing of controls cannot rely on the segment level report for planning and conducting related audits. These locations would establish control risk at maximum. If significant inadequacies/deficiencies are found at assist (offsite) locations, the opinion in the segment level report should be impacted and thus may be considered inadequate.

5-111 Auditing Internal Controls at Nonmajor Contractors

a. The process for obtaining an understanding of a contractor's internal controls and assessing control risk at most nonmajor contractors is accomplished by using the Survey of Contractor's Organization, Accounting System, and System of Internal Controls (ICQ) and the Internal Control Matrix, Control Environment and Overall Accounting Controls (ICM-ACTG) which are available on the DCAA Intranet and the APPS. Nonmajor contractors may use less formal means to ensure that internal control objectives are achieved. However, if the nonmajor contractor has one or more of the accounting and management systems listed in 5-102d that generate significant costs, the auditor can use the CAM guidance in Chapter 5, the audit program related to the system, and the related ICAPS with the ICQ to audit the internal controls. When an accounting or management system audit is performed at a nonmajor contractor, the auditor should follow the guidance contained in 5-109 and 3-300 to assess control risk and to document the assessment of control risk on the ICAPS.

b. Smaller entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Communications may be less formal and easier to achieve in a small or midsized company than in a larger enterprise due to the smaller organization’s size and fewer levels as well as management’s greater visibility and availability. However, when small or midsized entities are involved in complex transactions or are subject to the same legal and regulatory requirements as larger entities, more formal means of ensuring that internal control objectives are achieved may be necessary.

5-111.1 Understanding and Evaluating Internal Controls

a. The ICQ should be used to document the understanding of the internal controls at nonmajor contractors with auditable dollar volume (ADV) between $15 and $100 million. (MAAR 1). The ICM-ACTG should be considered with the annual risk assessments for financial capabilities and material misstatements due to fraud. The ICQ may also be used for contractors with ADV less than $15 million, or alternative procedures may be used provided they adequately document the required understanding of the internal controls. Alternative approaches for contractors with less than $15 million ADV include the use of a narrative format similar to the discussion on the contractor's accounting system (see 10-504.6b).

b. The control environment reflects management's overall attitude, awareness and actions concerning the importance of control and its emphasis in the company. To gain an understanding of the control environment, the auditor should consider the information in the ICQ or information from other identified alternative sources, and the ICM-ACTG.

c. The auditor should also obtain an understanding of the accounting system and specific control activities for each major cost element (i.e., labor, indirect costs, and purchased services and material). The auditor should consider the information contained in the ICQ, particularly Parts B - Control Environment and Overall Accounting System, C - Contractor’s Risk Assessment, Information and Communications and Monitoring, and D - Accounting System Control Objectives and Activities.

d. If the auditor concludes it would be inefficient to test the controls given the audit objectives and materiality of the assertions, control risk will be assessed at maximum (5-111.2). Planned audit procedures must achieve the audit objectives and be sufficient to reduce audit risk to an acceptable level. In such situations there is an additional documentation requirement where the assertions are significantly dependent upon computerized information systems. The work papers must document the basis of assessing control risk at the maximum level by addressing the ineffectiveness of the computerized system controls or the reasons why it would be inefficient to test the controls. In either

case the work papers must also document how the planned procedures will reduce audit risk to an acceptable level (such as tracing transaction amounts in the computerized records to source documents or other forms of corroborating evidence, comparing computer record balances to previously prepared journal vouchers, trial balances, tax returns, or financial presentations prepared for other purposes). Materiality and risk specific to the data supporting the assertion are important considerations in determining the scope of procedures necessary to reduce audit risk to an acceptable level. If the auditor is unable to reduce audit risk to an acceptable level, the report should be qualified with specific reference to the unreliability of computerized information systems (10-210.4j.).

e. Based on the information obtained in b., c., and d. above, the auditor should summarize the understanding of the control environment, accounting system and control activities. The summary may be in the form of a narrative explanation which includes an identification of significant internal controls or reasons for assessing control risk at the maximum. The form and extent of documentation is influenced by the level of control risk assessed, the company's size, the complexity of the internal structure, and the extent to which assertions are significantly dependent upon computerized information systems.

5-111.2 Assessment of Control Risk

a. The purpose of evaluating the internal controls is to assess the contractor's level of control risk for determining the nature, timing and extent of transaction tests in related audits. Frequently, the auditor assesses control risk at the maximum (high) at nonmajor contractors because it is more efficient to perform substantive tests for significant and sensitive accounts than to test the effectiveness of the contractor’s internal controls. Also, if the auditor determines that internal control systems do not exist because of the company's size or the internal control systems are so deficient that they cannot be relied on, the auditor would assess the control risk at the maximum (high).

b. If, on the other hand, the auditor determines that specific control activities exist and have been implemented, the auditor may decide to perform tests of the effectiveness of the specific controls in order to limit the amount of transaction testing in the areas or accounts impacted. The auditor may also rely on previous systems audits or other related audits if they adequately evaluated and tested the effectiveness of specific control activities that would affect the auditor's assessment of control risk. Generally, the standard audit program steps for Activity Code 17740 Accounting System Surveys/Audits (5-200) are not designed to provide sufficient tests of internal controls to assess control risk at less than maximum.

c. An assessment of control risk at less than the maximum (high), which could result in reduced substantive testing, requires that control activities exist, have been tested, and are operating effectively. For Government contract purposes control activities represent policies and procedures that management has established to provide assurance that contract costs are recorded, processed, summarized, and reported in a manner consistent with Government laws and regulations. The testing of control activities is generally time sensitive and needs to be performed during the year the costs are incurred. If the control activities were not tested, control risk would be assessed at the maximum (high).

5-111.3 Reporting as Part of the Annual Incurred Cost Audit

The auditor's reporting on the review and evaluation of internal controls at nonmajor contractors is usually included as part of the report on the annual incurred cost audit.

a. The Scope of Audit section should identify the internal controls and the assessment of control risk that the auditor considered in planning the audit. This section should also describe any significant accounting system deficiencies that have a material impact on the incurred cost proposal and the audit.

b. The Contractors Organization and Systems section should describe the contractor's accounting system as well as the current status of any outstanding accounting system deficiencies and their cost impact (see 10-410).

5-111.4 Flash Reporting at Nonmajor Contractors

If a significant system deficiency is encountered at a nonmajor contractor (e.g., it does not segregate unallowable costs or routinely includes significant unallowable costs in its price proposals), issue a separate flash report when it is in the Government's best interests to do so. Consider that flash reporting should typically :

(1) bring the deficiency to the contracting officer's attention much sooner and clearer than first noting the deficiency in a related audit report (e.g., incurred cost audit report), and

(2) expedite the resolution of the deficiency and avoid its impact on other contractual actions (which may not be audited by DCAA).

When a flash report is issued at a nonmajor contractor, follow-up audit steps should be performed (preferably within 90 days) to fully determine the systemic nature and impact of the deficiency. Depending on the significance of costs generated by the system, the follow-up audit steps may be performed as an appropriately-scoped systems audit or added to the incurred cost audit or other programmed audit (see 10-413).

5-200 Section 2 --- Preaward Surveys of Prospective Contractor Accounting Systems and Post Award Accounting System Audits

5-201 Introduction

This section provides guidance for performing preaward surveys of prospective contractor accounting systems and post award accounting system audits. The audit programs and report “shells” for both the preaward survey of a prospective contractor accounting system and the post award accounting system audit are available on the Agency Intranet and in the APPS.

5-202 Preaward Survey of a Prospective Contractor’s Accounting System

a. A preaward survey of a prospective contractor’s accounting system is an examination of the accounting system at either a major or nonmajor contractor before contract award. The audit is made at the request of a contracting officer to determine the acceptability of a contractor's accounting system for accumulating costs under a prospective Government contract. It is usually requested as part of an overall preaward survey of a contractor conducted by a contract administration office under FAR/DFARS/PGI 9.106/209.106/209.106. The audit scope should be limited to obtaining an understanding of the design of the prospective accounting system so as to appropriately complete Standard Form 1408, "Preaward Survey of Prospective Contractor Accounting System" (see FAR 53.301-1408) and those procedures essential to reach an informed opinion on whether or not the design of the prospective contractor’s accounting system is acceptable for accumulating costs under a Government contract. It is not necessary to conduct an in-depth evaluation of the overall accounting system (see 9-302). However, the auditor should be responsive to the request for audit.

b. When performing the preaward survey of a prospective contractor’s accounting system, the auditor will determine the acceptability of the contractor’s system and determine if the system is:

(1) in operation,
(2) set up, but not in operation,
(3) anticipated, or
(4) nonexistent.

Special emphasis should be placed on the ability of the accounting system to generate the specific cost information required under the anticipated contract and on inequities that might occur if the prospective contract were executed. Cost determinations after contract award will be easier if there is a workable relationship between contract provisions and the contractor's system. When appropriate, the examination should disclose whether the system will provide reasonable data for projection of costs to complete a contract. The auditor should determine the equity and consistency of direct charging as generally applied by the contractor and as it is intended to be applied to the proposed contract. If the type of contract contemplated is not clearly stated in the request, the auditor should call the requestor for clarification. When a cost-type contract is contemplated, the auditor should consider whether reimbursement of indirect costs will be on an actual or negotiated (e.g., ceiling rate) basis. Also comment on any particular or unusual items of cost that should be made the subject of advance agreements or special contract clauses (see FAR 31.109). If the audit opinion is that the accounting system is considered acceptable, with the recommendation that a follow-up accounting system audit be performed after contract award, a post award accounting system audit should be set up as soon as practicable.

c. If a prior preaward survey of a prospective contractor’s accounting system has been performed and is relatively current, it should serve as the basis for the current examination. If complete and current data are not available, perform an examination of sufficient

scope and depth to evaluate the acceptability of the design of the contractor's accounting system for accumulating costs under a Government contract.

d. If requested to perform a preaward survey of a prospective contractor's accounting system on a contractor that has an active Government contract, and a recent post award accounting system audit has not been performed, the auditor should contact the requestor to ascertain if a post award accounting system audit would be more useful. If a recent post award accounting system audit has been performed, the auditor should consider providing a copy of the report to the requestor.

e. A customer request for a preaward survey of a prospective contractor's accounting system should be started as soon as practicable. An untimely response to such a request could delay the award of a contract. Acknowledge the request in accordance with 4-103.

f. If the contracting officer also requests the company's financial capability to be audited during the preaward survey of the prospective contractor's accounting system, set up a separate assignment to perform the risk assessment in accordance with guidance at 14-300. If the contracting officer does not request a financial capability audit, the auditor should contact the contracting officer to determine if a financial capability audit is needed.

5-203 Post Award Accounting System Audits

a. The post award accounting system audit is an examination of the accounting system at nonmajor contractors after contract award. The major objective of the post award accounting system audit is to determine if the contractor's accounting system is adequate for accumulating and billing costs on Government contracts.

b. A post award accounting system audit is usually performed at the request of the contacting officer when:

(1) a follow-up audit to a preaward survey is recommended or

(2) a preaward survey was not conducted prior to contract award, and the contracting officer determines that an audit is now required to support contract requirements.

Additionally, auditors may self-initiate a post award accounting system audit, based on audit risk at a nonmajor contractor location. Generally, once a nonmajor accounting system is determined adequate for accumulating and billing costs on Government contracts, future full-scope accounting system audits should only be performed when deemed necessary based on audit risk.

c. The post award accounting system audit program includes comprehensive steps to gain a detailed understanding of the contractor's accounting system (e.g., tracing costs billed to source documentation) sufficient to render an opinion on the adequacy of the system.

d. The procedures in the audit program are not sufficient to render an opinion on the key control activities and objectives that comprise a full-scope audit of internal controls. If the auditor determines that a full audit of the internal controls is required, the appropriate ICAPS audit program should be selected for the audit of the billing system internal control and/or the audit of the accounting system internal control. These and the other ICAPS audits should also be used for all post award accounting system audits at major contractors.

e. The auditor should determine if a financial capability risk assessment or audit has been performed at the contractor in the last year. If not performed, and the auditor, in discussion with the supervisor, decides that it should be, a separate assignment should be set up in accordance with guidance at 14-300.

5-204 Audit Reports

Audit reports should be responsive to the specific needs identified by the audit request and in discussions, if any, with the requestor. The report "shells" are available on

the DCAA Intranet and in the APPS. The preaward survey report provides an opinion on whether the design of the accounting system is acceptable, not acceptable, or acceptable with a recommendation that a follow-on accounting system audit be performed after contract award. The post award accounting system report provides an opinion on whether the accounting system is adequate or inadequate. The audit report should be appropriately tailored to the specific circumstances of the audit. The scope paragraphs for the preaward and the post award report should contain the inherent limitations statement. Audit reports should also provide sufficient information (e.g., SF 1408 for the preaward, financial exhibits and schedules) to support audit conclusions. Refer to 10-400 for guidance in presenting the Statement of Conditions and Recommendations, if applicable and 10-1200 for additional guidance on the financial capability report format.

5-300 Section 3 --- Audit of Internal Controls -- Control Environment and Overall Accounting System Controls

5-301 Introduction

a. This section provides specific guidance for auditing the contractor's control environment and overall accounting controls and assessing control risk. An understanding of the control environment will serve as a framework for evaluating the overall effectiveness of the internal controls in the contractor's other accounting and management systems (i.e., labor, material, purchasing, etc.). Overall accounting controls include the contractor's controls to assure it remains financially capable to perform on Government contracts, and it maintains a current description of the accounting system, including a current, accurate, and complete disclosure statement (if CAS covered) and a current chart of accounts.

b. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk.

5-302 Background Information

a. The control environment has a pervasive influence on the way business activities are structured, objectives established, and risks assessed. It also influences control activities, information and communication systems, and monitoring activities. Control environment factors include:

- integrity and ethical values
- commitment to competence
- Board of Directors or audit committee participation
- management philosophy and operating style
- organizational structure
- assignment of authority and responsibility
- human resources policies and practices
- financial capability

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. Effectively controlled entities strive to have competent people, instill an enterprise-wide attitude of integrity and control consciousness, and implement upper management's commitment to ethical business practices and behavior. In evaluating the effectiveness of a contractor's control environment, the auditor should consider whether the following control objectives are met:

(1) Management conveys the message that integrity and ethical values cannot be compromised.

(2) The Board of Directors and Audit Committee are sufficiently independent from management to constructively challenge management decisions, act effectively on external audit communications and recommendations, and take an active role in ensuring that an appropriate "tone at the top" exists.

(3) The organizational structure provides an overall framework for planning, directing, and controlling operations.

(4) Management ensures that appropriate responsibility and delegation of authority is assigned to deal with goals and objectives.

(5) Management ensures that adequate financial resources exist to perform on Government contracts.

(6) The accounting system(s) is/are well designed and operate(s) effectively to provide reliable accounting data and prevent misstatements that would otherwise occur.

(7) Management ensures that an item of cost or group of items of cost are assigned to one or more cost objectives in accordance with rules, regulations and standards for proper distribution of direct cost and allocation of indirect costs.

c. Accounting and management systems differ among companies according to organizational size and structure, type of product or service, personal preferences of corporate officials, and other variables. Most systems, regardless of complexity, contain elements of information technology (IT) for recording, processing, analyzing, and reporting related accounting data. However, in order to be effective, any system must be soundly organized and facilitate the proper accumulation and allocation of contract costs. In evaluating the effectiveness of a contractor's accounting controls, the auditor should consider whether systems:

- are well designed and reflect adequate consideration of automated controls.
- provide for the assignment of costs to cost objectives in accordance with applicable Government contract rules and regulations.
- account for costs in accordance with Generally Accepted Accounting Principles.
- provide supporting documentation that is complete, accurate, and readily available for examination to support claimed/billed costs as allowable and allocable to Government contracts.

5-303 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the audit of relevant contractor accounting and management systems and related internal controls.

b. If the audit risk assessment indicates that only certain parts of a contractor's environment and overall accounting controls are subject to moderate or high risk, only these risk areas would require a complete audit. For example, a major change in billing system software may require an audit of the internal audit department's participation in the development, modification and implementation of significant systems. Areas of little or no risk need not be audited so long as the low risk determination is adequately documented.

c. These environmental and overall accounting control objectives apply to both major and nonmajor contractors. At nonmajor contractors, the auditor should consider the internal control matrix for the Evaluation of the Contractor’s Control Environment and Overall Accounting Controls (ICM-ACTG) and the Survey of Contractor's Organization, Accounting System, and System of Internal Controls (ICQ) to perform annual risk assessments for financial capabilities and material misstatements due to fraud. The ICM-ACTG and the ICQ are available on the DCAA Intranet and the APPS.

5-304 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of the system's control environment and overall accounting controls and the contractor’s compliance. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The adequacy of the contractor's environment and overall accounting controls affects the adequacy of other accounting and management systems and related internal controls. As a result, the auditor needs to understand the environment and overall accounting controls in order to effectively audit the internal control policies and procedures in other relevant contractor systems.

c. A significant weakness in the contractor’s control environment and overall accounting controls should affect the scope of internal control audits for other related accounting and management systems.

5-305 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The pervasiveness of IT activities in most organizations requires that the auditor consider the impact these activities have on the contractor's control environment. The auditor should endeavor to eliminate any duplicate effort with respect to audits of IT internal controls in other areas (i.e. labor, MMAS, indirect/OH, etc.) However, if the auditor determines that it would be most effective to audit these controls as a part of the Control Environment and Overall Accounting Controls, then the guidance contained in 5-1400 should be considered. Consideration of this guidance is also appropriate for auditing IT internal controls at a nonmajor contractor.

c. The majority of non-labor expenses may flow through the accounts payable system. Therefore, the auditor should perform a risk assessment, and based on materiality and sensitivity, consider performing an audit of the contractor’s accounts payable system internal controls if they have not been previously audited. In addition the auditor should consider performing an audit of the IT internal controls over the contractor’s General Ledger System. If either one of these audits are appropriate consider steps set forth in 5-1400.

d. The assessment of the risk of a material misstatement due to fraud is part of the assessment of audit risk for the contractor’s control environment and overall accounting controls and is documented on the related ICAPS

e. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the contractor’s submission and supporting data are free of material misstatement, whether caused by error or fraud. If fraud is suspected, the circumstances should be reported in accordance with 4-700.

f. The following paragraphs contain guidance for evaluating the critical control objectives relating to the contractor's environment and overall accounting controls. These objectives, if achieved, should provide a basis for reducing the scope of related contract audit activity. This guidance is intended to provide the auditor with a framework for evaluating the contractor's system. However, this framework is not a substitute for professional judgment. Consequently, the auditor should adapt the guidance to respond to unusual or unique situations encountered in varying audit environments.

5-306 Integrity and Ethical Values

a. Integrity and ethical values are the product of the entity’s ethical and behavioral standards, how they are communicated and how they are reinforced in practice. Management should convey the message that integrity and ethical values cannot be compromised, and employees should receive and understand that message. Management should continually demonstrate, through words and actions, a commitment to high ethical standards.

b. FAR Subpart 3.10 includes general policies and procedures related to contractor code of business ethics and conduct that apply to all Government contractors. That provision requires Government contractors to conduct themselves with the highest degree of integrity and honesty. In addition, contractors should have a written code of business ethics and conduct, an employee business ethics and compliance training program, and an internal control system that:

- are suitable to the size of the company and extent of involvement in Government contracting;
- facilitate timely discovery and disclosure of improper conduct with Government contracts; and
- ensure corrective measures are promptly instituted and carried out.

c. Specific requirements are included in the contract clause at FAR 52.203-13 which is mandatory for all contracts in excess of $5 million with a performance period of 120 days or more.

5-306.1 Codes of Business Ethics and Conduct

FAR 52.203-13(b) requires contractors to have a written code of business ethics and conduct, and to make a copy of the code available to each employee. Although FAR does not detail the specific areas that should be covered the contractor's written code of conduct should generally address ethical business practices and expected standards of ethical and moral behavior. This code of conduct should cover dealings with customers, suppliers, employees, and other parties. In evaluating the adequacy of the contractor's written code of conduct, consider whether:

- Codes address conflicts of interest, illegal or other improper payments, anticompetitive guidelines, and insider trading.
- Codes cover compliance with Government contracting requirements for procurement integrity, classified information, and recruiting and employing current or former Government personnel.
- Codes are periodically acknowledged by all employees.
- Codes clearly establish what behavior is acceptable or unacceptable, and what to do if employees encounter improper behavior.
- Codes cite consequences for violations.

5-306.2 Ethics Awareness and Compliance Program

FAR 52.203-13(c)(1) requires contractors to have an ongoing business ethics awareness and compliance program. The program should include periodically communicating the contractor's standards and procedures by providing effective training and otherwise disseminating information appropriate to an individual's respective roles and responsibilities. FAR requires that the training be provided to the contractor's principals and employees, as well as to the contractor's agents and subcontractors, as appropriate. An example of an agent or subcontractor to whom it would be appropriate to provide this training is a consultant providing a support service to the prime contractor. In contrast, contractors generally do not need to provide this training to a true subcontractor (i.e., one that performs a part of the contract) because contractors are required to flow down the requirements of the FAR clause to the subcontract level. As a result, such subcontractors should have their own ethics awareness and compliance program, which would include providing effective training to their employees. Auditors should evaluate the contractor's ethics awareness and compliance training materials to ensure it covers the contractor's code of business ethics and conduct (5-306.1). Auditors should also test the implementation of the program by obtaining completed training documents to determine that the training was periodically provided to the appropriate individuals.

5-306.3 Business Ethics Awareness and Compliance Internal Control System

a. Contractors should establish and maintain an effective system of internal controls and self-governance and should not condone inappropriate practices. Management must continually communicate the importance of a strong internal control system. The contractor's business ethics awareness and compliance program should have policies and procedures to facilitate timely discovery of improper conduct and ensure corrective measures are promptly instituted and carried out for any cases of improper conduct disclosed. Timely discovery and prompt corrective measures should generally be the result of a strong system of internal controls and policies and procedures that provide for, at a minimum, the following (FAR 52.203-13(c)(2)(ii):

(1) Assignment of responsibility at a sufficiently high level to ensure the effectiveness of the business ethics awareness and compliance program and internal control system. The manager responsible for the ethics program should report to a high level official such as the vice president or CFO.

(2) Procedures to ensure individuals that previously engaged in conduct that conflicts with the contractor's code of conduct are not appointed as a principal of the company (e.g., officer, director, partner). Auditors should review the contractor's policies and procedures and test the procedures to verify that they include steps for exercising due diligence in identifying such conduct (e.g., require background checks before appointing principals of the company) and that the steps have been taken when applicable.

(3) Periodic evaluations (i.e., at least annually) of the effectiveness of the business ethics and awareness compliance program and internal control system. Auditors should review the results of these evaluations and determine the impact on any audits. For example, if the contractor's recent evaluations disclosed weaknesses in the contractor's internal control system, the auditor should ensure the contractor has taken the necessary corrective actions to address these weaknesses.

(4) Disciplinary action for improper conduct, or failing to take reasonable steps to detect improper conduct. Auditors should request the contractor provide evidence of the assessment performed to determine if disciplinary action taken was needed, and evidence of the disciplinary action taken, if applicable. Auditors should remember that it is appropriate for contractors to remove Personally Identifiable Information (PII) before submitting documentation to the auditor. If the contractor states that no disciplinary action was needed, the auditor should take steps to ensure that there were no reports of improper conduct by the contractor (such as those reported under the requirements discussed in 5-306.3a(6) below). If the auditor finds that there is a report of improper conduct and the contractor failed to take disciplinary action when it should have been taken, the auditor should cite the contractor for an internal control deficiency.

(5) An internal reporting mechanism, such as a hotline, by which employees may anonymously or confidentially report suspected instances of improper conduct, and instructions that encourage employees to make such reports.

(6) Timely disclosure in writing to the agency Office of Inspector General (OIG), with a copy to the contracting officer, when there is credible evidence of violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations, or a violation of the civil False Claims Act in connection with Government contracts. Auditors should ensure that the contractor's policies and procedures include a reasonable definition of credible evidence, and a reasonable timeframe for disclosure once credible evidence is obtained. Contractors are allowed to take time for preliminary examination of the evidence to determine its credibility prior to disclosure. Once the contractor has had sufficient time to take reasonable steps to determine that the evidence is credible, the contractor should disclose the violation in a timely manner. Auditors should verify that the contractor did not delay disclosing the violation once it was determined that credible evidence exists. If the auditor finds that the contractor failed to disclose the violation in a timely manner, an internal control deficiency should be reported. Review any disclosures reported to the OIG and contracting officer and ascertain if

the contractor has taken the necessary corrective actions to protect the Government's interests. If the contractor has not taken the appropriate corrective action, the auditor should report this as an internal control deficiency. If any deficiencies are identified related to the requirement for timely disclosure to the agency OIG (FAR 52.203-13(c)(2)(ii)(F)), the DCAA Justice Liaison Auditor (DCAAHQJLA@dcaa.mil) will be included on the distribution for the audit report.

(7) Full cooperation with any Government agencies responsible for audits, investigations, or corrective actions. If there are known cases where the contractor has not cooperated with audits or investigations, the contractor should be cited for deficiency relating to its control environment. Auditors should confirm that there are no outstanding access to records issues or subpoenas that would indicate the contractor's lack of cooperation.

b. Auditors should also consider whether any:

- access to records problems exist which may adversely impact the ability to assess the contractor's internal controls; or
- DCAA Form 2000s have been issued or current investigative activity indicates weaknesses in established internal controls.

5-306.4 Display of Hotline Posters

FAR 52.203-14 establishes contract requirements for the contractor's display of hotline poster(s) if the contractor has not implemented a business ethics and conduct awareness program, including a reporting mechanism. Generally, FAR requires, for contract performance in the United States, prominent display in common work areas of:

- Department of Homeland Security fraud hotline poster(s) identified by the contracting officer (required when the contract is funded with disaster assistance funds); and
- Agency hotline poster(s) (unless the contractor has implemented a business ethics and conduct awareness program, including a reporting mechanism).

In addition, FAR requires display of an electronic version of the hotline poster(s) on the company website if one is maintained for providing information to employees.

5-306.5 External Influences

External influences heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may prompt management to establish specific internal control policies or procedures. The auditor should be alert for external factors which may have an influence on management's attention to internal controls. For example, publicly traded companies registered with the SEC are subject to additional certification and reporting requirements as a result of the Sarbanes-Oxley Act of 2002. Public companies' principal executive and financial officers are required to certify to the financial information and certain aspects of internal control over financial reporting. Public companies are also required to include in their annual report a report of management on the company's internal control over financial reporting and the independent auditor's attestation on management's assessment. Additionally, auditors should consider whether the contractor's internal controls are subject to external audits by organizations other than DCAA.

5-307 Board of Directors or Audit Committee

The Board of Directors and the Audit Committee should be sufficiently independent from management to challenge management's decisions, act effectively on external audit communications and recommendations, and take an active role to ensure an appropriate upper management's accountability for integrity and ethical behavior. An active and effective board, or committees thereof, provide an important oversight function and, because of management's ability to override system controls, the board plays an important role in ensuring effective internal control.

5-307.1 Independence

The Board of Directors and/or Audit Committee should be composed of independent members and be actively involved in significant decisions. For example, consider whether:

- the Board of Directors has a significant number of members who are not officers or employees of the contractor.
- shares are traded on NYSE, AMEX, or NASDEQ where listing requirements provide for a minimum of two “outside” directors.
- the board constructively challenges management's planned decisions, e.g., strategic initiatives and major transactions, and probes for explanations of past results (e.g., budget variations).
- board committees are used for matters requiring more in-depth or directed attention.
- a process exists for informing the board of significant issues.
- the compensation committee approves all management incentive plans.

5-307.2 Internal Audit Department

The internal audit department should be functionally and organizationally independent and sufficiently removed from political pressures to ensure that it can conduct its audits objectively and can report its findings, opinions, and conclusions without fear of repercussion. For example, consider whether:

- the internal audit department reports to an individual with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action relative to audit recommendations.
- the internal audit department has regular communications with the Board of Directors or Audit Committee.
- the internal audit department participates in the development, modification, and implementation of significant accounting systems.

5-307.3 External CPA Management Letter on Internal Controls

Management should effect prompt correction of deficiencies noted in the external CPA's management letter on internal controls. Responsiveness to external auditor notifications of internal control weaknesses can provide important insight to management's overall commitment to maintaining effective internal controls. For example:

- if the contractor's external auditors have reported any internal control weaknesses, the status of the contractor's corrective action is an indication of management’s responsiveness. The auditor needs to obtain the management letter to make this determination.
- if there have been recent changes in external auditors, this may indicate a disagreement on accounting or internal control issues

5-308 Organizational Structure

a. The organizational structure provides the overall framework for planning, directing, and controlling operations. The organizational structure should not be so simple that it cannot adequately monitor the enterprise's activities nor so complex that it inhibits the necessary flow of information. Executives should fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions.

b. The form and nature of the organization should be well defined, including the assignment of management functions, reporting relationships, and authority and responsibility. For example, consider whether:

- the contractor maintains formal organization charts which clearly define lines of authority and responsibility.
- responsibilities and expectations for the entity's business activities are communicated to the executives in charge of those activities.
- departments providing critical services (e.g., Information Services) report at a sufficiently high organizational level to reasonably preclude undue influence from other departments.

5-309 Assignment of Authority and Responsibility - Impact on Control Environment

a. The assignment of responsibility, delegation of authority, and establishment of related policies should provide a basis for accountability and control, and set forth individuals' respective roles.

b. Written policies and procedures should adequately address assignment of responsibility and delegation of authority to deal with organizational and departmental goals and objectives, regulatory requirements, and information systems and authorizations for changes to these systems. For example, consider whether:

- authority and responsibility are assigned to employees throughout the entity.
- responsibility for decisions is related to assignment of authority and responsibility.
- proper information is considered in determining the level of authority and scope of responsibility assigned to an individual.

5-310 Financial Capability

Management should periodically evaluate financial resource requirements to ensure that they are adequate to perform on Government contracts. Contractors who fail to properly manage their financial resources subject the Government to increased risk that contract performance will be adversely affected. Additionally, financial weakness can provide pressure or incentive to commit fraud. The audit of the contractor's financial capability is discussed in 14-300.

5-310.1 Policies and Procedures

Written policies and procedures should require regular evaluations of financial conditions in order to anticipate and avoid adverse conditions. Adverse financial conditions can have a significant impact on the contractor's ability to perform on Government contracts. Therefore, the contractor should regularly assess its financial condition and take steps to avoid potential problems. The auditor’s assessment of financial capability should include an evaluation of management’s self-assessment (see 14-305).

5-310.2 Assessment of Accounts Receivable/Payable

The contractor should conduct periodic assessments of accounts payable and accounts receivable including analysis of accounts payable aging and the collectability of accounts receivable. Effective cash flow analysis is dependent upon the proper assessment of cash inflows (accounts receivable) and cash outflow (accounts payable). The contractor should prepare detailed assessment of both the debit and credit balances for each of these accounts on a regular basis to ensure that cash flow projections are based on sound financial information.

5-310.3 Debt Payment

The contractor should conduct periodic assessments to ensure that it is meeting debt payment schedules and is in compliance with other loan covenants. Failure to meet debt repayment schedules can have a negative impact on the contractor's ability to perform on Government contracts. Therefore, it is important that the contractor periodically assess the status of its debt repayment efforts to ensure that they are adequate.

5-310.4 Cash Flow Projections

The contractor should regularly perform short and long term cash flow projections. The contractor should assess both current and future financial conditions in order to ensure that adequate financial resources are available to support the performance of Government contracts. For example, the auditor should consider whether:

- the contractor prepares cash flow analyses for current and future periods to ensure that adequate resources are available to meet current and projected cash flow requirements.
- the contractor establishes formal plans to meet anticipated cash flow deficiencies.

5-311 Accounting System (Control Environment)

The contractor's accounting system consists of methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The accounting system should be well-designed to provide reliable accounting data and prevent misstatements that would otherwise occur.

5-311.1 System Description

The contractor should establish and maintain a written description of its accounting system which clearly identifies the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. For example, consider whether the contractor:

- maintains a current, accurate, and complete chart of accounts.
- has flow charts, narrative descriptions, or other explanations of how information is processed through the accounting system from initiation of transactions to reporting of the transactions in the financial records. This should include identification and purpose of all transactions, schedules, tables, files, overrides, and reports generated and processed by the system.
- has a system that is fully or partially automated. If automated, the description should include the IT aspects of the accounting system transaction flow, including data input, data processing, and data output.
- has clearly identified personnel responsible for preparing, reviewing, modifying, and approving accounting transactions.

5-311.2 Disclosure of Cost Accounting Practices

The contractor should establish and maintain a current, accurate, and complete description of all cost accounting practices which impact Government contracts. Normally contractors who have approved CAS disclosure statements have complied with this requirement. Contractors should establish policies and procedures to ensure that disclosed cost accounting practices are current, accurate, and complete. In addition, the contractor should have policies and procedures to ensure that all changes in cost accounting practices are properly disclosed to the Government along with the related cost impact.

5-311.3 Management Intervention

Policies and procedures should provide guidance on the situations and frequency of management intervention in the collection, processing, and reporting of accounting data and transactions, and the types of approvals and documentation required. For example, consider whether:

- management has provided guidance on the situations and frequency with which intervention may be needed;
- management intervention is controlled, well documented, and explained appropriately; and
- deviations from established policies are investigated and documented.

5-312 Overall Accounting Controls - Information Technology System Internal Controls

a. Where information technology is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls or IT application controls. Whether the control activities are classified by the auditor as general or applications controls, the objectives of control activities remain the same, to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are sufficiently reliable to permit the preparation of financial statements and cost representations.

b. The auditor should audit the IT general controls and the Accounting System application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are comprised of:

(1) organization and operational controls,
(2) systems development and documentation controls,
(3) hardware and systems software controls, and
(4) data and procedural controls.

(See 5-400 for a more detailed explanation of general internal controls.)

d. Accounting System application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as billing, purchasing, and in this instance, general accounting. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-313 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

5-400 Section 4 --- Audit of Information Technology General System Controls

5-401 Introduction

a. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal control and assessing control risk.

b. This section provides guidance for auditing general IT internal controls applicable to centralized Information Technology (IT) operations, distributed processing environments, local/wide area networks (LAN/WAN), and client/server systems. The contractor's IT general internal controls establish the control environment within which all computerized accounting and management systems operate. See the IS Knowledge Base available on DCAA's Intranet for further guidance on auditing IT systems.

c. The guidance should be applied selectively, giving consideration to the unique aspects of the in-place data processing system and areas judged to be relatively high risk.

5-402 Background Information

a. IT general internal controls are comprised of the following elements:
(1) organization and operational controls
(2) systems development and documentation controls
(3) hardware and systems software controls
(4) access controls
(5) data and procedural controls
These controls help ensure that the contractor's transactions are valid, properly authorized, and completely and accurately processed.

b. Weaknesses in IT general internal controls often have pervasive effects on contractor overall accounting operations. When IT general internal controls are weak or absent, the auditor must consider the effect of these control deficiencies in the evaluation of IT application/functional controls. These types of internal controls apply to specific applications or functions such as the purchasing system or labor reporting systems. For example, internal controls should require proper authorization of source documents such as purchase orders or labor data recording prior to input to the IT system.

c. IT general internal controls could vary significantly between contractor locations. Size of the contractor is a major factor influencing the level of general internal controls the auditor may find installed. Larger contractors will generally have more extensive internal controls in operation than smaller contractors. The auditor must be prepared to assess the level of compensating controls at smaller contractor sites since it is expected that optimum control activities will not be in effect.

d. Larger contractors generally have most general internal controls in-place. However, large contractors having geographically dispersed locations may exhibit adequately documented internal controls, but may not consistently enforce the controls throughout the dispersed environment.

e. Contractors may not dedicate a data center to service the IT requirements of a single location. Sizable contractors may have a data center supporting a single location, or a centralized data center that services several geographically dispersed company locations. Some contractors may use an outside commercial data processing service instead of maintaining their own data center. The auditor must determine the extent of the contractor's IT resources when planning and defining the scope of the audit.

5-403 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. IT general internal controls meet the definitions of "record" and "data" contained in FAR 52.215-2, Audit and Records - Negotiation, and FAR 52.214-26, Audit and Records - Sealed Bidding. The applicability of these FAR sections is agreed to by contractors when submitting price proposals and executing contracts with DoD components. These contract clauses give the auditor the right of access to contractor records, including IT internal control data, after contract award. Refer to 1-504, Access to Records of Contractor, and 1-505, Other Access to Records Issues - Transfer of Records from Hard Copy to Computer Medium.

5-404 Audit Objectives

The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the IT system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

5-405 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The auditor should consider any IT related outstanding deficiencies identified in other accounting and management system audits. The nature of such deficiencies may affect the scope of the IT general control audit. For example, a labor reporting system deficiency involving application software changes to the labor system may affect the current audit of software modification procedures and controls.

c. The following sections contain general guidance for the evaluation of general IT controls. This guidance gives the auditor a framework for the audit. However, this guidance is not a substitute for professional judgment. The auditor should adapt this guidance to fit individual audit circumstances.

5-406 Information Technology Environments

The term Information Technology (IT) encompasses all forms of computer technology used to create, store, exchange, and use information in its various forms. With reference to computers, the term environment refers to the combination of hardware and software used in the information systems processing activity. Over the past two decades, there have been considerable changes in the IT environments not only in terms of hardware and software platforms, but also the methodologies employed to support the business activities of an organization. We have seen a gradual evolution from the centralized data processing operations to a widely dispersed distributed processing environment. These technological changes greatly impact the role of the auditor in evaluating the contractor’s operations and the risks associated with the processing of contract cost data.

5-406.1 Centralized Data Processing Operations

“Centrally organized data processing” implies that most, if not all, aspects of an entity’s data processing operation are geographically centralized. All of the organization’s applications and user data resides on mainframe computer equipment housed in a centralized computer facility and maintained by a centralized support staff. Perhaps the primary advantage to this organizational structure from the auditor’s perspective is the centralized control over the hardware and software as well as the data being processed.

5-406.2 Decentralized versus Distributed Operations

a. A decentralized information systems processing facility usually maintains a home office (control hub) computer, but disperses many data processing activities throughout the company. Remote locations in a decentralized facility possess independent processing capabilities through separate computing facilities. A distributed facility is a variation of a decentralized facility. The primary distinction between a decentralized and distributed operation is networking and data communications. In a decentralized system, each remote facility may periodically communicate with other sites. However, in a distributed network, each remote facility, while possessing autonomous processing capability, represents an integral part of an overall data communication and information network. Data communications among the sites is an ongoing and essential element of the network rather than a periodic, ad hoc routine. A distributed data network is a tightly bound facility.

b. Centralized and distributed facilities are configured using central computers, local area networks (LANs), wide area networks (WANs), and stand-alone microcomputers. Decentralized or distributed operations, if applicable, are normally an organizational element of the IT Department and are subject to the same audit procedures applied to centralized data center systems. The auditor should evaluate policies, practices, and procedures addressing LAN and WAN operations, including data control, data security, and data communication. The auditor should also determine the distributed system's configuration and the hardware and software in service. Due to the many electronic devices involved, the transmission of information between distributed nodes (or sites) presents a greater risk to data security and integrity than is experienced in a centralized data center. Accordingly, the auditor should be particularly attentive to the distributed database and data communication operations. In some instances, the auditor may have to obtain regional technical assistance.

5-406.3 Client/Server Computing

a. Client/server architecture provides the benefits of centralized and distributed processing to the end user. The evolution of client/server technology was due in large part to the significant reduction in the cost of computing resources along with the need to be more responsive to changing customer requirements. This new technology facilitates the seamless integration of personal computers (PCs) with host systems. This permits organizations to be more responsive to their customers, but still maintain the security and integrity to manage their business effectively.

b. Client/server computing has two basic components, a client and a server. A client is comprised of a PC or a workstation, that is used to access network applications and resources. A server is a dedicated computer that is physically attached to a network that provides electronic access to databases, e-mail, printing, FAX's, communications, and other services. Clients are typically PCs, but a client can also be a midrange or a mainframe computer. Servers are typically midrange or mainframe computers; however, a server could be another PC attached to the network. Client/server networks allow specific computers to be identified as servers, and to provide one or more services to other computers within a network. Client/server networks can have designated computers for file serving, database serving, application serving, and communications serving. Each of these servers are dedicated devices that provide a specific service to all authorized users operating within a network. Servers can also direct that a portion of the data processing be accomplished on each user PC or on a centralized server.

c. The following are among the more significant advantages of processing data in a client/server environment:

(1) Allows access to data and resources.
(2) Increases organizational flexibility.
(3) Processing of data can be done either locally or at a central location.
(4) Provides faster access to information.

(5) Data can reside where best suited.
(6) Users can have a greater role in systems design and development.

d. Another way to describe the client/server architecture is to view it as a model for a relationship between two computer programs in which one program, the client, makes a service request from another program, the server, which fulfills the request. Although the client/server model can be used by programs within a single computer, it is more commonly used in a network where computing function and data can more efficiently be distributed among many client and server programs at different network locations.

e. In evaluating the integrity, reliability and accuracy of data processed in a client/server environment, the auditor should view it from two different perspectives:
(1) the environment audit (general internal controls) and
(2) the application approach.

In an environment audit, primary audit consideration centers around key elements that make up the environment. These include the operating system, database management system, network components, program libraries, and change control. In the application approach, the auditor should evaluate the adequacy of critical control points associated with the user interface, user authentication process, menu level authority and file level access.

5-406.4 End-User Computing

a. The trend in IT has gradually evolved from performing all computerized data processing in a centralized environment to empowering users to perform much of their activity at their workstation or personal computer. End-user computing is where the end user develops, maintains, and processes computer-based information to meet their needs.

b. The primary audit objectives to be considered by the auditor in evaluating the personal computer (PC) or microcomputer environment include:
(1) Evaluating the adequacy and completeness of PC related policies and procedures.
(2) Determining whether physical security controls over PCs are adequate.
(3) Evaluating the adequacy and completeness of logical (system and data) security controls.
(4) Evaluating the adequacy and completeness of system and data integrity controls.
(5) Evaluating the adequacy and completeness of application system controls.
(6) Determining the adequacy of micro to host computer link controls.

5-406.5 Commercial-Off-The-Shelf (COTS) Software

a. COTS software are commercially developed IT systems applications that Government contractors can acquire and adapt to their various enterprises. In evaluating COTS software internal controls, the primary audit objective should be to ensure the contractor's software acquisition procedures conform to accepted system development standards. As with in-house developed applications, the audit procedures should include evaluating the adequacy of system controls, audit trails, and security features incorporated within the COTS application system.

b. A common term used in the COTS environment is ERP (Enterprise Resource Planning). ERP is an industry identifier for the broad set of activities supported by multi-module application software that help an organization manage specific aspects of its business, including product planning, parts purchasing, maintaining inventories, interacting with suppliers, providing customer service, and tracking orders.

c. Audit considerations relative to various components/modules of the contractor's ERP environment are addressed in the respective application system audits.

5-406.6 Relational Database Management Systems (RDBMS)

a. An RDBMS is a program used to create, update, and administer a relational database. A relational database is a collection of data items organized as a part of formally described tables from which data can be accessed or reassembled in many different ways without having to reorganize the database tables. In addition to being relatively easy to create and access, a relational database has the important advantage of being easy to extend. After the original database is constructed, a new data category can be added to the database structure without requiring all existing applications be modified.

b. An RDBMS takes Structured Query Language (SQL) statements, either entered by a user or contained in a system application program, and creates, updates, or provides access to the database.

c. Audit considerations in the database management environment center around several facets of the organization, including; database administration functions, database access, database management system functions, data communications, and database applications.

5-406.7 Enterprise Resource Planning Systems

Enterprise Resource Planning (ERP) systems are Information Technology systems that include broad functionality and a high degree of functional integration. They integrate company-wide information that can cover virtually all functional areas (e.g., purchasing, manufacturing, inventory, sales, accounting, human resources, etc.). These systems are generally comprised of commercial off-the-shelf (COTS) multi-module application software, specifically designed to operate in client/server data processing environments. ERP systems are designed to share common databases and are usually accessible by many contractor employees performing a wide variety of tasks. ERP systems use best business practices that are designed into the software to organize businesses along process lines as opposed to functional lines. This process orientation allows the business to focus on streamlining and improving its processes (see also C-105.7).

a. Auditors should determine how the audit coverage will be affected by the ERP system implementation. For example:

(1) Determine the overall scope and schedule of any ERP system implementations.

(2) Obtain an understanding of the differences between the contractor's current data processing environment and the data processing environment to which the contractor is converting.

(3) Identify the specific ERP software and its version or release the contractor intends to implement; e.g., SAP R/3, PeopleSoft, BaaN, or any of the several other available ERP systems. Generally, more recent releases and the implementation of aerospace and defense (A&D) specific products will more fully comply with Government regulations. Auditors should determine whether the contractor is implementing the latest version of whatever vendor's product the contractor is using.

(4) Determine the impact the ERP system will have on the contractor's accounting and management systems' internal controls and how the contractor intends to ensure the adequacy of the new system's internal controls.

(5) Determine if costs and cost reductions have been identified and are incorporated into forward pricing rates. Potential cost reductions may include but are not limited to the following:

- reduction or elimination of legacy systems,
- reduction in labor costs,
- reduction in inventory levels, and
- improved reporting processes.

(6) Determine what access to the system is required to perform the various audits most efficiently and effectively. Auditor read-only on-line user access to the new system is expected along with the ability to apply computer assisted audit techniques that extract data into external files for more complex analysis. This access is well-founded in regulatory requirements, which provide for auditor access to contractor books, records, documents, and other evidence and accounting procedures and practices, regardless of form (see 1-504.4). Auditors should also take advantage of any contractor-provided training for system end-users.

(7) Identify what additional hardware and software, if any, will be required to interface with the new ERP system.

(8) Assess the contractor's procedures for determining whether ERP implementation results in any cost accounting changes, disclosure statement changes, and/or cost impacts.

(9) Evaluate data conversion from the legacy system to the ERP system to ensure the integrity of the data entering the new system. Data conversion is generally a major project with the potential for significant errors. Contractors usually do not run their old non-ERP system in parallel with the new ERP system modules. However, an ERP system has many individual modules and each module may be implemented in a time-phased manner. For example, general ledger, cost ledger, and personnel modules could all be implemented at different times. Therefore, the auditor's early involvement in a single, or multi-phased, data conversion process is essential in order to ensure the integrity of the contractor's reconciliation of data between the old and new systems. The auditor should ensure that the contractor maintains ending legacy system balances in an electronic format reconcilable to beginning ERP system balances. The data must be reconcilable both to detail amount and to allocation to final cost objectives. It is also critical that the auditor ensures that the contractor maintains data conversion information at the necessary level of detail. For example, depending on the type of contract funding, data reconciliation at the contract level, CLIN level or some other lower level of detail, may be required to meet regulatory requirements and contract terms. Fourth generation software, such as SAS, can be employed to facilitate the auditor's review of the contractor's data conversion process.

b. The current functional, risk-based auditing approach inherent in DCAA's ten Internal Control System Reviews (ICSRs) is equally applicable to ERP systems. At contractors implementing ERP systems, the planning and timing of internal control audits should be concurrent with ERP system implementation.

c. Treatment of ERP system costs. See 7-105, Accounting for Costs Related to ERP Systems.

5-407 Independent Management Reviews

a. Most organizations are subject to dynamic change, therefore, the internal controls should include the requirement for periodic independent management review. Typically, these reviews are performed by the internal audit function or external auditors engaged by the organization. Internal or external auditors should possess sufficient technical competence, independence, and authority to conduct objective audits of IT internal controls, and submit reports on findings and recommendations for improvement in all functional areas of the organization's information services environment. A consequence of these audits is the obvious requirement for follow-up and resolution of identified deficiencies. Refer to Chapter 4-1000, Relying upon the Work of Others, for additional guidance.

b. Many factors, including changes in computer center equipment, systems software, information systems personnel, user requirements, and the general business environment can weaken established internal controls. However, changes in the same elements can also strengthen internal controls and eliminate the necessity for some redundant controls and their associated cost. Periodic management reviews should be designed to identify any new requirements and to eliminate redundant controls. These reviews should be scheduled on a recurring basis.

c. In addition to independent management reviews, the quality of the services performed by a contractor's IT Department should be ensured by the establishment of a separate function within the department devoted to maintaining established standards of quality. Quality policies, practices, and procedures should be available and should clearly define the responsibilities of the quality function. Moreover, review plans, schedules, and measurements should be developed, standardized, and maintained by the quality function to establish criteria for the guidance of assigned personnel. Reports on the results of quality reviews should be prepared and submitted to user management and IT management.

5-408 Organization

The effectiveness of most internal control activities is dependent on the actions of personnel responsible for implementation of the controls. An organization's structure is a significant control factor. A basic accounting internal control is the segregation of duties among those who:

(1) initiate and authorize transactions
(2) have custody of the asset acquired
(3) record accountability for the asset

Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and cancel errors or irregularities. This concept of segregation of duties is universal and must be maintained in order to achieve satisfactory internal control. The data processing function is subject to the same internal control criteria, both as an organizational element and as a functional department.

5-408.1 Independent Structure

a. Organizational and administrative controls are essential operational elements of most enterprises. The nature and extent of these controls depend on such factors as corporate culture, strategic importance of departments or divisions, legal requirements, assets employed, and a variety of other influences. Traditional organizational structures are based on the separation of functions by establishing independent departments reporting to senior officials or directors. For example, the finance department and the accounting department are typically independent, equal entities reporting to different officials. This organizational independence is viewed as a mechanism to prevent or minimize the opportunity for the perpetration and concealment of material irregularities and serves as a crosscheck to disclose potential errors. In this traditional organizational structure, each department usually accomplished its own clerical and data processing activities. However, with the advent of centralized data processing centers, many of the traditional departmental data processing activities were transferred to a separate centralized functional and organizational entity, the IT Department.

b. Centralization of data processing activities resulted in the concentration of many systems processing steps into one department. The concentration of traditional accounting data along with operating data is still a common practice in today’s network computing environment. Such concentration is referred to as integration, in which related elements of different data processing activities are combined into common and coordinated procedures and a logical workflow. Integration assists in the preparation of desired managerial reports from a single record of each business transaction, and all transactions are processed in a unified system. The centralization of data processing into one department emphasizes the importance of proper control of the data processing center itself.

c. The IT Department should be positioned in the organizational structure to enable it to meet established overall objectives and to ensure operational independence from user departments. Therefore, the contractor should be able to demonstrate that the IT Depart-

ment is not subjected to undue influence from other departments having the authority to initiate or authorize transactions. The IT function should be positioned within the organization at a level sufficiently high to ensure that its independence is not compromised. At small contractors, the IT Department might not report directly to senior management. In this situation, the contractor should be able to demonstrate that the level of management involved is sufficient to preclude the perpetration and concealment of material errors and misstatements.

d. The contractor should be able to show that the IT Department exercises adequate control over the data processed, and that they do not:

(1) initiate data for input

(2) have custody of or control non-IT assets

(3) have the authority to originate master file changes

The IT function should not correct errors unless the errors are generated as a result of information technology and they should also be prohibited from initiating or authorizing transactions.

e. Although the centralization of data processing activities still exists in current environments, many large and small enterprises are moving (distributing) their applications and data to where they can operate most efficiently in the enterprise, to some mix of desktop workstations, local area network servers, wide area network servers and Web servers. With each technological advance comes inherent organizational changes that may impact internal control within the enterprise. The auditor must give proper consideration to the network computing environment and the overall impact it has on assessment of internal controls over the processing of contract cost data.

5-408.2 Segregation of Duties

a. Just as there should be organizational independence between functions, there should also be independence or segregation of functions or duties within the IT Department. Management should provide for a segregation of incompatible duties within the IT Department. Examples of incompatible duties include:

(1) systems development and computer operations

(2) computer operations and data control

(3) database administration and systems development

b. Application development personnel having control over changes made to application systems and their eventual implementation, should not have access to the computer resources which process those systems. These type controls help prevent the introduction of unauthorized changes to the system. Likewise, computer center operations personnel who actually operate the computer system hardware should not have access to application systems libraries. This type control helps prevent unauthorized changes from being made to application software. Most large corporations employ some type of database management system (DBMS) directed by an administrator responsible for the control of database elements introduced into the system. Database administrators (DBA) should not have access to application systems that access and process the data in the system. Segregation of duties:

(1) provides an effective cross-check of the accuracy and propriety of changes introduced into the systems

(2) reduces the opportunity for computer operations personnel to implement revisions without prior approval and checking

(3) minimizes access to the equipment by non-operating personnel and other people who have knowledge of the system

(4) improves efficiency because the capabilities, training, and skills required in carrying out these activities differ greatly

c. The contractor should be able to show through IT Department organization charts and position descriptions that duties and responsibilities are adequately segregated. Small

contractors may have organizational structures where some incompatible duties and responsibilities may occur. The contractor may be able to demonstrate the existence of compensating controls that mitigate these problems. For example, data processing functions might be under the cognizance of the finance department. Under these circumstances, the contractor should ensure that adequate controls are installed which will preclude undue influence on data processing operations.

5-409 Software Acquisition, Development and Modification

a. Information technology has substantially reduced the time available for reviewing transactions before the transactions are entered into an organization's records. Consequently, in poorly controlled systems, the opportunity for detecting transaction errors before they have an impact on operations may be reduced, especially in the case of real-time and database systems where records are subject to immediate update. To help provide reasonable assurance that software systems contain adequate controls and security, organizations should employ a standardized methodology when acquiring, developing, and modifying either systems software or applications software. The goal of this methodology should be to achieve:

(1) system effectiveness
(2) economy and efficiency
(3) data integrity
(4) resource safeguarding
(5) compliance with laws and regulations

b. The methodology to effect software acquisition and/or development can vary significantly among contractors and is influenced by many factors such as:

(1) size
(2) type of business
(3) organizational structure
(4) current business environment

c. Senior management should issue a written policy statement establishing a standard System Development Life Cycle (SDLC) methodology as a means for structuring and controlling the process of acquiring, developing, and maintaining systems and application software. The SDLC methodology should include the following controls:

(1) definition of requirement
(2) participation of appropriate personnel
(3) software documentation
(4) validation, verification and testing
(5) final management approval

d. Software development begins when the need for an automated solution to a problem is identified and validated. Definition of requirements produces the functional requirements and begins the detailed planning for the development of an operable system. It is critical that internal control and specific security requirements be identified during this process. Requirements definition should include:

(1) internal audit plan
(2) project plan
(3) functional requirements document
(4) functional security and internal control requirements document
(5) data requirements document
(6) description of sensitive and critical data

e. It is good practice to require participation of cognizant personnel in the development process to provide reasonable assurance that internal controls, security, user, and organizational requirements are addressed. Participants should include:

(1) IT management
(2) systems security officer

(3) internal auditors
(4) users
(5) quality assurance personnel.

f. The development methodology should incorporate standards for systems, program, and user documentation. Good documentation policies and procedures facilitate program modifications, staff training, and establish a starting point for a review of control activities. System documentation should include a description of the system, information flow, various programs required, interrelationship with other systems, computing resources required, and operating environment. In addition to narrative, the documentation should include flowcharts depicting system operation. Program documentation should include a detailed narrative explaining the objective of the program. It should contain detailed narratives and flowcharts of the processes incorporated into the program to accomplish data processing objectives.

g. An effective validation, verification, and test plan is an essential part of any development and program change methodology. It helps maintain the integrity of the applications by assuring that only authorized modifications, revisions, or changes are made. The plan must provide for the testing of software, including detailed program specifications, data set descriptions, internal controls, security specifications, and procedures for all tests, as well as data reduction and evaluation criteria. Results of the test should be well documented and reflect any corrective actions taken as a result of the test. The decision to implement a system without exercising a well-designed test plan presents serious risks to system integrity, reliability, and organizational operations.

h. Signed approvals should be obtained from the requestor, users, quality function, and IT management, prior to putting into production new or modified system software or applications software. This procedure establishes accountability for system results and provides an incentive to properly test and validate a system prior to implementation.

i. The contractor should be able to explain whether SDLC methodologies are employed for software acquisition, development, or modification and should also provide policies and procedures that govern SDLC implementation. Reviewing at least one completed or in-process project processed under the SDLC methodology may test the adequacy of SDLC implementation and compliance.

5-409.1 In-House Software Development

a. “In-house software development” refers to those programming applications that are developed, supported, and maintained by the applications programming staff of an IT organization.

b. When evaluating in-house developed applications, an important audit procedure is the review of an organization’s systems development life cycle procedures to determine adherence to generally accepted system development standards. The primary goal of the contractor’s IT organization should be to develop a usable, securable, auditable, maintainable, and controllable application system that produces consistent results to satisfy user requirements.

5-409.2 Software Modifications

Software modification activity should be adequately controlled to ensure that modifications, revisions, or changes to operational application systems are made only as authorized, within a controlled and secured environment. At a minimum, the following guidelines should be in place to ensure adherence to management’s stated objectives:

(1) A standard maintenance policy should be established regarding application software modifications.

(2) Users should actively participate in software change or modification activities.

(3) Each system/software revision or change should be supported by a 'Request for Change' form with proper management and user approvals.

(4) Adequate systems analysis and detailed design and/or written software specifications should exist to support each system/software revision or change.

(5) There should be evidence of adequate testing and updating of applicable documentation to support each system/software revision or change.

(6) A clearly identifiable and traceable audit trail should be available for each software change or modification.

(7) There should be evidence of user sign-off or other written approvals before software changes are moved into production status. The approvals should be performed by an individual that is independent but yet knowledgeable of the process.

5-410 IT Computer Operations

Computer operations should provide reasonable assurance of the integrity of all activities impacting the physical operation of the computer and all peripheral components. Such activities may include system initiation, operator interaction, help desk assistance, print operations, and identification and correction of hardware and system software problems. As a minimum, controls should be established over:

(1) system documentation
(2) recording of transactions
(3) hardware and software changes
(4) hardware and software maintenance
(5) operational procedures
(6) telecommunications

5-410.1 System Documentation

a. Each major application system should be documented in a unique operations and maintenance manual. The manual should be available for use in all software testing and accessible by all appropriate operations personnel. To help provide reasonable assurance of the proper processing of the relevant application system, the manual should include:

(1) software function and hardware requirements
(2) interactive system operation, database involvement
(3) explanation of console messages, user screens queries, and related responses
(4) proper identification of output file labels for removable media, such as magnetic tape
(5) appropriate restart or notification procedures for error or failure conditions
(6) checkpoint controls for proper run-to-run control of program operation
(7) list of all reports generated by various run options for the system

b. The contractor should be asked to demonstrate that documentation on all system software is current and accessible only to appropriate system software personnel assigned to install and maintain the operating system and other system level software. Contractor data centers may be using on-line operations documentation in lieu of hard copy user manuals. Policies and procedures governing the creation and use of on-line operations documentation should be available.

5-410.2 Recording of Transactions

Manual and/or automated recording and reporting of systems processing activities are essential for safeguarding the integrity of the data processed. These reports, or system logs, provide audit trails for several functions, including system security, data

backup/recovery, and general problem resolution. Examples of where system log entries provide operational assistance include:

(1) update and recovery of databases and data files
(2) system accesses
(3) computer performance
(4) hardware/software failures
(5) corrective actions

System logs are extremely important and should be implemented at any data center, regardless of the size of the data center.

a. Access Logs may consist of records of physical access to data processing areas and equipment, or records identifying a system user's logical access to some application or communication network. The contractor should demonstrate that access logs are retained for a reasonable period and that they are periodically reviewed for compliance with established policies and procedures.

(1) Physical access logs are normally contractor maintained manual records that record visitor access to the data center or employee access at times other than normal working hours. Physical access logs can be automated depending on the type of access control system employed. For example, encoded identification badges could be electronically scanned and matched to a listing of authorized entrants. The authorized badge holder would be allowed entry and the badge number would be recorded.

(2) System access (logical) logs record, by User ID, all accesses to computer resources or to the data communications network. System logs help in the detection of unauthorized attempts to access computer resources and data.

b. Transaction Logs are the audit trail of all changes made to data elements contained in applications systems, including batch and interactive systems. These logs are normally automated and are critical to data center backup and recovery operations. Transaction logs should record:

(1) all additions, deletions, and changes to the application data elements
(2) the user making the changes
(3) the day/time the transaction was made

The logs provide the primary source of data recovery if a system failure should occur. The contractor should be able to show that application system documentation provides for these audit trails and that the logs are fully operational. Documentation on system testing prior to implementation should contain information on the operational test of these logs for backup/recovery and identification of inadvertent transaction errors. The auditor should request that data center personnel demonstrate the existence of these logs and provide documentation of their use during backup and recovery.

c. System Activity Logs record actual utilization of the hardware resources within the data center. These logs would normally identify:

(1) the level of central processing unit (CPU) utilization
(2) direct access storage device (DASD) activity and utilization
(3) number of system users
(4) job activity
(5) other processing measurements needed to manage the performance and capacity of the hardware resources

The logs are a primary means of identifying processing problems created by inadequate or failing components. The contractor should be asked whether systems activity logs are being generated, since most operating systems provide an option to either not collect any data or to collect only a limited amount. The auditor should also verify the retention period for these logs. Normally, two to three months of systems activity data should be stored on DASD for on-line access, with an additional twelve to eighteen months of data stored on magnetic tape.

d. Maintenance Logs record all scheduled/preventive maintenance (PM) and corrective/remedial maintenance (RM) performed on the hardware components installed in the data

center. PM provides reasonable assurance that required checks and procedures designed to minimize hardware failures are accomplished. RM is performed when hardware failures occur. RM logs are helpful in resolving recurring problems and identifying components requiring replacements. The auditor should determine whether the contractor maintains the PM and RM logs on a timely basis. The logs may be manually maintained or automated. The PM log should reflect the hardware manufacturer's basic requirements for periodic maintenance.

e. Problem Logs are maintained by the data center to identify system and application problems and to track the problems until corrected. The logs may be manually maintained or automated. The contractor should be able to show that the log is in use and that all recorded problems have been acted upon. At many contractors, problem logs are the responsibility of the Help Desk function. Information systems (IS) problems or questions are directed to the Help Desk from throughout the organization. Help Desk personnel are responsible for logging the call, identifying the problem, resolving the problem, and documenting the series of events. The Help Desk may transfer the issue to another resolution source. The functions of the Help Desk should be documented in a standard procedure approved by IT management and distributed to all IS users.

f. Software Change Logs provide a record of all installations of system level software and applicable changes. They are an important part of change management and should be well documented in the policies and procedures governing change control. The changes may be vendor supplied or in-house changes required to customize the software to the contractor's special needs. The types of software involved would be operating systems, utilities, compilers, database management systems (DBMS), and other non-application software products. The logs may be manual or automated. The auditor should determine whether this type record is maintained, and that it:

(1) contains all changes made to non-application software
(2) is accurate
(3) is current

There should be few in-house changes to operating system, utility, and computer software. The auditor should obtain copies of the contractor's work orders to the systems software developers to incorporate in-house changes in the next release of the system software.

5-410.3 Operational Procedures

a. Most computer hardware has the capability to detect and record hardware failures, although some systems are not designed to take advantage of available controls. Failure to utilize available hardware controls could result in significant processing errors. A number of undetected minor errors can have a cumulative effect that could result in a major system or subsystem failure.

b. Active preventive maintenance (PM) and remedial maintenance (RM) programs are necessary to keep data center equipment operational. The data center should maintain a current schedule of all PM to be performed as required by the equipment manufacturer and should ensure that the PM is completed as scheduled. Contracts should be negotiated with equipment manufacturers or related equipment maintenance providers to provide timely RM in the event of hardware failure. For example, response time for making repair to hardware components that are critical to the continuity of operations, should, on average, approximate no more than four hours.

c. The auditor should determine whether the contractor has installed all vendor supplied failure detection software and that operations personnel monitor the output on a routine basis. The auditor should evaluate the PM schedules and obtain contractor verification that PM has been performed as scheduled. The contracts for RM should be evaluated on a selective basis to ensure that maintenance responses are appropriate for critical hardware components.

5-410.4 Telecommunications

a. Over the years, contractors have steadily migrated from the traditional batch processing environment to an on-line access and processing environment. Although batch processing remains an important element of most data center activity, an even greater number of jobs are being submitted through on-line access procedures. The current environment also supports significant database activity as a replacement to storage and retrieval of data from conventional sequential type data files. Database activity includes centralized database operations having many users accessing the same centralized database. It also may include distributed operations where users are accessing only their portion of the entire database which may reside at the mainframe data center or at a local node (connection point) on the network. A network is a series of points or nodes interconnected by communication paths. Networks can interconnect with other networks and contain sub-networks.

b. During an audit, the auditor may encounter various network configurations in use within the contractor's telecommunications network. Common network technologies currently employed are the Internet, Intranet, Extranet, and Ethernet:

(1) The Internet is a cooperative public network of shared information that uses a subset of the total resources of all the currently existing public telecommunications networks. It is a worldwide "network of networks" that uses the TCP/IP (Transmission Control Protocol/Internet Protocol) which is the universal protocol suite for Internet communications. TCP manages the packaging of data into packets that get routed on different paths over the Internet and reassembled at their destination. IP manages the address of each data packet so that it is routed to the right destination.

(2) An Intranet is a network that is contained within an organization and services it exclusively. It may consist of many interlinked LANs and may also be linked to other functional elements of the organization via a WAN (wide-area network). Some Intranets, depending on their configuration, may be connected to the Internet through one or more gateways.

(3) An Extranet is a collaborative network that uses Internet technology to link enterprises with their suppliers, customers, or other businesses that share common goals. An Extranet can be viewed either as an element of a firm's Intranet that is made accessible to other companies or as a collaborative Internet connection with other groups.

(4) Ethernet is the most widely installed LAN technology. It is normally comprised of a network of interconnected workstations that are sharing resources.

c. The on-line or distributed users may access mainframe and peripheral hardware located in the data center through the contractor's or a commercially available telecommunication network. The telecommunications network may be a direct connection between the users and the data center or through other communication circuits, including landlines, microwave transmitters, or dial-up connections. In general, telecommunications circuits are vulnerable to access by unauthorized users; consequently, the effectiveness of the contractor's controls and management of the network should be closely scrutinized.

d. In evaluating the various aspects of a telecommunications network, the auditor's attention should be directed at the internal controls over the financial data being passed through the network rather than at the technical aspects of how the processes take place. If necessary, technical assistance should be requested to supplement the auditor's knowledge and experience level. To adequately address the internal control issues relative to the telecommunications network, the following audit objectives should be considered:

(1) Evaluating controls over data communication messages and data communications software.

(2) Reviewing administrative procedures and the effectiveness of the configuration management and network security functions.

(3) Evaluating controls over system security software.

(4) Evaluating the adequacy of policies, procedures, and controls over electronic-mail system.

(5) Determining the adequacy of security and integrity controls over local area networks (LANs).

(6) Assessing the adequacy of network change procedures and controls.

e. The contractor should be asked to demonstrate that a network management or other designated group has the responsibility to manage and control telecommunications resources. Standards for operation of the network should be published and distributed to all designated network users. The auditor should verify with network management personnel that all sensitive data in the network have been identified and that adequate precautions have been implemented to protect this data. The network hardware and software should be secured to minimize the possibility of unauthorized access to the telecommunication network. See 5- 411 for additional information on auditing the physical and logical security requirements for protection of hardware, software, and data.

5-410.5 Uninterruptable Power Supply (UPS)

Larger contractor data centers will have UPS units installed to furnish auxiliary electrical power in the event the normal power supply is disrupted. UPS configurations can vary between a simple battery backup to facilitate orderly power down of the system, to elaborate battery and motor-generator units that provide sufficient electrical power for the system to continue full operation. The contractor should have documentation regarding UPS operation and should demonstrate that the UPS is tested on a periodic basis.

5-411 Data Processing Security

a. Information is one of the most valuable resources an organization possesses. Access to the computing resources that process this information should be limited to users having a documented and authorized need for such access. Layers of physical and logical access controls should be provided to protect the organization's computing resources against damage, loss, or unauthorized use or modification.

b. Responsibility for assuring both the logical and physical security of the IT Department assets and processed data should be assigned to a security administration function that reports to senior management. The security administrator designee should have no conflicting job responsibilities or other incompatible duties assigned which would reduce the effectiveness of the position. For example, he or she should not perform systems or applications programming functions, operate the mainframe, or perform data entry duties. Where Security Administration is a part-time function, those duties should be performed under an exclusive User ID and all activities under this User ID should be logged and regularly reviewed by an appropriate person in the IT Department. The auditor should determine whether the security administrator position has been established, is currently filled, and that effective controls are in operation.

5-411.1 Physical Security

a. Physical access controls help protect computer center resources from unauthorized modification, theft, and/or destruction. Data centers should employ these controls to limit physical access to computing resources to only individuals who have been authorized to have such access. The auditor should request a demonstration by the contractor of all physical controls to verify that established policies and procedures have been effected.

b. Facility Security - Physical access to computer resources should be restricted to personnel having an authorized need for the access. Access control can be obtained by mini-

mizing the number of entrances and exits at the site and by installing security devices requiring keys, badges, cipher codes, or other means to impede and control entry into the installation. Personnel access devices such as badges, cipher lock codes, and keys should be changed or re-coded periodically, especially when employees who have had access to the computer center are terminated. Positioning the computer center in a relatively inaccessible area helps provide physical security. External identification of the facility should be limited to avoid bringing unwanted attention to the data processing department. IT personnel should not be authorized access to all areas of the data center. For example, computer operators should be restricted from data entry areas and systems programmers should be restricted from accessing the operations area. The auditor should verify that physical security has been provided for all computing resources including CPUs, peripherals, and telecommunications hardware.

c. Personnel Authorization - A current list of personnel authorized physical access to the installation should be maintained by the security administrator. Procedures should require the notification of the IT Department when an employee is no longer authorized access to the computer facility or other related resources. These procedures should also require that authorized visitors to the computer facility be escorted while in the restricted areas. The auditor should verify that a current list of personnel authorized entry into the data center is available. Also, a list of recently terminated or transferred employees could be obtained and compared with the latest authorization list to ascertain the timeliness of the data center access revocation procedure.

d. Inventory - A current inventory of IT Department computer hardware and software should be maintained outside the facility. The inventory could help facilitate the replacement of computer processing equipment following a disaster in which the data center was damaged or destroyed.

e. Alternate Storage Facilities - Offsite storage facilities should be used to store backup copies of critical data and program files. The contractor should ensure that procedures are in effect for the identification of critical data, system, and application files, and that there is a requirement for the routine backup and transportation of these files to an offsite storage facility.

f. Environmental Protection - In addition to the usual fire and safety precautions normally installed to protect computer hardware facilities, other special equipment, devices, or methods may be employed to further help protect sensitive computer hardware. For example, fire suppression devices that use dry chemicals or gas, such as Halon, may be installed. The auditor should obtain a description of the environmental safeguards available at the site, and evaluate the applicable policies and procedures in effect to monitor their operation.

g. Monitoring - In addition to controlling physical access to the computer facility and computing resources, continuous monitoring of personnel accessing the facility and resources should be effected. A log of all visitors to the data center should be required. Contractors may have automated security systems that require the use of magnetically encoded badges to unlock doors and automatically log personnel entries and exits to the facility.

5-411.2 Logical Security

Logical controls are encoded or embedded into systems and application software with the objective of restricting or permitting access only to users who have been properly authorized such access. Examples of logical controls are User IDs, and uniquely created systems passwords.

a. Systems Software - System logical security is accomplished through the use of the security features of the operating system or through the use of commercially acquired security software. In smaller data centers, the operating system security features may be the only software security package in service. The security administrator should control access to the computer system through the assignment of unique user identification codes. The

effectiveness of the policies and procedures which address the assignment of User IDs should be reviewed. The security administrator should not assign user IDs unless specifically authorized by the appropriate management. Systems users should be required to periodically change their passwords. Procedures should require that employees, who are terminated for any reason, have their access to system resources immediately revoked. All User IDs should be re-certified on a periodic basis and system access revoked for current employees whose job duties no longer require access to system resources. The auditor should review IT policies and procedures to determine whether logical security options are identified and in use. The auditor should verify that:

(1) system access cannot be effected without a valid User ID and password
(2) password input is masked
(3) passwords contain at least six characters
(4) passwords are changed periodically

b. Application Software - User access should be restricted to those applications required to accomplish assigned duties. Application restriction is effected through operating system security or commercial security packages. Commercial security software normally invokes automated rules that restrict system users' access to certain applications or database elements. These rules are usually established for certain classes of users. For example, personnel involved in material inventory would not be permitted access to financial data or programs used by payroll personnel, and vice versa. Security system rules may be further profiled to restrict access to certain users within a class. For example, a payroll clerk may not have the same user rights as the payroll supervisor. Moreover, read only, write only, and read/write authorizations over selected datasets are possible.

c. The auditor should coordinate regional technical assistance, as necessary, to verify that contractor acquired security software have been placed in operation and that appropriate security rules have been invoked to protect all systems/application access/software processed by the data center. Contractors have been found to install expensive logical security packages and then not use the full security capabilities of the system. The overall security administration function should be evaluated for adequacy, especially at the user level where access authorization for the various application is usually effected. Where database management systems are used, a database administrator may be the authorizing agent for assigning access levels to users. The auditor should verify that security personnel who authorize/assign user access to systems, promptly revoke access when the user transfers to a function not needing the level of access authorized or is terminated.

d. Dial-Up Security - Computer systems having communications capabilities can be accessed over common communication lines. This means that the physical security that protected the computer may no longer be effective. Where the computer can be accessed through a dial-up network (the CPU has a phone number), any telephone can theoretically access the system. Once the computer is accessed from a remote location, logical security should prevent unauthorized entry. Several dial-up security techniques are used. Some dial-up security systems call a subscriber back at a predetermined number; other techniques involve synchronous and/or encrypted methodologies. The auditor should review contractor procedures involving data center dial-up activity and determine whether dial-up is properly controlled and monitored.

e. The security software in operation (i.e., commercial security software or the operating system security software) should log all system access attempts. This access logging information should be used to generate violation and security activity reports which should be monitored by the contractor to identify and resolve incidents involving unauthorized activity. The auditor should review the contractor's procedures for monitoring and resolving reports of security violations and associated activities and verify that these procedures are being followed. The auditor should also determine that the contractor's records of security violations are protected from inadvertent or intentional destruction. Repeated failed access attempts should be identified, reported by the security system, and investi-

gated by security personnel to determine the cause. This could be an indication that someone is randomly entering User IDs or passwords in attempting to gain unauthorized access to the system. The auditor should verify that User IDs that have not had activity for a reasonable period are deleted and determine whether terminated employee User IDs are revoked in a timely manner.

f. The contractor should provide employee training in logical access to computer resources. Unambiguous logical access procedures should be developed and provided to all employees accessing computer resources. The auditor should verify that the contractor is providing adequate staff training in this area.

g. Modern data centers often consist of several computer platforms (mainframes, local area networks, workstations, and individual PCs) and a variety of security software and application software. Generally, each software system has its own inherent security that must be considered in order to assess the overall security level in effect within the data center. Users can pass through several computer platforms and security software systems, and possibly access more than one data center, during a single session. It is therefore important for the auditor to determine that security controls are in place over all operating environments. Logical security systems should be in use for the mainframe and its resources. The security software should also protect the communications network. Security software should also be in use for interactive processing systems and for database management systems. The auditor should identify the security systems in use at a data center, and the interaction among them, in order to verify that the contractor's data is being adequately protected from unauthorized access.

h. Application systems that are developed by the contractor or acquired commercially should follow a sequence of migrations as part of the implementation strategy. Data are first placed in a test environment. When testing is completed, the data are migrated to an acceptance/training environment, and finally, to a production environment. Generally, there will be a separate set of users and data for each environment. For example, in a database management systems (DBMS) environment there would normally be separate operating copies of the software and data for each environment. The security should be more restrictive as the application migrates from the testing to the production environments. The auditor should determine whether the contractor has a software migration strategy which is being used, and that security access levels for each environment have been granted based on a demonstrated need.

i. In a telecommunications network environment, firewalls play an important role in ensuring that an access control policy between two networks is enforced. A firewall is a program that protects the resources of one network from users from other networks. For example, an enterprise with an Intranet that allows its employees access to the outside Internet, will want a firewall to prevent outsiders from gaining access to the enterprise’s private data resources.

5-412 Data Processing Contingency Planning

Contractor policies and procedures should contain provisions for the continuation of IT operations in the event of a disaster or failure that renders the IT center inoperable. Contingency (disaster recovery) plans should be in place for the backup and recovery of IT department services in the event of unanticipated interruptions to IT operations. Contingency planning can be critical to the resumption of operations in the event of a major hardware or software failure for whatever reason. The plan should include:

(1) identification of critical processes and data
(2) provision for an alternate-processing site
(3) off-site storage of critical backup application programs, data and contingency plans
(4) provisions for periodic testing of the plan.

The auditor should review the contractor's IT Disaster Recovery Plan to determine whether the plan reasonably addresses the actions to be taken in the event of a disaster and identifies personnel and their responsibilities in restoring data processing operations.

5-412.1 Critical Processes and Data

Contingency planning should provide for priorities in the establishment of the processing of specific critical or sensitive application programs. Critical data processing applications, operating systems, and data files need to be identified and placed on a list of priorities for the establishment of services based on the nature and extent of a likely disaster. Priority on the list should be minimally based on a reasonable expectation of elapsed time before normal data processing operations are restored, and the potential loss to the organization if the processing of the application is not restored in a timely manner.

5-412.2 Alternate Processing Site

Contingency plans should contain provisions for an alternate processing site and appropriate data processing hardware needed to restore data processing operations after a disaster occurs. The contractor should have a written agreement or contract with the alternate site specifying the procedures each party will follow in the event of a disaster. Criteria for selection of the alternate site should include:

(1) compatible computer hardware
(2) sufficient time and processing capacity
(3) periodic tests of alternate site computer hardware

The auditor should review the contractor's alternate site plans to determine whether they are current and address equipment, capacity, and timing requirements. The auditor should review contract provisions the contractor has made with alternate-site vendors and equipment providers to determine whether an adequate site and essential computing hardware will be operational within the time limits prescribed in the contingency plan.

5-412.3 Offsite Storage

Normal systems operations should include routine back up of data files, application programs, and system software. The auditor should review the contractor's procedures for storage of these files at a location that should not be affected in the event of computer center disruption and would be available for use in data processing recovery at the alternate site. The auditor should also review the contractor's procedures and actual practices for storing files offsite.

5-412.4 Contingency Plan Testing

Contingency plans should be tested periodically to determine their effectiveness. Results of the tests should be documented. Deficiencies noted during the test should be resolved in a timely manner. The auditor should review the results of the test plan to determine whether all elements were tested and that deficiencies noted during the test were satisfactorily resolved.

5-413 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-500 Section 5 --- Audit of Contractor Budget and Planning System Internal Controls

5-501 Introduction

Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk.

5-502 Budgeting and Planning Concepts

a. Budgets and plans are key managerial tools used to plan and control operations. A budget or plan identifies expected revenues to be received and resources to be expended in achieving an organization's goals during a specified future period. Budgets and plans provide a control to measure performance. In general, a budget or plan:

(1) is stated in monetary terms

(2) covers a specific period of time (generally one year for the master budget and several years for long-range plans)

(3) implies commitment (i.e., managers agree to accept responsibility for attaining budgeted objectives), and serves as a motivational tool for individuals to strive to achieve stated goals

(4) is reviewed and approved by a management level higher than the unit preparing the budget

(5) can only be changed under specified conditions

(6) is compared to actual performance, with variances being analyzed and explained

b. Budgetary and planning systems vary among companies according to organizational size and structure, type of product or service, accounting system, personal preferences of corporate officials, and other influences. Budgeting and planning systems can be manual or automated. However, in larger companies IT systems are used more extensively to collect and analyze data and prepare budgets and plans. Budgets and plans may be prepared on either a functional or organizational basis. Generally, a contractor's budgetary and planning system should have:

(1) A functional organization with defined organizational responsibilities, a written description of the workflow in the budgeting and planning process, and policies and procedures for effectively controlling the process.

(2) A strategic and long-range planning process to develop the long-term goals and objectives critical to the operation of the company.

(3) Effective techniques for preparing budgets.

(4) Procedures for comparing actual performance to the budget, identifying and analyzing variances as work is accomplished, studying the impact on remaining effort, and initiating necessary corrective action. Procedures should provide for promptly revising estimates to complete and notifying the Government of projected overruns or underruns.

(5) A replanning capability to react to significant changes in assumptions, such as a major fluctuation in the forecast volume.

5-502.1 Access to Budgets

a. Budgets, plans and forecasts meet the definitions of "records" and "data" contained in FAR 52.215-2, "Audit and Records -Negotiation," and 52.214-26, "Audit and Records -Sealed Bidding." The applicability of these FAR sections are agreed to by contractors when submitting price proposals and executing contracts with DoD components. These contract clauses give the auditor the right of access to a contractor's budgetary and planning data after contract award. (Also see 1-504, Access to Contractor Records.)

b. Recognizing that budgetary and planning data is generally considered proprietary and sensitive by contractors, sound judgment must be exercised in determining which records and data are needed. (For example, data such as pricing formulas for commercial products

may not concern the Government.) In requesting budgetary data, informal arrangements acceptable to the auditor concerning the timing and frequency of access may be established, but see 1-504.1f.

c. Budgetary and planning information generally required during the performance of the internal control audit includes:

(1) identification of all budget documents and reports;

(2) policies and procedures concerning the preparation, authorization, and approval of budgets; and

(3) all current operating budgets, plans and performance and variance analysis reports for use in testing system effectiveness.

d. When the contractor denies access to such records, follow the procedures outlined in 1-504.

5-503 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. It is DCAA's policy that contractor budgetary and planning system internal control audits be performed at least every three years at large business contractors which in their preceding fiscal year received DoD prime contracts or subcontracts of at least $50 million which required cost or pricing data. These audits are oftentimes conducted in conjunction with the estimating system audit (5-1207.3). These audits may be waived or modified if past experience and a current assessment (see 3-300) indicate low risk. This determination of low risk must be fully documented in the planning document supporting the program plan. If the audit risk is considered to be high, budgetary system audits should be performed more frequently. These audits should also be considered at smaller contractor locations where there are indications of significant budgetary system problems.

c. If the audit risk assessment indicates that only certain parts of a contractor's budgetary system are subject to high risk, only the high risk areas would require a complete audit. Areas of little or no risk need not be audited so long as the low risk determination is adequately documented.

d. FAOs with audit cognizance over corporate and/or group offices allocating substantial costs to other segments for ultimate allocation to Government contracts are responsible for performing budget audits at these offices and providing the results of the audit to the segment auditors. Auditors at segments receiving these allocations are to request such audits as needed.

5-504 Audit Objectives

a. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The primary audit objective in auditing contractor budgetary systems and data is to establish that a sound budgetary system is operating for company planning and cost control purposes. A secondary objective is to obtain a comprehensive overview of the contractor's financial planning process. Related objectives are to determine whether:

(1) Costs estimated and/or incurred for Government work are developed, recorded, and controlled on a basis consistent with management's latest, "most probable" plans.

(2) Direct and indirect efforts for Government contracts are estimated and performed efficiently and economically.

(3) Significant changes in plans and circumstances are reflected promptly through controlled and documented revisions to budgets and estimates to complete.

(4) Reports to the Government on major contracts and weapon systems are consistent with the contractor's latest budgetary data. These latter objectives should be considered for in-depth coverage during audits of forward pricing proposals and indirect rate

forecasts (Chapter 9), audits of contractor compliance with the Earned Value Management System (EVMS) criteria (11-200), and postaward audits (14-100). To ensure adequate evaluation of the system and related output, and to preclude any duplication of effort, programmed surveillance should be coordinated with the CAO EVMS monitor (11-204d).

5-505 Scope of Audit

While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105. In general, the audit scope should include:

(1) obtaining an understanding of the contractor's budgeting and planning system and related internal controls;

(2) documenting the understanding of the budgeting and planning system internal controls;

(3) testing the operational effectiveness of budgeting and planning system internal controls;

(4) assessing control risk as a basis to identify factors relevant to the design of substantive tests; and

(5) reporting on the understanding of the internal controls, assessment of control risk, and adequacy of the system for Government contracts.

5-506 Budgeting and Planning - Functional Organization

a. The budgeting and planning function may be organized differently by individual contractors because of differences in their products or services, industry practices, size and type of organization, degree of departmentalization, management attitudes, personnel capabilities, and other factors. Responsibility for developing budgets and plans may be centralized in a budgeting or planning group or delegated to the various participating departments. However, the budgeting and planning function should be soundly organized on the basis of a definitive flow of authority and standard policies and procedures established at a top or upper management level.

b. The contractor should establish clear responsibility for preparation, review, and approval of budgets and plans, to include establishing and maintaining:

(1) Written documentation of current organizational responsibilities and the duties of budgeting personnel.

(2) A system description of the work flow in the budgeting process from the development of strategic objectives to budget execution and revision.

(3) Written policies and procedures.

5-506.1 Organization

Evaluation of a contractor's budgeting and planning organization requires analysis of the relationship of the organizational segments participating in the budgeting and planning process. When evaluating the organization of the contractor's budgeting and planning process, the auditor should consider whether:

(1) Preparation of required budgets and plans is effectively controlled either on a centralized or decentralized basis.

(2) Lines of authority, duties, and responsibilities are clearly defined, including responsibilities for preparing, reviewing, and approving budgets and plans.

(3) The budgeting and planning process is properly coordinated among segments of the organization responsible for developing related parts of budgets and plans.

(4) The department responsible for overall compilation of the budgets and plans has authority to review and question the reasonableness or accuracy of feeder information received from other departments.

5-506.2 System Description

a. The contractor should maintain a written description of the work flow in the budgeting and planning process from the development of strategic objectives to budget execution and revision. This description should contain sufficient detail to allow the auditor to obtain a thorough understanding of how the budgeting and planning system operates. The description should include references to written policies, procedures, and operations manuals. Information should be provided for each process or function within the system as well as existing internal controls.

b. The contractor's system description should identify the duties of personnel responsible for preparing, reviewing, and approving budgets and plans, and the various functions contributing to the budgeting and planning process.

c. If the contractor’s system is fully or partially automated, the description should include the IT aspects of the Budget and Planning system transaction flow, including data input, data processing, and data output.

5-506.3 Policies and Procedures

a. Written policies and procedures help ensure that:

(1) delegated duties and responsibilities are formally documented and communicated to employees

(2) specific budgeting and planning controls operate consistently from period to period

(3) established budgets and plans are consistent with management's goals and objectives. A formal written statement of policies and procedures rather than an informal one based on established customs of the organization should exist at all contractor locations with substantial Government business.

b. Budgets and plans policies and procedures represent the means by which goals and objectives established by management are translated into detailed guidance and direction to personnel engaged in the budgets and planning process. Policies and procedures should cover all aspects of the budgets and planning system, be approved by an appropriate level of management, communicated to appropriate personnel, and periodically reviewed to ensure that they are consistent with management's intentions. When evaluating the contractor's policies and procedures, the auditor should consider whether they:

(1) Address all major duties and responsibilities in the budgeting and planning system. The auditor should be alert for aspects of the budgeting and planning process which are not covered by policies and procedures. Additionally, the auditor should note any instances where actual practices are inconsistent with established policies and procedures. In these instances, the auditor should consider the underlying cause for these inconsistencies (i.e., failure to adequately communicate changes in established policies and procedures).

(2) Are approved by an appropriate level of management to signify the delegation of authority and to effectively convey management's commitment to following established policies and procedures. The auditor should carefully assess the level of management approval to determine if it is appropriate given the nature of the duties and responsibilities being assigned. While not inherently indicative of poor policies and procedures, failure to involve an appropriate level of management in the approval process can result in a perceived lack of importance and ultimately a lack of compliance.

(3) Were communicated to those individuals within the organization who are responsible for executing them. This communication involves not only making sure that appropriate employees are aware of established policies and procedures but providing the necessary training to ensure that they understand how to execute them.

(4) Have been subject to periodic reviews to ensure that they are consistent with current management intentions and actual budgeting and planning practices. Failure to keep established policies and procedures current is indicative of a poor internal control environment and typically leads to ineffective internal controls over the budgeting and planning process. For this reason, management should have a systematic process in place to periodically review and update the budgeting and planning policies and procedures, including applicable IT policies and procedures. The required frequency and depth of these audits depends on the nature of the contractor's business. If the contractor is undergoing significant organizational changes or major restructuring of its business operations, the budgeting and planning system should be closely monitored to ensure that it continues to produce budgets and plans which are consistent with management's goals and objectives.

5-507 Budgeting and Planning - Strategic or Long-Range Goals

a. Strategic or long-range planning refers to the process of developing general goals and objectives for a business unit, and the broad strategies to be used to attain them. It provides general direction covering a three- to ten-year period and forms the basis from which a more detailed plan, encompassing a shorter period and generally known as the master budget, is developed.

b. The strategic plan is generally a narrative document. It affects the physical, financial, and organizational structure in which operations are carried out and addresses the direction of the company regarding new markets, market share, profit objectives, sources of new capital, and the acquisition or elimination of segments, facilities, or product lines. Based on these considerations, a plan for future operations which provides for alternative courses of action under various conditions that may arise is developed. Contractors should review these plans periodically and revise them when new information yields different conclusions.

c. Long-range plans may include forecasted financial statements, cash flow projections, and various other data. This data is sometimes in graphic form and similar to that contained in short-range budgets. A typical long-range plan contains information on predicted sales and profit trends by major product line, backlog, potential awards, new product lines, diversification plans, planned plant facilities, staffing requirements, and independent research and development plans.

d. Strategic or long-range plans of major defense contractors generally include information which significantly affects proposals and contracts for long-term Government work. They may reflect contemplated substantial increases or decreases in future work load affecting plant population (payroll costs), plant expansion (depreciation or lease costs), physical moves (relocation costs), idle or excess facilities, and bases for determining overhead rates. In addition, they may reflect possible future financial problems in periods beyond those reflected in master budgets.

e. An adequate strategic and long-range planning process will ensure that important information related to the physical, financial, and organizational structure of the organization are available for the development of effective budgets. The development of a strategic or long-range plan is the first step towards identifying and documenting how management intends to accomplish the goals and objectives of the organization. Strategic and long-range plans, while broad in nature, set the foundation for more detailed budgeting and planning decisions. When evaluating the effectiveness of the contractor's strategic and long-range planning process, the auditor should consider whether these plans:

(1) Cover all areas which impact the overall operation of the company.

(2) Are documented in sufficient detail to enable assessment of the reasonableness of the underlying assumptions.

(3) Are communicated to personnel responsible for preparing long-range plans and related budgets.

5-507.1 Scope of Planning Activities

Strategic and long-range plans should cover all areas which have an impact on Government contract pricing, costing, billing, or related reporting requirements. These areas may include such things as projected business volume, planned reorganizations, anticipated plant expansions/retirements, etc. Contractor strategic and long-range plans should cover, at a minimum, the length of current and forecasted Government contract activity to ensure that sufficient information exists to prepare related contract reporting requirements (i.e., estimates at completion) and proposals for anticipated contract awards.

5-507.2 Documentation of Plans

Strategic and long-range plans should contain sufficient documentation for the auditor to assess the reasonableness of underlying assumptions and to facilitate the communication of key information to personnel responsible for preparing related budgets. For example, contractor plans regarding future sales volume should contain sufficient detail and documentation to assess the reasonableness of the assumptions used to arrive at firm and projected Government and commercial business. While contractors are not expected to develop infallible estimates, they should be able to present evidence in support of the reasonableness of such estimates in cases where those estimates will impact the pricing, costing, billing, or related reporting on Government contracts.

5-507.3 Communication of Planning Information

Key financial and related information contained in the strategic and long-range plans should be communicated to personnel responsible for preparing related budgets. While most contractors will not routinely release their strategic or long-range plans to the general work force, they should have in place a process for releasing key information to those individuals who are responsible for preparing budgets. This communication is essential to ensuring that budgeted amounts accurately reflect management's current business plans and forecasts.

5-508 Budgeting and Planning Preparation

Budgets are detailed and comprehensive plans for the immediate budget period, normally covering one year. They are developed through the coordinated planning of all functions and activities within an organization and consist of two major elements, the operating budget and the financial budget. The entire master budget is usually distributed only to executives and top-level managers. Lower level managers usually receive only those sections for which they are responsible.

a. Operating budget. An operating budget is a forecasted net income statement consisting of several sub-budgets (e.g. sales, cost of goods sold, direct and indirect expenses) and summarizing the individual budgets of each department or function within an organization.

(1) Sales budget. The sales budget is the starting point for the entire master budget. From the sales budget, resource requirements are developed for work already under contract, new work expected during the budget period, administrative functions, and independent research and development efforts. Required resources include total staffing needs, space, capital expenditures, utility requirements, direct and indirect material needs, employee fringe benefit costs, and others.

(2) Program or production budgets. A program or production budget is part of the operating budget. It is a summary type document used to project direct and indirect resource requirements needed to meet forecasted sales volume. It typically includes a series of sub-budgets. These sub-budgets are generally for direct labor, direct material, other direct costs, and overhead. It

may also include quantity and scheduling information on parts, major assemblies, and deliverable hardware. Once quantity requirements are defined, each of the various sub-budgets is developed based upon those requirements. Program budgets are generally prepared for each accounting period by contract, program, or product line. The level of detail in a program budget varies, based on program size and contractual requirements. The estimated effort in the program budget should reconcile to similar data in the operating budget, and the overall management controls imposed by the operating budget also apply to individual program or contract costs. Automated systems used in the process should include controls which identify and report reconciliation errors. Some small tolerances may be built into the system; for example, insignificant dollar amounts or percentages. However, these should be clearly identified with controls in place to prevent changes without proper authorization.

(3) Staffing budget. The staffing budget shows staffing requirements for both direct and indirect employees.

b. Financial budget. The financial budget is a forecasted balance sheet consisting of sub-budgets, typically the capital expenditure plan and cash flow projections. A capital budget shows total planned capital asset acquisitions, each designed to contribute to the productive facilities required to support planned volume. It formalizes capital expenditure funding and is typically approved by a special appropriations committee. (See 14-600.)

c. Motivational budgeting. Some companies use a budgeting philosophy known as motivational budgeting whereby management establishes extremely tight goals and targets as a means of motivating better performance and cost reductions. When such techniques are used, they are usually reflected in the budgets of lower level managers from whom resources expected to be available are held back. Sometimes these resources are ultimately distributed. On the other hand, top management may never intend to allocate these resources to the operating managers but instead use them as a control device against which to offset unfavorable variances. By using this technique, top management establishes different goals or levels of expected performance for selected segments of its organization. Accordingly, the auditor must determine that staffing level forecasts and supporting expense projections in operating level budgets reconcile with the higher level master budget. If significant differences are found, the auditor should obtain an explanation, and assess the reasonableness of any management reserves.

d. An adequate budgeting process will ensure that budgeted amounts reflect the reasonable cost of work to be performed. The preparation of effective budgets is an essential part of any contractor cost control effort. It not only serves as a baseline for evaluating performance but also helps identify areas requiring special attention. When evaluating the effectiveness of the contractor's budget preparation process, the auditor should consider whether controls are in place to ensure that budgets are:

(1) prepared for appropriate time periods and in all areas which impact Government contracts;
(2) prepared in a timely manner;
(3) consistent with strategic and long-range plans;
(4) aggressive but attainable;
(5) approved by an appropriate level of management; and
(6) communicated to appropriate individuals within the organization.

5-508.1 Scope of Budgets

Budgets should be prepared for all major aspects of the contractor's operations which have an impact on Government contracts. The auditor should be alert for areas of the contractor's operations in which budgets are not prepared or prepared in insufficient detail to serve as a baseline for controlling costs. In addition, budgets should cover a sufficient period of time to allow for the effective management of the operations being budgeted. For example, budgets for overhead or general and administrative expenses typically cover a single operating period while program budgets or capital expenditure budgets may cover

several years. The auditor must exercise considerable care in evaluating the scope of the contractor's budgeting activities and the effect that it has on other contract audit effort, particularly contract pricing.

5-508.2 Timeliness of Budgets

Budgets should be prepared and finalized early enough in the budget cycle to maximize the amount of time individual managers have to meet the budget objectives. Failure to develop budgets early in the budget cycle can result in ineffective control over cost incurred prior to implementation of the budget. This can often create additional pressure for managers to redirect costs in an effort to meet the budget objectives. The auditor should consider whether or not the contractor establishes a formal timetable for the budget preparation process and controls the process to identified milestones.

5-508.3 Consistency with Strategic and Long-Range Plans

Budgeted amounts should reflect the goals and objectives contained in the contractor's strategic and long-range plans. Since a major purpose of budgets is to help achieve the strategic and long-range goals of the company, it is important that those objectives be considered in the budget preparation process. For example, the auditor should consider whether:

(1) strategic and long-range planning information is communicated to budgeting personnel at the beginning of the budget preparation process;

(2) budget objective guidance is prepared and distributed by individuals who are familiar with strategic and long-range goals; and

(3) budgets are reviewed for consistency with strategic and long-range objectives prior to final approval.

5-508.4 Development of Budget Amounts

Budgets that are not sufficiently aggressive may not maximize the contractor's opportunity to achieve strategic or long-range objectives. Conversely, budgets that are too aggressive increase the risk that individual managers will misallocate resources in an attempt to meet budgets, or not attempt to meet budgets they perceive as unattainable. For example, the auditor should consider whether:

(1) guidelines are established for the use of scientific/technical studies (e.g., work measurement standards), historical performance, cost/benefit analysis, accepted economic indices, and/or other objective techniques;

(2) budgets are coordinated with appropriate personnel, particularly individual managers responsible for performing within budgets, by soliciting their input, and obtaining their concurrence before finalizing budgets; and

(3) supporting data and rationale is required to be documented for use in the preparation of future budgets.

5-508.5 Management Approval

Final budgets should be reviewed and approved by an appropriate level of management. Formal requirements for management approval help ensure that management is aware of specific budgetary objectives, and evidence of management approval increases the authority of budgets by demonstrating management support for budgetary objectives. For example, the auditor should consider whether:

(1) Budgetary documents require management approval.

(2) The level of management approval for different budgets has been identified.

(3) Managers are allowed sufficient time to effectively review budgets prior to approval.

(4) Documentation standards exist for management review, adjustments, and approval to ensure that individual managers are aware of management's support for budget objectives.

5-508.6 Communication of Budget Information

Budget information should be distributed to individual managers responsible for meeting budgetary objectives and to personnel responsible for monitoring budget performance. For budgets to be effective, these individuals must have the specific information they need to perform their duties. For example, the auditor should consider whether budget formats are formalized to ensure that relevant information is distributed to the individual managers and monitoring personnel; and, a distribution list is maintained showing the appropriate budget formats and/or relevant budget information to be distributed to individual managers and monitoring personnel.

5-509 Budget Performance and Measurement

Actual performance should be periodically compared to budgeted amounts to allow for the prompt identification of variances and implementation of necessary corrective actions. Budgets are designed to serve as a baseline for comparing actual performance with established strategic or long-range goals. To effectively accomplish this, contractors should have a formal system for monitoring actual budget performance. A budgetary reporting system may provide adequate report, but the reports may not be analyzed and acted upon. Accordingly, in evaluating the effectiveness of the contractor's monitoring, the auditor should consider whether actual performance is periodically compared to budgeted amounts and that variances are identified and reported; and, necessary corrective actions are identified and implemented in a timely manner.

5-509.1 Comparison of Actual and Budgeted Amounts

Periodic comparison of actual performance and budgeted amounts increases the likelihood that budgetary objectives will be met by providing individual managers with the opportunity to take corrective actions to control potentially significant variances. To accomplish this, the contractor should have a formal system which identifies:

(1) variance analysis reporting thresholds or other criteria to define what management considers to be a reportable variance

(2) variance computation guidelines to help identify potentially significant variances

(3) standard variance report formats to facilitate monitoring of significant variances by providing consistency and comparability between reporting periods

(4) formal variance analysis reporting periods

(5) distribution of detailed variance analysis reports to individual managers subject to budgetary control

(6) distribution of summary variance analysis reports to upper management so they can monitor budget performance in relation to strategic and long-range objectives to determine if revisions to strategic or long-range plans are needed.

5-510 Budget Performance - Revisions

Budget revisions, when necessary, should be controlled to ensure that they are justified, documented, approved, and processed in a timely manner. While budget revisions are inevitable, contractors should have a formal system for submitting, reviewing and approving requests for such revisions. Failure to establish such a system can result in excessive or unnecessary budget revisions and undermine the integrity of the entire budgeting process. In evaluating the effectiveness of the contractor's budget revision process, the auditor

should consider whether procedures are in place to ensure that budget revisions are justified and necessary budget revisions are made in a timely manner.

5-510.1 Justification for Budget Revisions

Requests for budget revisions should be carefully screened to ensure that a valid reason exists for adjusting the budgeted amounts. Failure to meet budget objectives should not be considered a valid reason for making adjustments. The contractor should establish a formal decision making process to review, document, and approve all requests for budget revisions. This process should include:

(1) A formal management policy on budget revisions to ensure that corrective actions or other measures are attempted before revising budgets.

(2) Criteria for evaluating requested revisions to ensure approvals are consistent with management policy.

(3) Thresholds established to minimize requests for immaterial revisions.

(4) Provisions for upper management to initiate budget revisions based on changes in strategic or long-range plans.

(5) Criteria for reviewing and approving requests for budget revisions that maintain the same level of control as those established for preparation of initial budgets.

5-510.2 Timely Implementation of Budget Revisions

Timely review and approval of budget revisions increases the likelihood that revised budgetary objectives will be met by maintaining the integrity (reasonableness/attainability) of the budget and by providing individual managers as much time as possible to achieve the revised objectives. For example, the auditor should consider whether:

(1) corrective actions are monitored to identify when budget revisions may be necessary.

(2) there is periodic communication between the budget department (or other organizational element responsible for reviewing and approving budget revisions) and individual managers to identify the need for budget revisions as soon as possible.

(3) standardized request formats and procedures are used to expedite processing of requests for budget revisions.

5-511 Budgeting and Planning System - Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls or IT application controls. Whether the control activities are classified by the auditor as general or applications controls, the objectives of control activities remain the same:

(1) to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition, and

(2) that financial and cost records are sufficiently reliable to permit the preparation of financial statements and cost representations.

b. The auditor should audit the IT general controls and the Budgeting System application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are comprised of:

(1) organization and operational controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and

(4) data and procedural controls.

(See 5-400 for a more detailed explanation of general internal controls.)

d. Budget System application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as labor, compensation, and in this instance, budgeting. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-512 Reporting Audit Results

a. The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

b. Conduct an exit conference in accordance with 4-304. Include the contractor's reactions in the working papers and the report.

c. If deficiencies have been disclosed and/or recommendations are presented in the report, schedule a follow-up audit to be performed within a reasonable period of time.

5-600 Section 6 --- Audit of Purchasing System Internal Controls

5-601 Introduction

a. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk.

b. This section presents guidance for auditing a contractor's internal controls of both a manual and automated nature over purchasing and subcontracting. The guidelines relate to the assessment of control risk based on an audit of the contractor's policies, procedures, and internal controls. Guidance on audits of other components affecting incurred material cost is in 5-700.

5-602 Background Information

a. The purchasing and subcontracting function includes make or buy decisions, the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administering of orders, and expediting delivery of materials.

b. Purchasing systems vary among companies according to organizational size and structure, IT capabilities, accounting system, personal preferences of corporate officials, and other influences. In general, the critical control objectives a contractor's purchasing system should have include:

(1) Internal audits or management audits, training, and policies and procedures for the purchasing department to ensure the integrity of the purchasing system.

(2) Policies and procedures to assure purchase orders and subcontracts contain all flow down clauses, including terms and conditions required by the prime contract, as well as any clauses needed to carry out the requirements of the prime contract.

(3) An organizational and administrative structure that ensures effective and efficient procurement of required quality materials and parts at the most economical cost from responsible/reliable sources.

(4) Selection processes to ensure the most responsive and responsible sources for furnishing required quality parts and materials and to promote competitive sourcing among dependable suppliers so that purchases are reasonably priced and from sources that meet contractor quality requirements.

(5) Price or cost analysis performed with every purchasing action.

(6) Procedures to ensure that proper types of subcontracts are selected and that there are controls including oversight and surveillance of subcontracted effort.

5-603 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the evaluation of contractor accounting and management systems and related internal controls.

b. The administrative contracting officer (ACO) is responsible for reviewing the contractor's purchasing systems. FAR 44.302(a) says, among other criteria, that if a contractor’s sales to the government (excluding competitively awarded FFP contracts, competitively awarded fixed price contracts with economic price adjustment, and sales of commercial items pursuant to FAR Part 12) are expected to exceed $25 million during the next 12 months, perform a review to determine if a CPSR is needed (generally – ACO can raise or lower the $25 million in the best interests of the Government. FAR 44-302(b) says once an initial determination has been made, at least every three years the ACO shall determine whether a purchasing system review is necessary. If it is necessary, the cognizant contract administration office will perform the review of the purchasing system. In accordance with DFARS 244.301, members of other organizations, such as audit or program management activities, should not conduct separate reviews of these contractors, but may

participate in a review conducted for the ACO by the DCMA CPSR team. These organizations may, if they suspect a problem, recommend that the ACO initiate a special review.

c. DCAA's audit objective is the adequacy of the internal controls over the system and the contractor's monitoring of compliance with its controls. The DCMA CPSR team normally covers many DCAA concerns regarding internal control objectives but not always all of them. The ACO, in consultation with the CPSR team leader, local management council, and PCO, conducts two sets of risk assessments. The first risk assessment will determine which contractors will require an on-site CPSR. Risk, as used in this context, means the Government's financial, quality, and delivery exposure posed by contractor operations. Having decided that a review is necessary, the team leader, in conjunction with the customer (ACO, PCO, and other cognizant Government personnel), will conduct a second risk assessment to determine the depth and scope of the review to be made. In most cases, an initial review should constitute a complete appraisal of the contractor's purchasing system. Later reviews may, if considered appropriate, constitute a complete appraisal of the contractor's purchasing system or be limited to those areas that the customer and the team leader determine necessary for adequate system analysis. Therefore, it is extremely important that prior to commencing any audit of the contractor's purchasing system, the auditor coordinate with the contracting officer (see 5-1300 and FAR Part 44 for discussion of DCAA's participation on joint CPSR reviews).

d. If a CPSR is planned, the DCAA auditor should be a member of the CPSR team and the scope of the review should be discussed. There should be mutual agreement in the planning stage on what additional audit steps will be necessary to address any DCAA concerns. During the CPSR, it is not the auditor's responsibility to review the quality of the CPSR team's work. However, the auditor should understand the scope of the work being performed in order to assess whether additional steps are required to satisfy any DCAA concerns. The auditor will make maximum use of the work performed and the conclusions reached during these reviews in establishing the extent of any separate coverage and audit tests to be undertaken in this area (see Appendix D-300).

e. At major contractor locations, DCAA will continue to share its annual program plans with the cognizant ACO, including the need for evaluations of purchasing system internal controls. When discussing the annual program plan with the ACO, FAOs should inquire whether a CPSR has recently been performed, and if DCMA has planned a CPSR at the contractor location during the period covered by the program plan. Where DCMA has planned a CPSR, but the scheduled CPSR does not coincide with DCAA's cycle for evaluating purchasing system internal controls, the FAO should, to the extent possible, adjust its schedule to perform the internal control evaluation as part of a joint DCMA/DCAA CPSR.

f. If a CPSR has not recently been performed, and if there is no CPSR scheduled within the normal DCAA cycle for accounting or management system audits (see 5-103), but the FAO believes a purchasing system internal control audit is required based on risk, the FAO should discuss those concerns with the cognizant ACO.

(1) Where the ACO agrees with DCAA concerns, the auditor should perform a purchasing system internal control audit (not CPSR) in accordance with guidance set forth in the following paragraphs.

(2) Where agreement is not reached with the ACO, and the FAO believes that the Government is at risk, these concerns should be elevated to the regional office prior to any audit effort. The regional office should determine whether the FAO purchasing system internal control audit is warranted and coordinate with the local and District DCMA management in gaining support for a joint DCMA/DCAA CPSR, or individual audit of internal controls. If the regional office is unable to resolve the issue, the concerns should be elevated to DCAA Headquarters (Attn: PPD). FAOs should document their coordination with the ACO with respect to CPSRs and purchasing system internal control audits, and retain the documentation in their permanent files.

(3) There may be instances where the FAO is aware of significant contract costing and administration risks that require immediate consideration and reporting. Based on audit judgment and the existence of significant risk (materiality and sensitivity) FAOs should follow the flash reporting procedures at 5-110c(2) and 5-111.4. The flash report should be followed-up in an appropriately-scoped purchasing system internal control audit, where ACO coordination is simultaneous, but where audit activity is not delayed. The need for expediency to protect the Government's interest may thus require the FAO to readily elevate the significant issues through the flash reporting process, and not wait for the ACO to decide to incorporate our immediate concerns into a future CPSR. Under these circumstances, however, FAOs should continue to coordinate on the annual CPSR plan.

g. In order to enhance coordination of the DCMA annual CPSR plan and the DCAA purchasing system internal control plan, DCMA has agreed to have its purchasing analysts provide their annual CPSR plan to the cognizant DCAA FAOs. (DCMA normally develops its annual plans in the 3rd quarter of each Government fiscal year, which coincides with DCAA's planning cycle.) This will facilitate the inclusion of effort to support DCMA CPSRs in the FAO program plan. If FAOs have instances where DCMA's annual CPSR plans are not being shared, those instances should be elevated through regional channels for discussion with the DCMA District Office, and, if needed, to DCAA Headquarters (Attn: PPD) for coordination with DCMA Headquarters.

h. To improve coordination and planning of CPSRs, DCMA has committed to meet with the cognizant DCAA office a month before the scheduled CPSR when appropriate, to discuss the scope of the CPSR. This meeting, which may occur in person or via teleconference, will provide the auditor an opportunity to share the DCAA audit program for purchasing system internal controls with the DCMA purchasing analyst, discuss other relevant audits the FAO has performed (e.g., evaluations of estimating system and material management and accounting system internal controls), and discuss any other concerns DCAA may have relative to the contractor's purchasing system. This enhanced coordination will facilitate the planning of a CPSR that will address the concerns of both organizations, leverage the resources of both organizations, and preclude duplicative effort. FAOs should adequately document this coordination in the audit working papers.

i. Purchasing system audits should also be considered at smaller contractor locations where there are indications of significant purchasing system problems. Such audits may be performed in conjunction with estimating system surveys (see 5-1200).

5-604 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the purchasing system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The primary objective in auditing a contractor's purchasing system is to obtain a sufficient understanding to plan related contract audit effort. This requires that the auditor assess the adequacy of the contractor's purchasing policies and procedures, whether they have been implemented, and if they are working effectively.

5-605 Audit Scope - Purchasing Controls

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The extent of audit effort should be influenced by:

(1) reviews by other agencies (CPSRs);

(2) the types of Government contracts and their materiality;

(3) the adequacy of the contractor's policies, procedures, and internal structure on other major systems;

(4) the results of prior reviews;
(5) deficiencies noted in ongoing audits (audit leads);
(6) the extent and results of contractor self assessment reviews;
(7) the extent of automation; and
(8) contract provisions.

General information regarding these scope areas is provided in 3-104 and additional considerations specific to the purchasing system are discussed below. Working papers will include a risk assessment documenting the impact of the above eight areas on audit scope.

c. The majority of non-labor expenses may flow through the accounts payable system. Therefore, the auditor should perform a risk assessment and based on materiality and sensitivity, consider performing an audit of the contractor's accounts payable system internal controls as a subsystem of the purchasing system. If this audit is performed, consider steps set forth in 5-612.

5-606 Compliance Audits, Training, and Policies and Procedures

The contractor should have policies and procedures for monitoring its purchasing systems, training its employees, and ensuring the integrity of the purchasing system.

5-606.1 Compliance Audits

Systems with weak or nonexistent internal control structures only increase the risk of cost mischarging or misallocation. The existence of strong self-controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should conduct regular internal compliance audits. These compliance audits should address the following areas: the adequacy of written procedures, employee knowledge and compliance with policies and procedures, consistency with which the policies and procedures are applied and by whom, and timely follow-up action on deficiencies.

a. Types of Audits. The contractor may perform internal compliance audits using auditors or nonauditors, rely on monitoring in the form of physical observation, rely on system audits or exception reports, request external audits, or use a combination of techniques.

The contractor may have several functions performing the audits. The contractor may also have various performance criteria and reporting requirements to upper management which relate to the timeliness and effectiveness of the purchasing function. For example, excessive number of days to process requisitions, work stoppages resulting from delays in receiving material, how many orders are issued per day per buyer, etc.

b. Adequacy of Procedures. Whatever the form of the audits, there should be procedures which identify the intervals of performance of the reviews, the personnel responsible for performance of the review, the areas to be covered during the reviews, documentary evidence that the review has been performed, and the requirements for follow-up action. The procedures should address coverage of the following areas: review of the adequacy and consistency of application of the written procedures by buyers, IT interface with the purchasing system, employee knowledge and compliance with these written procedures, and responsiveness to required corrective actions. Policies and procedures should assure that purchasing personnel are complying with applicable public laws and implementing Government regulations, (e.g. Truth in Negotiations).

c. Adequacy of Reviews. The adequacy of the reviews should be assessed in accordance with the criteria in 4-1000. The reviews should be performed in accordance with written procedures and by personnel possessing a level of competence, independence, and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor's risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, lack of employee knowledge or compliance with the written procedures, the adequacy of the contractor's ethics program, and untimely follow-up actions.

d. Policies and procedures should support a system that provides for tracking responses to and resolution of required corrective actions in a timely manner. The auditor should determine whether the corrective actions are:

(1) communicated to the management level responsible for action,
(2) monitored for timely resolution, and
(3) documented and verified.

5-606.2 Training

Training of Employees. A well trained staff results in current, accurate, effective, and efficient purchases. Contractor personnel need to be specially trained in Government purchasing regulations, contract clauses, and contractor procedures. Additionally, purchasing department personnel should have sufficient supplier and technical knowledge to make it unnecessary to depend wholly on engineers and other technicians to dictate the source of supply or price. Therefore, the contractor should have standards for the qualification, training, and experience of its purchasing personnel.

a. Types of Training. The contractor may require that personnel responsible for various types of procurement have special qualifications prior to their being hired. The contractor may provide opportunities for personnel to take outside educational courses or provide internal courses. The contractor may also provide detailed on-the-job training and/or detailed desk procedures.

b. Adequacy of Training Procedures. Procedures should identify the minimum required course topics, the frequency of the training, and the criteria for documentation of completion. If specific procedures are not available, the auditor should have the contractor identify its practice in the above areas for later verification with employees. The procedures should require the training program be updated to cover current Government rules and regulations and adjusted to comply with revisions to the contractor's system. These areas may be covered under more than one training class and some may be covered by memorandums, bulletins, or pamphlets.

c. Adequacy of Training Topics. Training programs may include:

(1) an overview of the contractor's accounting system;
(2) an overview of written purchasing policies and procedures;
(3) purchasing file requirements and standard forms;
(4) instructions on required contract clauses (such as those in 5-607);
(5) ethics procedures (conflict of interest, gifts, gratuities and anti-kickbacks);
(6) a description on the review and approval process; and
(7) information on penalties associated with the statutes on false claims and false statements.

5-606.3 Policies and Procedures

Written policies and procedures that encompass the purchasing operation help ensure that;

(1) delegated duties and responsibilities are formally documented and communicated to employees,
(2) specific controls operate consistently from period to period,
(3) established purchasing practices are consistent with management's goals and objectives, and
(4) are based on authorized requirements.

A formal written statement of policies and procedures rather than an informal one based on established customs of the organization should exist at all contractor locations with substantial Government business. When evaluating the contractor's policies and procedures, the auditor should consider whether they:

a. Address all major duties and responsibilities in the purchasing system. They should be comprehensive and easily understood in order to minimize the risk of errors arising from causes such as misunderstood instructions, and mistakes in judgment. The auditor should be alert for aspects of the purchasing system process which are not covered by policies and procedures. Additionally, the auditor should note any instances where actual practices are inconsistent with established policies and procedures. In these instances, the auditor should consider the underlying cause for these inconsistencies (e.g., failure to adequately communicate changes in established policies and procedures).

b. Are approved by an appropriate level of management to signify the delegation of authority and to effectively convey management's commitment to adhering to established policies and procedures, and complying with FAR and other applicable regulations. The auditor should carefully assess the level of management approval to determine if it is appropriate given the nature of the duties and responsibilities being assigned. While not inherently indicative of poor policies and procedures, failure to involve an appropriate level of management in the approval process can result in a perceived lack of importance and ultimately a lack of compliance.

c. Were communicated to those individuals within the organization who are responsible for executing them. This communication involves not only making sure that appropriate employees are aware of established policies and procedures, but also providing the necessary training to ensure that they understand how to interpret and execute them.

5-607 Purchasing System -- Contract Clause Flow Down

The contractor should have policies and procedures to ensure that all applicable purchase orders and subcontracts contain all flow down clauses, including terms and conditions and any other clauses needed to carry out the requirements of the prime contract. Purchasing personnel must be aware of the distinction between general or standard contract provisions, and those which are special (used only when warranted). Manual or computerized forms may be used with desk procedures or help menus that explain the criteria used to designate which clauses are special. A legal specialist may assist the CPSR team in performing the clause review.

5-608 Purchasing Management and Administration (Make or Buy)

The contractor should organize and administer the purchasing department to ensure the effective and efficient procurement of required quality materials and parts at the most economical cost from responsible/reliable sources

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5-608.1 Organizational Independence

The purchasing department should have an organizational plan which establishes clear lines of authority and responsibility. Items to consider include:

(1) The purchasing department is independent of other departments and is responsible for procuring all materials, supplies, services, and equipment.

(2) The receiving function is performed by personnel independent of the buying function (6-311).

(3) All purchasing department personnel should understand their assigned responsibilities, authority, and limitations.

(4) There should be procedures delegating who has the authority to make commitments and to question quality and quantity of material requisitioned or received.

5-608.2 Administrative Controls

In addition to controls related to Source Selection (5-609), Pricing/Cost Analysis and Negotiation (5-610), and Subcontract Award and Administration (5-611), management should have the following controls in place over placement and administration of purchase orders:

a. Purchase orders are based on authorized requisitions (6-308). The requisitions should indicate the specific contract, project, department, or account (i.e., cost objective) to which the materials or services will be charged.

b. Effective numerical document controls or status registers are maintained to record the receipt of purchase requisitions and the actions taken to accomplish the purchase.

c. The purchasing department notifies originators of purchase requisitions and other personnel concerned with the receipt of requisitions, the result of purchase actions, and other pertinent matters affecting the purchase.

d. The purchasing department has adequate controls to prevent the unauthorized use of canceled or voided purchase requisitions.

e. Purchase orders are prenumbered and all numbers are accounted for.

f. Purchase orders are specific and complete as to nomenclature, specification, delivery dates, freight, discounts, price, and clauses of any type required by the terms of the prime contract.

g. Copies of purchase orders are furnished when issued to the receiving and accounts payable functions and when appropriate to the expediting department.

h. Procedures preclude issuing numerous purchase orders for small amounts.

i. The purchasing department maintains specifications for all materials and services used by the contractor.

j. Procedures require complete history files for items purchased frequently and for all major procurements.

k. The contractor develops alternate sources when possible.

l. The purchasing department maintains and uses, as a means of effecting economies, price history data and a current copy of a priced bill of materials to ensure that:

(1) Material specifications recorded on the requisitions and purchase orders match the specifications on the bill of materials;

(2) Possible economies for ordering required material, recognizing the total needs as reflected in the bill of materials and the stock level requirements, are considered (6-308);

(3) Nonrecurring tooling/setup, and similar type charges are not paid twice; and

(4) The price agreed to at the time of purchase is comparable to the price projected in the bill of materials, or that price increases (see 5-610) are fully explained.

m. The contractor has written policies explaining what types of activity are prohibited by purchasing agents (e.g., acceptance of kickbacks).

5-608.3 Purchasing File Data

Purchasing and subcontracting files must be adequately documented so as to provide a complete and accurate history of purchase transactions to support the vendor selected and the price paid. If documentation is not available (i.e., certificate of current cost or pricing data), request an explanation.

Case Files. The contractor should maintain a case file of all pertinent actions affecting each contract and subcontract. In evaluating the adequacy of purchasing files, determine whether the files include:

a. Copies of the purchase order and requisition, invitations to bid (or requests for proposal), responses to solicitations, resulting subcontracts, and any subcontract changes.

b. Bid tabulations that summarize and compare vendor quotations.

c. Vendor surveys of production and financial capabilities.

d. Certificates for the rent/rent-free use of Government facilities.

e. As applicable, price and cost analysis to assess reasonableness of the proposed price. A certificate of Current Cost or Pricing Data (FAR 15.406-2) when required in FAR 52.215-12.

f. Evidence of evaluation and actions taken by the contractor to ensure:

(1) that the subcontractor has complied with the requirements to submit accurate, complete, and current cost or pricing data as required by FAR 52.215-12; and

(2) that where prices are based on "adequate price competition" or "catalog or market prices," these terms are verified to have meaning as defined by FAR 15.403-1.

g. Records of any negotiations conducted, including justification for the selection of the successful bidder, basis for selection of contract type, and evidence that the contractor used the results of its examination of the subcontractor's proposal in the negotiations.

h. Copies of technical data.

i. Price redetermination or termination data.

j. Correspondence between the purchasing department and the bidders.

k. Evidence of Small and Disadvantaged Business enterprise considerations.

l. Information concerning the use of special terms and conditions and approval thereof.

m. Written approvals or determinations of the contractor's reviewing authorities.

n. Administrative Contracting Officer approval of purchase orders when required.

5-608.4 Make or Buy Program

a. The contractor should have make or buy policies and procedures. The contractor's make or buy decisions determine which components, assemblies, subassemblies, or parts are to be manufactured and which are to be purchased. The contractor's decision to manufacture in lieu of purchase may be in the best interests of the company, but not in the best interests of the Government. When a contractor decides to manufacture a part or component not normally within its experience or production capabilities or which had been purchased in the past, the basis for that decision and the resulting cost impact should be reviewed. For example, the contractor may desire to gain experience in a particular manufacturing or fabricating process. Another consideration which may influence a contractor's make or buy decisions involves the extent of available idle facilities. FAR 15.407-2 requires contractors to develop make or buy programs for certain contracts based on a dollar threshold.

b. As a minimum, consider internal controls related to the following when evaluating make or buy policies and procedures:

(1) Determine whether the contractor has a formal make or buy committee, organization, or function.

(2) If a function has been established, ascertain the basis for assigning personnel to the function. Usually, the function is composed of representatives from various departments, including purchasing.

(3) Evaluate the contractor's established make or buy policies and procedures for propriety and acceptability. If the contractor deviates from the established policies and procedures for individual actions, evaluate the basis for deviation.

(4) Evaluate the basis for specific make or buy decisions to determine whether the contractor's policies and procedures are reasonable and effectively implemented.

(5) Determine whether procedures are in effect which provide for the prompt notification to the contracting officer of changes in make or buy decisions.

(6) The guidance in 14-600 for capital investments is equally applicable in the evaluation of make or buy determinations.

5-608.5 System Reporting

There should be a system of reports and controls that reflects performance and provides the means through which the purchasing organization reports its performance to company management. For example, the contractor may have a status report reflecting the number of days to furnish supplier quotes and negotiated price data for use in proposal preparation, aging of requisitions, number of purchase orders issued per buyer, on time deliveries, etc.

5-609 Purchasing Source Selections

There should be procedures to provide for the selection of the most responsible and reliable sources for furnishing required quality parts and materials. These procedures should also promote competitive sourcing among dependable suppliers in order to obtain the most reasonable prices from sources that meet contractor quality requirements.

5-609.1 Competitive Sourcing

In order to ensure acquisition of the least expensive material consistent with contract specifications, the contractor's procedures should provide for bid solicitations from a sufficient number of prospective sources to promote effective competition commensurate with the nature and dollar value of the purchase action. In accordance with FAR 52.244-5(a), the contractor should use competition to the maximum extent practical.

a. Management should promote competitive sourcing by:

(1) requiring regular reports on competitive buying which in addition to identifying the number of competitive bids would also identify suspect situations where the lowest bidder may always be the same and always slightly under the next lowest;

(2) providing historical part number and vendor data bases; and

(3) performing marketing surveys to determine alternative sources.

b. Bidders Lists. The purchasing department should maintain bidders lists or other appropriate reference files of potential vendors who may be solicited for the various items of supply and service required for company operations. These lists aid in locating supply sources and in soliciting competitive bids. The contractor's files should reflect the financial responsibility, technical capability, and history of past performance of suppliers, particularly those from which the contractor has purchased items on a noncompetitive basis. An evaluation of this area should determine if bidders lists are maintained on a current basis to ensure maximum usefulness.

c. Purchasing Bid Procedures. The auditor's review of purchasing procedures should determine whether:

(1) Bid solicitation procedures provide that:

(a) all quotations for major procurements are in writing;

(b) each prospective supplier is furnished complete sets of specifications for the item or service to be procured, and sufficient lead time is allowed for the preparation of the proposal;

(c) the purchasing office establishes case files reflecting a ready record of all actions; and

(d) all Government directives are reviewed for special considerations concerning small business and labor surplus areas.

(2) Procedures provide for sufficient justification for awarding intracompany purchases or work orders. Files are reviewed independently within the company for any evidence of "bid-matching" on orders issued to affiliates, subsidiaries, or other divisions. In "bid-matching" the buyer waits until outside bidders respond and then informs the "inside" company of the low bid (see 6-313).

(3) Procedures provide for justification when the low bidder is not selected.

(4) Procedures ensure that debarred or suspended contractors are excluded from receiving contracts, unless the acquiring agency's head or a designee determines that there is a compelling reason for such action, as explained in FAR 9.405-2, 9.406-1(c), and 9.407-1(d). An important criterion in determining the propriety and allowability of payments for material purchases or subcontracts is the "consent" requirement of specific contracts. FAR 52.244-2 and 52.244.4 are the pertinent solicitation provisions and contract clauses which, if included in a contract, delineate the "consent" requirements by types and categories of contracts. If by the terms of the contract, prior consent is required of the ACO in subcontracting/purchasing, the ACO is prohibited from consenting to award to a debarred contractor. "Consent" here means to consent to contract with a particular entity or person; not consent to make a purchase. If prior consent is not required or if it is required for approval to make purchases only, a prime contractor is free to solicit from any sources available, including debarred, suspended, or ineligible contractors.

5-609.2 Vendor Performance Evaluation

The contractor should use a vendor evaluation system when selecting sources. The system should provide for the review of price, quality, delivery, technical capabilities, financial capabilities, and service. The contractor should document vendor evaluations on each buy or have a vendor rating system. If the contractor has a rating system, the system should allow for consistency of comparisons among competing subcontractors, protect rating information, provide documentation for each element rated, allow opportunity for new subcontractors to compete, provide for evaluation by functional areas and be kept current and accurate.

5-609.3 Sole/Single Source

Contractor policies should view each single or sole-source purchase as an exception. The policies and procedures should require justification, cost/price analysis, if applicable, and approval by a responsible company official. Factors to be considered when evaluating purchases involving noncompetitive items, which could affect the evaluation of the purchasing procedures, are whether

(a) the vendor was designated by the contracting officer who awarded the prime contract and

(b) the purchase, if made from a sole source supplier, was approved by a responsible company official.

5-610 Pricing/Cost Analysis and Negotiated Purchases

The contractor ensures that some form of price or cost analysis is performed in connection with every purchasing action.

5-610.1 Cost/Price Analysis and Technical Evaluation

a. The contractor should perform cost/price analysis and technical evaluation of its subcontractor's and supplier's proposals/quotations. The scope and conclusions of the analysis should be documented and included in the purchase order file. The contractor should obtain a certificate of current cost and pricing data when applicable.

b. Buyers should document the purchase order file to explain price increases (over previous buys or over bill of material estimates) and lack of decreases in price when circumstances indicate that the price should be lower (when quantity is increased over a previous buy or vendor quote, or when learning or other factors indicate lesser costs than in a previous buy).

5-610.2 Negotiation

The auditor's review of purchasing procedures should determine whether:

a. Buyers are required to negotiate separate price breakdowns for significant elements of the purchase (such as for facilities, tooling, engineering, setup, testing, and special packaging) to allow separate cost control of these significant elements.

b. Prices are established at the time the order is placed for goods manufactured to order, rather than on an "advise price" basis.

c. Procedures require sufficient evidence of negotiation when it is necessary to establish a reasonable price because the item is nonstandard or an insufficient number of bids have been received.

d. Awards have been made to other than the low bidder on the basis of delivery. If so, the purchase order should provide for a downward price adjustment if delivery schedules are not met.

e. The contractor's procedures provide for the timely implementation of repricing clauses included in subcontracts or purchase orders. The contractor's repricing procedures should require that the:

(1) revised contract prices are negotiated or arrived at as provided by contractual requirements;

(2) cost or pricing data which was used as the basis for repricing is current, accurate, and complete; and

(3) results of the repricing action are in the best interests of the Government.

5-610.3 Purchase Discounts, Quantity and Payment

The contractor is responsible for having a system in place for seeking and taking advantage of cash discounts, trade discounts, quantity discounts, rebates, and freight allowances. The contractor should combine requirements where appropriate. Usually this is part of the requirements system (6-308) at larger contractors. Additionally, contractors may have a corporate purchasing system to provide volume discount advantages for the whole company. The contractor should have a methodology for handling high volume, low value orders, such as subcontracting with distributors, competing long term blanket orders (FAR 13.2) or opened ended subcontracts.

5-611 Subcontract Award and Administration

The contractor ensures the proper types of contracts are selected and that there are controls including oversight and surveillance of subcontracted effort.

5-611.1 Types of Contracts

a. The contractor should have policies and procedures in place for determining the types of subcontracts to be awarded and under what circumstances they are to be awarded. FAR 16.1 can be used as a guideline when evaluating the contractor's policies and procedures.

b. Unallowable Procurement. Determine whether the contractor's procedures prohibit the issuance of cost-plus-a-percentage-of-cost subcontracts (FAR 44.203(b)(2). Under this type of procurement, the subcontractor would receive payment for, and the prime contractor would pass on to the Government as cost of its contract, the costs incurred in performing the contract, plus a specified percentage of such costs as a profit or fee. Thus, the fee would increase in direct proportion to any increase in cost.

5-611.2 Subcontract Surveillance

Administration of Subcontracts. Advantages gained by prudent and capable efforts in planning and negotiating subcontracts can be dissipated through the failure of upper-tier contractors to administer subcontracts properly. Upper-tier contractors must be aware of the progress of the subcontracts to ensure timely delivery of an acceptable product. When the subcontract is other than firm-fixed-price, the upper-tier contractor must also maintain surveillance over subcontract costs to keep current with the financial aspects of the upper-tier contract. The cognizant auditor should review and evaluate the upper-tier contractor's policies and practices pertaining to the administrative and technical controls exercised over delivery schedules, change orders, modification notices, and overall costs. The contractor should have a policy and procedures for alerting the Government on award of all auditable subcontracts (those requiring interim and final audits) and a method for notifying the Government of potential significant sub contract problems that may impact delivery, quality, or price.

a. In evaluating the upper-tier contractor's procedures for controlling delivery schedules, determine whether:

(1) some form of register or control is maintained to "flag" delivery due dates;

(2) procedures are in effect to expedite delivery of subcontract material, particularly when it is apparent that the supplier will not meet the established delivery date, or is in fact delinquent; and

(3) corrective action is taken when the supplier is delinquent in delivery schedules including, where appropriate, adjustment of the purchase price.

b. In evaluating the upper-tier contractor's procedures for controlling change orders and modification notices, determine:

(1) if the upper-tier contractor evaluates the delivery schedules when engineering changes have been introduced;

(2) the timeliness of notification from the upper-tier contractor to subcontractors when modifications are introduced into production; and

(3) the adequacy of the action taken by upper-tier contractors when change orders or modification notices affect cost.

c. The evaluation of the upper-tier contractor's procedures relative to cost controls should be directed to the:

(1) production and financial controls, with emphasis on those controls which ensure that physical progress of production is commensurate with reimbursement;

(2) timeliness and adequacy of the repricing action when production is performed under redeterminable subcontracts (including a determination of the timeliness of recoveries resulting from downward repricing actions);

(3) propriety of the costs generated by the subcontractor, particularly when the upper-tier contractor is also a subcontractor to the same or a lower-tier subcontractor; and,

(4) audit of progress payments (refer to 5-1107.7 billing system audit of subcontractor progress payments).

d. In evaluating the upper-tier contractor's procedures for adequate documentation, determine whether contractor representatives are required to prepare trip reports covering each visit to a subcontractor. Procedures should require timely reporting of significant and relevant issues including additional funding actions and status of physical progress in relation to costs incurred. Subcontractor financial reports should be adequately supported by trip report documentation.

e. Subcontract Changes. Procedures should be in place to document and justify the reasons for subcontract changes which affect cost or price. The Government is at risk when the cost of the subcontract, before the change, has exceeded or is expected to exceed original estimates. Lack of adequate procedures could result in changes which have been overpriced to avoid an overall loss or to provide total profit or fee in accordance with original contract estimates.

f. Audit of Subcontracts. Timely consideration of redeterminable, incentive, and cost-type subcontracts is essential to the audit of upper-tier contracts. The Government's interest in these types of subcontracts is similar to its interests in costs of variable-price prime contracts when the subcontract awards are made in a chain unbroken by a firm-fixed-price subcontract. When the upper-tier contractor proposes to audit records of a subcontractor, evaluate:

(1) the procedures which address the extent of coordination between the contractor's purchasing and audit function;

(2) criteria established by the contractor for waiving audits;

(3) established procedures for ensuring that the Government is notified when access to subcontractor records is denied the upper-tier contractor (6-800);

(4) independence and qualifications of the contractor's auditors; and

(5) adequacy of their audit programs and working papers (see also 4-1000). Procedures should ensure that adequate controls are maintained for early identification of auditable subcontracts (see 6-802).

5-612 Purchasing System - Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls and IT application controls. Whether the control activities are classified by the auditor as general or applications controls, the objectives of control activities remain the same: to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should review the IT general controls and the Purchasing System application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are composed of:

(1) organization and operation controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and

(4) data and procedural controls. (See 5-400 for a more detailed explanation of general internal controls.)

d. Purchasing system application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as labor distribution, inventory control, and in this instance, purchasing. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-613 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

5-700 Section 7 --- Audit of Material Management and Accounting System Internal Controls -- Standards 1 Through 10

5-701 Introduction

a. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk.

b. This section provides audit guidance for evaluating the contractor's internal controls for material accounting (5-100) and compliance with DFARS 252.242-7004, Contractor Material Management and Accounting Systems (MMAS). If a contractor does not have contracts that include DFARS 252.242-7004, this audit guidance can be used to determine if the contractor's MMAS meets CAS and FAR requirements.

5-702 Background Information

MMAS can range from highly automated to manual systems. The requirements of DFARS 242.72 apply equally to automated or manual systems. MMAS are normally comprised of a material requirements planning (MRP) system and material accounting systems. For background information, MRP systems are briefly discussed, as follows:

a. Many contractors have an automated system for determining requirements. A material requirements planning (MRP) system is a system for identifying requirements, initiating procurement, and maintaining current and future materials necessary to support production operations. Hence, MRP is a method of inventory control, not inventory costing. However, an MRP system does initiate inventory transactions and provides information used for costing those transactions. It takes into account the specific timing of material requirements, with the objective of minimizing inventory investment consistent with meeting a given production plan. An effective MRP system will result in having the optimum amount of material available for planned production. Consequently, a contractor's investment in inventories is minimized.

b. MRP system configurations can vary depending upon needs. However, the following features are common to all designs:

(1) Highly Automated Systems. Extensive use of information technology (IT) enables MRP systems to react instantly to changed conditions.

(2) Balance of Requirements (often referred to as RQ) and Replenishments (often referred to as RP). MRP systems maintain a balance between all the requirements for a part and all the replenishments for the part. Replenishments generate the need for procurement actions or releases to production for the needed parts. The replenishments can be in various stages of completion or can be available from stock. A requirement may be a record for a deliverable item (independent RQ) or a record for a requirement to be consumed in a next assembly (dependent RQ). Key data ingredients in each requirement record are the required quantity, need or schedule date, and requirement origin (i.e., contract spare item, shipping date).

(3) Netting Process. The netting process involves comparing requirements with replenishments to determine the need for parts. It begins with the total bill of material for the requirement for each specific part being netted. If the requirement is for an assembly, each part incorporated into the assembly must be separately netted. The system nets requirements against the replenishments for that part. The most basic form of the netting formula is:

STATUS OF A PART = Replenishments less Requirements

- If status is zero, replenishment and requirements are in balance.
- If status is negative, then replenishments are needed.
- If status is positive, then excess replenishments (parts) exist.

(4) Dynamic Rescheduling. Dynamic rescheduling of all items in the production process can result from a timing change or an introduction or deletion of items in the production process. Depending on location, the rescheduling may be automatic or may require a manual "go/no go" decision. Changes in schedule may result in different numbers of requirements, replenishments, or both. The timing difference will change the status of the netting formula.

5-702.1 DFARS 242.72

a. In December 2000, the Director, Defense Procurement, Acquisition Policy, and Strategic Sourcing issued a final rule revising DFARS 242.72 and the related material management and accounting system (MMAS) contract clause (DFARS 252.242-7004). The revised rule was effective on and applicable to contracts awarded on or after December 13, 2000. Subsequently, the DPAPSS, in a policy memorandum dated August 3, 2001, directed contracting officers to retroactively apply the revised rule to the maximum extent possible to contracts awarded prior to December 13, 2000. The revised DFARS rule specifically eliminated the requirement for the contractor to demonstrate compliance with MMAS policies, procedures and operating instructions. In lieu of the demonstration requirement, the contractor is required to accurately describe its MMAS policies, procedures and practices and provide sufficient detail for the Government to reasonably make an informed judgment regarding the adequacy of the MMAS. Contractors are also required to provide the Government, upon request, the results of internal reviews conducted to ensure compliance with established MMAS policies, procedures and operating instructions. Accordingly, the Government continues to have the same access to contractor records it had prior to the issuance of the final rule. DFARS 242.72 and the related MMAS contract clause (DFARS 252.242-7004) continue to prescribe policies, procedures, and standards for use in the evaluation of a contractor's MMAS. DFARS requires applicable contractors to assess their MMAS and take reasonable action to comply with MMAS standards. Considering applicability requirements, some contractors may also be required to disclose their compliance with MMAS standards. The cognizant auditor should advise and assist the ACO in evaluating both the contractor's MMAS and the contractor's correction of any deficiencies. “Contractor” means a business unit as defined in section 31.001 of the FAR.

b. DFARS 242.72 ordinarily requires the contractor to conform to MMAS standards on all prime contracts that

- exceed the simplified acquisition threshold and
- are cost–reimbursement contracts or fixed-price contracts that provide for progress payments based on costs.

Contracts awarded to small businesses, educational institutions, or nonprofit organizations are exempted. Additional requirements are as follows:

(1) The Government may review any large business contractor’s MMAS when the contractor has received qualifying sales of DoD prime contracts or subcontracts totaling $40 million or more in its preceding fiscal year and the ACO, with advice from the auditor, determines that an MMAS review is needed based on a risk assessment of the contractor’s past experience and current vulnerability. Qualifying sales are sales for which cost or pricing data were required under 10 U.S.C. 2306a, as implemented in FAR 15.403, or that are contracts priced on other than a firm-fixed-priced or fixed price with economic price adjustment basis.

(2) The cognizant contract administration office and the auditor must jointly establish and manage programs for evaluating the MMAS systems of contractors and must annually establish a schedule of contractors to be reviewed. The MMAS reviews must be a team effort. The auditor participates as a team member or serves as team leader and is required to issue an audit report to be incorporated into the team MMAS report. The MMAS review must be tailored to take full advantage of the day-to-day work done by the contract administration office and the auditor.

c. DoD policy stipulates that all contractors must have an MMAS that reasonably forecasts material requirements, assures proper charging and allocation of purchased and fabricated material (based on valid time-phased requirements), and maintains a consistent, equitable, and unbiased logic for costing of material transactions. The MMAS contract clause (DFARS 252.242-7004(e)) specifies that MMAS must have adequate internal accounting and administrative controls to assure system and data integrity and must comply with ten specific MMAS standards.

d. For contractors required to disclose and maintain compliance of their MMAS, DFARS 252.242-7004(c) provides system disclosure and maintenance requirements.

(1) MMAS disclosure is adequate when the contractor has provided the cognizant ACO documentation which accurately describes MMAS policies, procedures, and practices in sufficient detail for the Government to reasonably make an informed judgment regarding the adequacy of the contractor's MMAS currently being used. The contractor is also required to provide the ACO, upon request, the results of internal reviews that it has conducted to ensure compliance with established MMAS policies, procedures and operating instructions. Anticipated changes to the existing system would be subject to future audits after implementation. Significant changes to the MMAS must be disclosed to the cognizant ACO at least 30 days prior to their implementation per DFARS 252.242-7004(c)(3).

(2) If the contractor receives a report from the ACO that identifies any deficiencies in its MMAS and the contractor agrees with the report findings and recommendations, the contractor shall, within 30 days (or such other time period as may be mutually agreed to by the ACO and the contractor), state its agreement in writing. After submitting its agreement in writing, the contractor has 60 days (or such other time period as may be mutually agreed to by the ACO and the contractor), to correct the deficiencies or submit a corrective action plan showing milestones and actions to eliminate the deficiencies. If the contractor disagrees with the report findings and recommendations, the contractor has 30 days (or such other time period as may be mutually agreed to by the ACO and the contractor), to state its rationale for each area of disagreement.

(3) The ACO is required to evaluate the contractor’s response and notify the contractor in writing of the determination concerning any remaining deficiencies, adequacy of any proposed or completed corrective action plan; and the need for any new or revised corrective action plan.

(4) If the ACO determines the MMAS deficiencies have a material impact on Government contract costs, the ACO must reduce progress payments by an appropriate percentage based on affected costs (in accordance with FAR 32.503-6) and/or disallow vouchered costs on vouchers (in accordance with FAR 42.803) until the ACO determines that the deficiencies are corrected or the amount of the impact is immaterial.

5-703 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. It is DCAA's policy to assist the ACO in evaluating the contractor's MMAS. When appropriate, DCAA should provide the ACO with an assessment of the significance of contractor deficiencies and an estimate of the resulting adverse material impact to the Government. Also, DCAA should assist the ACO in evaluating the contractor's correction of deficiencies.

c. DFARS 242.7203(c) requires that cognizant contract administration and audit activities will jointly establish and manage programs for evaluating the MMAS of contractors subject to disclosure and maintenance requirements and will annually establish a schedule of contractors to be reviewed (see 5-702.1b). MMAS audits should be accomplished as a team effort with a team leader appointed by the ACO. These audits should be conducted

where the ACO (in consultation with the auditor) determines that the Government is subject to high risk.

d. The guidance contained in the following paragraphs can be applied to contractors who are not subject to the disclosure and maintenance requirements. However, prior to initiating any such audit, the auditor should coordinate with the regional audit manager and cognizant ACO.

5-704 Audit Objectives

a. The purpose of the audit is to express an opinion on the adequacy of the contractor's MMAS internal controls and determine the cost impact, if any, resulting from any system noncompliance.

Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems. The MMAS standards are stated in DFARS 252.242-7004(e).

b. The contractor is responsible for providing sufficient evidence that its policies, procedures, operating instructions and related internal reviews ensure compliance with the 10 MMAS standards outlined in the contract clause at DFARS 252.242-7004(e), specifically MMAS standard number 1. This standard requires the contractor to have an adequate system description including policies, procedures, and operating instructions that comply with the FAR and Defense FAR Supplement. Further, DFARS 242.7203(c)(2) requires the auditor take full advantage of the day to day work done by the contract administration office. Accordingly, the auditor should determine the level of reliance that can be placed on the work of others (4-1000).

c. The auditor should scope the audit to meet the objective of determining compliance with MMAS standards. If the contractor refuses to provide sufficient documentation that its policies, procedures and operating instructions comply with the MMAS standards, the auditor (after a reasonable period of time) should notify the ACO for assistance in obtaining the required documentation. Actions which could be considered by the ACO would include reductions or suspension of progress payments under FAR 32.503-6, disallowing vouchered costs under FAR 42.803, disapproval of the contractor's cost accounting system and/or cost estimating system, and/or recommendations concerning award of future contracts. The auditor should implement audit steps to identify the potential harm to the Government as the basis for any recommended ACO withholding. The FAO and ACO must coordinate with the contractor as early as possible, preferably at the time of requirements planning. This early coordination should assure an understanding of Government expectations, audit timing, and methods for system disclosure and maintenance.

d. For contractors that do not have contracts containing DFARS 252.242-7004, MMAS audits will be conducted when material costs are significant and a vulnerability assessment projects the need. The objective of the audit is to determine whether the contractor's MMAS adequately conforms to CAS and FAR requirements as amplified by MMAS standards. In these circumstances, the auditor should conduct an audit to determine the degree of compliance with MMAS standards. For any noncompliance disclosed, the report will identify appropriate FAR/CAS citations and pertinent contract clauses.

5-705 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business and audit risk (materiality and sensitivity), the scope should be consistent with the guidance in 5-105. DFARS 242.7203 states that reviews of the contractor's MMAS will be done as a contract administration office and contract audit team effort; therefore, the scope of audit must be coordinated closely with the ACO. The evaluation will be based on the disclosures provided by the contractor, transaction testing and other testing as necessary.

(1) Where the contractor meets the criteria in DFARS 242.7203(a), the auditor should request that the contractor provide the results of any system testing which has been done (see 5-715).

(2) In determining the scope of audit, the auditor should consider how much reliance can be placed on the contractor's transaction testing and disclosure of internal controls, and day to day work done by the contract administration office (see 4-1000).

b. The auditor should also review completed audits related to MMAS, including, as a minimum:

(1) Billing system audits
(2) IT audits (general and application controls) of MMAS
(3) Estimating system audits
(4) MMAS operations audits
(5) Material incurred cost audits
(6) Defective pricing audits
(7) Contractor purchasing system audits

c. The auditor should coordinate with DCAA auditors at other contractor divisions/segments, the ACO, and the contractor. To ensure positions and interpretations are consistent, the auditor should contact the CAC, CHOA, or other segment auditors to determine similarities of systems among segments, deficiencies found at other divisions, and interpretations of compliance/noncompliance to specific standards. Coordinate the audit with the ACO to assure full understanding of the overall scope and areas of responsibilities. Since the review deals primarily with financial and accounting issues, the ACO should be encouraged to assign DCAA as the team leader. Further, the auditor should coordinate closely with other responsible Government representatives such as Government property specialists and engineering and other technical representatives. Team tasks must be clearly defined to take advantage of the available Government expertise and mission requirements of all members. Most important, the team must make every effort to avoid duplication of effort. Early discussions with the contractor should be established to assure adequate disclosures in a reasonable period. Be sure that the contractor and ACO have a good understanding of what is expected in terms of the format and timing of the disclosures and the expected level of detail (including sufficient evidence).

5-705.1 Inadequate Disclosure and Maintenance

a. DFARS 252.242-7004(c) requires contractors to have policies, procedures and operating instructions that adequately describe their MMAS and to provide to the ACO, upon request, the results of internal reviews that have been conducted to ensure compliance with established MMAS policies, procedures and operating instructions. The DFARS also requires contractors to disclose to the ACO significant changes to their MMAS at least 30 days prior to implementation. Audit considerations related to each of the 10 MMAS standards are discussed in the following paragraphs.

b. If the contractor does not adequately describe its MMAS or fails to provide the ACO with the results of internal reviews, and the auditor has identified potential harm relative to premature or excess billings, calculate any estimated harm to the Government and recommend that the ACO implement a withhold to protect the Government's financial interests. The following steps can be used to help determine the potential harm relative to premature or excess billings.

(1) Review current inventory to identify materials that are in excess of known requirements by comparing the contractor's listing of contract requirements (parts lists, etc.) to the on hand inventory.

(2) Review the material months on hand, e.g., date received to the date of usage, to determine if materials appear to be unreasonably time phased.

(3) Review contractor inventory cycle count data if available or sample inventory to determine the level of record accuracy.

(4) Sample material transfer activity to determine if transfers of costs or loan payback procedures resulted in noncompliance with MMAS Standard 7 and increased or duplicated costs to the Government.

(5) Tailor other steps that would identify potential harm to the government based on leads or information available to the FAO.

(6) Notify the ACO of the disclosure and maintenance problems and identify deficiencies found in the above steps.

(7) Recommend that the ACO withhold the amount of the potential impact to the Government (the effect of the identified procedural and/or control deficiencies) identified through the above steps until the contractor adequately describes its MMAS and/or provide the requested results of internal reviews. See 5-717 for guidance on computing cost impacts.

5-706 System Description (MMAS Standard 1)

MMAS Standard 1 (DFARS 252.242-7004(e)(1)). This standard requires the contractor to provide an adequate system description including policies, procedures, and operating instructions compliant with FAR and DFARS. While the contractor is required to provide a broad range of documents, the auditor should focus attention on the adequacy of the policies, procedures, and operating instructions related to MMAS Standards 2 through 10.

a. The contractor should establish and maintain descriptions of the major manual and automated systems that comprise the MMAS. These descriptions should cover all integrated component systems and include:

(1) narrative descriptions of each of the component IT systems and the interaction with one another,

(2) detailed flowcharts for each of the component IT systems,

(3) identification and purpose of all MMAS related transactions, tables, schedules, files, and reports for each component IT system,

(4) descriptions of available historical data files, retention periods, and storage format, and

(5) identification of the programming languages used to implement, process, and query the system.

b. The contractor should provide a written description of its MMAS in enough detail to allow the auditor to get a thorough understanding of how the MMAS operates. The contractor's write-up should include references to written policies, procedures, and operations manuals. Information should be provided for each process or function within the system as well as existing internal controls.

c. The system write-up should identify the generation of material requirements, bills of material, and development of lead times. The contractor should provide information on how this information is used to purchase material. All data input (whether manual or automated) should be identified. This should include a description of how the material is:

(1) ordered and tracked once a purchase order is issued;

(2) tracked once it arrives at the contractor's warehouse or plant;

(3) handled and accounted for in storage locations;

(4) issued to a task;

(5) billed to the Government;

(6) accounted for when it is moved among tasks or inventories and incorporated into the end item; and

(7) disposed of during contract performance and at contract completion.

5-707 Material Requirements (MMAS Standard 2)

MMAS Standard 2 (DFARS 252.242.7004(e)(2)). MMAS Standard 2 requires contractors to assure that purchased and fabricated material charged to contracts are based on "valid time-phased requirements." Costing practices are valid and time-phased when material is purchased and/or fabricated for a specific production plan and the cost is charged and billed within a reasonable time related to production process needs.

a. There is no standard number of days (months) that constitute adequate time phasing. Time phasing is the product of good material management and internal controls. Reasonable time phasing ensures all material management processes are justified and followed. In turn, material management processes should ensure that materials are received as close to manufacturing need dates as possible under existing circumstances.

b. The auditor's primary goal is to determine that sufficient procedures and controls are established to assure contracts are charged based on valid time-phased requirements. The standard specifies accuracy goals as a validity measure to assure that the bill of material (BOM) or master production schedule (MPS) reflects the most accurate, complete, and current information. The auditor should review IT related policies and procedures that address the system's automated operations. Current flowcharts of the material time-phasing process and the processes used to determine BOM and MPS accuracies should be reviewed, analyzed, and a conclusion made regarding the adequacy of the automated process. Internal controls over access to component IT systems should be reviewed to determine that only users needing access to perform their duties are allowed onto the system (see 5-1406.1). Data entry sources and related material system transactions should be identified and their applicable security system authorization tables examined to determine that transaction authorities (e.g., read, update, delete) are adequately controlled (see 5-1406.2).

c. Auditors must be alert for situations where the contractor's current systems are accurate (the BOM system is generating valid requirements and the MPS system is identifying accurate material need dates) but contracts include invalid or unreasonably time-phased materials. However, this should be the exception---an accurate system should generate valid time-phased material costs. Even though the current system is functioning accurately, prior deficiencies or other circumstances may have allowed invalid or unreasonably time-phased materials to be charged to the contracts. This would be noncompliant with the objective of the standard if controls were not instituted to relieve the Government of the impact of this unallowable practice.

d. The auditor should verify contractor use of the BOM and MPS as a basis for material costing and review measures of performance that assure charges or allocations are based on valid time-phased requirements. Standard 2 states that a 98 percent BOM accuracy and a 95 percent MPS accuracy (see 5-707.1d. and 5-707.2b. respectively, for discussions on the accuracy calculations) are desirable goals to assure that requirements are valid and time-phased. If the system accuracy is lower, the contractor must provide adequate evidence that there is no material harm to the Government and that the cost to meet the accuracy goals is excessive in relation to impact on the Government. Reviews of the BOM and MPS require close coordination with Government technical representatives.

e. As the auditor evaluates contractor compliance with the 10 MMAS standards, observations in other areas may provide indicators of problems with the MPS and BOM. A large number of material expediters, substantial excess inventory, and frequent inventory shortages can all be strong indicators that formal MPS and BOM systems are not providing accurate information or that established policies and procedures are not being followed. These circumstances can also be indicators that the contractor is operating under an informal system and ignoring problems reported by formal MPS and BOM systems. This can lead to problems with excess inventory and financing of material far in advance of need.

5-707.1 Bill of Material Accuracy

a. Requirements are considered valid when material is purchased or fabricated to provide quantities necessary to complete specific production units. The bill of material (BOM) identifies materials and quantities required to manufacture the assembly. An accurate BOM represents contractually required materials. By combining the requirements for the various assemblies, the contractor can determine total contract requirements. Total requirements can then be compared with material charges to the contract. This process can identify the existence of costs that:

(1) are not based on requirements
(2) exceed contract requirements
(3) represent requirements for which no costs have been incurred

b. The contractor should have BOM policies and procedures addressing:

(1) BOMs for assemblies and fabricated parts that generate requirements
(2) the development of original material requirements and subsequent changes
(3) approval authority for releasing and maintaining bills of material
(4) material requirement adjustments for engineering changes
(5) controls for converting engineering BOMs to manufacturing BOMs
(6) materials used on an "as required" basis (no specified quantity requirement)
(7) substitute material to include controls that prevent requirements from being input for both primary and substitute materials
(8) how and when bills of material records are maintained and purged
(9) a reasonable basis for measuring the accuracy of the bill of material

c. The contractor's system should provide for systematic testing of the bills of material for accuracy, appropriate corrective measures as warranted, and a record of the results of such tests.

d. The techniques for calculating the accuracy percentage for BOMs will vary from contractor to contractor. The technique used is dependent on BOM preparation methods and the production process. BOM accuracy indicates whether the BOM represents the actual material required to produce the product. Using traditional methods, material requirements on an "as-built" basis is the best measure of accuracy. However, the BOMs which are loaded into the system and drive purchase and fabrication orders are the ones affecting billing and costing. These BOMs are the most appropriate for measuring to assure they reflect the most current, accurate, and complete information. The contractor should have procedures and internal controls for ensuring accurate BOMs and a reasonable method for calculating BOM accuracy. An example of one formula follows:

$$\text{BOM Accuracy} = \frac{\text{BOMs in Agreement}}{\text{Total BOMs Reviewed}} \text{ X } 100 = ___\%$$

e. Each level of production (i.e., fabricated parts, subassemblies, assemblies, and line replaceable units) has BOMs that may be tested for accuracy. BOMs can be inaccurate at any level. In order for the auditor to assess BOM accuracy, selected BOMs must be compared to appropriate data (e.g., engineering BOM, part drawings, engineering changes) to ensure that 98 percent of the BOMs driving procurement are accurate. Necessary adjustments for the actual calculation of the BOM accuracy must be made as circumstances warrant.

5-707.2 Master Production Schedule Accuracy

a. The contractor should have a document(s) that represents the master production schedule (MPS). The MPS details what and how much material, labor, and capacity is

required and when these resources are needed. The contractor should have MPS policies that address:

(1) level of approval and identification of approving official

(2) whether or not past due effort is allowed (past due effort is unplanned effort and should be rescheduled)

(3) methods for evaluating reasonableness of capacity constraints

(4) definition of planning horizon and identification of planning time increments.

(5) techniques for systematic testing for accuracy and appropriate corrective measures, as warranted

(6) procedures and identification of authorities for changing policies

(7) methods for periodically verifying the reasonableness of lead and flow times

(8) timely processing of changes

(9) product changes being planned and implemented to minimize disruption to the master schedule, scrap, rework, and obsolete material

b. An accurate MPS and related policies and procedures should provide time phasing of production materials. The techniques for calculating the accuracy percentage for MPS will vary, depending on the method used to prepare the MPS and the nature of the production process. Although there are some common methods used for measuring MPS, no specific method is required. Each contractor should assess its own system and then identify the most appropriate method to provide evidence that the system generates realistic need dates for material. Traditional MPS accuracy measures consider historical performance by comparing end item deliveries accomplished versus end item deliveries planned for a given time period, determined as follows:

$$\text{PERFORMANCE} = \frac{\text{ACTUAL PRODUCTION}}{\text{PLANNED PRODUCTION}} \times 100 = ___\%$$

c. The accuracy measure must be supported by adequate evidence of the reliability of the schedules being measured. The contractor should provide documentation identifying the various lead times and process flows and show the justification for times used. This includes documentation showing that the data used in the MPS is consistent actual shop floor practice. The documentation should include all processes that contribute to timely scheduling of material receipts and end item completion at the point that the measure is taken. The contractor is expected to establish a reasonable basis for accuracy measurements, and a program for on-going measurement and improvement of accuracy levels to reach desired accuracy goals.

d. Another example of a measure of MPS accuracy is:

$$\frac{\text{No. of End Items with Accurate Delivery Dates in Schedule}}{\text{No. of Contractually Deliverable End Items}} \times 100\% = \text{MPS Accuracy}$$

In this example, the contractor will determine the universe of contractual end items and their applicable delivery dates. Once the universe is identified, a determination is made as to whether these contractual end items are included in the schedule and that the schedule reflects contractual due dates. When basing the measurement on prospective contractual end item delivery dates as shown in the above example, be aware that contracts may allow a "window" in which to deliver or allow early delivery of contractual end items.

e. The auditor should ensure that these types of measures are not misleading. The critical points are the accuracy of the lead and process times used in the schedules being

measured. Before these types of measures can be of value, the contractor must demonstrate the accuracy of the data within the schedules and its consistency with practice.

f. The auditor should evaluate the reasonableness of whatever measure the contractor chooses to employ and render a judgment on whether that measurement appropriately depicts the schedule accuracy and assures that materials required in the manufacturing process will be reasonably time-phased to need in the manufacturing process. In addition, the contractor and auditor should evaluate the reasons for identified variances to determine the causes of inaccuracies.

g. To assure that contract costing or billings are time-phased, the contractor should provide an analysis of inventory turnover and/or "months-on-hand" of current inventory. The documentation will vary from contractor to contractor. The auditor should evaluate the reasonableness of whatever approach the contractor chooses to employ and render a judgment on whether or not the contractor has adequately justified materials carried for long periods of time. In addition, the contractor and auditor should evaluate the reasons for premature costing or billings to determine the cause and any potential harm to the Government.

5-707.3 Justification of Exceptions

a. Even though the contractor's system achieves the desired BOM and MPS accuracy levels, it is possible for invalid or unreasonably time-phased material to get into contract costs and current billings. These situations can be caused by prior system deficiencies that have not been corrected, minimum buy requirements, or other circumstances. Therefore, it is important that the contractor have policies and procedures in place to identify when such situations may exist, investigate the causes, and take necessary corrective actions to ensure that the Government is not over billed.

b. The contractor should have controls in place to identify situations where materials in excess of contract requirements or significantly before production need dates are charged to Government contracts. While these conditions are not necessarily unreasonable, it is important that they be identified and investigated to ensure that the MMAS is continuing to operate effectively. In addition, the contractor should ensure that the Government is not billed for unreasonable material costs.

c. For example, because of minimum buy and/or economic order quantity restrictions for some items of material, material quantities greater than valid time-phased requirements may be purchased or fabricated and charged to a cost objective. In these instances, the contractor should demonstrate that its method reduces overall costs of purchases and fabrication and that receipt and costing of the materials is done as close to the need date as possible to take advantage of available price reductions. Normally, the contractor should not charge contracts for materials when a requirement does not exist. However, consideration must be given when minimum buy or other necessary circumstances are imposed on the contractor to buy greater quantities than immediately needed.

5-708 System Monitoring (MMAS Standard 3)

MMAS Standard 3 (DFARS 252.242-7004(e)(3). Standard 3 requires the contractor to provide a mechanism to identify, report, and resolve system control weaknesses and manual overrides. As with any system, sufficient internal controls should exist so any significant irregularity will be identified through normal system operation. The MMAS system should include policies and procedures that describe how and when operational exceptions are to be identified, reported, and resolved. Operational exceptions are irregular situations that result from system logic (analysis and correction of errors and irregularities) or system overrides.

a. The standard specifically cites excess inventory as one area that needs control mechanisms. The system should identify excess inventory as soon as known. MRP activ-

ity can mask any excess by constantly causing it to be moved because of new requirements or changed priorities.

b. Experience has shown that inappropriate costing can result from contractor use of excess inventory on spares contracts. Excess parts are sometimes used on spares contracts at no cost (i.e., never transferring the cost or the replacement part), understating actual recorded contract costs on the gaining contract and overstating cost on the losing contract. Further, nondisclosure of such activity (i.e., proposing purchase or fabrication costs when the parts will be used at no cost) at spares contract price negotiation could result in defective pricing.

c. While reporting mechanisms for excess/residual inventory are critical ones, they are not the only exceptions or problems the auditor should be concerned with. The auditor should look at the contractor's entire exception reporting system to verify the existence, and adequacy, of major controls in all areas that need to be identified. These areas include, but are not limited to:

(1) unauthorized changes to BOMs,
(2) materials charged to contracts in excess of requirements;
(3) materials charged to contracts prior to its production need date (time-phasing);
(4) monitoring of attrition, rework, scrap, and lost/found material;
(5) transfers and loan/paybacks; and
(6) manual overrides (i.e., material adjustments).

d. The most common method used by contractors to facilitate the identification of system irregularities, or problems, is the "exception report." The auditor should obtain a listing of all exception reports and their usage. If there are a significant number of exception reports that are either no longer in existence or not currently used, this should be brought to management's attention.

e. The contractor's policies and procedures should address the resolution of reported exceptions. To be fully compliant with the intent of this standard, the contractor should do whatever is necessary to prevent exceptions, where feasible, or at least minimize their recurrence.

5-709 Audit Trail (MMAS Standard 4)

MMAS Standard 4 (DFARS 252.242.7004(e)(4). This standard requires adequate MMAS audit trails and necessary records to evaluate system logic and to verify through transaction testing that the system is operating as desired. The auditor should determine that

(1) all original entries and subsequent transactions are recorded in the system,
(2) there is an appropriate audit trail, and
(3) sufficient evidential matter exists to allow the expression of an audit opinion.

a. All transactions, both original and subsequent entries, should be recorded in the system to enable verification of system performance. The auditor should be alert for situations where entries, especially adjustments, can be entered into the system without evidence of the entry being recorded. The contractor should identify each type of transaction covered by the MMAS and the controls for ensuring that these transactions are properly recorded in the system.

b. An audit trail refers to the ability to trace transactions from their authorization through any intermediate books and records to the books and records of final entry, and vice versa. The contractor should be able to show how both purchased and fabricated parts flow through its system from beginning to end. At a minimum, the auditor should trace a few transactions through each significant aspect of the contractor's system. If this effort was accomplished to support the auditor's basic understanding of the system it need not be duplicated here.

c. The contractor must be able to provide sufficient evidence, through transaction testing, that its MMAS system is reliable. To fully comply with this standard, the contractor's system should provide for periodic transaction testing to ensure that the system

is continuing to operate as designed. This testing may be included as part of Standard 10.

d. The auditor should carefully assess the adequacy and sufficiency of the contractor's transaction testing and revise the scope of audit accordingly (see 4-1000). In addition, the contractor's transaction testing may fulfill some or all of the required substantive testing necessary to issue an opinion on the allowability of incurred material costs. Therefore, the nature and results of the contractor's testing efforts should be considered in scoping the extent of our annual evaluation of incurred material costs (see 6-300).

5-710 Physical Inventories (MMAS Standard 5)

MMAS Standard 5 (DFARS 252.242-7004(e)(5)). The main objective of this standard is the requirement to maintain accurate recorded inventory validated through periodic reconciliation of recorded to physical inventory quantities. This will help to ensure that purchases do not exceed requirements, progress payments are based on valid inventory records, and physical inventory information is accurate for estimating and pricing purposes. The standard specifies 95 percent accuracy as a desirable goal. If this accuracy goal is not achieved, the contractor must provide adequate evidence that there is no harm to the Government and that costs to meet the goal are excessive (considering the potential harm to the Government). See 6-306 for additional guidance on physical inventories.

5-710.1 Receipt and Inspection of Material

a. The contractor should establish and maintain policies and procedures for receipt and inspection of material. The receiving activity is responsible for the receipt and inspection of incoming materials and the movement of these materials to the areas where the storage and usage functions are carried out. Common responsibilities include:

(1) unloading, unpacking, identifying, sorting, and verifying that the quantity and quality of materials received agree with purchase order requirements

(2) noting shortages, damage, and defects

(3) reporting receipts and discrepancies

(4) moving materials to storage or other appropriate activities

(5) providing appropriate transaction inputs to the inventory requirements and accounting systems

b. In evaluating internal controls, as a minimum determine the following conditions and procedures are used as a means of controlling the activities of the receiving and inspection department:

(1) The receiving function is independent of the purchasing, invoice processing, and shipping functions.

(2) Incoming material is centrally controlled.

(3) Receiving reports, signed by an authorized representative, are prepared for all material received, and a copy is furnished to the accounting department.

(4) The receiving department is advised, by copy of the purchase order, of the type of material purchased.

(5) Quantities of materials received are verified by actual count, weight, or measurement by the receiving department.

(6) Quality inspection is evidenced by inspection reports, notations on receiving reports, or other acceptable records.

(7) Procedures are in effect which control defective and damaged material, overshipments, returned material, material received but not ordered, and claims against carriers and vendors, with related responsibilities for the issuance of debit memorandums.

(8) Where the contractor accepts and reworks defective vendor-furnished material instead of rejecting and returning it, Government contracts are not charged with the cost of rework, unless this is clearly justified in the circumstances.

(9) Material returns are routed to the shipping department and are controlled by authorized shipping advises or material releases.

(10) Procedures are in effect for controlling the distribution of material from the receiving area to stores or to production areas.

(11) The flow of accounting documentation is controlled by use of prenumbered forms, batch transmittals and/or other appropriate means.

c. The pervasiveness of modern IT systems requires the auditor to obtain reasonable assurance that the authority of data origination, accuracy of data input, integrity of processing, and verification and distribution of output within the receiving and inspection functions are adequately controlled (see 5-716). The results of the most recent IT System General Internal Control audit and other related systems audits should be reviewed for reported deficiencies which could adversely impact internal control of the receiving and inspections functions. The following elements should be considered when reviewing internal controls related to automated material receiving and inspection systems:

(1) The contractor's representation of receiving and inspection systems internal controls. This representation should include identification of system transactions and related security, material processing and exception reporting, inspection processing, adjustments, etc. System operation and the identification of all related system policies, practices, and procedures.

(2) The number of employees having access to material and inspection system data should be reasonable and based on need. Adequate security controls (logical and physical) should be incorporated to control access to the system (see 5-1406.1) and to control specific material transaction capabilities. Authority to make changes to receiving and inspection data should be limited, logged, and closely monitored (see 5-1406.2).

(3) Current receiving and inspection system/subsystem flowcharts showing data input characteristics, internal control points, internal control tables, and output reports. System operation should be verified to the policies, practices, procedures, and flowchart.

(4) Test system internal controls by tracking selected receipt transactions to their source purchasing documents. Verify the results of the test to the related bills of material or contract. Any differences must be resolved with the contractor. Consider using CAATs to expedite the process.

5-710.2 Storage and Issuance of Material

a. The storing and issuing function is responsible for:

(1) Protecting and preserving material in storage, including appropriate safeguards for items of a sensitive nature and items subject to deterioration by the elements.

(2) Accessing fast moving items.

(3) Examining material requisitions for the appropriate stock number, nomenclature, and authorized usage.

(4) Substituting, if appropriate, another item when a requisitioned item is not available.

(5) Issuing material timely when presented with an authorized requisition.

(6) Initiating purchase requisitions when stock levels reach the reorder point or when authorized requisitions cannot be filled, duly noting due-ins and due-outs.

(7) Reviewing stock for slow moving items and items in long supply and initiating appropriate action for consumption or disposal.

(8) Providing appropriate transaction inputs to the inventory requirements and accounting systems.

b. In evaluating the internal controls in this area, determine the extent to which the contractor employs the procedures listed below:

(1) separate accountability is maintained for contractor-owned and Government-owned materials for each class of material

(2) material received is delivered directly to the warehouse, storeroom, or production area, via an inspection area if appropriate

(3) when material received is delivered directly to a production area, procedures insure that proper documentary and accounting control is maintained

(4) excess stock is not permitted to accumulate in production areas

(5) stores records are maintained by employees functionally independent of storekeepers

(6) there are adequate controls to prevent theft or diversion of material. Unauthorized persons are denied access to storerooms. There are special safeguards for high dollar value material and material susceptible to personal use or sale

(7) materials are stored to facilitate locating, withdrawing, handling, and counting

(8) procedures provide for the timely reporting of slow moving, obsolete, and overstocked material, such as electronic, automotive and truck parts, or copper, brass, or other high value metals or components

(9) procedures provide for the release of materials only upon the receipt of a properly approved requisition

(10) requisitions applicable to Government-owned materials are distinguishable from requisitions for contractor-owned materials

(11) controls provide for proper charges and credits when material is transferred between/among contracts

(12) procedures provide that appropriate credits are issued when unused material is returned to stock, or where material is diverted to other work

(13) procedures are in effect to control the collection, segregation, and disposition of scrap and the issuance of appropriate credits (see 6-308)

(14) procedures are in effect which control and account for returnable items such as reels, containers, skids, boxes, and barrels

(15) procedures provide for issuing materials subject to spoilage or shrinkage on a first in first out basis

(16) the flow of accounting documentation is controlled by use of prenumbered forms, batch transmittals and/or other appropriate means

5-710.3 Inventory Accuracy

a. The contractor should have established procedures that prescribe how inventory record accuracy is verified as to quantity and location. Prior audits have found accuracy rates to be far below the recommended 95 percent level. A large number of material expediters, substantial excess inventory, and frequent shortages of material to satisfy production needs can all be strong indicators that the formal system is not providing accurate information. Specific attention should be accorded the policies, practices, and procedures governing the classification, location, requisition, and responsibilities for contract inventory. Although not normally part of the testing of inventory accuracy, the MMAS procedures should include requirements for shop floor accountability of materials in the production process.

b. For MMAS purposes, accuracy should not be determined based on the dollar value of an aggregate inventory. This technique is not representative of the physical accuracy of the inventory because the netting process and material planners rely on the accuracy of recorded inventory quantities when deciding to fill requirements and generate orders. A highly accurate inventory is necessary for the netting process to function reliably.

c. Inventory record accuracy attests to the accuracy of the on hand inventory as opposed to the physical (recorded count) inventory. Inventory record accuracy should be at or above 95 percent within preestablished tolerances (see 5-710.3e.). Inventory re-

cords used by the contractor to make decisions regarding the purchasing or fabrication of materials should be used when counting the on-hand inventory. An example of a formula for calculating inventory accuracy is:

INVENTORY ACCURACY =

$$\frac{\text{\# OF PARTS ACCURATE}}{\text{\# OF PARTS COUNTED}} \times 100 = ___\%$$

d. An inventory classification system may be used by a contractor to focus available resources on controlling those materials posing the greatest risk. An example of this is the ABC inventory method. This system classifies inventory items in a decreasing order of annual dollar volume or other criteria. This array is then split into classes A, B, and C. Class A contains items with the highest annual dollar volume and receives the most attention. The medium class B receives less attention while class C, which contains low dollar items, has minimum controls. The principle behind the ABC method is that effort will be saved through relaxed controls on low value items that do not pose a significant risk. Effort can then be applied to reduce inventories and maintain stricter accountability of high value items.

e. The precision or degree of accuracy (tolerance) will vary by types of inventory. In the ABC inventory method, the acceptable tolerance for an item count of a particular part within a preestablished range will vary depending on its A, B, or C classification. Tolerance is very similar in nature to precision as used in statistical sampling (i.e., +/- 5 percent). If a variable falls within a preestablished range, then results are considered acceptable. For inventory accuracy, the difference between recorded and physical inventory is computed and compared to the preestablished acceptable tolerance. The more expensive items or items crucial to maintaining production have tighter tolerance ranges.

f. The following table depicts the test results for 10 parts within a particular classification.

Part No.	On-Hand Per Records	On-Hand Per Physical Count	Difference	Tolerance*	Accurate?
1	100	100	0	5	Yes
2	80	78	2	4	Yes
3	100	95	5	5	Yes
4	200	206	6	10	Yes
5	120	130	10	6	No
6	80	80	0	4	Yes
7	100	90	10	5	No
8	150	145	5	8	Yes
9	100	100	0	5	Yes
10	80	80	0	4	Yes

Number of parts accurate	=	8
Number of parts counted	=	10
Accuracy of this class	=	80% (8/10)

* Assume acceptable class tolerance of 5 percent

g. Accuracy is based on counts within established tolerances. In the example above, the class tested has a preestablished tolerance of 5 percent. This means that for a recorded quantity of 100, units physically counted during a cycle count must fall between 95 and 105 to be recorded as accurate. The following is an example of summarizing tests for inventory accuracy:

Class	(1) Parts Sampled	(2) Part Counts in Tolerance	Count Accuracy by Class*
A	50	50	100%
B	500	400	80%
C	1,000	950	95%
	1,550	1,400	90.3%

*Col (2)/Col (1)

h. Audit steps must include observations of contractor count procedures. Count procedures should ensure integrity of the process and include "blind counts."

5-710.4 Inventory Adjustments

The contractor should have established policies and procedures for making adjustments for the difference between booked and physical inventory counts, including the costing of such adjustments in the accounting records, if appropriate. The Government has an interest in whether the contractor makes an adequate investigation of inventory adjustments and whether losses are acceptable as a reasonable cost on Government contracts. Adjustments of losses and overrates and deterioration of inventory items may indicate inadequate inventory control and storage procedures. Adjustments of items that are surplus or obsolete may indicate the contractor is purchasing excessive quantities. The auditor should evaluate the contractor's policies and procedures to ensure that they provide for the proper investigation of inventory adjustments and follow-up to help reduce the need for future adjustments.

5-711 Material Transfers (MMAS Standard 6)

MMAS Standard 6 (DFARS 252.242-7004(e)(6)). Standard 6 was established to assure that physical transfers of parts are based on valid reasons. Under normal circumstances, contractors are required to account for costs by contract. This standard recognizes that there may be times when it makes good business sense to transfer material from one contract to another with a more immediate need. However, prior audits have disclosed that in many instances transfers (physical, financial, or both) may occur with no apparent necessity. This standard requires the contractor to provide the Government and users of the system descriptive reasons for transfer activity. In addition, the contractor should have controls in place to ensure that material transfers which are inconsistent with these reasons are identified, reported, and resolved on a timely basis.

5-712 Costing of Material Transactions (MMAS Standard 7)

MMAS Standard 7 (DFARS 252.242-7004(e)(7)). This standard requires consistency in the methods used for costing material transactions. The costing methodology may be standard cost, actual cost, or any inventory costing method discussed in CAS 411-50(b). Consistency must be maintained across all contract and customer types and accounting periods. The contractor must maintain and disclose written policies describing transfer methodology and the loan payback technique.

5-712.1 Costing Methodology

The contractor's system should clearly describe the methodology to be used in the costing of material transactions. The contractor may use standard or actual costs or any of the inventory costing methods in CAS 411-50(b). The audit of the contractor's compliance with CAS 407 or CAS 411 should satisfy the requirements related to this area.

5-712.2 Sensitive Areas of Cost

The contractor's system should clearly describe how sensitive material transactions are to be costed. Sensitive transactions may be any material transactions identified by the Government and contractor including areas such as interorganizational transfers (see 6-313); Government furnished material/equipment (see 9-604.2); or special tooling and special test equipment (see 9-605.2). The auditor should identify all sensitive areas of material cost applicable to the contractor and related costing methodologies.

5-712.3 Costing of Transferred Parts

a. The MMAS system should transfer parts and associated costs within the same billing period. The billing period implied is a monthly accounting period.

b. For initial and subsequent transfer charging methods, the standard does not require contractors to use the same method for costing both an initial charge and a transfer charge. For any specific item, the value used for the transfer transaction may be different than the value(s) previously used to charge the item to inventory or to the contract from which it is being transferred. Transfers from one contract to another may be based on any CAS 411 valuation method. Selected valuation procedures must be documented, disclosed, and consistently applied to all subject transfers regardless of the nature of the final cost (Government or commercial) or type of contract (cost reimbursable or fixed price).

c. When it is not appropriate to transfer parts and costs within the same period, a loan payback technique may be used if approved by the ACO. A loan payback occurs when parts purchased or fabricated for one or more cost objectives are assigned or used on another cost objective without a corresponding transfer of cost. The need for a loan payback is typically caused by the borrowing contract's need for a particular part earlier than the loaning contract, which still has a need for the part. When this technique is used, the auditor should verify that controls are in place to ensure that parts are paid back expeditiously, corrections are made for any overbillings, the borrowing contract and loan date are identified, and the cost of the replacement part is charged to the borrowing contract.

d. Prior audits have disclosed conditions where:

(1) borrowed parts may not be paid back on a timely basis or are never paid back;

(2) progress and/or final payments may be received by the contractor for the same parts on more than one cost objective resulting in over recovery of cost;

(3) no audit trail exists providing visibility of the lending or borrowing contract or when the parts were borrowed and/or paid back; and

(4) the borrowing contract may not be charged for the cost of the replacement parts.

e. The contractor should disclose written policies describing the transfer methodology used for manufactured parts. This would include parts that may be transferred at a sub-level, for which actual cost data is not accumulated. If the method provides a reasonable estimation of actual cost, it complies with the requirements of Standard 7.

5-713 Inventory Allocations (MMAS Standard 8)

MMAS Standard 8 (DFARS 252.242-7004(e)(8)). When allocations from common inventory accounts are used, controls are needed in addition to the requirements of MMAS Standards 2 and 7. These controls will ensure that reallocations and any credit due are processed no less frequently than the routine billing cycle, inventories retained for requirements which are not under contract are not allocated to contracts, and algorithms are maintained based on valid and current data.

a. Common inventory represents those parts in inventory that are required for use on more than one cost objective. Prior audits have disclosed that allocations have not been

based on valid time-phased requirements, or were not costed using consistent, equitable, or unbiased methodologies.

b. This standard addresses allocations of common inventory but requires that the contractor's system handle allocations in such a manner as to preclude improper costing.

c. Evaluate the contractor's submission to determine the magnitude of contractor cost allocations from common inventories. If allocations are immaterial, further effort may not be required.

d. The auditor should determine that the classifications are appropriate for types of materials costed as common inventory. Common materials allocated must benefit contracts charged (when requirements exist). Allocations should not be too far in advance of required production dates without sufficient justification, such as availability of quantity discounts, economic order quantities, and known or expected vendor problems.

e. Assess the contractor's analysis of the common inventory being allocated to determine that the pool of common inventory allocated is accurate.

f. Evaluate the contractor's analysis and any tests that assure billings show common inventory costs were properly calculated (automated or manually) and costed on a current basis. Where common inventory is reallocated on a periodic basis, evaluate the contractor's analysis performed to determine the reasonableness of the basis and method for reallocation. Evaluate the contractor's evidence that shows the total adjustments (debits/credits) of reallocations are accurately reflected in billings.

5-714 Commingled Inventories (MMAS Standard 9)

MMAS Standard 9 (DFARS 252.242-7004(e)(9)). This standard specifies that MMAS Standards 1 through 8 apply to commingled materials for which costs are charged or allocated to fixed price, cost-reimbursement, and commercial contracts. A contractor authorized to use a multi-contract cost and material control system under FAR 45.505-3(f) is not exempted from meeting the requirements of MMAS Standards 1 through 8.

5-715 Internal Audits (MMAS Standard 10)

a. MMAS Standard 10 (DFARS 252.242-7004(e)(10)). The MMAS system must be subjected to periodic internal audits to ensure compliance with established policies and procedures. This standard recognizes the contractor's commitment to self-governance and its contractual responsibility for systems and accounting internal controls. The contractor should be conducting on-going, self-initiated reviews of various aspects of its MMAS in a timely manner. Contractors may comply with this standard using in-house staff efforts or through the services of outside consultants.

b. Our interpretation of "internal audits" for purposes of compliance with this standard includes reviews performed by functional units as well as the internal audit staff. The auditor should be aware of the requirements of 4-1000, Relying on the Work of Others. The level of objectivity and competence of personnel performing the reviews will have a significant impact on the reliability of the reviews. This should be clearly communicated to the contractor. Both the auditor and the contractor should be aware that the objective is to ensure that adequate MMAS procedures and controls are in place and being followed, and that system adequacy is maintained on a real-time basis.

c. The auditor should ensure that the system is subjected to periodic internal audit. Although this standard does not create additional access requirements beyond those discussed under access to records (see 1-504) and identified in FAR 52.215-2. The contract clause at DFARS 252.242-7004(c)(2) (Disclosure and Maintenance Requirements) specifically requires the contractor to provide the ACO, upon request, the results of internal reviews that it has conducted to ensure compliance with established MMAS policies, practices and operating instructions. Consideration should be given to both the contractor's internal audit schedule of completed audits and audits performed by functional units that

meet the objective of Standard 10. If the contractor contends that such reviews have been performed but is unwilling to make them available to DCAA in any form, the auditor may be unable to determine if the contractor has complied with the standard. The auditor should evaluate the need for such access. If the auditor determines that access to internal reviews is required, the auditor should immediately contact the ACO and advise the ACO to request that the contractor provide access to its internal reviews. If the contractor refuses to provide the requested information, the auditor should advise the ACO to cite the contractor for noncompliance with the Disclosure and Maintenance Requirements of the contract clause. The auditor should also determine whether the denial of access to records has a material impact on the Government contract costs. If so, the auditor should advise the ACO to reduce requested progress payments and interim voucher amounts by an appropriate percentage until the denial of access issue is resolved. Continued denial of access to relevant data should be escalated in accordance with 1-504.

d. If a contractor is not performing periodic reviews of its MMAS, then it should be cited for noncompliance with standard 10. This should be cited as a serious internal control weakness in light of the complexity of MMAS and the risk of inaccurate costs being charged to contracts and included in billings. This control weakness should also be tied to cost impacts found during the audit and to FAR 32.503-6, Suspension or reduction of payments.

5-716 MMAS - Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls and IT application controls. Whether the control activities are classified by the auditor as general or applications controls, the objectives of control activities remain the same, to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should evaluate the IT general controls and the MMAS application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are composed of

(1) organization and operation controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and

(4) data and procedural controls.

(See 5-400 for a more detailed explanation of general internal controls.)

d. MMAS application control activities are applied to the input, processing, and output phases of this IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as estimating, purchasing, and in this instance, the comprehensive MMAS. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-717 Reporting on the Results of Audit

a. The auditor should follow the guidance in 5-110, 10-200, and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

b. The auditor should formulate an opinion as to the contractor's compliance with the ten MMAS standards. Where deficiencies are disclosed, the auditor should quantify the impact. If the impact is considered significant, the auditor should recommend withholding appropriate amounts to protect the Government's interest pending contractor corrective action.

c. The team leader should inform the contractor and the ACO of significant findings during the conduct of the evaluation. Although DCAA is a team member, observation and recommendations will be forwarded via a separate internal control audit report (10-400) for incorporation in the team evaluation report. If the audit discloses significant deficiencies, the report will provide an estimate of the adverse impact on the Government (the effect of deficiencies in procedures and/or controls). The report will also include a recommendation about the acceptability of the contractor's corrective action plan to the extent it is included in the contractor's response to our draft statements of conditions and recommendations. Until significant deficiencies are corrected, all field pricing reports for that contractor will contain a recommendation about proposed cost and pricing data adjustments necessary to protect the Government's interest. Contract audit follow-up procedures under DoD Instruction 7640.02 (Section 15-600) apply to these reports. MMAS deficiencies should be identified as material accounting system deficiencies which are recorded in the permanent file Internal Control Audit Planning Summary (ICAPS) form (see 3-300) and the status of corrective action should be reported in the Contractor's Organization and Systems section of field pricing reports (10-306).

5-718 Disposition and Audit Follow-Up

a. On receipt of the MMAS report, the ACO will provide a copy to the contractor and allow 30 days, or a reasonable extension, for a written response. If no significant deficiencies are identified, the ACO will notify the contractor in a timely manner.

b. When the ACO determines there is a significant MMAS deficiency, the ACO will act in accordance with FAR 32.503-6 to suspend an appropriate percentage of affected costs on progress payment claims and public vouchers. After acceptance of the corrective action plan, but before complete implementation, the ACO will reduce the suspension, as appropriate, to reflect the contractor's progress. However, total amounts of affected costs will not be approved for progress payments or public vouchers until the contractor's system is determined to be acceptable for Government contracting or the amount of impact is determined to be immaterial.

c. The specific procedures for computing a cost impact will vary significantly based on the contractor's operations, conditions of the deficiencies, and compensating controls. The auditor should make every effort to quantify the effect of the specific deficiencies found during the audit. The auditor should:

(1) develop an independent quantification of the identified deficiency

(2) ensure that the methodology is representative of the specific conditions

(3) ensure it provides a reasonable estimate of the harm to the Government at the specific location.

5-800 Section 8 --- Compensation System Internal Controls

5-801 Introduction

Refer to 5-100 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk. This section provides guidance for:

(1) evaluating contractor compensation systems and related internal controls, and

(2) determining whether compensation costs resulting from the system are allowable and reasonable in accordance with the requirements of the FAR.

The audit guidance described in the following paragraphs applies primarily to major contractors, but can also be adapted for use at nonmajor contractors where audit risk warrants a detailed audit of the contractor's compensation system.

5-802 Background Information

a. Compensation for personal services is one of the largest components of cost incurred under Government contracts. It includes all remuneration paid currently or accrued, in whatever form, and whether paid immediately or deferred, for services rendered by employees to contractors during contract performance. The objective of a compensation system is to provide the level of pay and benefits necessary to attract, retain, and motivate employees to direct their efforts toward achieving the goals of the organization. To be considered adequate, a contractor's compensation system must be reliable, be subject to applicable management control objectives and activities, and result in allowable, allocable and reasonable compensation costs charged to Government contracts in accordance with FAR provisions.

b. The regulatory foundation for audits of contractor compensation systems resides in FAR 42.302, FAR 31.201-3, and FAR 31.205-6. FAR 42.302(a)(1) provides that the contract administration office will review a contractor’s compensation structure. FAR 31.201-3, Determining reasonableness, provides general criteria for determining whether a cost is reasonable in its nature and amount, and FAR 31.205-6, Compensation for personal services, provides both general criteria and additional requirements for evaluating the allowability, allocability, and reasonableness of the different elements of compensation.

c. As provided in FAR 31.205-6(a), to be allowable, total compensation:

(1) must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages,

(2) for individual employees or job classes of employees, must be reasonable for the work performed,

(3) must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment,

(4) is not presumed to be allowable where the contractor introduces major revisions of existing compensation plans or new plans and the contractor has not provided the cognizant ACO, either before implementation or within a reasonable period after implementation, an opportunity to review the allowability of the changes,

(5) costs that are unallowable under other paragraphs of FAR 31.2 are not allowable under FAR 31.205-6 solely on the basis that they constitute compensation for personal services, and

(6) costs for certain individuals (e.g., owners of closely held corporations, immediate family members, and others with a substantial financial interest) require special consideration. For these individuals, compensation must be reasonable for the personal services rendered; and not be a distribution of profits (which is not an allowable contract cost). Refer to 6-414 for guidance on evaluating the reasonableness and allowabilty of

compensation costs to individuals who pose a higher risk of unreasonable compensation.

d. As provided in FAR 31.205-6(b)(2), Compensation not covered by labor-management agreements, compensation for each employee or job class of employees is considered reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. The reasonableness of compensation is directly influenced by the compensation practices of other firms and by the supply and demand for a job as measured in the labor market for the job being evaluated. In addition to the provisions of FAR 31.201-3, in testing the reasonableness of compensation for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer, as well as those factors identified at subparagraph (b)(2) of the cost principle. Examples of factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms:

- of the same size,
- in the same industry,
- in the same geographic area; and
- engaged in similar non-Government work under comparable circumstances.

e. Certain elements of compensation are made expressly unallowable by FAR 31.205-6. These include compensation based upon changes in the prices of corporate securities (31.205-6(i)) and compensation in excess of specific limitations on the allowability of compensation for certain contractor personnel (31.205-6(p)).

f. As provided in FAR 31.205-6(b)(1), special provisions exist for determining the reasonableness of compensation amounts established under “arms length” labor-management agreements. Refer to the guidance at 6-413.1 for evaluating compensation costs set by the provisions of a labor-management agreement.

5-802.1 Description of a Compensation System

a. An adequate compensation system is considered an inherent part of establishing reasonable compensation. A system includes the organizational structure; established lines of authority, duties, and responsibilities; internal controls and managerial reviews; internal and external consistency; pay structures; budgeting; merit and incentive pay programs; and benefits program. A contractor may establish one compensation system to administer the compensation programs for hourly, administrative, technical, professional, and executive employees or establish separate systems for each group. The guidance provided is generally applicable to each situation, but should be adapted to the circumstances of the audit.

b. When auditing a contractor's compensation system, consideration should be given to the presence of characteristics that are generally indicative of an adequate system. An adequate compensation system:

(1) Requires periodic internal reviews of policy compliance, administrative process measures, and adequacy of documentation; reports to management on the results of reviews and recommendations for improvements; and requires corrective action plans to be developed, implemented, and tested.

(2) Is organized based on a definitive flow of authority.

(3) Includes written policies and procedures that specifically: (a) set forth the contractor’s compensation package, including cash and fringe benefit items, jobs, job families and career levels, pay grade assignments and changes to the pay structure, job analysis and job description requirements, external equity and market comparison process, performance management system, and employee benefits programs, and (b) ensures that compensation paid to employees for services rendered under Government contracts complies with FAR 31.205-6.

(4) Provides for sufficient training, experience, and skills to perform pay administration tasks in accordance with the contractor's established policies and procedures and current compensation theory.

5-802.2 System Deficiencies

Refer to 5-109 for guidance on determining whether an internal control system deficiency is significant. Significant compensation system internal control deficiencies:

(1) result in a determination that additional audit procedures must be performed in related audits to protect the Government's interest, or

(2) may directly result in or cause unreasonable compensation costs for the employee services rendered.

5-803 General Audit Policy for Compensation System Review(s) (CSR)

a. Refer to 5-103 for general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. It is DCAA's policy that Compensation System Reviews (CSRs) need only be routinely planned and performed for major contractors. However, if the field audit office has sufficiently documented that the compensation system for a particular nonmajor contractor presents a significant audit risk, then a CSR should be planned and performed for that contractor. Audits at major contractors may be modified if past experience has been favorable and current audit risk is considered to be low. This determination of low risk must be fully documented in the planning documents supporting the program plan. If audit risk is considered to be high, CSRs should be performed more frequently. Most compensation audits will be performed as separate assignments; however, at smaller contractor locations, selected compensation audit steps may be added to existing incurred cost or forward pricing audit programs.

5-803.1 Audit of Executive Compensation

a. The contractor's executive compensation system should be evaluated separately, even if the contractor does not have a separate pay structure for executives. FAR 31.205-6(b)(2) provides compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Policies and procedures for administering the compensation of executives should be evaluated using the guidance in 5-808, as appropriate to the circumstances. Some executives are also owners or in some other manner may directly influence their own compensation levels. See 6-414 for criteria to use in evaluating compensation under those circumstances.

b. The contractor's organizational structure should identify the contractor's executive positions. Generally, the list of contractor executives would include anyone with the title of vice president or above, and normally includes all individuals responsible for managing these primary functional areas:

(1) executive office,
(2) controller-accounting,
(3) legal counsel,
(4) engineering,
(5) manufacturing,
(6) purchasing,
(7) contracts, and
(8) individuals responsible for major programs or product lines.

c. Top executive positions are unique and must be audited individually. Position descriptions emphasize rank, function, responsibility areas, goals to be attained, impact of decisions, and number of employees directed. Divisional executives can be distin-

guished from corporate home office executives by their reporting level. Executives are not a class of employees. Overpayment of one cannot normally be offset against underpayment of another. However, in large organizations there may be a class of vice-presidents who have similar rank, function, and responsibility. In these cases, offsets may be appropriate.

d. Executives may be rewarded not only for their contribution to the organization, but also on the profitability of their functional unit, as well as the overall profitability of the company. Pay packages include short- and long-term incentive pay, as well as base pay, benefits, perquisites, and services. Amounts reimbursed for the executives for the payment of taxes may also be included. These are a directly associated cost (see 5-1009.1), which may be allowable or unallowable, that are generated solely as the result of the incurrence of another cost. For publicly traded companies, the board of directors normally sets executive pay packages based on the compensation committee's recommendations. Details of the compensation committee's meetings and research are available in the proxy statement.

e. An audit of the contractor's executive compensation system should include:

(1) Evaluation of the compensation system, as appropriate, in 5-806 to 5-811.

(2) Determination that the policies and procedures provide a description for how executive compensation levels are established and who approves these levels; and eligibility criteria and basis for determination of how base salary, cash bonuses, long-term perquisites, benefits, services, and incentive pay bonuses are established.

(3) Supplemental Benefits. In many cases, executives have available to them enhanced or supplemental benefits which are not available to the majority of the workforce. These supplemental benefits or executive benefits should be evaluated on a case by case basis. The supplemental plans should be evaluated in accordance with the applicable subparts of FAR 31.205-6 and CAS. These benefits should be evaluated for reasonableness based on market surveys or any other available data. The prevalence of such plans should also be considered in determining reasonableness. For example, if a survey states that the average Long-Term Incentive (LTI) Payment for a contractor is 10% of base salary, a 10% LTI plan would not necessarily be reasonable. The reasonable amount could be significantly different, or the payment could be unreasonable altogether if only a small percentage of the participating companies have LTI plans. A few of the supplemental or enhanced executive benefits that should be audited in detail are described below:

(a) Supplement Executive Retirement Plans (SERPs). These plans are designed to provide the executive with earned benefits in excess of amounts payable under qualified retirement plans. These plans are often referred to as ERISA Excess Plans. These plans should be evaluated in accordance with FAR 31.205-6(j) and CAS 412. It is the contractor's responsibility to demonstrate the reasonableness of a SERP by providing the auditor with comparable market data. If the contractor is unable to provide measurable market data for comparison purposes, the auditor should attempt to determine a reasonable amount or reasonable percentage of base salary for total pension expenses based on surveys or other sources. If the auditor is unable to obtain comparable market data to demonstrate the reasonableness of material SERP costs, the auditor should challenge the costs and report this as a significant deficiency.

(b) Deferred Compensation. Deferred compensation is an award given by an employer as compensation to an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt by the employee. The cost of deferred awards shall be measured, allocated, and accounted for in compliance with CAS 415 in order to be allowable. There are many forms of deferred compensation, such as Split-Dollar Life Insurance and "rabbi trusts." Split Dollar Life Insurance is a plan that gives both the employer and employee an interest in a cash value life insurance policy on the employee's life. A rabbi trust is used to accumulate deferred compensation, usually to fund a SERP. The amount of the award should also be evaluated

for reasonableness if the contractor's award is determined to have been made in accordance with CAS 415.

(c) Long-Term Incentive plans. LTI plans are compensation plans that have an award period of two or more years. These payments are typically based on achievement of long-term business goals or as a method of retaining key executive talent. The most common LTI plans are based on stock options that are unallowable per FAR 31.205-6(i). Long Term Incentive payments should be evaluated on a case-by-case basis, including prevalence of such plans, in order to determine reasonableness.

(d) Executive Severance. Severance payments should be evaluated in accordance with FAR 31.205-6(g). Most severance policies are based on a formula that relies on length of service/employment as the determining criterion in the calculation of the severance amount. In many cases, executives are awarded severance in excess of the normal or established policy. Contractors often argue that severance payments are based on executive employment contracts. However, the fact that a severance payment is based on an executive employment contract does not necessarily support the amount as reasonable. This amount should be evaluated based on severance policies of comparable executive positions in accordance with FAR 31.205-6(b)(2). Refer to 7-2107 for additional guidance on severance payments.

(4) The costs of "golden parachute" benefits were made expressly unallowable in FAR 31.205-6(l)(1), effective April 4, 1988. Refer to 7-2107.8 for additional guidance on the evaluation of "golden parachute" benefits.

(5) A comparison of executive pay (salaries, bonuses, and deferred compensation) for the current year to several past years for the purpose of establishing trends. The auditor should obtain the contractor's explanation and justification for significant increases. Also, consider the company's financial performance trends relative to the trends in executive compensation. (See 6-414)

f. When evaluating the contractor's market comparisons of top executive pay (see 5-808.8), the executive compensation components being evaluated should be consistent with that shown in executive compensation survey data. Survey data most frequently includes base pay and cash bonuses combined and long-term incentive pay as a percentage of base pay.

g. Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by comparable firms for executives with similar duties. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance, as documented by financial performance that exceeds the particular industry's average.

(1) Examples of such financial performance measurements may include the following:

- Revenue Growth
- Net Income
- Return on Shareholder's Equity
- Return on Assets
- Return on Sales
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share

(2) The contractor must show that the measure chosen is representative of the executive's performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard which is not affected by the executive's performance, and certainly there should be no extra compensation due to performance which results primarily from the contractor being a Government contractor.

(3) Use of a particular criterion to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measure reflected in the changes to compensation claimed as reasonable.

h. If the audit of the contractor's executive compensation system determines that significant system deficiencies exist or the contractor has established pay policies or procedures that appear to promote unreasonable compensation levels, conduct specific testing of the reasonableness of the executive compensation under FAR 31.205-6(a)(6), as outlined in 6-414.

5-803.2 CAC/CHOA Network Coordination

a. The CAC/CHOA should consider coordinating compensation audits at all major network components. The amount of coordination will depend on the degree of centralization of the contractor's compensation system and the location of the contractor component responsible for the administration and control of each significant element of the compensation package. For instance, a large multi-segmented Government contractor may administer and control both the executive compensation plan and the fringe benefit packages for non-bargaining unit employees from the corporate office, the incentive compensation plan for mid-management personnel out of a group office, and salary administration for the personnel providing services in the performance of Government contracts at the division level. Consideration must be given to such factors when programming and performing a CSR at a large multi-segmented contractor. When control over executive compensation or some other component of compensation is at another location or another corporate level, do not complete a segment/division CSR without obtaining input from the auditor at the other location or level on the compensation component administered at that location or level.

b. For compensation audits to be effective and completed on a timely basis, early and adequate CAC/CHOA coordination, planning, and audit initiation is required. Lack of coordination and planning can cause increased audit effort and inconsistency among network components. A CAC/CHOA network planning meeting may be necessary for this purpose. (See 15-200 for guidance on DCAA's CAC program.)

c. Establish each segment/division CSR within a CAC/CHOA network as a separate assignment. Follow this procedure even for network segments/divisions located within the same region regardless of the degree of centralization of the contractor's compensation system. Issue a separate audit report for each segment/division CSR performed and forward a copy to the CAC/CHOA. The CAC/CHOA may consolidate these reports into one overall report if all CSR issues from all segments/divisions are to be addressed at the corporate level by the corporate ACO (CACO).

5-803.3 ACO and PCO Coordination

a. FAR 31.205-6(b)(2) provides the contracting officer with the authority for determining whether compensation for each employee or job class of employees is reasonable for the work performed. Also, a determination of compensation reasonableness can be made by job grade level in accordance with FAR 31.201-3. From July 1997 to August 2003, FAR 31.205-6(b) contained language to allow offsets of allowable elements of employees' compensation packages among jobs of the same pay grade or level. In August 2003, the Cost Principles Committee eliminated the job grade level language as being redundant with the reasonableness provisions of FAR 31.201-3. The provisions of FAR 31.201-3 allow compensation to be determined as reasonable at the job grade level. Compensation can be justified as an ordinary and necessary business practice, a generally sound business practice, or an established practice. Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Offsets between individual compensation elements are implied in this concept in order to determine total reasonableness. The authority includes the determination of the factors to be considered relevant when evaluating the reasonableness of

compensation. It is important that the auditor seek a mutual understanding with the contracting officer at the start of the audit regarding the (1) factors to be considered relevant when evaluating the contractor's level of pay in relation to the labor market, and (2) approach for evaluating compensation by particular employee, job classes of employees, and/or by job grade.

b. Meet with the ACO before the scheduled starting date of a CSR to discuss its scope and audit objectives. Advise the ACO regarding DCAA audit policy for determining and evaluating the contractor's use of the relevant factors identified in FAR 31.205-6(b)(2) and request the ACO to provide the auditor with any other factors the ACO may consider relevant under the circumstances. Also advise the ACO regarding the planned audit approach for testing reasonableness by particular employee for contractor executives, and by job classes of employees and job grade for non-executive/non-bargaining unit employees. Request comments on any problems or special areas of interest relating to the contractor's compensation policies, procedures, and practices for consideration in the CSR.

c. Coordination with the ACO is essential throughout a compensation audit. Actively solicit ACO participation at the entrance and exit conferences, and keep the ACO informed of all significant audit developments. After completion of the field work, but before the draft report is released to the contractor, review all significant findings and recommendations with the ACO (see 5-811). Report disagreements with the ACO that cannot be resolved locally to the regional office.

5-803.4 Coordination with the Contractor

Inform the contractor of the upcoming CSR by sending a letter to the management executive responsible for the organizational unit to be audited. Describe the purpose and general scope of the audit, indicate the tentative starting date, identify the auditor in charge, and request the name of a contractor representative with whom audit matters can be coordinated. Identify specific data needed at the start of the audit (e.g., a list of all individuals who develop the compensation policy) and state the proposed date for an entrance conference. Also suggest the contractor present an orientation briefing on its compensation system, policies (including the process used to develop them), procedures, and other relevant data. Provide an information copy of this letter to the ACO.

5-804 Audit Objectives

The audit of a contractor's compensation system has two objectives. The first objective is to assess control risk to determine the degree of reliance that can be placed on the contractor's internal controls as a basis for planning the scope of other related audits. The second objective is to perform sufficient audit procedures to demonstrate that a contractor's compensation system results in allowable and reasonable compensation on Government contracts. Refer to 5-104 for guidance relating to the primary objectives for auditing the contractor's accounting and management internal control systems. Refer to 5-108 for guidance on the auditor's tests of controls. Testing controls involves selecting a limited sample of transactions and evaluating whether they were executed in accordance with established policies and procedures. They provide the auditor with evidential matter to support a determination that internal controls are designed and operating effectively to prevent or detect material misstatements in a timely manner. Tests of controls are necessary to support a control risk assessment below the maximum.

5-805 Scope of the Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. In establishing the scope of audit effort, the auditor should carefully consider the nature and extent of documentation available from prior system audits, related audit effort, permanent files, and the results of contractor's self assessment efforts and internal audits (see 4-1000, Reliance on the Work of Others). Reliance on this information allows the auditor to better focus current audit efforts on areas of greatest risk.

c. Additionally, contractor management has the responsibility to establish and maintain effective internal control over the compensation system. This includes the control activities established to provide reasonable assurance that compensation for each employee, job class of employees, or job grade of employees on Government contracts complies with the requirements of the FAR, including FAR 31.205-6. As part of the preliminary audit effort, the contractor should be requested to disclose its compensation system, how the control objectives outlined below are accomplished, what efforts management has made to evaluate the continued effectiveness of control procedures, and provide their assessment of the aggregate of compensation elements for reasonableness prior to the auditor expending considerable resources.

d. The determination that the contractor has established and maintained an adequate compensation system, and has demonstrated that it is compliant with the requirements of FAR 31.205-6, as set forth in the guidance, will negate the necessity to perform independent tests of reasonableness. Only in the specific circumstance identified at 5-808.9b(1) will the auditor perform an independent test of reasonableness, as provided for in 6-413.2.

e. The evaluation of a compensation system that governs compensation, established in accordance with an arm's-length negotiated labor-management (union) agreement, and the reasonableness of compensation costs resulting from such agreements, will be limited to the guidance in 6-413.1.

f. The Service Contract Act of 1965 requires contractors to pay minimum wages and fringe benefits, in accordance with Department of Labor (DOL) wage determinations, to employees performing on service contracts with the Government. Covered employees do not include those employees in an executive, administrative, or professional capacity. If contractors subject to the Act are compensating employees in accordance with DOL determinations on prevailing wages in the area, no determination of the reasonableness of compensation should be made for these employees. Therefore, audit guidance contained in 6-413.2 is not applicable.

g. Other wage laws that require payment of prevailing wages, as determined by DOL, are the Davis-Bacon Act of 1931 and the Walsh-Healy Public Contracts Act of 1936. Accordingly, audit guidance contained in 6-413.2 does not apply to employees' wages covered by these laws.

h. Cost principles for educational institutions are contained in OMB Circular A-21. Refer to 13-210, 13-406, and OMB Circular A-21 for the general audit approach for the audit of a compensation system at an educational institution.

5-806 Management Reviews of the Compensation System

a. Company management should monitor its compensation programs to ensure that they are properly administered and maintained and result in compensation costs paid for services rendered on Government contracts that comply with the requirements of FAR. Monitoring is one of the five interrelated components of internal control. It is the process that assesses the quality of internal control performance over time (refer to 5-102).

b. Periodic monitoring should serve to assess the effectiveness of the pay administration system and the company policies to achieve specified pay objectives. A contractor's monitoring system should be designed to provide reasonable assurance that financial related transactions resulting from the compensation system are recorded properly to permit the preparation of Government contract cost representations in accordance with applicable laws and regulations. In addition, the results of the contractor's monitor-

ing efforts should provide feedback to management by identifying problem areas for directing future development and design efforts.

c. The contractor should have policies and procedures relating to its monitoring of the compensation system. These policies and procedures should outline who will perform the monitoring function, what will be reviewed and under what circumstances the review will be performed. The policies and procedures should specify the role that the contractor's internal audit department will have in monitoring the compensation system.

d. A team or committee should be formed with experience in compensation to perform the periodic internal reviews. At the conclusion of its review, this committee should provide management a detailed report of its review along with any recommendations. Management should review the results and recommendations, prioritize the improvements that are required, allocate the necessary resources, and follow up to ensure that the work is completed.

e. Evaluate the contractor's system of monitoring to determine that:

(1) Contractor management has established policies and procedures for periodically monitoring the compensation program to ensure that resulting costs comply with the requirements of FAR.

(2) The contractor has qualified personnel performing the monitoring function that receive specific training relating to the field of compensation or whose work experience is relevant.

(3) Reviews are performed and the frequency of the reviews (such as semiannual, annual, two-year cycle) is adequate.

(4) Recommendations from the review are implemented or other alternatives assessed within a reasonable period. Reasons for not implementing recommendations are documented.

f. The scope of the audit to be performed on the contractor's compensation system should be adjusted to consider the extent that the contractor's internal review of the system can be relied upon. Refer to 4-1000, Relying on the Work of Others.

5-807 Evaluation of Organization and Assignment of Responsibility

a. The compensation function may be organized differently by individual contractors because of the nature of their products and services, size and type of organization, degree of decentralization, management attitudes, capabilities of personnel, and other factors. Decentralization of the compensation function refers to a management strategy of giving separate organizational units the responsibility to design and administer their own systems. In contrast, a centralized system locates the design and administration responsibilities in a single corporate unit. Determine early in the audit the degree of centralization of the compensation function in order to adequately plan the audit scope when an organization with multiple operating units is involved. Refer to the guidance on CAC coordination on multiple unit audits in 5-803.2.

b. Another structure variation sets up the corporate compensation function as if it were an internal consultant with pay professionals required to market their pay programs and services to operating units. Normally, certain compensation plans such as health and medical plans, pensions, and corporate-wide profit sharing plans remain under the control of the corporate group. However, the responsibilities for other compensation functions, such as job analysis, evaluation, surveys, and pay structure design, are delegated to the operating units.

c. The compensation function should be organized on the basis of a definitive flow of authority and standard policies and procedures established at a top or upper management level. Each contractor should maintain a written description of the organization and duties of the personnel responsible for the design and administration of the compensation function.

d. Evaluation of the contractor's organization requires an analysis of the relationship of the organizational segments participating in the compensation function. For this purpose, the contractor should provide:

(1) organization charts,

(2) written procedures or directives describing the organizational structure and responsibilities of the compensation design and administration group(s) and contributing departments, and

(3) flow charts showing the work flow of the compensation system design and administration.

e. The evaluation should disclose whether:

(1) The total compensation function is effectively controlled, either on a centralized or decentralized basis.

(2) Lines of authority, duties, and responsibilities are clearly defined, including responsibilities for establishing, reviewing, and approving changes to the cash and non-cash compensation plans.

(3) The organization structure clearly identifies the unit responsible for ensuring that the value of the total compensation package (cash plus other benefits) offered employees for services rendered in the performance of Government contracts is allowable and reasonable in accordance with the FAR.

(4) The organization structure clearly identifies the unit responsible for ensuring the contractor complies with FAR 31.205-6(a)(4) by coordinating major revisions to its existing plan or new plans with the cognizant ACO.

5-808 Evaluation of Policies and Procedures for Non-Bargaining Unit Employee Compensation

a. Contractor management is responsible for establishing and maintaining adequate internal control. As defined by SAS No. 78, internal control is "a process effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

(1) reliability of financial reporting,

(2) effectiveness and efficiency of operations, and

(3) compliance with applicable laws and regulations."

Control activities, one of the five interrelated components of internal control, are the policies and procedures that help ensure that management directives are carried out (refer to 5-102). The compensation system of a company is of sufficient importance that direction and guidance for the implementation of the company's compensation objectives must be in a form that ensures understanding and avoids misinterpretation. As an internal control measure, a formal statement of policies and procedures, rather than an informal one based on established customs of the company, is expected to exist at all contractor locations with substantial Government business.

b. Policies are management's statements of principles for accomplishing the contractor's compensation objectives. These include:

(1) basic policies used by proprietor(s) or board(s) of directors to guide the course of business and to make the most effective use of resources including employee services,

(2) supplemental and broad policies by top management to explain and carry out the board's basic compensation decisions, and

(3) operational policies issued at lower management levels expanding the company's broad compensation policies as they apply to subordinate organizational elements.

c. Policies and procedures should cover such areas as the contractor's:

(1) total compensation package including cash and fringe benefit items,

(2) jobs, job families and career levels,

(3) pay grade assignments and changes to the pay structure,

(4) job analysis and job descriptions,

(5) job evaluation processes,

(6) external equity and market comparison processes,

(7) employee benefits programs, and
(8) compliance with Government laws and regulations including FAR 31.205-6.
d. Determine whether the contractor's compensation policies are:
(1) adequately documented,
(2) consistent with prudent business practices,
(3) adequate to provide sufficient control and accomplish management goals,
(4) consistent with FAR, promulgated cost accounting standards, Government laws and regulations, and contractual requirements,
(5) periodically reviewed and updated, and
(6) effectively implemented by adequate procedures.

5-808.1 Evaluation of the Total Compensation Package

a. Contractor management is responsible for designing a total compensation package that takes into consideration the mix of cash and benefits needed to attract, retain and motivate the kinds of personnel needed to accomplish the entity's mission. Cash compensation is any type of cash payments made to employees in exchange for their contributions to the entity. It includes wages and salaries, cost of living allowances, bonuses, incentives, and merit adjustments. Benefits include all forms of non-cash compensation made to employees including health coverage, life insurance, pension plans, FICA/FUTA payments, and paid time off. Additionally, payment of some elements of the compensation package may be deferred to later accounting periods. The total compensation package design and any proposed changes to it should take into consideration budgetary constraints, employee expectations, the needs of the company and management, as well as cost/benefit analyses.
b. Evaluate and test the contractor's control activity over the compensation function to determine that policies and procedures exist for:
(1) Identifying and communicating to employees the specific elements of the total compensation package.
(2) Ensuring that the aggregate of each element of the total compensation package complies with the allowability and allocability requirements of FAR 31.205-6, and that the compensation in total is reasonable in accordance with FAR 31.205-6(b)(2). Refer to 6-413.2 for guidance regarding evaluation of reasonableness on Non-Bargaining Unit Compensation in accordance with FAR 31.205.6(b)(2). Also refer to 6-413.4a for guidance regarding auditor use of the 10 percent range of reasonableness when evaluating compensation costs.
(3) Determining the business mix of wages, bonuses and benefits to meet the needs of their business and workforce. Compensation should be reviewed for reasonableness in total by employee, job class of employees; or job grade of employees and that offsets are implied in this concept. Refer to 6-413.7 for guidance regarding offsets.

5-808.2 Evaluation of Jobs, Job Families (Classes) and Career (Grade) Levels

a. A job is a cluster of work tasks, the completion of which serves an enduring purpose for the organization. At FAR 31.001, definitions are provided for each of the following terms: job, job class of employees, and labor markets. These terms are central to the regulatory provisions for determining reasonableness found in FAR 31.205-6(b)(2). The cost principle provides that the reasonableness of compensation costs shall be tested by individual employee or job class of employees. In compensation practice, jobs are categorized into job families (classes), which include jobs involving work of the same nature, but requiring different skill and responsibility levels. The FAR definitions for job and job class of employees match the concept of a job family as used in the field of compensation. A job family (class) represents the career (grade) level progression for a job. For instance, the job family (class) of engineers would include the job of junior engineer, intermediate

engineer, senior engineer, and lead engineer (skill/responsibility level). The career (grade) level represents the progressive degrees of accountability, complexity, leadership, knowledge and experience within a job family (class). The career (grade) levels established by a contractor typically reflect the career (grade) levels in the labor market for the same job family (class).

b. Evaluate and test the contractor's control activity over the compensation function to determine that:

(1) The compensation department's market comparison process tests the reasonableness of wages and salaries by job class or grade level to demonstrate reasonableness in accordance with FAR 31.205-6(b)(2) (See section 5-808.8).

(2) Management takes corrective action to bring into line the pay levels for those job classes or grades found to have unreasonable levels of compensation. Unreasonable levels of compensation can occur when the contractor's actual weighted average rate of pay for a job class or grade exceeds by ten percent the market weighted average rate reported in the pay survey. Refer to 6-413.4a for DCAA policy regarding auditor use of the 10 percent range of reasonableness when evaluating compensation costs.

5-808.3 Evaluation of Pay Grade Assignments and Changes to the Pay Structure

a. A pay or salary grade is defined as one of the levels or groups into which jobs of the same or similar value are grouped for compensation purposes. A pay grade will include all jobs having the same relative value to the entity. Jobs are assigned to grades based upon market value and job content. Job family progressions, supervisor/subordinate relationships, and administrative considerations influence the number of job grades. For control purposes, each pay grade will have a pay range maximum, minimum, and midpoint.

b. A pay structure is a hierarchy of job grades and pay ranges. It is an administrative tool designed to be internally fair, externally competitive, and cost effective. A pay structure provides management with a means to effect administrative and financial controls. An entity may have more than one pay structure depending upon the diversity of jobs in the organization. A pay structure can provide a consistent basis for controlling and promoting the equity between external and internal factors.

c. Broadbanding is an approach to pay structure design that uses fewer pay grades. The characteristics of a broadband pay structure include:

(1) the use of bands in lieu of pay grades,

(2) each band containing a wide variety of jobs,

(3) salary ranges that are very wide, typically exceeding 100 percent,

(4) vertical advancement from band to band that is de-emphasized in favor of career level progressions within the band,

(5) band midpoints that are de-emphasized due to the wide level of labor market data associated with each band, and

(6) market pay survey data as the primary means of managing cash compensation.

d. Periodically, management should review the pay structure for needed adjustments. The adjustments are made to reflect assumptions about inflation, the impact of changes in the labor market, and the effect of changes to base pay. Changes can include general pay increases, market adjustments, cost of living adjustments, and merit increases. Also, new jobs may be added to the pay structure and existing jobs may be re-slotted into different pay grades.

e. Evaluate and test the contractor's control activity over the administration of its pay grade assignments and changes to its pay structure(s) to determine that:

(1) The assignment of a new job(s) into a pay structure is based upon, and supported by, a job analysis (5-808.6a.) and job evaluation techniques (5-808.7).

(2) The reassignment of an existing job from one pay grade into another is based upon, and supported by, the results of job analysis and job evaluation techniques.

(3) The compensation department tests the impact of the annual adjustment to salaries and wages to determine that the resulting levels of compensation by job class and grade remain reasonable in accordance with FAR 31.205-6. Refer to 6-413.4a for DCAA policy regarding the use by the auditor of the 10 percent range of reasonableness when evaluating compensation costs.

(4) Management takes corrective action to bring into line the pay levels for those jobs in a pay grade found to have unreasonable levels of compensation.

5-808.4 Market Based Pay Systems

a. Market based pay systems are pay systems where labor market data takes priority over internal considerations when valuing a job. Market based pay systems have become the predominant method used by contractors today to establish salary levels for jobs and to design pay structures. Characteristics of market based pay systems include: ease of administration; ease of comprehension; responsiveness to market changes; and a requirement for market data. In a market based pay system, the contractor's primary means for valuing a job is through the use of pay surveys. Pay survey data indicates what an entity's product and labor market competitors are paying for a job. In a market based pay system, a high percentage of the total number of jobs are valued using pay survey data. A market based pay system is a system based upon external equity.

b. Market based pay systems place limited emphasis on internal equity as a means of valuing jobs. Elaborate systems of job evaluation such as the point factor method and the factor comparison method, which use internally generated data to assess the value of each job in comparison to all other jobs in an organization, are de-emphasized in favor of the slotting method (5-808.7(3)) However, a market based pay system still requires the maintenance of adequate job descriptions for use in matching contractor jobs to pay survey job descriptions.

5-808.5 Evaluation of Internal Equity or Consistency

a. Internal equity refers to the pay relationships among jobs or skill levels within an organization. It involves establishing and maintaining equal pay for jobs of equal worth and acceptable pay differentials for jobs of unequal worth. This is accomplished primarily through job analysis, job descriptions, job evaluations, and pay structure design.

b. When establishing pay structures, organizations may place primary emphasis on internal or external considerations or a blend of the two, depending on the needs of the organization. Refer to 5-808.4 for a discussion of a market based pay system.

5-808.6 Evaluation of Job Analysis and Job Descriptions

a. Job Analysis. Job analysis is a systematic and formal process for obtaining relevant information and data about a job. The information and data collected usually falls into two categories. The first category relates to the nature of the work and focuses on the duties and responsibilities of the job. The second category relates to the level of work and focuses on the skill, effort, accountability and working conditions of the job. Some of the common methods of collecting data for job analysis include questionnaires, checklists, diaries, interviews, and direct observation. The basic premise underlying job analysis is that jobs are more likely to be described, differentiated, and valued fairly if accurate information about them is available. Job analysis procedures may be used to evaluate changing jobs and to establish new jobs.

b. Job Descriptions. The information and data gathered about a job through the performance of a job analysis becomes the basis for the job description. Job descriptions identify, define and describe the most important features of the job as it is performed. These include the duties and responsibilities of the job as well as the level of skills, ef-

fort, accountability and working conditions of the work performed. Job descriptions have a variety of uses that include market comparison, salary survey exchanges, job evaluation, performance appraisal, recruiting and third party defensibility. Job descriptions play a key role in a contractor's market comparison process. The accuracy of a contractor's match of their job to the job described in a pay survey depends upon how well their job description describes the job actually being performed.

c. Evaluate and test the contractor's control activity over the compensation function to determine that:

(1) There are qualified personnel possessing training and experience to perform job analysis and write job descriptions,

(2) All job descriptions are reviewed on a cyclical basis to determine that they remain current, and accurately depict the duties and responsibilities of the job being performed,

(3) Job analysis is performed on new and changing jobs, and

(4) Job descriptions are revised based upon the results of the job analysis.

5-808.7 Evaluation of the Job Evaluation Process

Job evaluation is a formal process by which management determines the relative value to be placed on jobs within the organization. It involves the systematic evaluation of the job descriptions that result from job analysis. The job evaluation process compares jobs within an organization, and assembles these jobs in a hierarchy based on their worth. This hierarchy is called a pay structure. There are an almost limitless variety of evaluation methods emphasizing job content, but virtually all of them are modifications or derivations of the five major job evaluation methods listed below.

(1) Ranking. Ranking is the fastest and simplest of the classic methods of job evaluation. Evaluators rank jobs in order of their overall worth or value to the organization. The job that the evaluators believe to be most valuable is placed first, the one that they perceive as being worth least is ranked last and so on. Minimal job specifications are needed to use this method. These include the educational and knowledge or other qualities required to meet the demands of the job.

(2) Classification. A number of grades or levels are specified beforehand, and broad descriptions are written to delineate the characteristics of the jobs to be placed in each of the grades. Each job is then evaluated by comparing the job documentation to the grade description, and the job is assigned to the grade that most closely describes the job characteristics.

(3) Slotting. Slotting is similar to the classification procedure. The evaluator compares new job descriptions with jobs already in the structure, and slots each job into the grade assigned to jobs of similar overall worth. A matrix is often used, with grades on the vertical axis and departments or job families on the horizontal axis, to facilitate comparisons across organizational lines.

(4) Factor Comparison. In factor comparison, key (benchmarked) jobs are identified. A series of distinct factors such as skill, effort, responsibility, working conditions, or subfactors thereof are selected and set forth in an evaluation manual. Each key job is ranked within each factor listed in the manual. A monetary or point value scale then is assigned to each factor and apportioned to every job ranked within a factor. Nonbenchmarked jobs, or new jobs, are added to the system by finding the most appropriate monetary or point value within each factor. Totaling the points from each of the factors produces the final job rate. Job description specifications are derived from the job factors that are contained in the evaluation manuals.

(5) Point Factor. The point factor method is an evaluation technique used for exempt jobs. A number of factors are selected, such as those mentioned in factor comparison. These factors are weighted and a scale of point values is assigned to each to reflect this weighting. These factors are often set forth in an evaluation manual. Each job is compared to descriptions of the various levels or degrees within each factor. When the appropriate degree is selected for each factor, the assigned points are combined to produce a total score for each job.

Job description specifications are derived from the factors that are contained in the evaluation manuals.

5-808.8 Evaluation of External Equity and the Market Comparison Process

a. External equity or competitiveness refers to the relationship of the contractor's pay levels relative to that of its labor and product market competitors. The process is referred to as the market comparison process and focuses on the cash element of the total compensation package. It is accomplished by comparing the actual wage and salary pay levels for jobs within an entity to wage and salary pay levels established in the labor market for the same job. Data regarding pay levels existing in the relevant labor market is obtained from pay surveys. The specific jobs that are included in the market comparison process are referred to as benchmark jobs.

b. FAR 31.205-6(b)(2) provides four factors to be considered when evaluating the reasonableness of compensation costs (refer to 5-802d.). It also provides that the appropriate factors for evaluating the reasonableness of each element of compensation depend upon the degree to which these factors are representative of the labor market for the job being evaluated. Other factors having a direct impact on the labor market for a job include (1) the supply and demand for sought after skills and abilities, and (2) the extent of competition in product and service markets. Additionally, a contractor must consider internal factors such as its ability to pay, business strategies, productivity, and the skills and abilities of its work force when evaluating particular labor markets.

c. In administering its market comparison process, the contractor must establish control activities relating to the relevant market and the source of pay survey data.

(1) Relevant Market. The contractor's selected benchmark jobs are the basis for defining its relevant labor markets. The primary relevant labor market for a job generally includes companies that the contractor competes with for similarly skilled employees or the source of supply. This market consists of the geographic area(s) within which it would ordinarily expect to recruit all potential employees for a job and the geographic area(s) to which it would ordinarily expect to lose employees in that job. These geographic areas may be identical but need not be. This market can be defined within a geographic area, which consists of all or similar companies in the local, regional, national, or international market. Typically, the contractor would evaluate where it loses and finds employees to establish the initial basis of its relevant labor market.

(a) The relevant market will vary among each contractor and job family depending on pay objectives and the skills being evaluated. The relevant labor market will change depending on the job family being evaluated. For example, exempt jobs (administrative, professional, and managerial) tend to compete on a regional or national basis, while nonexempt (clerical) and hourly (production) jobs are most likely to compete in local and regional markets. However, generalizations of labor markets are not always correct. In large cities and metropolitan areas, high concentrations of engineers will translate into a regional labor market instead of a national market.

(b) Wages and benefits tend to vary according to the size of an organization. Accordingly, firms similar in size to the contractor should be included in the relevant market. The factor of size is most relevant in influencing pay for executives and to a lesser degree exempt and nonexempt.

(c) The factor of industry in defining the relevant market of a job relates to the company's competition in its product/service markets. This is important because of cost control and ability to pay considerations. Where possible, companies of the same industry, within the relevant geographic areas, should be included in the relevant market data for the job being evaluated. The factor of industry is most influential on the pay levels of exempt jobs. Where jobs are tied to a specific industry, as aerospace engineers are to the aerospace industry, the market for those jobs should be defined on an industry basis.

(2) External Pay Surveys. External pay surveys provide detailed data regarding market pay levels for specific jobs and are the primary tools used by the contractor to ensure compliance with its external equity pay policy and demonstrate compliance with FAR 31.205-6(b). The pay survey data identifies rate ranges and a central tendency figure such as a mean, median, or mode salary/wage level for each job. Pay surveys also provide a standard job description for each job along with career level progression charts that identify the knowledge, education, level of supervision required and work experience for each job within a particular job family. Do not use free internet surveys. They are not considered independent or objective.

(a) Three sources of pay surveys are available to a contractor making market comparisons:

- Published surveys that are available for the general public to purchase regardless of participation in the survey.
- Private surveys based upon data from survey company clientele and which only participants may purchase.
- Contractor self-conducted surveys.

(b) Contractors generally use private surveys and self-conducted surveys. The contractor can tailor these surveys to represent its relevant market by including specific companies representing its perceived product and labor market competitors. If a contractor uses free internet surveys to support proposed or incurred compensation costs, request assistance from the field or regional compensation technical specialist to perform an independent market analysis.

(c) In most cases, no one survey is sufficient to determine the market rate of pay for all jobs. Most companies use several surveys. A primary survey may be selected with secondary surveys used to corroborate the results of the primary survey.

(d) Consider the basis for the contractor's reliance on a source of pay survey data, including internal sources. Minimal information should include:

- The company name, society, or group that collected the data.
- The expertise in job evaluation and job analysis possessed by the individuals collecting the data.
- The names of the companies contributing data and the geographical location of the source data. The relation to and influence of these companies in the contractor's labor markets.
- The size of the sample of companies reporting data and the size of the companies reporting data for each job.
- The extent that the data is based on job titles and job descriptions.
- The number of years that the survey has existed.

(e) If the contractor uses internally developed pay surveys, determine if the contractor independently ensures that they are unbiased and reliable.

(f) Evaluation of the contractor's selected pay surveys should consider if:

- The survey provides specific job classifications with corresponding job content survey descriptions that identify duties, responsibilities, and experience. An acceptable alternative would be a maturity-curve survey because of difficulties encountered in evaluating professional, scientific, or engineering jobs.
- Well-defined written policies and procedures are established detailing what criteria are used to select the pay surveys in evaluating its wages (i.e., geographical location, company size, and type of industry).
- The pay surveys provide the weighted average rates (or median) by job. Also, the survey should provide sufficient range values, minimum and maximum rates, and/or percentile and quartile data to validate the average rate and changes to pay structures.

(g) Deficiencies in the contractor's selection and use of pay surveys include:

- Lack of job descriptions in pay surveys that cause the contractor to benchmark jobs based on position titles only. The use of job titles only in benchmarking does not ensure proper comparability of jobs.

- Lack of weighted average rate (or median) in the pay survey. Pay surveys may provide only the minimum, midpoint, and maximum pay ranges for each job classification. The midpoint of the range would not be reflective of the market rate because survey participants actually pay employees under the minimum and over the maximum.
- The contractor is unable to rationally support its basis for relying on the survey data used to make market comparisons.
- The pay survey the contractor uses is not representative of its labor market and there is no supporting data for the selection criteria.
- The contractor's compensation data were not excluded from the pay survey weighted average.
- The contractor does not remove identifiable and measurable unallowable compensation elements from market survey data prior to benchmarking.

d. Management is responsible for determining the extent to which external market considerations are used to monitor and influence its pay levels for the purposes of:

(1) ensuring that pay rates are sufficient to attract and retain employees

(2) controlling labor costs so that the organization's product and service prices are competitive, and

(3) ensuring that compensation paid for services rendered on Government contracts is reasonable in accordance with FAR 31.205-6(b).

e. Evaluate and test the contractor's control activity over the market comparison process to determine that:

(1) A valid match is obtained when comparing the job descriptions and career levels for the contractor’s job(s) included in the market comparison process and the job descriptions and career levels for the job(s) included in the market pay survey(s).

(2) The relevant labor market selected for those jobs included in the market comparison process takes into consideration the factors identified in FAR 31.205-6(b)(2) that are representative of the labor market for the job being evaluated.

(3) The actual wages and salaries paid by the contractor to its employees for services rendered in the performance of Government contracts remains reasonable in accordance with FAR 31.205-6(b)(2) and FAR 31.201-3 for particular employees, job classes of employees, and/or between the compensation packages of employees in jobs included in the same pay grade.

(4) Corrective action is taken when necessary to bring into line the actual wages and salaries for those jobs found to have unreasonable levels of compensation. Unreasonable levels of compensation occur when the contractor’s actual average (or median) rate of pay for a job class or grade exceeds by 10 percent the weighted average (or median) market rate reported in the pay survey. See 6-413.4a for a discussion of DCAA policy regarding the use of the 10 percent range of reasonableness when evaluating compensation costs.

5-808.9 Performance of Audit Procedures to Determine the Reasonableness of Wages and Salaries for Non-Bargaining Unit Employees

a. The second objective of a compensation system audit is to determine whether compensation costs resulting from the contractor’s compensation system are allowable and reasonable in accordance with FAR 31.205-6. An adequate compensation system will provide the auditor with sufficient evidence to determine and demonstrate in the audit working papers the reasonableness of the contractor’s wages and salaries in accordance with the requirements of FAR 31.205-6(b)(2).

b. Where the auditor has determined that, due to the existence of significant internal control deficiencies, a contractor’s compensation system does not sufficiently demonstrate that wages and salaries are reasonable in accordance with FAR 31.205-6(b)(2), the auditor must perform additional audit procedures. The scope and direction of the additional audit procedures will depend on the nature of the significant deficiencies. The determining factor is

whether the system deficiencies are such that they prevent a demonstration of reasonableness. System deficiencies related to the following control activities may prevent a demonstration of reasonableness:

- Classification of jobs, job families and career levels,
- Pay grade assignments and pay structure design,
- Job analysis and job descriptions, and
- External equity and market comparison processes.

For example, if the contractor lacks job descriptions for a significant number of its jobs, this would prevent the demonstration of reasonableness of compensation, either by the contractor's compensation personnel, or by the auditor.

(1) When system deficiencies are such that they do not prevent a demonstration of reasonableness, the auditor will follow the guidance at 6-413.2 and perform an independent assessment for reasonableness. The auditor will also follow the guidance at 5-811.3 and report, as a significant system deficiency, the specific defect in the contractor's control activity that is causing the compensation costs to be unreasonable and in noncompliance with FAR 31.205-6.

(2) When system deficiencies are such that they prevent a determination of the reasonableness of wages and salaries, the auditor should not follow the guidance at 6-413.2 and should not perform an independent assessment of reasonableness. Under these circumstances, the auditor should follow the guidance at 5-811.3 and report the condition as a significant system deficiency. The contractor will be given time to correct the deficiencies and then will be asked to demonstrate to the Government that the compensation system results in reasonable wages and salaries. The auditor should request that contractor management provide in writing the amount of time required before they will be able to demonstrate the reasonableness of its employee wages and salaries. This could be addressed in the contractor's written response to the draft audit report. When the contractor indicates the amount of time needed, the auditor should coordinate with the ACO to determine if the Government should take any other actions (e.g., contract billing withhold) to protect the Government from being billed for potentially unreasonable compensation costs in the interim.

5-808.10 Evaluation of Employee Benefits Programs

a. Employee benefits consist of compensation other than pay for time worked. Common benefits include health and life insurance, pensions, worker's compensation, pay for time not worked, etc. The contractor's benefit structure should complement its wage and salary structure(s). Benefits tend to be provided by an organization rather than by job, except for executive perquisites and certain deferred income programs.

b. Although organizations compete over wage and salary levels more than benefit packages, it is still necessary for the contractor to consider the competitive labor market when establishing benefit levels. As an essential control measure for benefit costs, the contractor's policies should require the comparison of its absolute level of benefits to those of its labor and product competitors. The contractor may decide to lead, lag, or stay competitive. This requires the use of benefit survey data.

c. Benefit costs are allowable to the extent that they are reasonable and required by law, employer-employee agreement, or an established policy of the contractor under FAR 31.205-6(m).

d. The contractor's benefit policies should establish:

(1) the contractor's competitive objective in the overall value of the benefits package compared to that of other firms,

(2) eligibility requirements for various benefits and the rationale for different probationary periods with different benefits,

(3) the flexibility in plan coverage offered to employees ("cafeteria-style" plans or average employee plans),

(4) the method of financing the benefit plans by either noncontributory, contributory, or employee financing.

e. As a means to control costs, the contractor should establish procedures to periodically conduct cost-benefit analyses of the company's benefit plans in total and of forecasts of future years' costs. These may be performed as adjuncts to the yearly budgeting process. The analyses should include determinations of the cost commitments for existing benefits programs and the costs of alternate or new benefits. If projected cost commitments are prohibitive, then alternative financing such as employee contribution may be necessary.

f. Evaluate and test the contractor's control activities over the employee benefit package to determine that:

(1) Each element of the employee benefit package complies with the allowability and allocability requirements of FAR 31.205-6(m).

(2) The aggregate of each measurable and allowable element in the compensation package (cash compensation plus fringe benefits) is reasonable in accordance with FAR 31.205-6(b)(2).

5-808.11 Evaluation of Employee Merit Pay Programs

As a means of increasing organizational productivity and controlling compensation costs, the contractor may adopt pay for performance programs in place of, or supplemental to, general wage increases, cost of living allowances (COLA), and seniority increases. Pay for performance programs include incentive and awards directly linked to desired employee behavior, contributions, or results achieved. Merit pay programs measure and rate employee performance through the performance appraisal system.

5-808.12 Performance Appraisal System

a. The performance appraisal system provides the mechanism by which the job holder's contribution and work performance during a specific time period are identified and documented. A formal appraisal process promotes desired organizational goal attainment. Without a formal appraisal process, employees' achievements may not be directed to desired goals and the controls and feedback to the organization are unlikely. The performance appraisal system provides an organization with information used for:

(1) human resource planning,

(2) identification of employee development and training needs,

(3) compensation administration, and

(4) validation of promotional selection procedures.

b. Determine the adequacy of the contractor's methods and procedures for evaluating employee performance and the pay rewards given for acceptable achievement of prescribed goals.

c. An adequate performance appraisal system should include:

(1) Policies that outline the kinds, format, and sufficiency of documentation required for each employee performance appraisal.

(2) Established evaluation periods and dates for completion of appraisal forms.

(3) Standardized appraisal formats for each system or type of appraisal system.

(4) Performance dimensions of a job to facilitate accurate and objective measurement of performance.

(5) An established rating scale with performance intervals such as unacceptable, acceptable, good, and superior performance and performance standards for each interval of performance.

(6) Required periodic training for all raters in the policies and procedures of the organization's appraisal system and in rating skills.

(7) Provisions for periodic program maintenance.

(8) Monitoring of performance appraisal ratings in appropriate groupings to evaluate training needs, provide feedback to managers and reports to senior management on the adequacy of the system and/or what needs improvement.

d. Performance-based pay plans include short- and long-term incentive pay plans and gain-sharing plans. Incentive pay plans establish a standard of accomplishment to which worker performance is compared to determine the level of increases. It can be a group or organizational goal. Incentive and gain-sharing plans involve three forms of payment: base pay, commission, and bonus. Review 6-414 for applicable guidance regarding compensation for employees who pose a higher risk pursuant to FAR 31.205-6(a)(6). An adequate performance-based pay plan should include:

(1) Documented policies and procedures.

(2) Established methods of rate determination or standard performance measures and guidelines on the relationship between the performance and the amount of award or incentive pay.

(3) The rules for eligibility for participation.

(4) An incentive fund based on a documented formula.

(5) Documentation requirements for the basis for the awards.

(6) Established timing of the evaluation and payment of award.

5-809 Training

a. Compensation administration employees should receive adequate training on those aspects of the compensation system which impact their respective duties and responsibilities. Adequate training is an important factor in the effective implementation of any system. When determining the adequacy of the training, the following factors should be considered: source of the training (e.g., American Compensation Association, university, etc.), method of training (e.g., formal course/seminar, self-study course, etc.), and the amount of training received over a period of time (e.g., the last year). When reviewing the contractor's training activities, the auditor should evaluate whether or not the contractor has a formal plan for ensuring that pay administration employees are kept apprised of developments within the pay administration profession as well as changes in the contractor's compensation system.

b. Evaluate the contractor's training system to determine that:

(1) Adequate training is provided in the application of Government procurement laws and regulations for employees involved in compensation administration.

(2) Compensation professionals receive adequate on-going training and continuing education in the field of compensation, in the use of advanced pay structure design, and in maintenance and administration techniques including appropriate documentation procedures.

(3) Employee training modules are periodically reviewed and updated.

5-810 Compensation System – Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control procedures are sometimes defined by classifying them into two types, IT general controls or IT application controls. Whether the control procedures are classified by the auditor as general or applications controls, the objectives of control procedures remain the same: to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should evaluate the IT general controls and the compensation system application controls to determine if they have been designed according to management

direction, GAAP, and applicable Government regulations and that control procedures are operating effectively to provide reliability of and security over the data processed.

c. General controls are comprised of:

(1) organization and operation controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and

(4) data and procedural controls. (See 5-400 for a more detailed explanation of general internal controls.)

d. Compensation system application control procedures are applied to the input, processing, and output phases of this single IT application. In contrast, general controls affect all applications and operational elements of all IT systems. Separate control procedures are developed for each unique application system, such as billing, MMAS, and in this instance, compensation. Although some application control procedures affect only one or just a few control objectives, most of the control procedures are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-811 Compensation System Review and Audit Results

5-811.1 Preliminary Findings

Discuss audit findings with the contractor during the audit to confirm factual accuracy. At the completion of the field work, summarize all tentative findings and conclusions and coordinate with the ACO. If the ACO does not support the audit position, immediately inform the regional office.

5-811.2 Exit Conference

a. After resolving any differences with the ACO, hold an exit conference in accordance with 4-304 to discuss the findings with the contractor. Include the contractor's reactions in the working papers and the report.

b. During these discussions, address the total variance between the cost of the compensation element challenged and that of the comparison point of the comparative survey data used to establish the unreasonable elements. However, challenge costs only to the extent they exceed the 10 percent range of reasonableness (see 6-413.4).

5-811.3 Corrective Action Plans

a. If the contractor concurs with the findings, request that it submit a specific time-phased corrective action plan for reducing compensation costs to reasonable levels and correcting related system deficiencies. If the contractor disagrees with the findings, request that it provide documentation justifying the reasonableness of the compensation elements challenged. Send the contractor a letter summarizing the conference discussions and request either the time-phased corrective action plan or the justification documentation. Send the ACO an information copy of the letter.

b. Contractor management is responsible for establishing and implementing corrective action plans to resolve system deficiencies and unreasonable compensation levels. The contractor is in the best position to evaluate and implement action plans. Action plans are expected to correct system deficiencies and eliminate trends of unreasonable compensation within a reasonable period of time. However, contractors are expected to initiate corrective action as quickly as practicable. A contractor is normally expected to reduce starting salaries and delay within-grade increases almost immediately and to make major strides to bring compensation costs under control within 12 months. Audi-

tors are expected to advise ACOs of the adequacy and timeliness of contractor action plans to resolve system deficiencies and the resulting unreasonable compensation.

5-811.4 Major Compensation Plan Revisions

Challenge increased compensation costs resulting from major revisions to existing compensation plans or new plans introduced by the contractor if the contractor has not provided the cognizant ACO either before implementation or within a reasonable period after it, an opportunity to evaluate the allowability and reasonableness of the changes. See FAR 31.205-6(a)(4) and 31.201-3.

5-811.5 Major Redeterminable Contracts

For major re-determinable contracts, consider recommending in price proposal reports that a ceiling be placed on labor escalation and fringe benefit costs. Another approach is for the ACO to enter into an advance agreement with a contractor limiting labor escalation and fringe benefit costs on all contracts.

5-812 Compensation System Review and Audit Report

5-812.1 General Reporting Considerations

a. After each compensation audit, issue an audit report to the ACO following the general guidance set forth in 5-100 and 10-400, as amplified below. If related audits or reviews by any other organization have recently taken place, incorporate the results into the compensation audit report, if feasible. Auditors should follow the guidance in 4-1000 when relying upon the work of others.

b. Because FAR 31.205-6 addresses some compensation elements only in general terms of their reasonableness and others in specific terms of allowability along with general reasonableness, the specific subsections referenced in the opinion paragraph should relate to the scope of the audit.

c. The purpose paragraph should accurately describe the systems audited. If the contractor has more than one compensation system or pay structure, the purpose paragraph should identify which systems or structures are the subject of the audit. All subsequent paragraphs should address each of the systems audited. If one system has a deficiency not shared by others, that deficiency should be separately identified to the particular system or pay structure.

d. Each CSR serves as the starting point for the next CSR for the same compensation system or pay structure, and establishes the basis for converting the findings of the next CSR to a monetary equivalent. It is therefore critical for system control deficiencies to be reported even if the current CSR does not disclose that those control weaknesses are causing unreasonable costs.

e. For compensation paid to top executives, owners, and other high risk employees (see 6-414), it may be appropriate to issue a separate report with the scope and reporting of results restricted solely to the reasonableness of compensation paid or proposed for those individuals. Such an audit report would specifically exclude an opinion on the adequacy of any systems in relation to the high-risk compensation if there is not adequate control within the system to assure that it is consistently applied to such employees.

5-812.2 Reporting on CSR Results of Audit

a. If the contractor's compensation system is determined generally adequate, the following statement would be appropriate in the results of audit:

> "In our opinion, the contractor's compensation system is adequate to consistently provide reasonable employee compensation costs to Government contracts in accordance with FAR 31.205-6 (a) and (b)."

This paragraph should be appropriately modified if some compensation subsystems or pay structures are not subject to adequate control to ensure that the compensation produced will continue to be reasonable in the future.

b. If the CSR determines that:

(1) Some systems or pay structures within the contractor's compensation system are deficient, or

(2) Some positions or individuals have inadequate internal controls over their compensation to assure consistently reasonable compensation, the control deficiencies will be reported even if the CSR does not find unreasonable costs caused by those deficiencies. This reporting will establish that the Government has noted the potential problem and reserves the option to question any unreasonable costs caused by those deficiencies in the future.

c. If unreasonable compensation is found, the results of audit section of the audit report may state:

> "In our opinion, under the contractor's current compensation system, cost avoidance in the amount of $1.6 million, of which $1 million is allocable to Government programs, was determined for pay grades identified in [applicable appendix or audit report section]. These costs were determined to be unreasonable under FAR 31.205-6(b)."

d. This statement should be followed by briefly describing the condition(s) or system deficiencies that resulted in the unreasonable findings and how the correction of the deficiencies could result in cost avoidance per 10-400.

e. When unreasonable costs are identified in the audit report, the following should be included:

(1) A listing of the contractor's jobs for which compensation levels are unreasonable.

(2) An estimate of the unreasonable compensation costs for each job.

(3) The methodology used and basis for determining that compensation costs are unreasonable and how all of the relevant factors were considered.

(4) A description of the surveys used for making the FAR comparison tests.

(5) The contractor's response to the audit findings (and, if appropriate, the auditor's rebuttal).

(6) A copy of the contractor's proposed corrective action plan along with auditor comments on its adequacy and timeliness.

(7) A recommendation that the ACO put the contractor on notice of the Government's intent to disallow unreasonable compensation costs if the contractor fails to take timely corrective action. Such a notice by the ACO should identify the first period during which it would be feasible for the contractor to make significant changes to its system. This "period of corrective action" should be determined on a case-by-case basis but should generally be the first full 12 months after the audit report is issued. The notice should also state that starting after the period of corrective action unreasonable compensation costs, both actual and projected, will be questioned. If the ACO issues a notice of intent, we will question all unreasonable compensation costs, actually incurred or proposed, for periods after the period of corrective action.

f. Audit reports issued on price proposals and rate agreements will question all unreasonable compensation costs proposed for periods after the period of corrective action.

5-812.3 CSR Reporting Considerations for Employee Fringe Benefits

All audit reports will contain the following qualifications relating to fringe benefits:

a. Scope: Modify this paragraph to refer to the "Qualifications" paragraph below.

b. Qualifications: Include within this paragraph a statement to the effect that the results of audit expressed in this report are qualified to the extent that subsequent audits by DCAA, the contract administration office, or others, of insurance, pension, and other fringe benefits may supplement the findings of this audit. When aware that specific audits are already in process or planned, state this information and identify the specific areas to be covered. In addition, determine if a recent DCAA or DCMA insurance and pension audit or review has taken place. If so, incorporate the results, if feasible, into the compensation system audit report. If incorporated, state this fact and reference the specific DCAA or DCMA report number and date. (See 5-1303 for guidance on insurance/pension reviews.)

c. Results of Audit: Always qualify this paragraph by referring to the “Qualifications” paragraph.

d. If, after giving consideration to offsets, fringe benefits in total and by individual element are within the range of reasonableness, include the following statement in the "Results of Audit" paragraph:

"Our audit disclosed no employee benefit costs considered unreasonable under FAR 31.205-6 (a) and (b)."

e. If a contractor cannot justify employee benefit costs that significantly exceed the average of the comparison data by more than 10 percent (after giving consideration to appropriate offsets), include the following information in the report:

(1) A statement in the results of audit paragraph that our audit disclosed that compensation costs for employee benefits are unreasonable under FAR 31.205-6 (a) and (b).

(2) A recommendation (in the results of audit paragraph) that the ACO issue the contractor a written notice of the Government's intent to disallow future unreasonable benefit costs.

(3) A listing of each unreasonable employee benefit element, identifying the unreasonable costs for each, and a listing of unreasonable incurred employee benefit costs questioned per FAR 31.205-6(a)(4) and 31.201-3.

(4) A summary or copy of the supporting documentation or action plan provided by the contractor.

5-812.4 Dispositioning CSR Report Findings

a. Except as noted in d. below, unreasonable compensation is not questioned for periods prior to completion of the “period of corrective action” [Refer to 5-812.2e.(7)] when unreasonable compensation costs are found during a compensation system audit and a prior CSR:

(1) Audited the compensation system as it is currently,

(2) Determined that the compensation system audited was acceptable at the time of the prior audit; and,

(3) Determined that the costs produced by that system were acceptable at the time of the previous CSR.

However, cost avoidance estimated for a 12 month period after the period of corrective action is recorded. Forward pricing rates for periods after the period of corrective action should also be adjusted. [Refer to 9-308, Incorporating Cost Avoidance Recommendations Into Price Proposal Audits, and 9-1200, Forward Pricing Agreements, for further guidance.]

b. If prior CSRs identified unreasonable compensation and the Contracting Officer (CO) issued a Notice of Intent to Disallow Costs (FAR 42.801), then all compensation costs that are unreasonable after the allowed period of corrective action should be questioned in forward pricing audits, proposals, and incurred cost audits. If the CO has not made a final determination on the unreasonable costs in a CSR, continue to question any unreasonable com-

pensation for periods after the period of corrective action until a final determination is made. If a CSR report discloses unreasonable compensation and the CO dispositions the audit report without supporting the unreasonable compensation, subsequent unreasonable compensation should not be questioned based on that audit.

c. Costs should be questioned for all periods of incurred costs and forward pricing if unreasonable costs are produced by:

(1) Failure to adhere to the previously audited system;

(2) Changes to compensation systems previously audited if the changes have not been audited; or,

(3) Pay structures or portions of systems previously audited which were found to be unacceptable or lacking controls at the time of the previous CSR.

d. Some contractors will have some pay structures, usually for executives or owners, which should be questioned for all periods if the compensation is found to be unreasonable. See 6-414 for additional information on special considerations of executives and owners.

5-900 Section 9 --- Audit of Labor System Internal Controls

5-901 Introduction

a. This section provides guidance for auditing contractor labor internal controls to evaluate the adequacy of the contractor's labor system and assess control risk related to the allowability and allocability of labor costs charged to Government contracts. The reasonableness of labor costs is addressed in 5-800 (Compensation System Reviews), 6-412 (Evaluation of Quantitative and Qualitative Utilization of Labor) and 6-413 (Reasonableness of Compensation Costs).

b. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal control and assessing control risk.

5-902 Background Information

a. Labor costs are usually the most significant costs charged to Government contracts, and usually comprise the base, or the largest element in the base, used for allocating indirect costs. Historical labor costs are often used to estimate labor for follow-on or similar item Government contracts. Unlike other cost items, labor is not supported by third party documentation such as an invoice, purchase order, or receipt. Contractor personnel have complete control over the documents or devices of original entry, whether they consist of timecards, electronic media, or some other means. Responsibility for accuracy is diffused throughout the contractor's organization. Consequently, the risks associated with the accurate recording, distribution, and payment of labor are almost always significant.

b. To assess control risk on the labor system as low and reduce substantive testing, the contractor's system should have:

(1) An effective method to monitor the overall integrity of the Labor/Timekeeping System.

(2) An effective employee awareness training program to reasonably assure that all employees are aware of the importance of proper time charging.

(3) Effective procedures for labor authorizations/approvals to facilitate the proper accumulation and recording of labor costs to cost objectives.

(4) Effective procedures for timekeeping to reasonably assure that labor hours are accurately recorded and that corrections to timekeeping records are documented, authorized, and approved.

(5) Effective procedures for labor distribution to reasonably assure the proper recording of labor costs to cost objectives.

(6) Effective procedures for labor cost accounting to reasonably assure that labor charges to the Government are in compliance with promulgated Cost Accounting Standards, generally accepted accounting principles, and contract terms/clauses.

(7) Effective procedures for payroll preparation and payment to reasonably assure independent preparation of the payroll, and that pay rates are appropriately authorized and accurate.

(8) Effective procedures for labor transfers and adjustments to reasonably assure that they are documented and approved.

5-903 General Audit Policy

Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

5-904 Audit Objectives

a. The purpose of the audit is to evaluate the adequacy of and the contractor's compliance with the labor system's internal controls. The objective is to assess control risk for the allowability and allocability of labor costs charged and billed to Government contracts.

b. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

5-905 Scope of the Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. Controls for interrelated audit concerns regarding the adequacy of the contractor's other major systems (e.g., IT General Internal Controls, Estimating, etc.) will be audited under separate assignments. While the controls for these areas are not part of this audit, the results of all audits of these interrelated controls must be considered in forming an overall audit conclusion on the labor system internal control and also commented on in the related audit report.

c. In many instances, control activities may be embedded in the contractor's IT system. In these cases, the auditor should adequately document and test the automated portions of the system and give proper consideration to the use of Computer Assisted Audit Techniques (CAATs) (see 5-108f).

d. The extent of audit effort should also be influenced by:

(1) the types of Government contracts and their materiality
(2) sensitive audit issues
(3) deficiencies noted in ongoing audits (audit leads)
(4) input from the contracting officer
(5) contract provisions

These areas are discussed in 3-104 and the auditor should document the impact of these considerations on the scope of this audit in the working papers.

e. The following paragraphs describe specific control activities considered significant for an adequate labor system.

5-906 Labor System Management Compliance Audits

a. The existence of strong self-controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should have policies and procedures for monitoring its labor system, including regular compliance audits, to ensure the timely and accurate recording, distribution, and payment of labor costs. These policies and procedures should be well defined, reasonable in concept, and effectively implemented by contractor personnel.

b. As a minimum the contractor should conduct regular internal control compliance reviews. These compliance reviews should address the following areas: the adequacy of written procedures, employee knowledge and compliance with policies and procedures, consistency with which the policies and procedures are applied and by whom, and timely follow-up action on deficiencies.

(1) Types of Reviews. The contractor may perform internal compliance audits by monitoring in the form of physical observation (floor checks), by testing labor charges for accuracy, by reviews of performance or exception reports, by requesting external audits, or by using a combination of techniques.

(2) Adequacy of Compliance Review Procedures. Whatever the form of the compliance reviews, there should be procedures which identify the intervals of performance of

the reviews, the personnel responsible for performance of the reviews, the areas to be covered during the reviews, the specific steps to be performed in the reviews, the documentation needed to demonstrate the procedures have been performed, and the requirements for follow-up action.

(3) Overall Adequacy of Compliance Reviews. The adequacy of the compliance reviews should be assessed in accordance with the criteria in 4-1000. The reviews should be performed in accordance with written procedures and by personnel possessing the level of competence, independence, and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor's risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, lack of employee knowledge or compliance with the written procedures, or untimely follow-up actions.

5-907 Review of Employee Awareness Training

a. Policies and Procedures. The contractor should have policies and procedures for training employees to reasonably assure that all employees are aware of the importance of proper time charging. The training should cover indoctrination for new hires, management's responsibility for the accuracy of accounting for labor charges, refresher courses for existing employees, explanations of penalties for mischarging, the importance of segregation of duties, and a system of feedback to provide an opportunity for employees to report any suspected mischarging or violation. When evaluating contractor policies and procedures for employee awareness training, the auditor should consider whether there is formal company-wide timekeeping and labor charging training, and whether there is documentation to verify that the training has occurred (e.g., presentation and handout material, sign-in logs, and memoranda of attendance.).

b. New Hire Training. New hires should be trained on proper timekeeping shortly after being hired. The training should include proper timekeeping procedures and the penalties associated with the statutes on false claims and false statements (see 5-907.d). Further, those employees with contractual responsibilities should be made aware of the FAR, DFARS, CAS, and contract provisions. Specific responsibility should be placed on an individual or group to perform the training.

c. Management's Responsibility. It is critical to labor charging internal control systems that management continues to emphasize the employee’s independent responsibility for accurately recording time charges. The contractor should have training programs stressing management's responsibility to provide for the accurate recording of labor hours.

d. Refresher Courses. The contractor should have periodic refresher courses on proper timekeeping and labor charging practices, as shown in 5-907a. above, especially for employees found not to be complying with company labor charging procedures.

e. Penalties for Mischarging. Individual employees must be constantly, although unobtrusively, made aware of controls that act as an effective deterrent against violations. There should be an explanation of the penalties for knowingly mischarging time. This would include penalties imposed by the company and those by the Government (i.e., False Claims Act). Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through posting of signs throughout the workplace, which remind employees of the importance of accurate and current timecards.

f. Segregation of Duties. The contractor should have training programs that stress the importance of maintaining a segregation of duties for labor-related activities to prevent the appearance of and opportunities for improprieties. For example, the responsibility for timekeeping and payroll accounting should be separated. In addition, supervisors who are accountable for meeting contract budgets should not have the opportunity to initiate or change employee time charges.

g. Feedback system. The contractor should have a system of feedback to provide employees an opportunity to report to management any suspected mischarging or violations of the contractor's system of internal controls, with anonymity guaranteed. In addition, appropriate fraud hotline posters must be displayed (see CAM 5-306.4).

5-908 Labor System Authorization/Approvals

The contractor should have procedures to facilitate the accumulation and recording of labor costs to cost objectives for the purpose of determining proper cost reimbursement on Government contracts. These procedures should address the control and issuance of work authorizations, as well as the detail descriptions required for labor documentation. When evaluating the contractor's policies for labor authorizations/approvals, the auditor should consider whether the policies and organizational structure provide for adequate control over work authorizations to assure the integrity of labor recording.

5-908.1 Control and Issuance of Work Authorizations

The contractor should have procedures to ensure the segregation of duties for work authorizations and/or job assignments, to the extent practical. The work authorizations/job assignments should be controlled and issued by individuals independent of those responsible for performing the work. A critical control is the procedure used to open and close work authorizations. These controls decrease the potential for circumventing cost targets or ceilings.

5-908.2 Work Descriptions

The contractor should have procedures for the preparation of labor documentation/work descriptions that require clear identification of the nature of the work performed. The work descriptions should provide enough detail to be trackable to the intermediate or final cost objective, and describe if the effort is allowable or unallowable/direct or indirect. Work descriptions should be sufficiently detailed to determine the allocability of the labor charges to Government contracts.

5-909 Evaluation of Timekeeping

The contractor should have procedures to assure that labor hours are accurately recorded and that any corrections to timekeeping records are documented, including appropriate authorizations and approvals. When evaluating the contractor's timekeeping procedures, the auditor should consider whether the procedures are adequate to maintain the integrity of the Timekeeping System.

5-909.1 Manual Timekeeping Systems

Procedures for manual Timekeeping Systems should provide for the accurate and complete recording of labor hours, as well as appropriate controls to ensure corrections to labor records are accurate and authorized. Generally, they may be categorized as procedures that pertain to:

a. Supervisory observation of employee arrival and departure to prevent improper clock-in/clock-out.

b. Employee possession of timecard/timesheet.

c. Employees prepare their timecards in ink, as work is performed.

d. Only one card/sheet is prepared per employee per period; cards/sheets are preprinted with employee name and identification number; and cards/sheets are turned in to the designated timekeeping office or collected by an authorized person.

e. Precoded data is printed on the job cards for identification purposes.

f. Direct labor employees record their time no less often than daily. Sufficient formal subsidiary records are maintained, if necessary, to assure accurate time recording and allocating of labor costs to intermediate and final cost objectives when multiple jobs are worked in a day.

g. Corrections are made in ink, initialed by the employee, properly authorized, and provide a sufficient and relevant explanation for the correction.

h. Employees and supervisors sign the timecards/timesheets in accordance with procedures, verifying the accuracy of the recorded effort.

5-909.2 Automated Timekeeping Systems

Procedures for automated Timekeeping Systems should provide for the accurate and current recording (e.g., no less than daily) of labor hours by authorized employees, as well as appropriate controls to ensure corrections to labor charges are accurate and authorized. Generally, they may be categorized as procedures that pertain to:

a. Only the employee uses their labor charging instrument to access the labor system.

b. Employee badge issuance is sufficiently controlled so that no number is duplicated and badges are not issued to unauthorized persons.

c. Procedures are in place which require the employee to report lost badges promptly.

d. Changes are initialed, authorized, and dated by the employee and supervisor and include a description of the reason for the change. This may be done electronically.

e. A verifiable audit trail process is in place that collects all initial entries and subsequent changes.

5-910 Evaluation of Labor Distribution

The contractor should have policies to reasonably assure the proper recording of labor costs to cost objectives. These policies should address the reconciliation of labor hours between labor distribution summaries and Timekeeping/Payroll Systems, recording of both compensated and uncompensated hours worked, and maintenance of an audit trail.

5-910.1 Reconciliations

The contractor should have procedures which require that the total labor hours reflected in labor distribution summaries agrees with the total labor charges as entered into the Timekeeping and Payroll Systems. This reconciliation attests that the labor charges to contracts represent actual paid or accrued costs and that such costs are appropriately recorded in the accounting records. Each employee's time charge should be distributed as recorded.

5-910.2 Recording Hours Worked

The contractor should have procedures to ensure that all hours worked are recorded, whether they are paid or not, to assure the proper distribution of labor costs. This is necessary because labor rates and labor overhead costs can be affected by total hours worked, not just paid hours worked (also see 6-410).

5-910.3 Audit Trail

The contractor should have procedures that require the generation of an audit trail which documents distribution of direct and indirect labor charges to the appropriate cost objectives (e.g., a labor distribution report.). When evaluating the contractor's procedures, the auditor should consider whether direct and indirect labor charges are supported by sufficient eviden-

tial matter to verify the allocability to final cost objectives, and that they are traceable to time cards and approved work authorizations.

5-911 Audit of Labor Cost Accounting

The contractor should have procedures to reasonably assure that labor costs charged to the Government are in compliance with promulgated Cost Accounting Standards, generally accepted accounting principles, and contract terms/clauses. The procedures should address concerns such as: sensitive labor accounts, briefing of contract terms, directly associated unallowable labor costs, lump-sum wages, overtime authorization, uncompensated overtime, and records retention.

5-911.1 Sensitive Labor Accounts

The contractor should have procedures to audit significant increases and decreases in sensitive labor accounts for reasonableness and allocability. These procedures should also address changes in labor charging practices to assure consistency with CAS and FAR. Audit effort in this area may help satisfy MAAR 7 (changes in charging direct/indirect cost) and MAAR 8 (comparative analysis-sensitive labor accounts).

5-911.2 Briefing of Contract Terms

The contractor should have policies and procedures which address briefing of special contract terms and advance agreements relative to allowability and allocability of labor costs (See 3-200). The contractor should identify all contract terms with Government costing implications such as military standards, overtime, and skill mix requirements, to ensure compliance with those terms.

5-911.3 Directly Associated Unallowable Labor Costs

The contractor should have procedures that require that direct and indirect labor costs directly associated with unallowable costs be identified and segregated. When evaluating the contractor's procedures for unallowable labor costs, the auditor should consider whether the chart of accounts and the contractor's disclosure statement adequately identify and describe the treatment of these costs.

5-911.4 Lump-Sum Wages

The contractor should have procedures to ensure that lump-sum wages resulting from union contracts are accounted for in accordance with EITFIS 88-23 (see 7-2119). The matching concept requires that lump-sum payments benefiting future periods should be deferred and amortized over the period benefited (i.e., the period covered by the union contract).

5-911.5 Overtime Authorizations

The contractor should have procedures that address overtime authorization requirements prescribed by FAR 22.103. Such procedures, if applicable, ensure that:
(1) overtime is necessary to meet delivery requirements,
(2) overtime is necessary to meet performance requirements, or
(3) overtime is necessary to make up for delays beyond the control or without the fault or negligence of the contractor (see 6-409 and 6-410).

5-911.6 Records Retention

The contractor should have policies and procedures that address retention of labor records to comply with current FAR requirements. These procedures should address the retention of labor records such as payroll records, labor distribution records, work authorizations, and timecards.

5-912 Review of Payroll Preparation and Payment

The contractor should have procedures to provide reasonable assurance that payrolls are prepared by persons independent of those responsible for the timekeeping operation and actual payroll payment, and pay rates and labor hours are appropriately authorized and accurate. (See 6-407).

5-912.1 Segregation of Duties

The contractor should have procedures to ensure that there is a segregation of responsibilities between timekeeping and payroll. These procedures are necessary to reduce the opportunity for any person to be in a position to both perpetrate and conceal errors or irregularities such as fictitious employees, improper time charges, etc.

5-912.2 Accuracy of Labor Costs

The contractor should have policies and procedures that address the accuracy of the labor costs, particularly that pay rates in effect are supported by written authorization from the personnel department or other authorized source. When evaluating the contractor's policies, the auditor should also consider whether cross-checks are required (either manual or automated) for verifying the accuracy of names, rates of pay, hours worked, extensions, and accounting distributions. Labor hours used in the payroll process should be based on the labor distribution records.

5-913 Review of Labor Distribution, Transfers, and Adjustments

The contractor should have procedures to provide reasonable assurance that labor transfers or adjustments of the labor distribution are documented and approved. These procedures should address management review and approval of labor transfers, labor distribution edit errors, and review and correction of labor errors. Particular attention should be given to IT assisted "on-line" adjustments. In these cases, controls should be in place to ensure that unauthorized or undocumented adjustments are prevented or detected in a timely manner.

5-913.1 Review and Approval of Labor Transfers

The contractor should have procedures that provide for a system of documenting, approving, and reviewing the transfer of labor costs from one cost objective to another by proper management officials. Written justification should be required for any such transfer, to ensure the proper allocation of labor costs to final cost objectives. Audit effort in this area may help satisfy MAAR 10 regarding adjusting entries and exception reports for labor.

5-913.2 Labor Distribution Edit Errors

The contractor should have procedures to ensure that labor distribution edit errors are processed into a suspense account and billed to customers only after correction.

5-913.3 Evaluation and Correction of Labor Errors

The contractor should have procedures to ensure that reports of suspense labor and edit errors are generated and provided to the appropriate personnel for review and corrective action. These corrections should be adequately explained, and endorsed by both the employee and supervisor.

5-914 Labor System - Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls or IT application controls. Whether the control activities are classified by the auditor as general or application controls, the objectives of control activities remain the same, to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should evaluate the IT general and labor system application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are comprised of:

(1) organization and operation controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and

(4) data and procedural controls. (See 5-400 for a more detailed explanation of general internal controls.)

d. Labor system application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as billing, MMAS, and in this instance, labor. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-915 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200, and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-1000 Section 10 --- Audit of Indirect and Other Direct Cost System Internal Controls

5-1001 Introduction

a. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal controls and assessing control risk.

b. This section presents guidance for auditing a contractor's internal controls of both a manual and automated nature over indirect/other direct cost. The guidelines relate to the assessment of control risk based on an audit of the contractor's policies, procedures, and internal controls.

5-1002 Background Information

a. An indirect cost is any cost which is not directly identified with a single final cost objective, but is identified with two or more final cost objectives or an intermediate cost objective (FAR 2-101(b)). Indirect costs are to be accumulated by logical groups and distributed on the basis of benefits accruing to the several cost objectives. The number and composition of cost groupings should be governed by practical considerations.

b. Other direct costs are costs which are in addition to direct labor and material and can be readily identified with a specific job. Examples are:

(1) special tooling, dies, jigs, and fixtures;
(2) plant rearrangement;
(3) packaging and packing;
(4) consultant's fees;
(5) outbound freight;
(6) expediting;
(7) royalties;
(8) travel; and
(9) computer center and other service center costs.

Costs of this nature may be charged direct to jobs, allocated on some representative basis, or charged partially direct and partially by allocation.

c. Generally, a contractor's indirect/other direct cost system should have:

(1) Contractor compliance audits to provide reasonable assurance that the policies and procedures relating to indirect/other direct cost submissions are established, currently in practice, understood, and effectively implemented by contractor employees.

(2) Policies and procedures established and maintained to charge/allocate, directly or indirectly, allowable costs in billings, claims, or proposals applicable to U.S. Government contracts in accordance with FAR 31.2 and CAS.

(3) Policies and procedures to ensure indirect/other direct costs are properly classified as allowable or unallowable in accordance with FAR and contract terms, including directly associated costs, and unallowable costs are identified and excluded from proposals, billings, and claims submitted to the Government.

(4) Policies and procedures to ensure indirect/other direct costs are properly charged/allocated to cost objectives in accordance with FAR and CAS.

5-1003 General Audit Policy - Indirect and Other Direct Costs

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. In the absence of indicators of widespread risk as documented by a current audit risk assessment, the need for a comprehensive audit of a contractor's indirect/other direct cost system would normally be limited to certain situations. Such situations might include:

(1) Contractor locations with significant Government business where a detailed indirect/other direct cost system audit has never been performed or has not been recently

performed and where the auditor's knowledge of the indirect/other direct cost system is limited.

(2) New Government contractor locations where anticipated or actual Government business is significant.

c. FAOs with audit cognizance over corporate and/or group offices allocating substantial costs to other segments for ultimate allocation to Government contracts are responsible for performing indirect/other direct cost audits at these offices and providing the results to the segment auditor. Segment auditors are responsible for requesting such audits as needed.

5-1004 Audit Objectives

The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the indirect and other direct cost system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems. The objectives of auditing the indirect/other direct cost system are to:

a. Gain an understanding of the contractor's indirect/other direct cost system and related internal control to provide reasonable assurance that indirect/other direct cost in billings, claims, or proposals applicable to U.S. Government contracts are properly classified as allowable, allocable and reasonable in accordance with FAR 31.2 and CAS.

b. Document the understanding of the indirect/other direct cost system internal control in working papers and permanent files (see 5-100).

c. Test the operational effectiveness of indirect/other direct cost system internal controls. Refer to 5-108 for additional detail on the testing of internal controls.

d. Assess control risk as a basis to identify factors relevant to the design of substantive tests.

e. Report on the understanding of the internal controls, assessment of control risk and adequacy of the system for Government contracts.

f. Document in the working papers evidence of the performance of the assessment of risk of material misstatement due to fraud. The discovery of fraud or other unlawful/improper activity is not the primary audit objective, but the auditor must be attentive to any condition which suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with 4-700.

5-1005 Scope of Audit

a. The nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk. In general, the audit scope should be consistent with the guidance in 5-105.

b. In many instances, control activities will be embedded in the contractor's IT system. In these cases, the auditor should adequately document and test the automated portions of the system, and give proper consideration to the use of Computer Assisted Audit Techniques (CAATs).

c. The extent of audit effort should also be influenced by:

(1) the types of Government contracts and their materiality,

(2) deficiencies noted in ongoing audits (audit leads),

(3) input from the contracting officer,

(4) contract provisions, and

(5) the degree of system automation, especially where new or existing IT systems have been revised to better identify, extract, and record indirect and other direct costs.

General information regarding these scope areas is provided in 3-104 and additional considerations specific to the indirect/other direct cost system are discussed below. A risk assessment documenting conclusions reached regarding the impact of the above areas on the scope of this audit should be documented in the working papers.

d. The scope of audit should include both indirect and other direct costs (ODCs), unless ODCs are not considered material. The audit should provide assurance that when items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner.

e. If the contractor uses the same process for both indirect and ODCs, and the ODCs are considered material, the auditor should include test transactions related to both indirect and ODC in determining whether the internal controls are operating effectively. If the contractor uses different processes for indirect and ODCs, and the ODCs are considered material, the auditor should evaluate the internal controls for indirect cost and ODC separately, and determine whether the controls related to each are in place and operating effectively.

f. As noted in 5-1004c, one of the objectives is to test the operational effectiveness of the indirect/other direct cost system internal controls. Transaction testing performed as part of the incurred cost audit should periodically include a trace of selected transactions through the system to fully test and evaluate the controls (see 5-108). Alternatively, controls may be separately tested as part of the internal control audit of the indirect/other direct cost system.

g. The contractor's indirect and ODC system may be comprised of numerous processes and/or subsystems (i.e., travel, accounts payable, etc.). The auditor should identify those processes and/or subsystems that comprise the indirect and ODC system and consider the materiality and risk, in terms of both indirect costs and ODCs, of the processes and/or subsystems in establishing the scope of audit.

h. The majority of the non-labor expenses may flow through the accounts payable system. Therefore, the auditor should perform a risk assessment. Based on materiality and sensitivity, consider performing an audit of the contractor's accounts payable system internal controls as a subsystem of the indirect/ODC system if it has not been previously examined in another internal control audit. If an audit is performed, consider steps set forth in 5-1400.

5-1006 Compliance Reviews

Contractor compliance reviews should provide reasonable assurance that policies and procedures relating to indirect/other direct cost claims, billings, and proposals applicable to U.S. Government contracts are established, currently in practice, understood, and effectively implemented by contractor employees. The existence of strong internal controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should have written policies and procedures for monitoring its indirect/other direct cost systems, including regular compliance reviews.

5-1006.1 Internal Audit Function

The auditor should ascertain the effectiveness of the internal audit staff and consider the manner in which the internal audit function is utilized by management. Occasionally contractors use management teams in lieu of internal auditors to perform compliance reviews. The auditor should evaluate the competence, independence, and objectivity of the management teams. (Refer to 4-1000).

5-1006.2 Scope of Compliance Reviews

a. Adequacy of Procedures. The contractor's policies and procedures should provide for regular internal compliance reviews. These compliance audits should address the following areas:

(1) adequacy of written policies, procedures, and controls for indirect and other direct costs;

(2) employee knowledge and compliance with policies and procedures;
(3) composition of indirect cost pools and the bases over which they are allocated;
(4) periodic sampling of expense accounts to ascertain if unallowable costs are properly identified and segregated;
(5) periodic sampling to determine that when items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner;
(6) consistency with which the policies and procedures are applied; and
(7) treatment of miscellaneous income, credits, rebates, and discounts.

b. Adequacy of Reviews. The adequacy of the reviews should be assessed in accordance with the criteria in 4-1000. The reviews should be performed in accordance with the written procedures and by personnel possessing a level of competence, independence, and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor's risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, and lack of employees' knowledge or compliance with the written procedures. The auditor should consider and rely on, if appropriate, contractor internal audit control tests already performed. The auditor should:
(1) identify and evaluate the documentary evidence and the frequency of the internal and external reviews to determine whether the scope of such reviews are appropriate, the conclusions are sound, and appropriate follow-up actions recommended, and
(2) determine if the methodology used to select sensitive accounts to be reviewed is consistent with the risk assessment level as documented by the contractor.

5-1006.3 Follow-up Procedures

There should be policies and procedures for tracking responses to, and resolution of, required corrective actions. The policies and procedures should provide that corrective actions are communicated to management responsible for action, and that corrective actions are documented and verified.

5-1007 Trained Employees

A well trained staff results in accurate submissions to the Government. Contractor personnel should be aware of the certification requirements and potential penalties associated with submissions; therefore, they require special training in the preparation and submittal of billings, claims, and proposals.

a. Types of training. The contractor may provide internal courses or opportunities for personnel to take outside education courses. The contractor may also provide detailed on-the-job training and/or detailed desk procedures. In some instances, the contractor may require that personnel assigned to the preparation, approval and/or review process have special qualifications prior to their being hired.

b. Adequacy of Procedures. Procedures should identify the minimum required course topics, the frequency of the training (periodic training should be given as needed, e.g. issuance of new and revised regulations, evidence of internal control weaknesses, etc.), and the criteria for documentation of completion. If specific procedures are not available, have the contractor identify its practice in the above areas for later verification with employees. The procedures should require that the training program be updated to cover current Government rules and regulations, and adjusted to comply with revisions to the contractor's systems. These areas may be covered under more than one class, and some may be covered by memorandums, bulletins, or pamphlets.

c. Adequacy of Training Topics. The contractor should have policies and procedures requiring an employee awareness training program which informs employees of the special requirements that apply when a business contracts with the Government. The training should include procedures for reporting and identifying false claims and the penalties as-

sociated with the statutes on false claims and false statements. Further, those employees with contractual responsibilities related to costs should be made aware of the FAR, DFARS, CAS, and applicable contract provisions. The contractor's procedures should provide instruction in claim preparation that provides for compliance with the following clauses:

(1) FAR 52.216.7, Allowable Cost and Payment clause, which requires that the contractor submit a final indirect cost rate proposal reflecting actual cost experience during the covered period, together with supporting data (see DCAAP 7641.90 section on Incurred Cost Proposals for sample illustration of what is considered an adequate submission); and

(2) FAR 42.703-2 which requires that the submissions include a signed "Certificate of Final Indirect Costs."

Policies and procedures should also require that employees be trained in contract briefing, reconciliations of claims to accounting records, year-end adjustments of direct and indirect costs, and other related procedures.

d. The auditor should evaluate the adequacy of the training policies and procedures to determine if they cover the appropriate topics, contain interpretation of the Government rules and regulations on the allowability of indirect/other direct costs, and that there are provisions to assure course materials are adjusted to comply with revisions to Government rules and regulations. The contractor may have training records or attendance sheets that document employee training. If the contractor does not provide formal training, evaluate alternative procedures that ensure that employees and management involved in the approval process and/or preparation of indirect/direct costs submissions have the required knowledge. The auditor may consider making inquiries of employees who performed a procedure and inspecting documents and reports to ensure that employees are knowledgeable.

5-1008 Indirect and Other Direct Costs Preparation and Submissions

a. The contractor should establish and maintain written policies and procedures for preparing submissions (billings, claims, or proposals), applicable to U.S. Government contracts that include only allowable costs in accordance with FAR 31.2 and CAS.

b. The contractor's policies and procedures should require that claimed indirect/other direct costs be reconciled with actual costs as recorded in the books and records. Claimed costs may often be different from actual costs incurred; however, there should be a clear identification of all adjustments and an explanation that describes why such adjustments are necessary.

c. In addition, the contractor should have sufficient documentation for the auditor to assess the reasonableness of the contractor's interpretations of allowability. This documentation can be in the form of policies and procedures, desk instructions, preprinted forms, etc., and should provide enough detail for employees to determine the allowability of costs. Documentation supporting the allowability of costs per advance agreements should also be provided. There should be documentation supporting the segregation and control of data rejections, corrections, and adjustments, e.g., year-end accruals, variances, and suspense accounts.

5-1009 Unallowable Costs Screening and Segregation

Policies and procedures should provide for the identification and exclusion of unallowable costs from Government contract costs as required by FAR 31.201-6 and CAS 405.

a. Certain costs are rendered unallowable by provisions of pertinent laws and regulations. Examples of costs declared expressly unallowable by federal statute or regulations are:

(1) costs for contingencies (FAR 31.205-7),

(2) entertainment expenses (FAR 31.205-14),
(3) fines and penalties (FAR 31.205-15),
(4) costs of organizing or reorganizing a business enterprise (FAR 31.205-27),
(5) contributions (31.205-8),
(6) interest (FAR 31.205-20),
(7) losses on other contracts (FAR 31.205-23),
(8) certain types of advertising and business meetings (FAR 31.205-1),
(9) bad debts (FAR 31.205-3), and
(10) federal income taxes (FAR 31.205-41). A description of these and other items and the criteria for a determination of allowability are provided in FAR Part 31 (see Appendix A) and Chapter 7.

b. Other costs may be specifically identified in the contract as being unallowable. In these instances, the contract terms may also provide specific criteria that must be met before a cost is considered allowable, or there may be ceiling limitations on certain types of costs. For example, the contract may state that subcontracts or travel must be approved by the contracting officer prior to incurring the cost, or it may state that overtime is unallowable over a specific dollar amount. Contract briefs should be prepared to identify these clauses.

c. Still other costs or portions of cost may be identified as unallowable based on advance agreements negotiated by the ACO, such as IR&D and B&P Advance Agreements.

d. In addition, all costs which are directly associated with unallowable costs are also considered to be unallowable. For example, travel costs associated with an unallowable business activity (e.g., business reorganization) are also considered to be unallowable.

5-1009.1 Screening of Unallowable Costs

a. General Policies and Procedures. The contractor's accounting procedures should be in writing and should provide that indirect/other direct costs are properly classified as allowable or unallowable, including directly associated costs, and unallowable costs are identified and segregated for U.S. Government contract costing, billing, and pricing purposes as required by FAR 31.201-6 and/or CAS 405, if applicable. When evaluating the contractor's policies and procedures, the auditor should consider whether they:

(1) Address all major duties and responsibilities in the indirect/other direct cost system. The procedures should be comprehensive and easily understood in order to minimize the risk of errors arising from causes such as misunderstood instructions, and mistakes in judgment. The procedures should require management/supervisory review and approval at appropriate control levels. Management review should be evidenced by the proper approval signature on the documentation and records in accordance with the contractor's policy. Electronic signature procedures should be implemented for automated cost records. There should be separation of key duties such as authorizing, processing, recording, and reviewing; and accountability over access to and use of assets and records. The auditor should be alert for aspects of the indirect/other direct cost system process which are not covered by policies and procedures. Additionally, the auditor should note any instances where actual practices are inconsistent with established policies and procedures. In these instances, the auditor should consider the underlying cause for these inconsistencies (e.g., failure to adequately communicate changes in established policies and procedures). When testing the critical control points outlined in the procedures, the auditor should review evidence on adjustments as well as on regular transactions. If applicable, the auditor should compare relevant parts of the contractor's CAS disclosure statement to the policies and procedures.

(2) Are approved by an appropriate level of management to signify the delegation of authority and to effectively convey management's commitment to adhering to established policies and procedures, and complying with FAR 31.2 and CAS.

(3) Provide for the design and use of adequate documents and records. Records should be kept on all aspects of a procedure to ensure the proper recording of transactions. Records should also be classified in a way that permits easy access for audit trail (e.g., chart of accounts could be imbedded in the applicable systems internal edit schedules which segregates and identifies unallowable accounts at point of origin). Supporting documentation should be complete (i.e., include purpose), accurate (e.g. include credits if applicable), and readily available for examination. Various FAR clauses require specific documentation in order for allowability to be established. FAR 31.201-2(d) states that contractors are responsible for accounting for costs appropriately and for maintaining records to support claimed costs. This rule permits contracting officers to disallow any inadequately supported cost. The contractor's procedures should provide for documentation that contracts have been briefed and expressly/mutually agreed to be unallowable costs, and directly associated costs have been identified and excluded.

(4) Were communicated to those individuals within the organization who are responsible for executing them. This communication involves not only making sure that appropriate employees are aware of established policies and procedures but providing the necessary training to ensure that they understand how to interpret and execute them. If the training for employees who approve, process, and screen costs is separate from that provided to employees who prepare cost submissions, follow the guidance in 5-1006.2.

b. Controls for Selected Sensitive Accounts. The following are examples of sensitive costs that warrant special consideration to comply with the regulations (refer to Chapter 7 and FAR 31.2 for a complete list of sensitive areas and their requirements):

(1) Entertainment costs. Procedures and controls should be established that distinguish entertainment costs, as defined in FAR 31.205-14, from allowable costs, such as public relations cost; travel cost; employee morale, health and welfare cost; and trade, business, technical and professional activity cost.

(2) Independent Research and Development (IR&D) and Bid and Proposal (B&P) cost. Procedures and controls should be established which provide that IR&D and B&P are classified and allocated to U.S. Government contracts in accordance with FAR 31.205-18 and CAS 420. Specifically, procedures should require that:

(a) Each IR&D and B&P project should be separately identified if material in amount. When not material in amount, these costs may be accumulated in one or more project(s) within each of these two types of effort.

(b) The B&P projects should be described and identified, as appropriate, with a specific procurement objective and/or applicable request for proposal (RFP), request for quotation (RFQ), or invitation for bid (IFB).

(c) Effort such as production engineering, productivity improvement, etc. should not be confused with IR&D and/or B&P effort. Effort of this type and the related cost accounts should be described in sufficient detail and specificity that distinguishes it from IR&D and B&P effort so as to preclude misclassification of these costs.

(3) Legislative lobbying costs. Procedures and controls should be established to provide that all allowable and unallowable costs under FAR 31.205-22 are properly classified and documented.

(4) Professional and consultant service costs should be supported as prescribed in FAR 31.205-33.

(5) Relocation costs. Procedures and controls should be established to require that:

(a) Payments be in accordance with an established policy or practice that is consistently followed.

(b) Amounts claimed as allowable costs under Government contracts be in accordance with the requirements stated in FAR 31.205-35.

(6) Selling costs. Procedures and controls should be established which provide that selling costs are classified in accordance with FAR 31.205-38 and that:

(a) Allowable direct selling and market planning costs should be separately identified from unallowable costs.

(b) Allowable selling costs should be distinguished from B&P costs with respect to Government business.

(c) The method selected and analysis used to allocate selling and marketing costs should be documented and in compliance with FAR and CAS, as appropriate.

(d) Direct selling and market planning costs should be segregated by class of customer (i.e., U.S. Government, FMS/foreign sales of military products, and commercial). The method of segregation should be verifiable through documentation.

(7) Travel costs. Procedures and controls should be established which provide that:

(a) Allowable and unallowable travel costs in accordance with FAR 31.205-46 are appropriately classified at some point between incurrence of the cost and the time when claimed as a contract cost.

(b) Routines are in place to identify material amounts of unallowable labor activity based on the purpose of the travel.

(c) Records required to substantiate and justify contractor-owned, leased, or chartered aircraft costs are maintained in accordance with FAR 31.205-46.

(8) Trade, business, technical, and professional activity costs. Procedures and controls should be established which provide that an adequate description of the business purpose of meetings and conferences is either contained in or referenced in the reimbursement voucher.

c. Screening. Point of entry screening is inherently more effective than after-the-fact screening/scrubbing for the identification and segregation of unallowable costs. As a point of entry control, the contractor can use its chart of accounts to identify and segregate allowable and unallowable accounts (refer to the accounting system internal control). The contractor's failure to establish point of entry controls places an added risk on after-the-fact screening (refer to compliance reviews in 5-1006). Contractor follow-up on unclear or questionable costs can become ineffective with the passage of time. This added risk would translate into higher required confidence levels and precision than would otherwise be required, thereby impacting the nature and extent of audit effort. As a result of the required certification process, some contractors have incurred extraordinary costs for screening overhead costs prior to certifying their proposal. This extraordinary effort is often the result of the contractor's earlier negligence in establishing, maintaining, and/or implementing an adequate system of internal control, and may not be subject to reimbursement (see 7-2109.2). Deficiencies should be reported in accordance with 8-302.7 if they are noncompliances with CAS 405, or in accordance with FAR 31.201-6 if they are not CAS-related.

d. Self-governance. When a contractor that participates in self-governance programs furnishes the FAO with its initial internal control evaluation and compliance testing plans on its screening procedures for unallowable costs, the FAO should establish a current assignment to update its audit of related internal controls. The objective is not to complete an overhead audit, but rather to provide the contractor with feedback on its control activities and its compliance approach.

e. Directly Associated Costs. All costs which are directly associated with unallowable costs are also unallowable and should be screened to preclude charging such costs to Government contracts. In auditing the adequacy of contractor procedures for screening directly associated costs, the auditor should also consider materiality of the costs (FAR 31.201-6(e)(1). A directly associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. The following are examples of directly associated unallowable costs:

(1) Bad debts. Actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims and any directly associated costs i.e., collection fees and/or legal costs associated with collection efforts are unallowable (see FAR 31.205.3).

(2) Entertainment costs. FAR 31.205-14 states that cost of amusement, diversion, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable.

(3) Lobbying costs. Pursuant to FAR 31.205-22, costs incurred in attempting to improperly influence (see FAR 3.401), either directly or indirectly, an employee or officer of the executive branch of the Federal Government to give consideration or to act regarding a regulatory or contract matter are unallowable. Employee(s) travel and/or administrative support costs directly associated with unallowable lobbying effort are also unallowable .

5-1010 Allocability Policies, Procedures, and Controls

Policies and procedures should assure that indirect and other direct costs are properly charged/allocated to cost objectives in accordance with FAR and CAS as appropriate.

a. The contractor's accounting procedures should ensure that items of the same nature as those charged as direct costs are not included in the indirect cost pools. The auditor should be alert to the possibility of inconsistencies in the treatment of direct and indirect costs, especially between cost reimbursable and other contracts or between Government and other contracts. Such inconsistencies may result in inequitable charges to the Government. For example, the auditor should ensure that costs charged to Government work as direct costs are to be treated in the same manner on the contractor's other work, as required by FAR 31.202, FAR 31.203, and/or CAS 402. Therefore, the contractor should have policies and procedures for adequately describing and classifying costs as direct or indirect.

b. For CAS-covered contractors, such policies and procedures are a requirement of CAS 418.40(a). They should include provisions for justification and approval of changes in the direct or indirect classification of costs. Effective procedures will minimize the amount of testing needed. The extent of required testing may be further reduced by evidence of thorough contractor internal audit coverage of this area.

c. The contractor should have accounting policies and procedures which provide that all items of other direct costs are readily identifiable with the contract to which they have been charged. When an item is purchased, documents such as the purchase requisition, purchase order, receiving report, and inspection report should identify the contract for which the cost was incurred. When the contractor manufactures components or parts, the work orders and all documents serving as a basis for charges to the work order, such as requisitions and job tickets, should be identified with the contract.

d. Procedures should provide that indirect costs be accumulated by logical (homogeneous) cost groupings (pools), with due consideration of the reasons for incurring such costs, and allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pool costs to the final cost objective (FAR 31.203(c)). To satisfy MAAR 18, the auditor should determine that the allocation bases used by the contractor for the allocation of indirect costs are equitable and consistent with any applicable CAS requirements, generally accepted accounting principles, and applicable provisions of the contract.

(1) Procedures and controls should be established to provide that all costs (allowable and unallowable) properly included in an indirect cost allocation base bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs in accordance with FAR 31.203(d).

(2) Procedures and controls should be established to provide that expressly unallowable costs and costs mutually agreed to be unallowable are excluded from any indirect cost pool which is allocated to U.S. Government cost objectives. Directly associated costs should be handled in the same manner, unless the cost with which it is associated

is included in the base over which the indirect cost pool is allocated. In such instances, the directly associated cost should remain in the indirect cost pool.

e. The auditor should determine if the contractor's policies and procedures require a thorough study of the indirect cost activity, including the activity bases used for allocation and the costs to be allocated, to determine whether the activity base chosen is appropriate for cost allocation and results in a reasonable measure of the activity. The base should:

(1) be a reasonable measure of the activity,

(2) be measurable without undue expense, and

(3) except for the residual G&A expense, fluctuate concurrently with the activity which is the source of the costs.

f. Part IV of the contractor's disclosure statement provides information on the contractor's bases and pools, including a functional or departmental breakdown of indirect expenses. An audit of the disclosure statement (or equivalent data from non-CAS-covered contractors) will frequently assist in determining whether cost allocations described in the policies and procedures are equitable. Any differences or inadequacies should be identified and reported to the cognizant Federal agency official (CFAO) in accordance with 8-200.

5-1011 Indirect/ODC System - Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls and IT application controls. Whether the control activities are classified by the auditor as general or applications controls, the objectives of control activities remain the same: to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should audit the IT general and indirect/ODC application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are composed of:

(1) organization and operation controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and (iv) data and procedural controls. (See 5-400 for a more detailed explanation of general internal controls.)

d. Indirect/ODC application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all systems applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as labor, billing, and in this instance, indirect/ODC. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-1012 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200, and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-1100 Section 11 --- Audit of Billing System Internal Controls

5-1101 Introduction

a. This section provides guidance for auditing contractor billing systems and related internal controls of both a manual and automated nature. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control and assessing control risk.

b. Audits of contractor billing systems addressed in this guidance relate to incurred cost evaluations of interim and final public vouchers (6-1000), progress payments (14-200) and other incurred cost presentations (Terminations 12-000, FPI closings, interim cost evaluations).

5-1102 Background Information

Billings on public vouchers, requests for progress payments, contract closing proposals, and related cost statements submitted by contractors do not normally reflect contract costs as recorded in the basic accounting records. Normal reconciling items include both timing differences and permanent differences and special controls and processes must be established to assure that these differences are properly removed from billings on public vouchers and progress payments. The contractor's billing system should include processes for:

a. Segregating and excluding unallowable costs as required by FAR, DFARS and/or contract terms.

b. Segregating incurred costs that are nonbillable because the costs do not meet specified criteria for inclusion in voucher and progress payment requests (e.g., accrued material costs that ordinarily will not be paid within 30 days of the contractor’s progress payment request to the Government).

c. Withholding costs that are appropriate adjustments to the submission or request (e.g., costs in excess of ceilings, or liquidated progress payments).

d. Adjusting submissions for final rates or indirect billing rates that differ from the contractor’s currently applied rates.

e. Identifying costs that require specific contracting officer approval (special purchases, overtime authorizations, etc.).

f. Identifying contract overpayments, making refunds due the Government in a timely manner, and offsetting significant contract overpayments against contract underpayments based on contracting officer and/or paying office instructions.

5-1103 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. The auditor should be alert to changes in the contractor's IT environment or changes in application software that may affect the billing system. A partial list of such changes includes:

(1) automation of a manual billing system

(2) automation of any billing system activities that were previously performed manually

(3) changes in other systems (e.g., labor, material, indirect and ODC, etc.) that may affect the data files used by the billing system.

5-1104 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the billing system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The contractor's billing system should provide reasonable assurance that billings applicable to Government contracts are prepared in accordance with applicable laws and regulations, and contract terms; and that material misstatements are prevented, or detected and corrected in a timely manner.

5-1105 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk(materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The auditor should evaluate the contract mix to determine the materiality and sensitivity of certain aspects of the contractor's billing system (see 6-10S1)

(1) Identify those contract types which are sufficiently immaterial to justify substantive testing only and delete steps covering their unique billing controls. T&M and labor hours contracts generally require a unique set of billing controls because it is quite common for the contract to specify labor categories which do not coincide with the contractor established labor classifications. Similarly, due to security requirements, classified contracts may have a unique set of billing controls.

(2) Areas of emphasis may be determined by contract type. Cost reimbursement type contracts generally contain many more special contract provisions than FFP and FPI contracts; therefore more risk may be associated with the contract briefing systems when this type of contract is in the majority. The contractor may also use the billing system to provide incurred cost data for forward pricing proposals, FPI closings, and terminations. The other uses of the system may affect materiality considerations.

(3) Sensitive audit issues can have a significant impact on audit scope. For example, congressional interest in contractor overbillings would necessitate increased emphasis on contractor procedures to prevent overbilling on public vouchers or progress payments. The auditor should be alert to recognize and take appropriate action on matters of a sensitive nature.

(4) Other Related Systems---Billings are generally prepared from accounting records either manually or by computer applications. The major critical controls and system considerations related to the billing system are:

(a) Management's Philosophy and Operating Style. Analyze and briefly summarize the overall management philosophy and operating style based on information in the permanent file regarding the control environment. Determine whether management endorses the philosophy of written policies and procedures including the currentness and frequency of updates, advocates employee training and awareness, funds needed equipment and computer programming, encourages internal and external audits and develops performance controls.

(b) Accounting System and CAS Compliance Audits (5-300 and 8-000). The contractor should have adequate controls to ensure costs recorded in the official cost accounting records used to bill costs are allowable, allocable and reasonable under FAR 31.2. (and CAS as appropriate)

(c) General IT Systems (5-400). IT systems should provide reliable data and the data should be properly secured.

(d) Budget and Planning System (5-500). Estimates of cost to complete contracts used for progress payment purposes should be current, accurate, complete, realistic, reasonable, and consider all relevant information.

(e) Material and ODC Systems (5-700 and 5-1000).

(i) Charges from material issued from contractor inventory for use on contracts should be identifiable on the billing record and supported by journal vouchers recording issuance of contractor-owned material; individual items of material should be traceable to the issue document; and, item pricing should conform to an acceptable practice and contractor established policy.

(ii) Billed material should be issued for current use on the contract and not merely issued to an intermediate holding area for the purpose of obtaining reimbursement. The contractor should not be purchasing material and charging it to common inventory (when it should be charged directly to the contract) to circumvent the actual payment requirement.

(f) Labor and ODC Systems (5-900 and 5-1000). Weekly and/or biweekly direct labor entries in the billing record should be based on the source documents for the journal vouchers distributing salaries and wages for the accounting period. Any labor adjustments appearing in the billing record should be supported by correction or reclassification journal vouchers. For T&M or labor hour contracts in the contractor labor distribution system, incurred labor hours should be input by contract category to the billing system, and the controls preventing misclassification of employees should be evaluated as a part of the labor controls.

(g) Indirect and ODC Systems (5-1000). The contractor should have controls to provide for developing, approving, and applying proper indirect expense rates in the billings (see 6-700).

(h) Financial Capability. The contractor should have controls to assess on a periodic basis if it has sufficient financial resources to complete its contracts.

(5) The auditor should consider the following possible audit leads in determining scope of the billing system audit:

(a) billing system audit leads

(b) outstanding internal control deficiencies in other relevant accounting systems

(c) material misstatements found in incurred cost audits, i.e., public vouchers, progress payment requests, contract closing statements or other incurred cost evaluations.

(6) Contractor's Organization---contract billings or portions of the billing information may be the responsibility of different sections of the contractor organization. For instance, because of their unique nature T&M or labor hour billings may have an entirely different process flow than cost type billings. The number of processes to be evaluated and the consistency of the processes will influence the scope of the audit.

c. Assessing control risk---To assess control risk on the billing system as low and reduce substantive testing, the auditor should determine if the internal control policies and procedures in contractor's billing system accomplish the following control objectives by providing:

(1) Effective methods of monitoring the billing system and performing management compliance reviews to assure that the company’s policies and procedures are adequate and current, are disseminated to all appropriate personnel, and are implemented in a timely and consistent manner.

(2) Adequate written billing system policies and procedures which address employee training, how to determine billing requirements, billing approvals, reconciliations of billed cost to the cost accounting records, adjustments of direct and indirect costs to year-end actual allowable rates, exclusions of unpaid cost, that is not eligible for reimbursement until paid, estimates of costs attributed to items delivered/invoiced, adjustments of billings on potential loss contracts, title to assets whose costs are billed, and the development of estimates at completion.

(3) Adequate and effective implementation plan for the billing system to assure that policies and procedures are executed including dissemination of policies and procedures to employees, training of employees and management review of billings.

(4) Effective general IT controls over data center operations and adequate physical and logical security over relevant systems like labor, material, and indirect and ODC.

d. The following paragraphs contain general guidance for the audit and evaluation of the contractor's billing system. This guidance gives the auditor a framework for the audit, but it

is not a substitute for professional judgment. The auditor should adapt this guidance to fit their individual circumstances.

5-1106 Management Compliance Reviews

Systems that rely on external controls only increase the risk of cost mischarging or misallocation. The existence of strong self-controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should have policies and procedures for monitoring its billing system, including regular compliance reviews. These compliance reviews should address the following areas: the adequacy of written procedures, employee knowledge and compliance with policies and procedures, consistency with which the policies and procedures are applied and by whom, and timely corrective action on deficiencies.

a. Types of Reviews. The contractor may perform internal compliance audits using auditors or nonauditors, physical observation, reviews of performance that involve exception reports, external audits, or use a combination of techniques. Because billing is generally performed in the accounts receivable area and this function is consistently audited by both internal and external auditors, some or all of the compliance reviews may be performed by them. The contractor may also have various performance criteria and reporting requirements to upper management which relate to incurred cost billings. For example, excessive numbers of vouchers returned by paying offices or excessive number of days to process vouchers, may indicate noncompliance with control activities.

b. Adequacy of Procedures. Whatever the form of the reviews, there should be procedures which identify the intervals of performance of the reviews, the personnel responsible for performance of the reviews, the areas to be covered during the reviews, the documentation required to evidence the reviews have been performed and the requirements for follow-up action. The procedures should address coverage of the following areas:

(1) review of the adequacy and consistency of application of the written procedures for the billing personnel

(2) employee knowledge and compliance with these written procedures

(3) responsiveness to required corrective actions.

In addition, procedures for inputting billing related data and procedures for the correction of erroneously entered data should be available.

c. Adequacy of Reviews. The adequacy of the reviews should be assessed in accordance with the criteria in 4-1000. The reviews should be performed in accordance with written procedures and by personnel possessing the level of competence, independence and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, lack of employee knowledge or compliance with the written procedures, or untimely corrective actions.

5-1107 Billing System Policies and Procedures

A formal written statement of policies and procedures rather than an informal one based on established customs of the organization should exist at all contractor locations with substantial Government business. Therefore, the contractor should have adequate written policies and procedures, and training on the preparation and submission of billing requests in accordance with applicable regulations and contract provisions. Written policies and procedures help ensure that:

(1) directions for performing both automated and manual tasks are clearly defined

(2) delegated duties and responsibilities are formally documented and communicated to employees

(3) processes are performed consistently from billing to billing.

5-1107.1 Training of Employees

A well trained staff results in current and accurate billings to the Government. Because of the unique requirements associated with Government contracts, certain contractor certifications, and potential penalties associated with billings, contractor personnel need to be specially trained to prepare and submit Government billing requests. Therefore, the contractor should assure that all appropriate personnel have training in the preparation and submission of billing requests.

a. Types of Training. The contractor may require that personnel assigned to the processing of Government billings have special qualifications prior to their being hired. The contractor may provide opportunities for personnel to take outside educational courses or provide internal courses. The contractor may also provide detailed on-the-job training and/or detailed desk procedures.

b. Adequacy of Procedures. Procedures should identify the minimum required course topics, the frequency of the training and the criteria for documentation of completion. If specific procedures are not available, have the contractor identify its practice in the above areas for later verification with employees. The procedures should require the training program be updated to cover current Government rules and regulations and adjusted to comply with revisions to the contractor's system. These areas may be covered under more than one class and some may be covered by memorandums, bulletins, or pamphlets.

c. Adequacy of Training Topics. Training programs may include:

(1) an overview of the contractor's accounting system
(2) information on specific billing procedures (automated or manual)
(3) an overview of written policies and procedures
(4) instructions on briefing contracts
(5) a description on the review and approval process
(6) information on penalties associated with the statutes on false claims and false statements acts
(7) guidance on applicable FAR, DFARS, CAS and contract clauses
(8) information on the contract closeout process.

IT workstation procedures relative to billing system transaction activity should be covered as well as procedures for correcting erroneously entered billing data.

5-1107.2 Contract Briefings

Government contracts sometime have unique documentation requirements, withhold criteria and cost exclusions associated with interim and final payment approvals. An effective billing system identifies these requirements and includes them in the process. Therefore, procedures and controls should be established to ensure that contracts are reviewed to identify all billing requirements and that these requirements are documented either in a contract brief and/or directly input into an automated system. Policies and procedures should address the following:

a. Identifying Requirements. Procedures should clearly identify the types of information required on the brief (see 3-200 for examples of requirements).

b. Compiling Data. Procedures should identify the process for briefing contracts. The contractor may have a form (automated or manual) with blanks for various types of contractual requirements, or check marks to indicate the inclusion of FAR, DFARS and other regulatory mandatory clauses. Training manuals may also provide a handy reference for briefing personnel.

c. Frequency of Briefs. Procedures should identify the frequency criteria for briefing contracts. As a minimum, briefs should be updated as soon as modifications are received or prior to the start of the next billing interval.

d. Responsibility for Briefing. Procedures should identify those responsible for briefing contracts. Briefs are most often prepared by billing personnel but may be prepared by contracts or other personnel as long as there is appropriate segregation of duties and the personnel are trained.

e. Manner of Updating. To facilitate updating, verification, and review, the contractor may include the latest modification number on the billing. If an automated system is used, exception reports may identify contracts not briefed, or ones that have not been updated in excess of certain specified intervals. The billing system may not allow processing unless the briefing has been completed or approved. Manual systems may require attachment of the brief or modification to document auditor and/or supervisor review.

f. Method of Inputting. If applicable, the procedures should identify how the briefed requirements will be included in the billing.

5-1107.3 Management Review and Approval

The contractor should have procedures which require supervisory or management review and approval of billings prior to submission. Formal requirements for management approval help ensure compliance with specific contract provisions. Progress payment requests in fact require some management certifications. When evaluating the adequacy of the contractor policies and procedures for management reviews of billings, the auditor should consider whether:

(1) contract briefings require management review and approval
(2) managers review billings prior to submission
(3) items or elements are identified for specific review
(4) established thresholds and management approval levels are appropriate
(5) managers have sufficient time to effectively review billings prior to approval.

5-1107.4 Reconciliation of Recorded and Billed Cost

a. The contractor should be able to demonstrate that billing requests are prepared directly from the cost accounting records or from other records which are reconciled to the cost accounting records. Billings prepared from subsidiary ledgers and/or memorandum reports must be reconciled to the general ledger by element of cost.

b. The contractor may identify normal reconciling differences and require any other differences to be subject to management review. Contractor-identified differences other than those identified in 5-1102 above should be subject to additional consideration. The contractor procedures and/or flowcharts should identify appropriate sources of inputs, internal control points, ancillary IT applications, related transactions, and any documentation requirements. In manual systems, the contractor may require the attachment of a copy of the job cost ledger or verification to the billing as a condition to the presubmission approval process. In modern automated billing systems, the billing data may be simultaneously posted to the cost and billing ledger or posted at specified intervals. However, the system should have the capability to input such things as billing ceilings and withholding requirements, or to automatically code items which are not billable and then identify such cost suspensions or reconciling differences on the face of the voucher or in a separate attachment (see also 5-1107.6, Exclusion of Nonbillable Costs).

c. Periodic reconciliations of contract costs, as identified by the accounting system, to costs billed provides management necessary contract status information (e.g., cash flow, profit/loss, etc.), and allows the contractor to prepare timely final vouchers which detail allowable costs by contract by year.

5-1107.5 Adjustment of Cost and Rates

Interim billings of cost often involve several contractor years. The status of incurred cost audits changes as time passes, particularly with regard to indirect rates. Initially, billings may be based on projected rates for the year, which may change during the year as projections change; these rates should be monitored (FAR 52.216-7(e) and FAR 42.704) throughout the year and if significant deviations between billing rates and incurred rates occur during the year, or at year end, adjustments to the billing should be requested from the contracting officer. This process ensures that at year end the amount of indirect costs reimbursed is as close to the certified amount as possible. Similarly, direct costs may be subject to adjustments based on year-end procedures, audits and negotiations. Incurred cost billings are cumulative, and therefore, should reflect the impact of any of these adjustments as soon as they are known. The contractor should have procedures and controls in place to ensure the prompt adjustment of billings to reflect these adjustments in indirect rates and direct costs. The contractor's billing system should be capable of providing cumulative cost data by contract. Cumulative costs are necessary to assure that the cumulative amounts billed do not exceed the total estimated ceiling costs on the contract and/or the current contract maximum funding levels. Cumulative amounts billed must appear on the SF 1035, Continuation Sheet of the Public Voucher. Maintenance of cumulative allowable costs allows the contractor to prepare accurate final vouchers on a timely basis.

a. The contractor's system should provide for the segregation of cost by year so that rate adjustments can be easily made and the rates used can be identified. Controls over who authorizes rate changes, or how unauthorized rate changes to contracts can be prevented, should be clearly identified. Rate computations should be subject to easy verification.

b. To assure rates are current, the contractor should have a procedure which requires reapproval of rates at stated intervals (at least annually) or revision upon the occurrence of the events mentioned in 5-1107.5 above. These procedures should identify the organization responsible for establishing billing rates, both projected and actual, as well as any adjustments to billing rates.

c. For tracking and documentation purposes, the contractor should maintain a rate folder or computer file which identifies the date of rate changes and includes the supporting documentation (ACO or auditor approvals). Overhead and G&A expenses should be calculated on the basis of billing rates, quick close-out or final overhead rates.

d. Generally, direct cost adjustments are identified as suspensions or withholds on the face of the voucher or on a separate attachment.

5-1107.6 Exclusion of Nonbillable Costs

As discussed in the introduction, one of the primary differences between basic accounting records and billed Government contract cost is the exclusion of nonbillable or ineligible costs. It is essential that procedures and controls are established requiring the exclusion from billings of the following nonbillable costs:

(1) Accrued costs of direct materials and subcontract costs that will not be paid in accordance with the terms and conditions of the subcontract or invoice and ordinarily will not be paid within 30 days of the contractor's payment request (public voucher or progress payment) to the Government;

(2) accrued costs that the contractor is delinquent in paying in the normal course of business; and,

(3) accrued costs of pensions, post retirement benefits, and profit sharing or employee stock ownership plans that have not been paid at least quarterly (costs not paid within 30 days after the end of the quarter are not eligible for reimbursement). The specific clauses identifying reimbursable costs are in FAR 52.216-7b for vouchers and FAR 52.232-16(a)(2) for progress payments. The criteria are the same for both types of bill-

ings. When evaluating the adequacy of the contractor procedures, the auditor should determine:

a. Potentially nonbillable direct costs are, when possible, automatically coded and identified as such in the accounting or billing ledger data based on programmed criteria applied to cost ledger source codes. This would include unallowable direct costs, nonbillable accrued costs, and costs subject to special approval requirements or other contract limits such as overtime premium.

b. The billing system should identify and segregate any nonbillable direct costs that cannot be identified to a program or job order. Such costs should be reclassified as billable only when required conditions have been met.

5-1107.7 Subcontractor Progress Payments, Performance-Based Payments and Commercial Financing Payments

FAR 52.232-16(j) requires the contractor to exclude costs of:

(1) progress payments made to subcontractors on terms less favorable to the Government than the progress payment clause contained in the prime contract;

(2) performance-based payments made to subcontractors on terms not substantially similar to the requirements of the Performance-Based Payments clause at 52.232-32; and

(3) commercial financing payments made to subcontractors on terms not structured in accordance with FAR 32.206(c).

When evaluating the adequacy of the contractor policies and procedures for subcontracts, the auditor should determine whether the contractor has purchasing policies and procedures which are adequate to assure that the terms of subcontracts or interdivisional fixed price orders are the same as FAR 52.232-16(j) (CPSRs may be used to determine the adequacy of this area). In addition, the contractor should have policies and procedures to ensure monitoring of performance and expected profitability under subcontracts, review and approval of the subcontract progress payments, performance-based payments and commercial financing payments and resultant reductions in upper tier progress payments, performance-based payments and commercial financing payments. The contractor should also have policies and procedures to ensure reductions or suspensions of subcontractor progress payments, performance-based payments, and commercial financing payments, as necessary to protect against overpayment and losses.

5-1107.8 Estimates to Complete, Estimates of Costs of Delivered/Invoiced Items

a. Estimates to Complete. For progress payment purposes, the amount on line 12b on the SF 1443, “Contractor's Request for Progress Payment,” is critical in the determination of the reasonableness of the request because it is used in the computation of the various critical limitations of reimbursable cost as discussed below. Because it is a critical factor, the FAR requires that the contractor keep these estimates to complete current (not more than 6 months old). The contractor should have policies and procedures to assure the most current estimates are used in progress payments, that these estimates reconcile with other external reporting requirements such as EVMS and the FPI limitation on payment requests, and other contractor internal/external reports. Based on the adequacy of the contractor budgetary system, these estimates should be taken directly from those systems used to report status to contractor upper management. The contractor may have IT controls or tickler files that identify estimates that exceed the 6-month requirement. However, contractor procedures should also require significant changes in the estimate to be included in the progress payment even if they occur prior to the 6 month update.

b. Alternate Liquidation Rates. The estimate at completion is also used to verify the continued applicability of liquidation and alternate liquidation rates which impact the unliquidated balance of progress payments.

c. Estimates of Costs of Delivered/Invoiced Items. Because costs by individual deliverable item are not generally available from cost accounting records, the contractor generally computes the costs of items delivered by applying the estimated cost/price ratio to the contract price of items delivered. The cost/price ratio is computed by dividing the estimate of costs to complete (line 12a plus line 12b) by the contract price (line 5). The contractor should have policies and procedures which describe how the estimated cost for delivered items is computed or how actual costs are determined.

5-1107.9 Loss Contract Procedures

The contractor should have policies and procedures to provide for the computation of loss ratios and adjustments of billings on potential loss contracts. FAR 32.503-6(g), "Loss contracts," 14-200, and the progress payment audit program provide examples of these loss computations. The estimate at completion (line 12a plus 12b) is used to determine the loss ratio to be applied to incurred costs to adjust for loss contracts.

5-1107.10 Title to Assets

When the contracting officer has given the contractor consent to dispose of property under the progress payment clause (FAR 52.232-16(d)), the procedures should assure that the contractor disposes of the property systematically over the life of the contract, and appropriate credit is applied against the contract for the disposal proceeds. The contractor's failure to dispose of the property before contract completion could cause the Government to lose the credits, since title to all property not delivered to and accepted by the Government is vested in the contractor upon completion of all obligations under the contract. The contractor should have policies and procedures which require prompt disposal of property charged to fixed price contracts that are not deliverable end items.

5-1107.11 Contract Overpayments, Refunds and Offsets

The contractor should have internal control policies and procedures in place and operating adequately to:

- compare amounts billed to amounts received for each public voucher, progress payment request, performance-based payment, and invoice (both delivery and final) to readily identify contract over/underpayments;
- process refunds due the Government in a timely manner; and
- make offsets to contract billings based on contracting officer and paying office instructions.

Credit vouchers (net credit) cannot be submitted electronically through WAWF. FAOs should refer contractors to their local Administrative Contracting Officer (ACO) for specific guidance on submitting credit vouchers.

a. Over/underpayments. Contract over/underpayments are identified based on comparisons of amounts billed to amounts received. The auditor should determine if the contractor's internal controls:

(1) ensure identification of all outstanding over/underpayments;

(2) provide for timely notification to the contracting officer and paying office; and

(3) identify and document the reason(s) for the over/underpayments and why certain over/underpayments were not timely liquidated.

In addition, the auditor should verify that the contractor has documentation for its:

- notification to the contracting office and paying office;
- significant activities during the resolution process; and

- compliance with contracting officer and paying office instructions to resolve the difference.

b. Refunds. Contract refunds include funds returned to the Government due to:
(1) contractor or paying office errors,
(2) contract administration adjustments, and
(3) responses to Government demand letters.

Contract administration adjustments are payments the contractor received in accordance with contract provisions but which need to be reduced due to subsequent events or actions. For example, a contract administration adjustment may result from a contract modification changing the alternate liquidation rate for deliveries made on a contract using progress payment financing. The auditor should verify that the contractor's internal controls:

- require maintaining a list of refunds made to the Government;
- provide for timely refund of amounts due the Government; and
- identify and document the reason(s) for the refunds and why certain refunds were not timely processed.

The auditor should also verify that refunds caused by contract administration adjustments (contract modifications) are computed accurately. Finally, if the contractor disputes an amount requested by a demand letter, the contractor should have documentation to support its position.

c. Contract Offsets. Contractors may offset amounts due the Government (overpayments and refunds) against underpayments. The auditor should verify that the contractor's internal controls require:

(1) significant offsets be made only after notification to and instructions from the contracting officer and/or paying office;

(2) offsets are made on a timely basis, usually within 30 days of the identification of the overpayment or refund; and

(3) maintenance of a list of all significant offsets and documentation showing coordination with the Government.

d. Subcontractor Reviews. The contractor should have policies and procedures to ensure that their subcontractors' accounting and billing systems include adequate policies and procedures for identification and timely resolution of subcontractor overpayments, refunds, and offsets. Subcontractors should be able to document their identification and resolution of subcontract overpayments, refunds, and offsets with the prime contractor.

5-1108 Implementation of Billing System Policies and Procedures

Written policies and procedures help ensure that internal control objectives are documented. The contractor should ensure that these written policies and procedures are executed to assure only billable costs/prices/fees applicable to Government contracts are included in billings in accordance with applicable regulations and contract terms. In addition, the contractor should have policies and procedures to ensure that all changes which impact how billings are prepared are promptly disclosed to the Government.

5-1108.1 Disseminating Policies and Procedures

In order for policies and procedures to be effective they must be communicated to the employees responsible for implementing them. Employees should be made aware of the existence of the policies and procedures and they should have ready access to them. The auditor should be alert for aspects of the billing process that are not covered by policies and procedures, especially dealing with external data entry, data correction, and supervisory approvals. Additionally, the auditor should note any instances where actual

practices are inconsistent with formal policies and procedures. In these instances, the auditor should consider the underlying cause for these inconsistencies.

5-1108.2 Training Applicable Employees

Merely making employees aware of policies and procedures and providing access to them, does not assure employees know how to interpret and execute them. Therefore, the contractor should provide training to the applicable employees. This training should include the topics described in 5-1107.1c above. The contractor should have training records---course materials and attendance sheets that document employee training. If the contractor does not provide formal training, evaluate alternative procedures that ensure that employees and management involved in the billing process have the required knowledge. The auditor may consider making inquiries of employees who performed a procedure and inspect documents and reports to ensure that employees are knowledgeable.

5-1108.3 Briefing Contract Requirements

Contract briefings should reflect contract requirements and these contract requirements should be reflected in the billings. The requirements may be documented either in a contract brief or directly into an automated system. Policies and procedures should ensure that contracts are adequately briefed and updated as modifications are received. When evaluating the adequacy of the contractor briefings, contract requirements in the briefing matrix at 3-2S1 should be used.

5-1108.4 Management Review and Approval

Effective procedures require that all billings, including final billings, are subjected to management review prior to their submission. The contractor should have procedures and controls in place to ensure that vouchers and invoices are accurate and have the appropriate level of review and approval prior to their submission. The review should be evidenced by approval on the billing in accordance with contractor policy. When evaluating the reviews the auditor should use the guidance in 4-1000.

5-1109 Billing System - Information Technology System Internal Controls

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls or IT application controls. Whether the control activities are classified as general or applications controls, the objectives of control activities remain the same, (i) to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition, and (ii) that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should review the IT general controls and the billing system application controls in order to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are comprised of:

(1) organization and operation controls,
(2) systems development and documentation controls,
(3) hardware and systems software controls, and
(4) data and procedural controls.

(See 5-400 for a more detailed explanation of general internal controls.)

d. Billing system application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as labor, MMAS, and in this instance, billing. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-1110 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-1200 Section 12 --- Audit of Estimating System Internal Controls

5-1201 Introduction

a. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk.

b. This section provides guidance for conducting surveys of contractor estimating systems and discusses the requirements of DFARS 215.407-5 and 252.215-7002.

5-1201.1 Definitions

a. "Estimating System" is a term used to describe a contractor's policies, procedures, and practices for generating cost estimates which forecast costs based on information available at the time. It includes the organizational structure; established lines of authority, duties, and responsibilities; internal controls and managerial reviews; flow of work, coordination, and communication; and estimating methods, techniques, accumulation of historical costs, and analyses used by a contractor to generate cost estimates and other data included in proposals submitted in the expectation of receiving contract awards (DFARS 252.215-7002).

b. "Significant Estimating System Deficiency" means a shortcoming in the estimating system which is likely to result in proposal estimates for either total cost or a major cost element which are consistently unacceptable as a basis for negotiating fair and reasonable prices (DFARS 215.407-5-70(a)(4)).

NOTE: Whenever significant deficiencies are outstanding, the overall opinion on the estimating system should be inadequate. Further, a recommendation should be made to disapprove the part of the estimating system that is deficient - see 5-1213b. and 10-408.1d.

5-1202 Background

DFARS 215.407-5-70 requires all DoD contractors to have acceptable estimating systems, requires certain large businesses to disclose their estimating systems in writing, provides guidelines concerning the characteristics of an adequate estimating system, and provides guidance for conducting team estimating system surveys.

5-1202.1 Applicability of DFARS 215.407-5

a. It is DoD policy that all contractors have estimating systems that consistently produce well supported proposals acceptable as a basis for negotiating fair and reasonable prices. Estimating systems should be consistent and integrated with a contractor's related management systems, and be subject to applicable financial control systems (DFARS 215. 407-5-70(b)(1)). To be considered adequate, an estimating system must be established, maintained, reliable, and consistently applied. It must also produce verifiable, supportable and documented cost estimates (DFARS 215. 407-5-70(a)(1)).

b. Any large business contractor which in its preceding fiscal year received DoD prime contracts or subcontracts of at least $50 million requiring cost or pricing data is subject to the requirements of DFARS 215. 407-5-70(c)(4), (d), (e), and (f) and paragraphs (d) and (e) of DFARS 252.215-7002 (see 5-1202.2, 5-1203.2, 5-1204.1 and 5-1204.2).

c. Any large business contractor which in its preceding fiscal year received DoD prime contracts or subcontracts of at least $10 million requiring cost or pricing data may also be subject to the requirements of DFARS 215. 407-5-70(c)(4), (d), (e), and (f) and paragraphs (d) and (e) of DFARS 252.215-7002. Such coverage is required if the PCO, with the concurrence or at the request of the ACO, determines it to be in the best interest of the Government (e.g., significant estimating problems are believed to exist or the contractor's sales

are predominantly to the Government). The additional coverage will apply if during contract performance the contracting officer provides written notification to the contractor.

d. The disclosure, maintenance and review requirements of DFARS 215. 407-5-70 (c)(4), (e), and (f) do not apply to small businesses, educational institutions, or other nonprofit organizations.

5-1202.2 System Disclosure and Maintenance Requirements

Contractors subject to DFARS 215. 407-5-70(c)(4) (see 5-1202.1b and c), are required to establish and maintain an adequate estimating system and disclose it in writing to the contracting officer responsible for contract administration. Disclosure is considered adequate when the contractor has provided the cognizant ACO with: documentation accurately describing the policies, procedures, and practices that are currently used in preparing cost proposals, and sufficient detail for the Government to reasonably make an informed judgment regarding the adequacy of the contractor's estimating practices. Significant changes to the cost estimating system must be disclosed to the cognizant ACO on a timely basis. If disclosed information contains commercial or financial information which the contractor regards as privileged and confidential, such information will be protected and not released outside the Government without the permission of the contractor.

5-1203 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor accounting and management systems and related internal controls.

b. The auditor is responsible for evaluating contractor estimating methods and procedures. This is accomplished by estimating system surveys designed to determine the reliability of a contractor's estimates, identifying areas requiring special emphasis in the audit and negotiation of individual price proposals, and recommending improvements when deficiencies are noted in a contractor's estimating system. Estimating system surveys provide knowledge of the strengths and weaknesses in a contractor's estimating system. Effective reporting on the existence and impact of estimating system deficiencies can stimulate contractor corrective action. Corrective action can substantially reduce the incidence of defective pricing and the time and effort required to audit individual price proposals.

c. It is DCAA's policy that contractor estimating system audits be performed every three years unless past experience and current audit risk is considered to be low. A determination of low risk must be fully documented in the planning documents supporting the program plan. In addition to a current audit risk assessment and documented past experience, the documentation must also include evidence of coordination with the ACO. If the audit risk is considered to be high, estimating system audits should be performed more frequently. These audits should also be considered at nonmajor contractor locations where there are indications of significant estimating system problems. Such audits may be performed in conjunction with other planned contract audit activity.

d. Other changed circumstances that may impact risk are:

(1) Changes in the regulatory or operating environment and adoption of new accounting principles or changes accounting principles.

(2) New personnel with a different focus or understanding of internal control.

(3) New or significantly rapid changes in information systems.

(4) Rapid growth, which can increase the risk of a breakdown in controls.

(5) Incorporation of new technologies into production processes or information systems.

(6) Entering into business areas or transactions (e.g., new lines, products, or activities) with which an entity has little experience.

(7) The impact of corporate restructurings on staffing, changes in supervision, and segregation of duties.

5-1203.1 Comprehensive Surveys-Estimating Systems

a. Most estimating system surveys are conducted as comprehensive surveys. Comprehensive surveys pertain to effort accomplished primarily by auditors, although technical specialist assistance is recommended for the quantitative and qualitative aspects of the survey. (See Appendix D for guidance on the use of technical specialists.) Comprehensive surveys are conducted at contractor locations not requiring a team review (see 5-1203.2). Auditors assigned should include individuals normally involved in the evaluation of the contractor's proposals. A regional office representative should also be available, if required, to provide advice and assistance in planning and conducting the survey.

b. The guidance contained in 5-1204 through 5-1212 forms the basis for evaluating a contractor's estimating system. Although much of the guidance refers to team reviews, it may also serve as the basis for performing comprehensive surveys.

5-1203.2 Team Reviews

a. Definition. Team reviews pertain to effort accomplished as a DCAA and contract administration office team effort in accordance with DFARS 215. 407-5.

b. Selection of Contractors for Team Reviews.

(1) Team reviews apply to contractors subject to DFARS 215. 407-5-70(b)2 (see 5-1202.1b and c). DCAA and the cognizant contract administration activities are to establish and manage regular programs for evaluating selected contractor estimating systems (DFARS 215.407-5-70(c) and (e)). Factors to consider in selecting contractors for a team review follow:

(a) The annual DoD sales under prime contracts and subcontracts in the preceding fiscal year requiring cost or pricing data (should normally be at least $50 million).

(b) The frequency of proposals subject to price analysis and audit.

(c) The date of the last team review.

(d) Any special pricing problems.

(2) Team reviews are to be conducted at least every three years at applicable contractors, except where the auditor and ACO determine that recent past experience has not found significant deficiencies and the current audit risk is low. A determination of low risk must be fully documented in the planning documents supporting the program plan. In addition to a current audit risk assessment and documented past experience, documentation must also include evidence of auditor and ACO coordination. Some examples of low risk indicators follow:

(a) No significant contractor reorganization has occurred which could affect its estimating or accounting functions.

(b) The contractor has not adopted major changes in its estimating methods or procedures.

(c) The contractor has carried out and submitted to the Government periodic self-assessments of its estimating practices and procedures, using self-governance programs, which substantiate the reliability of its system.

(d) There is no other evidence indicating the estimating system contains a major deficiency.

(3) If the auditor and ACO determine that the Government is subject to high risk, estimating system surveys should be done more frequently. However, the auditor's objective should be to work with the ACO and contractor to correct the deficiencies rather than perform more frequent reviews of the estimating system.

(4) At the beginning of each fiscal year, regional offices will coordinate a list of contractors selected for a team review with the responsible contract administration office (regional or other supervisory office).

c. Team Makeup and Responsibilities.

(1) The team will consist of members of the cognizant audit office, and technical specialists designated by the responsible contract administration office. The contract auditor will be designated as the team leader and is to be assigned responsibility for survey planning, direction of the work, and report finalization. Depending upon the nature of the contractor's activities, the contract administration office will designate quality control, production, engineering, packaging, transportation, and/or other specialists. Both offices are to assign sufficient personnel to permit completion of the review and issuance of the report within a reasonable time. If technical specialist assistance cannot be provided, inform the regional audit manager so the region can elevate the matter to appropriate acquisition management officials. If technical assistance is still not provided, the region should elevate the matter to DCAA Headquarters (ATTN: PPD). DCAA Headquarters will attempt to obtain the technical support. In those instances where DCAA Headquarters is not successful and believes that further resolution is required, Headquarters will direct the request to the attention of the Under Secretary of Defense (Acquisition & Technology). DCAA will not, in any case, use its own resources to perform these specialist functions.

(2) To provide for an efficient and effective audit, auditors and technical specialists assigned as team members should include individuals normally involved in the evaluation of the contractor's price proposals.

d. Regional Office Assistance. Regional offices are to assist in resolving problems relating to the scheduling of specific team surveys, the participation of technical specialists on survey teams, and disputes between a team member and the team leader on survey findings and recommendations (see 5-1205.3c). Regional offices will also provide advice and assistance in planning and conducting the survey, as required.

5-1204 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the estimating system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. There is a clear interrelationship between estimating system, price proposal, and defective pricing audits. It is important that the auditor recognize that the results in one or more of these areas will have a direct relationship on the scope of audit in the other area(s). In addition to meeting the DFARS requirement for review, an estimating system survey serves as the fundamental basis for determining audit risk and scope for future price proposal and defective pricing audits. The primary objectives of the survey are to:

(1) evaluate the adequacy of a contractor's system for developing cost estimates for price proposal purposes,

(2) evaluate a contractor's compliance with its written estimating procedures and disclosed estimating system (if applicable),

(3) identify areas of a contractor's estimating system requiring special emphasis or attention during the audit and negotiation of individual price proposals, and

(4) inform interested Government activities on the reliability of a contractor's estimating system, and of actions necessary to correct existing deficiencies.

5-1204.1 Characteristics of an Adequate Estimating System

The adequacy of an estimating system depends on the successful interrelationship of many variables. The relative importance or necessity of each is largely determined by the particular conditions existing at each contractor location. In general, adequate estimating systems should provide for the use of appropriate source data, utilize sound estimating techniques and appropriate judgment, maintain a consistent approach, and adhere to established policies and procedures. Although it is not possible to list all characteristics that should be present in an adequate estimating system, DFARS 215.407-5-70(d)(2) states

that in evaluating the adequacy of an estimating system, the ACO should consider whether the contractor's estimating system:

a. Establishes clear responsibility for the preparation, review, and approval of cost estimates.

b. Provides a written description of the organization and duties of personnel responsible for preparing, reviewing, and approving cost estimates, and the various functions contributing to the estimating process such as accounting and planning.

c. Ensures that relevant personnel have sufficient training, experience, and guidance to perform estimating tasks in accordance with the contractor's established procedures.

d. Identifies sources of data and the estimating methods and rationale used in developing cost estimates.

e. Provides for appropriate supervision throughout the estimating process.

f. Provides for consistent application of estimating techniques.

g. Provides for detection and timely correction of errors.

h. Protects against cost duplication and omissions.

i. Provides for the use of historical experience where appropriate.

j. Requires use of appropriate analytical methods.

k. Integrates information available from other management systems as appropriate.

l. Requires management review including verification that the company's estimating policies, procedures, and practices comply with DFARS 215. 407-5.

m. Provides for internal review of and accountability for the adequacy of the estimating system, including the comparison of projected results to actual results and an analysis of any differences.

n. Provides procedures to update cost estimates in a timely manner throughout the negotiation process. (Also see 14-120.4 on defective pricing sweeps.)

o. Addresses responsibility for review and analysis of the reasonableness of subcontract prices.

5-1204.2 Indicators of Potentially Significant Estimating Deficiencies

Some indicators of, or conditions that may cause, significant estimating deficiencies as discussed in DFARS 215.407-5-70 (d)(3) are listed below. These indicators or conditions are not intended as a comprehensive checklist. They may, however, suggest the need for further analysis or evaluation. Since estimating is not an exact science and is partly based on judgment, differences between individual estimates and subsequent actual data are not necessarily indicators of a significant estimating system deficiency.

a. Failure to ensure that relevant historical experience is available to and used by cost estimators as appropriate.

b. Continuing failure to analyze material costs or failure to perform subcontractor cost reviews as required.

c. Consistent absence of analytical support for significant proposed cost amounts.

d. Excessive reliance on individual personal judgment where historical experience or commonly used standards are available.

e. Recurring significant defective pricing findings within the same cost element(s).

f. Failure to integrate relevant parts of other management systems (e.g., production control or cost accounting) with the estimating system, impairing the ability to generate reliable cost estimates.

g. Failure to provide established policies, procedures, and practices to persons responsible for preparing and supporting estimates.

Not all estimating system deficiencies will be significant as defined in DFARS 215. 407-5-70(a)(4). For example, the lack of written policies and procedures for a seldom-used cost estimating relationship is not necessarily an indicator of a significant deficiency when considered in the context of an otherwise adequate estimating system.

5-1205 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk, (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. Controls for interrelated audit concerns regarding the adequacy of the contractor's other major systems (i.e., budgets, general accounting, etc.) will be audited under separate assignments. While the controls for these areas are not part of this audit, the results of all audits of these interrelated controls must be considered in forming an overall audit conclusion on the estimating system internal controls and also commented on in the related audit report.

c. The extent of audit effort should also be influenced by:

(1) the types of Government contracts and their materiality

(2) deficiencies noted in recent proposal and postaward audits

(3) deficiencies noted in the prior estimating system survey and flash estimating system reports

(4) participation of the contractor in self-governance programs (this includes the work performed by the contractor's internal audit staff)

(5) input from the contracting officer

(6) contract provisions

General information regarding these scope areas is provided in 3-104 and additional considerations specific to the estimating system are discussed below. A risk assessment documenting conclusions reached regarding the impact of the above areas on the scope of this audit should be documented in the working papers.

d. If possible, estimating system surveys should be completed in a timely and efficient manner early in the year. By minimizing the cycle time and completing the review early, the results can be used in assessing control risk when establishing the scope for audit effort on price proposal and defective pricing audits.

5-1205.1 Coordinating Team Surveys-Estimating Systems

Preparation for an effective audit requires proper coordination with interested procurement and contract administration activities, and the contractor as follows:

a. Approximately 30 to 60 days before the scheduled starting date, notify in writing each Government procurement office having a significant volume of business with the contractor that an estimating system survey will be made. Request comments on any problems or special areas of interest related to the contractor's price proposals which would be appropriate for consideration.

b. Contact the ACO to discuss personnel and technical specialist requirements, survey scope, time phasing of the work, and the planned entrance conference with the contractor. Request that the ACO designate a member of his or her staff to coordinate the activities of the technical specialists assigned to the team. If the contractor is subject to DFARS 252.215-7002(d) (see 5-1202.1b and c), determine if it has disclosed its estimating system in writing to the ACO as required. If disclosure has not been made, immediately issue an estimating system deficiency flash report (see 9-310 and 9-1209d), and recommend that the ACO obtain the disclosure. In addition, report this deficiency in all subsequent forward pricing audit reports issued until corrected. Also consider deferring the estimating system survey until disclosure is made. If, however, you have leads or suspect that significant estimating system deficiencies exist, continue the audit.

c. Inform the contractor of the planned survey by sending a letter to the management official responsible for the total operations of the organizational unit being surveyed. Describe the purpose and general scope of the survey, indicate the tentative starting date, and identify the team leader and key participants. Request the contractor designate a company representative from its estimating department with whom survey matters can

be coordinated. Also request that the contractor alert contributing departments of the planned survey and of their need to provide information and records required by the survey team. Identify data needed at the beginning of the survey and propose a date for an entrance conference. Invite the contractor's top management personnel to attend the entrance conference. Suggest that the contractor present an orientation briefing at the entrance conference on its organizational structure, operating policies, and other areas of concern to the review team. Invite a prompt reply and provide a copy of the letter to the ACO.

d. Prior to the entrance conference, hold a preliminary meeting with team members to develop a tentative survey program. The team leader will ensure that overall survey scope will be responsive to procurement and audit needs.

e. Conduct the entrance conference in accordance with 4-302. Explain the purpose of the audit, the overall plan for its performance, the estimated duration, and the types of books, records, and data to be evaluated. Also allow enough time for the contractor to present an orientation briefing. Discuss coordinated audit planning and self-governance programs with the contractor and explain its relevance to estimating system surveys. If the contractor has implemented self-governance programs, describe the effect of the self-governance program on the scope of audit. If the contractor is not a participant in self-governance, explain the benefits of these programs. Describe how it can strengthen internal controls and thereby reduce audit scope and decrease the frequency of estimating system surveys.

f. Shortly after the entrance conference, hold another team meeting to finalize survey plans and make appropriate modifications to the survey program. Assign specific program areas to individual team members and establish time-phased schedules. Tailor the survey to take advantage of the daily work performed as part of the normal activities of the contract audit and contract administration functions.

5-1205.2 Areas of Coverage and Team Assignments

a. At any contractor location, certain areas of coverage or survey steps may be inapplicable, or applicable only in part. Read 5-1206 through 5-1211 to obtain a general understanding of the potential coverage requirements. Develop a survey program appropriate for the specific contractor location under review. A pro forma estimating system audit program is on the DCAA Intranet and the APPS under activity code 24010.

b. For areas of coverage dealing with the development of quantitative and qualitative requirements, carefully plan and coordinate with the technical specialists to eliminate duplication of effort and to ensure adequate audit coverage. The assignment of specific steps to an auditor, a technical specialist, or both depends upon the conditions encountered at each location. Base assignments to team members upon mutual agreement as to who can most effectively perform the work.

c. An auditor's areas of coverage will normally include cost and production records and data, learning and improvement curves, bills of material, operation or process time sheets, and other similar documentation. Such documentation provides a factual basis for determining the adequacy of a contractor's system for developing material and labor quantities and related usage, scrap, spoilage, and efficiency factors.

d. Technical specialists will normally be assigned to areas requiring technical knowledge and judgmental evaluations. Such areas include production processes, shop practices, machine loadings, time-and-motion factors, drawings and specifications, and engineering principles and techniques. They may also be required to evaluate data relating to plant layout and rearrangement, planning and scheduling plant capacity, and value engineering.

e. In assigning specific steps to team members, recognize that auditors and technical specialists have a common interest in:

(1) The quantitative aspects of the contractor's estimates.

(2) The methods by which requirements for the various types and quantities of labor hours and material are determined.

(3) Other areas such as special tooling and test equipment, packaging, and technical data.

5-1205.3 Team Monitoring and Coordination

a. Although technical specialists are responsible for the execution of their assigned functions, the team leader will coordinate the efforts and monitor the progress of all team members. The team leader will evaluate the scope of coverage and results obtained and determine with team members if efforts should be curtailed or expanded, or methods modified. All team members should adhere to professional standards, particularly those pertaining to the preparation of adequate working papers.

b. The team should meet periodically to resolve problems encountered and discuss progress and interim findings. The team leader should be currently informed of all interim findings so they may be referred for further development and consideration by other team members examining related areas.

c. Resolve any disagreements between a team member and the team leader at the local level so that coordinated views are reflected in the survey report. If resolution cannot be obtained at the local level, refer the matter to the DCAA regional office and, if appropriate, the contract administration counterpart. In unusual cases involving broad policy, refer the matter to Headquarters, ATTN: PPD.

d. Coordination with the ACO is essential throughout the survey. The team leader should actively solicit the personal participation of the ACO at the entrance and exit conferences. The team leader should also keep the ACO currently informed of significant developments. After completion of the field work and before the final report is issued, review all significant findings and recommendations with the ACO. Also review any substantive changes made after this point with the ACO.

5-1206 Internal Audits

The estimating system should be subjected to periodic internal audits to ensure the following:

(1) The policies and procedures comply with applicable rules and regulations.

(2) Established policies and procedures are being followed.

(3) Prior internal audit findings have been properly dispositioned.

This objective recognizes the contractor's commitment to self-governance and its contractual responsibility for systems and accounting internal controls. The contractor should be conducting on-going, self-initiated reviews of various aspects of its estimating system in a timely manner. Contractors may comply with this standard using in-house staff efforts or through the services of outside consultants.

a. Our interpretation of "internal audits" for purposes of this objective includes reviews performed by functional units as well as the internal audit staff. The auditor must be aware of the requirements of 4-1000, Relying on the Work of Others. The level of objectivity and competence of personnel performing the reviews will have a significant impact on the reliability of the reviews and should be clearly communicated to the contractor. Both the auditor and the contractor should be aware that the objective is to ensure that adequate estimating system policies, procedures, and controls are in place and being followed, and that system adequacy is maintained on a real-time basis.

b. The auditor must ensure that the system is subjected to periodic internal audit. This objective does not create additional access requirements beyond those identified in FAR 52.215-2 and 1-504. Consideration should be given to both the contractor's internal audit schedule of completed audits and audits performed by functional units that meet this objective. If the contractor contends that such reviews have been performed but is unwilling

to make them available to DCAA in any form, the auditor may be unable to determine if the contractor has met this objective. The auditor must evaluate the need for such access. Denial of access to relevant data should be escalated in accordance with 1-504.

c. The contractor cannot comply with the system disclosure and maintenance requirements if it does not provide to the Government "sufficient detail" for the Government to reasonably make an informed judgment regarding the adequacy of its estimating practices. If the internal auditor performs work supporting the system disclosure and maintenance effort, access to the detailed work products is necessary to assess the adequacy of the estimating practices

d. If a contractor is not performing periodic reviews of its estimating system, then it should be reported for not achieving this objective. This should be reported as a serious internal control weakness in light of the complexity of the estimating system and the risk of inaccurate costs being proposed on Government contracts. This control weakness should also be tied to prior questioned costs, where applicable.

5-1207 Estimating System-Description

a. The contractor should have an adequate estimating system description including policies, procedures, and operating instructions compliant with FAR and DFARS. While the contractor is required to provide a broad range of documents, the auditor should focus attention on the adequacy of the policies, procedures, and operating instructions related to the control objectives outlined in the remainder of this section.

b. The contractor should provide a written description of its estimating system in enough detail to allow the auditor to get a thorough understanding of how the system operates. The contractor's write-up should include items listed below:

(1) The overall organization and assignment of responsibilities.

(2) References to written policies and procedures.

(3) The flow of information between each process or function within the system as well as other management systems.

c. If the contractor’s system is fully or partially automated, the description should include the IT aspects of the estimating system transaction flow, including data input, data processing, and data output.

5-1207.1 Evaluation of Contractor's Organization and Assignment of Responsibility

The estimating function may be organized differently by individual contractors because of differences in their products or services, industry practices, size and type of organization, degree of departmentalization, management attitudes, personnel capabilities, and other factors. Responsibility for developing estimates may be centralized in an estimating group or delegated to the various participating departments. However, the estimating function should be soundly organized on the basis of a definitive flow of authority and standard policies and procedures established at a top or upper management level. Each contractor should maintain a written description of the organization and the duties of personnel responsible for preparing, reviewing, and approving cost estimates, and the various functions contributing to the estimating process such as accounting, planning, training, etc.

a. Evaluation of a contractor's organization requires analysis of the relationship of the organizational segments participating in the estimating function. For this purpose, request that the contractor provide organization charts and written procedures or directives describing the organizational structure and responsibilities of the estimating group(s) and contributing departments. Request flow charts from the contractor which show the flow of work in the estimating process, from the initiation of a proposal to the contract certification date, and the integration of data prepared by personnel responsible for functions such as accounting, cost control, budgeting, estimating, planning, purchasing, production control, engineering, and sales.

b. The auditor should determine if:

(1) Preparation of required estimates is effectively controlled either on a centralized or decentralized basis.

(2) Lines of authority, duties, and responsibilities are clearly defined, including responsibilities for preparing, reviewing, and approving cost estimates.

(3) The estimating process is properly coordinated among segments of the organization responsible for different parts of the estimate.

(4) The department responsible for overall compilation of the estimate has authority to review and question the reasonableness or accuracy of feeder information received from other departments.

5-1207.2 Evaluation of Policies and Procedures

The estimating function is of such importance that direction and guidance for its implementation must be in a form that ensures complete understanding and precludes misunderstanding. A formal written statement of policies and procedures, rather than an informal one based on established customs of the organization, should exist at all contractor locations with substantial Government business. Estimating procedures represent the means by which policies and objectives established by management are translated into detailed guidance and direction to personnel engaged in estimating functions. Policies and related implementing procedures should cover such areas as estimating organization; lines of authority; formats for proposal preparation; make-or-buy determinations; quantitative and pricing aspects of each cost element; use of statistical aids and estimating techniques (e.g., learning curves and scatter charts); extent of documentation; and review and control requirements.

a. Determine if standard policies have been established at a sufficiently high organizational level, and are in sufficient depth and detail to serve as a basis for definitive implementation.

b. Evaluate procedures for compatibility with underlying policy and for completeness as a source of guidance in all aspects of proposal preparation. Procedures should cover matters such as:

(1) Designation of individuals authorized to initiate and approve requests for preparing estimates.

(2) The required form of the request and the supporting detail to accompany the request. The latter includes documents such as the technical proposal, supplemental statement of work required under the proposed contract, and performance schedules.

(3) The basis for control, time phasing, review and approval of the estimate, and for the orderly flow of documentation and data in the buildup and support of the estimate.

(4) Methods for obtaining contributions from, and coordination among, segments of the organization responsible for different aspects of the estimate. Such segments include engineering, quality control, purchasing, accounting, budgeting, and production control.

(5) Format of the estimate and the detail required to support it.

(6) Identifying the sources of data and estimating methods and rationale used in developing cost estimates.

(7) The consistent application of estimating techniques.

(8) Use of appropriate analytical methods.

(9) Procedures to update cost estimates in a timely manner throughout the negotiation process.

(10) Pricing of component cost elements with emphasis on using the most accurate, complete, and current cost and pricing data available at the time the estimate is prepared. (If the contractor makes more than one estimate for the same component of cost, all estimates should be available for the Government's evaluation.) To the extent applicable, maximum use should be made of historical cost data for pricing the same or similar items or services, or elements thereof. Procedures should also provide for furnishing current, accurate and com-

plete data up to the date of the price agreement, for estimates requiring the execution of a certificate of current cost or pricing data.

(11) Responsibility for review and analysis of the reasonableness of subcontract prices.

c. Evaluate estimating procedures to determine if they are kept current, disseminated to all responsible employees, and consistent with the company's established cost accounting policy, system, and procedures.

5-1207.3 Integration with Other Management Systems

a. Cost Accounting System. The contractor's cost accounting system is usually a major source of data used in developing cost estimates. An evaluation of a contractor's cost accounting system is normally accomplished separately from an estimating system survey (9-302). One area which should be covered in an accounting system evaluation is the impact on the system of technological modernization (see 14-800). Any changes to the accounting system must be disclosed to and approved by the ACO. The following areas should be covered in an estimating system survey. (Reliance placed upon separate accounting system evaluations should be documented in accordance with 4-1000.)

(1) The extent to which cost accounting and adjunct statistical records contain sufficient refinements for cost estimating purposes. Examples of such refinements are lot costing and the segregation of nonrecurring costs.

(2) The consistency between estimating and cost accounting in the classification of cost elements as either direct or indirect. Determine the reasons for any inconsistencies and their effect upon the validity of cost estimates and indirect cost rates.

(3) The suitability of the contractor's standard costs and related variances for use in preparing cost estimates, considering:

(a) The extent to which variances are segregated by product line and according to contributing causes such as price and rate variances, use and efficiency variances, and variances due to "make" versus "buy" decisions.

(b) The degree to which historical cost variances used for estimating are adjusted to reflect anticipated or planned changes in conditions.

(c) The magnitude of the variances and their composition. Variances should be documented by the contractor and evaluated by the auditor before they are accepted on future estimates.

b. Budget and Planning System. In addition to serving as a management control over the cost of operations, the contractor's budget system also provides data for use in developing estimates, particularly indirect cost projections and volume of activity forecasts. Contractor budget system audits should be made separately and preferably in advance of estimating system surveys (see 5-500). The following areas, however, should be considered during an estimating system survey. (Reliance placed upon separate budget system audits should be documented in accordance with 4-1000.)

(1) The degree to which the projected level of costs and volume of activity are considered in preparing cost estimates.

(2) The reliability of sales forecasts and the extent to which such forecasts are reflected in indirect cost projections.

(3) Consideration given by the contractor when preparing cost estimates to information contained in facilities budgets, e.g., commitments for the acquisition of new and improved equipment expected to reduce production costs.

(4) If either the estimating system or budget and planning system are fully or partially automated, consideration should be given to ensuring the accuracy of any data files flowing from the budget and planning system to the estimating system (see 5-1406.5).

5-1208 Training

a. Training should be provided to appropriate employees (including technical employees) on Government regulations and company policies and procedures pertaining to the estimating process. Training on the use of statistical aids and advanced estimating techniques including appropriate proposal file documentation procedures should be provided.

b. Training modules should be periodically reviewed and updated and periodic training sessions provided for new hires and experienced personnel.

5-1209 Evaluation of Cost Estimate Development

a. A major part of the survey is an evaluation of the effectiveness of the methods and procedures used to develop estimates of individual cost elements. A contractor should ensure that estimating source data is appropriately applied and the basis for estimating each cost element is disclosed by providing written guidelines for developing and supporting consistent and verifiable proposals. Procedures and instructions on the documentation required for a proposal should cover items such as:

(1) Conditions, assumptions, and qualifications.

(2) Basis of each cost element including the methods and support used to develop indirect rates, pools and bases.

(3) Milestones for contract performance.

(4) Reconciling detail and summary level data.

b. In determining the scope and extent of coverage to include in the program for this part of the survey, team members should consider the preliminary survey work accomplished and the prior experience of the auditors and technical specialists. Give particular attention to costs questioned and findings disclosed during price proposal and postaward audits. Comparisons of previous estimates with actual costs of completed negotiated contracts may also furnish useful information, provided the methods used to develop such estimates are still in effect. Do not request that the contractor submit special data for this purpose if its preparation requires extensive effort.

c. Where information developed under recent incurred cost, price proposal and other audits provides the basis for an informed conclusion regarding a particular area of coverage, no further steps are needed for the evaluation of that area. However, reliance placed upon these other audits must be documented in accordance with 4-1000. Where further effort is considered necessary, use recent price proposals previously submitted by the contractor to test the effectiveness of the contractor's procedures.

5-1209.1 Estimating Methods

The methods employed by a contractor to develop cost estimates may vary depending on the type of work covered by a proposal, e.g., research, production, etc. Request the contractor to provide a flow chart for each type of proposal, showing how individual cost elements are developed and integrated into the total estimate. In addition, evaluate the estimating methods employed by the contractor in preparing various proposals to consider:

a. Appropriateness of the estimating methods employed in preparing cost estimates for each type of proposal, and if different methods should be used considering factors as:

(1) Nature of product or service.

(2) Degree of firmness of specifications.

(3) Contractor's prior experience with the same or related products or services.

(4) Extent detailed cost data can be derived from the accounting system, adjunct statistical records, and other sources.

(5) Relative dollar amount of estimates.

(6) Cost and time restrictions on the preparation of estimates.

b. A contractor should clearly identify the pricing policy for areas identified as sensitive by the Government and contractor. Such areas include pricing policy for start-up costs on follow-on contracts; burdens for intracompany effort; inventory items including residual inventory; and Government owned or furnished equipment.

c. Extent estimating methods make appropriate use of historical cost data relating to:

(1) entire products,

(2) individual tasks required on new procurements similar to those accomplished under previous contracts, and

(3) indirect cost ratios and percentage factors applicable to a common base.

d. If cost estimates based upon prior cost experience adequately consider:

(1) Differences in complexity, quantity, rate of production, state of development, etc., between items previously produced and those for which estimates are being developed.

(2) Applicability of preproduction engineering, special tooling, plant rearrangement, and other nonrecurring costs.

(3) Anticipated changes in production methods, material usage, prices, wage rates, labor efficiency, production volume, plant capacity, and make-or-buy structure.

e. The propriety of using company-wide forward pricing factors developed for the preparation of cost estimates and if such pricing factors are current, based upon reliable cost data and procedures, and correctly applied.

f. Applicability of historical standard cost variance factors. If standards have been revised to represent expected actual cost, historical cost variances are not applicable.

g. Reasonableness of formula pricing methods for spare parts to ensure individual elements of cost are not duplicated in base cost and loading factors.

h. Suitability of catalog pricing and prepriced listing methods for developing reasonable prices for spare parts proposals, if used by the contractor.

i. Acceptability of the contractor's methods for developing cost estimates for contract changes, considering:

(1) Degree to which estimates properly reflect the nature and scope of the change and status of the work at the time the change is issued.

(2) If work deleted by changes is priced correctly.

j. If there is effective use of the contractor's IT capabilities in developing estimates and summarizing detailed data for proposal preparation.

k. If analytical methods are used, when appropriate, to develop cost estimates and/or evaluate the reasonableness of cost estimates developed using other procedures.

5-1209.2 Evaluation of Proposal Format and Support

a. A contractor's estimating procedures should provide a standardized format for proposals and the submission of supporting data. Estimating system documentation should include or reference policies and procedures on the formats for proposal preparation and the required detail for support. Where contractors are required to submit cost or pricing data, the contracting officer will specify the format to be used including: FAR 15.408, Table 15-2, an alternate format, or permit submission in the contractor’s format (see 9-304). Evaluation should cover:

(1) Determination that proposals are submitted on appropriate forms (or acceptable substitutes) and all data required by the forms is furnished.

(2) Sufficiency of detail contained in proposals and supporting data.

(3) Adequacy of the contractor's identification of cost and pricing data submitted in support of the price proposal and the related Pricing Certification, when required by FAR 15.403.

b. The auditor should determine whether the contractor’s procedures include submitting forward pricing proposals electronically. If the majority of the contractor’s proposals are not being submitted electronically, the auditor should recommend that the con-

tractor revise its procedures. Submitting proposals electronically facilitates a more effective and efficient proposal review and negotiation process. This recommendation should not be included in the report since we do not report suggestions to improve the system, but should be provided to the contractor in a separate letter.

5-1209.3 Subcontract Price/Cost Analysis

a. The contractor's policies and procedures should require the contractor to:

(1) conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices;

(2) include the results of these analyses in the price proposal; and

(3) when required in accordance with FAR 15.404-3(c), submit subcontractor cost or pricing data to the Government as part of its own cost or pricing data.

Adequate and timely subcontract cost/price analysis is critical to the negotiation of fair and reasonable prime contract prices. For this reason, the contractor should have policies and procedures in place to accomplish such analyses prior to the submission of their own cost or pricing data.

b. Due to time and other constraints, the contractor may be unable to perform a detailed price/cost analysis prior to submission of its own cost or pricing data. In these instances, the contractor's policies and procedures should require that a plan be in place to complete the required analysis and provide it to the Government negotiator prior to negotiation of the prime contract price.

c. In some exceptional cases, the contractor may be unable to obtain adequate cost or pricing data and/or perform the required analysis prior to negotiation of the prime contract price. The contractor's policies and procedures should provide for the timely identification of such circumstances and submission of a request, to the contracting officer, to be excused from the submission of subcontractor cost or pricing data and related analysis. This request should be supported by:

(1) an explanation as to why the data and analysis cannot be submitted in a timely manner, and

(2) an alternate analysis such as application of a negotiation reduction factor based on the historical difference between the initial subcontractor proposed amount and the ultimate negotiated amount.

5-1209.4 Evaluation of Contractor Control and Review of Estimates

The reliability of estimates depends largely upon the effectiveness of the internal controls and managerial reviews, including internal audits of the estimating function (see 5-1206), incorporated into the estimating process. Evaluate the contractor's estimating controls and reviews to determine the sufficiency of internal controls, including:

a. If the various phases and functions in the estimating process are adequately controlled to ensure timely processing of proposals.

b. If internal controls are adequate to ensure uniformity of approach, timely detection and correction of errors, and prevention of cost duplications and omissions.

c. If supervision in each area and at each level of the estimating process is adequate.

d. If management reviews of proposals cover the soundness of judgmental estimates and adherence to established procedures.

e. If estimators are required to summarize the conditions, assumptions, contingencies, qualifications, risks, etc., that were considered in developing estimates.

f. The quality, frequency, scope and results of management reviews of the estimating function. Such reviews should determine if the company's estimating policies, procedures, and practices comply with DFARS 215.407-5 and other applicable Federal regulations. They should also determine if the overall estimating system is adequate. In doing so, they should compare, on a sample basis, projections to actual results, and

analyze any differences. DCAA should evaluate management action and follow-up on reported findings and recommendations.

5-1210 Contract Certification-Estimating Systems

a. The contractor should have established policies and procedures for ensuring that all cost or pricing data is current, accurate, and complete as of the date of agreement on price. The auditor should evaluate these policies and procedures to determine if they are adequate to reasonably ensure that the additional cost or pricing data will be identified and submitted to the Government negotiator prior to execution of the Certificate of Current Cost or Pricing Data.

b. The auditor's evaluation should carefully consider the results of recent postaward audits in determining the scope of audit for this objective. Additional audit guidance on Defective Pricing "Sweeps" is contained in 14-120.4.

5-1211 Information Technology System Internal Controls-Estimating Systems

a. Where information technology (IT) is used in significant financial applications, control activities are sometimes defined by classifying them into two types, IT general controls or IT application controls. Whether the control activities are classified by the auditor as general or applications controls, the objectives of control activities remain the same, to provide reasonable, but not necessarily absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial and cost records are reliable to permit the preparation of financial statements and cost representations.

b. The auditor should review the IT general controls and the estimating system application controls to determine if they have been designed according to management direction, GAAP, and applicable Government regulations and that internal controls are operating effectively to provide reliability of and security over the data processed.

c. General controls are comprised of:

(1) organization and operation controls,

(2) systems development and documentation controls,

(3) hardware and systems software controls, and

(4) data and procedural controls.

(See 5-400 for a more detailed explanation of general internal controls.)

d. Estimating system application control activities are applied to the input, processing, and output phases of this single IT application. In contrast, IT general controls affect all system applications and operational elements of all IT systems. Separate control activities are developed for each unique application system, such as labor distribution, inventory control, and in this instance, estimating. Although some application control activities affect only one or just a few control objectives, most of the control activities are designed to prevent or detect several types of errors in most or all phases of the application. (See 5-1400 for a more detailed explanation of application internal controls.)

5-1212 Summarization

a. Upon completion of each assigned area and appropriate supervisory review, the auditor will discuss his or her tentative findings and recommendations with contractor personnel responsible for the specific area evaluated. The purpose is to confirm the factual accuracy of the findings and assess the feasibility of the recommendations. After the discussions, the auditor should promptly summarize the specific areas evaluated and those that need to be reported upon, as follows:

(1) An overall evaluation of the acceptability of the estimating methods and procedures applicable to the area.

(2) A description of each condition requiring corrective action, and related recommendations in such form and detail as required for the survey report.

(3) The contractor's reaction to that part of the findings and recommendations.

b. The ACO or a representative should coordinate the activities of the contract administration office team members; consolidate the technical findings and recommendations; and, when appropriate, prepare a comprehensive written report to be submitted to the team leader. Attach this report to the overall estimating system survey team report. The contract administration activity will be responsible for the technical sufficiency and validity of the technical report(s). If requested technical assistance was not provided, qualify the estimating system survey audit report.

c. The technical specialists will retain their working papers. In some instances, copies of technical specialist summary schedules, etc., may be needed for the survey audit report. Such copies should be provided upon request of the team leader. These copies, as well as the reports of the team members and the detailed working papers prepared by the auditors, will be maintained in the survey file.

d. After completion of the field work, the team will meet to evaluate all findings and recommendations and establish the general content of the overall survey audit report. The team leader will prepare the report using the written input of the various team members. The team leader will coordinate the draft report with the ACO to resolve differences in conclusions or recommendations. Disagreements between a team member and the team leader should be resolved in accordance with 5-1205.3c.

5-1213 Internal Control Reporting-Estimating System

a. The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems. A shell report on an estimating system survey is included on the DCAA Intranet and the APPS.

b. If significant deficiencies are identified, the overall audit opinion on the system should be inadequate. Further, a recommendation that all or part of the estimating system be disapproved must be included in the report (DFARS 215.407-5). When making this recommendation, the estimating system survey report should include the estimated cost impact of each significant estimating deficiency. Calculation of the impact should be based on such factors as the amount of questioned and unsupported costs found in previous price proposal audits and the amount of recommended price adjustments found in previous postaward audits that are attributable to the estimating deficiency. Where appropriate, the report should also recommend that the ACO consider notifying contracting activities that cost or pricing data on negotiated procurements should be requested at the $100,000 level.

c. The auditor should recommend disapproval of an entire estimating system when deficiencies are so significant that the system is likely to produce proposal estimates which in total are consistently unacceptable for negotiating fair and reasonable prices. This may be appropriate when defective pricing findings, or estimating system deficiencies adversely affecting audit or negotiations, consistently occur in all major cost areas.

d. Recommend disapproval of part of an estimating system when significant deficiencies are likely to produce proposal estimates with one or a few major cost elements consistently unacceptable for negotiating fair and reasonable prices. This may be appropriate when defective pricing findings, or estimating system deficiencies adversely affecting audit or negotiations, consistently occur in one or a few major cost areas.

e. Only significant estimating system deficiencies should be reported. If correction of the minor issues would enhance the contractor's estimating system, those can be addressed with the contractor in a separate letter at the FAO’s discretion.

5-1214 Exit Conference

After completion of the draft report, the team leader will arrange and conduct an exit conference attended by all team members and the ACO. At the exit conference, discuss the results of audit and provide the contractor with a draft statement of the condition(s) and recommendation(s). Inform the contractor that its written response to the draft, if provided within a reasonable time, will be included in the audit report to the ACO (see 4-304.5b). After receipt of the contractor's response or lapse of a reasonable time, the team leader will issue the final report in accordance with 10-400. If findings are significant, send information copies to each procurement office doing substantial business with the contractor. Do not unduly delay issuance of the report awaiting the contractor's response.

5-1215 ACO Processing of the Estimating System Report

a. Upon receipt of the report, the ACO will provide a copy to the contractor and allow 30 days or a reasonable extension for submission of its written response. If no significant deficiencies are identified, the ACO will notify the contractor in writing in a timely manner (DFARS 215.407-5-70 (f)(2)).

b. If the contractor agrees with the report findings and recommendations, the contractor should, within 60 days of receipt of the initial ACO notification, correct any identified system deficiencies or submit a corrective action plan showing milestones and actions leading to elimination of the deficiencies. If the contractor disagrees with the report findings and recommendations, the contractor's response should contain the rationale for each area of disagreement (DFARS 215.407-5-70(f)(2)).

c. The ACO, in consultation with the auditor, will evaluate the contractor's response and determine if:

(1) the estimating system contains deficiencies needing correction;

(2) any deficiencies are significant enough to warrant disapproval of all or part of the contractor's estimating system; or

(3) any proposed corrective actions are adequate to correct the deficiency (DFARS 215.407-5-70(f)(3)).

When recommending disapproval of portions of an estimating system, identify specific portions that should be disapproved. This will direct attention toward the significant deficiencies as well as inform the ACO which portion should not be relied upon.

d. The ACO will notify the contractor and the auditor of his/her determination and, if appropriate, of the Government's intent to disapprove all or a selected part of the system. The notice will list the cost elements it covers and identify any deficiencies requiring correction. The notice will also require the contractor to make correction or submit a corrective action plan within 45 days showing proposed milestones and actions related to all identified deficiencies (DFARS 215.407-5-70 (f)(4)).

5-1216 Monitoring and Follow-up-Estimating System

a. The auditor and ACO will monitor the contractor's progress toward correction of deficiencies. In addition, a follow-up audit will be performed to ascertain the status of the corrective action plan and to reevaluate the significance of any uncorrected significant deficiencies. Since all reported deficiencies require follow-up, make the necessary follow-up within six months of the report issuance date to determine if the contractor has corrected the deficiencies. This period may be adjusted to allow for such factors as the significance of the deficiencies, volume of proposal activity, and realistic time frames for implementing corrective action. When a follow-up audit is not expected to be performed within six months, the auditor should indicate in the report why the follow-up audit has been deferred and the anticipated time frame when the review will be performed.

b. The follow-up audit should include steps to determine that the proposed corrective actions are adequate to correct any deficiencies, including those reported in flash reports issued after the system survey report date (see 9-310), as well as to determine that the contractor is complying with its corrective action plan. However, if there is an insignificant amount of proposal activity, the portion of the follow-up to determine contractor compliance with its corrective action plan may be deferred--but the report should note the limited scope. Compliance should then be evaluated during another follow-up audit. If required, request technical specialist assistance.

c. If the contractor fails to make adequate progress toward corrective action, recommend that the ACO take action to ensure the contractor corrects the deficiencies. Actions for the ACO to consider include reducing or suspending progress payments per FAR 32.503-6 and/or recommending against the award of potential contracts (DFARS 215.407-5-70(f)(6)).

d. Issue a new report advising recipients of the original report on the status of the corrective actions. Include a description of the deficiency, status of corrective action, and status of any prior recommendation to disapprove portions of, or an entire, estimating system. Also, include the current opinion on the effectiveness of the estimating system with any recommendations to disapprove portions or the entire system. This new report should reference the previous report(s). If necessary, the report will request the assistance of procurement and/or contract administration activities to obtain contractor implementation of survey recommendations. If, as a result of estimating deficiencies, the contracting officer has lowered the threshold for requesting field pricing support (see 9-102.3), recommend that the threshold be raised if the follow-up work reveals that the deficiencies have been corrected. If the deficiencies were not corrected, recommend that the contracting officer take appropriate steps to stimulate contractor corrective action (see 5-1215).

e. If a follow-up audit discloses a significant estimating system deficiency not previously reported, it should be included in the follow-up report.

5-1217 Continuous Evaluation-Estimating System

a. Between estimating system surveys, auditors and technical specialists should carefully analyze exceptions taken to contractor estimates which support submitted price proposals. Make arrangements through the ACO for technical personnel to notify the auditor of estimating system deficiencies found during technical evaluations. Also, evaluate conditions attributable to estimating deficiencies disclosed during postaward audits and issue an estimating system deficiency flash report (see 9-310c), if appropriate.

b. When the report on an estimating system survey recommends disapproval of the system in whole or part, subsequent proposal audit reports should disclose the recommendation to disapprove the system. For any significant estimating system deficiency, disclose the cost impact where possible in subsequent proposal audit reports. These disclosures should continue until the deficiencies are resolved (DFARS 215.407-5-70(g)(1)). This also applies to significant estimating system deficiencies discovered during price proposal audits (see 9-310), estimating system survey follow-up audits (see 5-1216), and postaward audits (see 14-120.7d). In addition to questioning any inappropriate proposed costs resulting from estimating deficiencies, consider the following actions to improve the likelihood that the deficiencies will be corrected:

(1) When an estimating system deficiency exists that has only a minor impact on the adequacy of the proposal, qualify the audit report relative to the acceptability of the cost or pricing data.

(2) When an estimating system deficiency exists having a material impact on the adequacy of the proposal, consider the above, plus the following actions. (Pursue those actions considered most appropriate in the circumstances.)

-- Recommend that the contracting officer return the proposal to the contractor, and allow the contractor additional time to correct the deficiency and submit a corrected proposal (DFARS 215.407-5-70 (g)(2)(i)).

-- Recommend that the contracting officer consider another type of contract, e.g., a FPIF instead of a FFP contract (DFARS 215.407-5-70 (g)(2)(ii)).

-- Recommend that the contracting officer use additional cost analysis techniques to determine the reasonableness of the cost element(s) affected by the deficiency (DFARS 215.407-5-70(g)(2)(iii)).

-- Recommend that the contracting officer segregate the questionable areas as a cost reimbursable line item in any awarded contract (DFARS 215.407-5-70(g)(2)(iv)).

-- Recommend that some profit or fee adjustment be made in consideration of the system deficiency. This could be accomplished by a direct reduction to the profit objective that would normally be considered based on the weighted guidelines calculation (DFARS 215.407-5-70(g)(2)(v)).

-- Recommend that the contracting officer include a contract clause that provides for adjustment of the contract amount after award (DFARS 215.407-5-70(g)(2)(vi)).

(3) When a significant deficiency exists that prevents the auditor from measuring the impact, or the impact is so significant that the estimates are not acceptable as a basis for negotiating a fair and reasonable price, the auditor should issue an adverse opinion as provided by 9-211.3 in addition to pursuing the appropriate steps identified above, issue an adverse opinion as provided by 9-211.3.

c. Cost Accounting Standard 401, Consistency in Estimating, Accumulating and Reporting Costs, was established to:

(1) make the cost accounting practices used by a contractor in estimating costs consistent with its practices for accumulating and reporting costs during contract performance and

(2) provide a basis for comparing estimated to actual costs.

Use the guidance in Chapter 8 to determine if contractor estimating systems comply with CAS 401 requirements.

5-1300 Section 13 --- Participation on Joint Team Reviews

5-1301 Introduction

This section provides guidance as a participant on a joint system review team. As appropriate, the guidance in 9-1300 also applies. Guidance for the auditor on the joint estimating system team is stated in 5-1200.

5-1302 Purchasing and Subcontracting System Reviews

5-1302.1 Introduction

Basic audit requirements in Chapter 6 provide for the review of the operating effectiveness and transactions of a contractor's purchasing and related departments as an integral and necessary part of the audit of purchased material and service costs. When contractor purchasing system reviews (CPSRs) are regularly performed at a contractor location (see 5-1302.2), the auditor should rely upon this work to the maximum extent feasible in establishing the extent of audit coverage to be undertaken in this area. See 5-1302.4 for guidance on the effect of a CPSR on the performance of audits.

5-1302.2 Contractor Purchasing System Review (CPSR)

a. FAR 44.302 requires a CPSR to be made for each contractor whose sales to the Government (excluding competitively awarded FFP contracts, competitively awarded fixed price contracts with economic price adjustment, and commercial items pursuant to FAR Part 12) are expected to exceed $25 million during the next 12-months. Such sales include prime contracts, subcontracts under Government prime contracts, and modifications. Unless segregation of subcontracts is impracticable, the CPSR evaluation shall not include subcontracts awarded by the contractor exclusively in support of Government contracts that are competitively awarded FFP contracts, competitively awarded fixed price contracts with economic price adjustment, and sales of commercial items pursuant to FAR Part 12. Once the initial determination that a CPSR is needed under the above criteria has been made, the cognizant contract administration activity will decide whether a subsequent CPSR is needed at least triennially. The detailed procedures for conducting initial, subsequent, special, and follow-up CPSRs are in DFARS 244.3 and FAR 44.3. These reviews form the basis for the administrative contracting officer (ACO) to grant, continue, withhold, or withdraw approval of a contractor's purchasing system.

b. The ACO is responsible for reviewing the contractor's purchasing system. Members of other organizations, including DCAA, may participate in a review conducted under the ACO's authority, but are not to conduct separate reviews of a contractor's purchasing system. If a problem appears to exist, DCAA may recommend to the ACO that an additional review be performed.

c. CPSRs are conducted by teams under the direction of a purchasing system analyst (PSA) assigned by the local or regional contract administration office. The PSA is responsible for accomplishing the CPSR and conducting surveillance reviews. The review team consists of PSAs, the auditor, technical personnel, and other representatives of the ACO. The team captain, normally the senior PSA, will devise the overall review program, make assignments to the individual team members, and coordinate and monitor accomplishments. He/she is also responsible for the preparation and signing of the CPSR report, which is transmitted to the ACO after review by the appropriate CPSR Board. It is the ACO's responsibility to review the recommendations in the CPSR report to determine the appropriate action to be taken to correct any deficiencies and to so advise the contractor.

5-1302.3 Auditor Participation on CPSR Teams

a. Coordination with the PSA. The cognizant audit office will appoint an auditor to participate as a team member on initial and subsequent CPSRs or in the continuing surveillance process if used in lieu of a subsequent CPSR. Since the auditor and PSA have related responsibilities, it is imperative that they coordinate and correlate their activities to avoid duplication. The review program should be sufficient in scope to be responsive to the needs of both procurement and audit. The CPSR should make full use of day-to-day work performed by the auditor as an integral part of the contract audit mission. Maximum use should be made of the auditor's past audits and evaluations, and results of other audit work which bear upon the effectiveness of the contractor's purchasing system. See 4-1000 for documentation requirements when relying upon such work.

b. Auditor's Role. The auditor will be responsible for the timely performance of those areas specifically assigned by the CPSR team captain.

c. Auditor Performance and Supervision. The auditor will be responsible for the preparation and execution of detailed audit programs for all areas assigned by the team captain. Technical direction will be provided by an audit supervisor. The team captain will correlate the efforts and monitor the accomplishments of the auditor and other team members to the extent necessary for effective coordination of the overall review. During the audit, the auditor should discuss audit findings with the contractor in accordance with 4-300. After the auditor's findings and recommendations are developed, they will be reviewed with the audit supervisor and furnished in draft form to the team captain prior to completion of the in-plant effort of the CPSR team, to enable the team captain to conduct the exit conference with the contractor.

d. Reports and Working Papers. The FAO will retain the detailed working papers covering DCAA's part of the review, and submit a complete written report to the team captain setting forth the findings and recommendations in such form and detail as required for the survey report. The auditor's report will be formally issued by the appropriate audit office as soon as possible after the exit conference with the contractor. The team captain will also be provided with any summary schedules and/or copies of working papers required for consolidation of statistical data or as additional supporting documentation for the survey file.

e. Differences Between Audit and ACO Personnel. Differences between the auditor and PSA, or other ACO personnel, with respect to the delineation of responsibilities, policies, procedures, and other requirements related to the CPSR which cannot be resolved locally will be referred to the regional office. The regional office should also be informed of any differences between the auditor and the team captain relating to audit findings, conclusions, and recommendations.

5-1302.4 Effect of CPSR on Performance of Audits

a. The auditor should coordinate and seek agreement from the ACO and PSA whenever a review of an area affecting the CPSR is contemplated. At contractor locations where CPSRs are regularly performed, the auditor should obtain copies of reports and memorandums issued by the PSA and the ACO. Such items include the CPSR and final summary reports and notifications relating to the approval of the contractor's purchasing system. Based upon DCAA's prior participation in the CPSR and a review of these reports and documents, the auditor will determine the extent to which the work performed under the CPSR meets the audit objectives established in the functional areas enumerated in 6-300 for purchased material and service costs. See 4-1000 for documentation requirements when relying upon the work of others.

b. Where the scope of coverage in the CPSR is considered sufficient to support a conclusion that the policies, administrative procedures, and control activities in a related functional area are well defined, reasonable in concept, and effectively implemented,

the audit program need provide for only minimum substantive testing. When the policies and procedures are not adequate, the audit program should provide for increased substantive testing. Perform substantive testing and verification of individual transactions in the functional area commensurate with the degree of reliability that can be placed on the control activities. In developing tests of transactions, the auditor should consider the items and periods covered by the CPSR and not duplicate this work.

c. Where a current evaluation of a contractor's purchasing system is needed for audit purposes and a CPSR has not been recently performed, the auditor should coordinate this need with the ACO and should give due consideration to the timing and scheduling of the next CPSR in planning an audit of purchased material and service costs.

d. PCOs may make requests to the auditor for information pertaining to the adequacy of the contractor's purchasing system even though FAR 44.302 does not require a CPSR at the contractor's location. After appropriate coordination with the cognizant ACO, auditors will be responsive to such requests. The results of recent activity or functional surveys or other audits can serve as the basis for the auditor's reply. However, if the request from a PCO is in effect a request for performance of a CPSR as contemplated by FAR/DFARS 44.3, the auditor will refer such request to the cognizant ACO.

5-1303 Review of Contractor Insurance Cost and Pension Cost

Basic audit requirements for the review and evaluation of indirect costs are found in 6-600, with additional coverage of insurance and pension costs in 7-500 and 7-600 respectively. DFARS 242.73 sets forth the requirements for conducting Contractor Insurance/Pension Reviews (CIPR). DFARS 242.73 requires that:

(1) a CIPR be conducted based on need,

(2) a CIPR is a joint DCMA/DCAA evaluation and

(3) DCAA perform audits for compliance with Cost Accounting Standards.

The auditor should consider data developed during previous audits of these areas in establishing the scope of audit effort related to a CIPR. Conversely, the results of the CIPR should be fully integrated in planning the coverage of future reviews of pension and insurance costs. See 4-1000 for documentation requirements when relying upon such work.

5-1303.1 Insurance/Pension Team Reviews

a. DCMA is the DoD Executive Agency for the performance of all CIPRs. CIPRs are performed on an as needed basis. DFARS Procedures, Guidance and Information 242.7302 provides that a CIPR be performed when two conditions are met. First, a contractor has $50 million of annual Government sales on prime contracts, subcontracts and contract modifications that are negotiated using cost or pricing data or that are priced on other than a firm-fixed-price or fixed-price with economic price adjustment basis. Second, the administrative contracting officer determines that a CIPR is needed based on a risk assessment [see c below]. A CIPR consists of a thorough evaluation of a contractor's corporate insurance programs, pension plans, and other deferred compensation plans, including policies, procedures, practices and costs, to determine whether they are in compliance with CAS and FAR provisions and pertinent contract clauses.

b. A special CIPR may also be performed on the insurance and pension programs of those contractors that do not meet the criteria established for a CIPR. A special CIPR may be performed when any of the following circumstances result in a material impact on Government contracts:

(1) information reveals a deficiency in the contractor’s insurance/pension program,

(2) the contractor proposes or implements changes in its insurance, pension, or deferred compensation plans,

(3) the contractor is involved in a merger, acquisition, or divestiture, or

(4) the Government needs to follow up on contractor implementation of prior CIPR recommendations.

c. The ACO determines the need for a CIPR or special CIPR. As an advisor to the ACO, the auditor should notify the ACO of the need for a CIPR or special CIPR based on a risk assessment performed during the annual planning process or at the beginning of each insurance and pension audit. In addition, when the auditor identifies a potential risk or an event that requires the assistance of a DCMA insurance/pension specialist (I/PS), the auditor should send a request to the ACO and provide a copy of the request to the cognizant DCMA I/PS. The request should identify the area of risk and the time period that assistance of the I/PS will be needed. The CIPRs or special CIPRs may be performed in conjunction with incurred cost audits, forward pricing audits, or CAS compliance audits. Examples of effective use of CIPRs are to determine the reasonableness and propriety of group insurance reserves, the reasonableness of settlements of workers compensation claims, the recognition of unrealized appreciation of assets in contractor pension trusts, the proper measurement of pension plan liabilities in a segment closing, whether segment accounting is required, and the impact of full funding limitation on forward pricing.

d. The ACO is responsible for notifying the contractor of pending insurance and pension reviews and for arranging for the contractor to furnish information required, such as a schedule of insurance coverage, copies of pension plans, and related cost information.

e. To ensure timely and responsive CIPRs and special CIPRs, the Regional Special Programs Office should:

(1) Identify when FAOs have requested a CIPR or special CIPR.

(2) Obtain and maintain a current schedule of DCMA CIPRs.

(3) Coordinate the CIPR schedule with the FAO and ensure that DCAA participation is planned and scheduled.

(4) Notify Headquarters, PAC if any FAO is unable to participate in a scheduled CIPR.

(5) Establish procedures for monitoring the progress of scheduled reviews.

(6) Review significant issues identified during the CIPRs and special CIPRs.

f. CIPRs are conducted by joint teams that are generally under the direction of a DCMA I/PS. The team will normally consist of the I/PS, the cognizant auditor, and other specialists required in the circumstances. The I/PS usually serves as team captain and is responsible for maintaining complete documentation for CIPR reports, resolving discrepancies between audit reports and CIPR draft reports prior to releasing the final CIPR report, preparing and distributing the final CIPR report, providing the final audit report as an attachment to the CIPR report and preparing a draft letter for the ACO's use in notifying the contractor of CIPR results. The CIPR report is addressed to the cognizant ACO, with a copy furnished the auditor. Upon receipt of the CIPR report, the ACO is then responsible for transmitting it to the contractor for reply.

5-1303.2 Auditor Participation on CIPR Teams

There are currently two joint CIPR programs available on the DCAA Intranet and the APPS. Review steps can be added or deleted from the joint CIPR programs as needed to address the specific areas of audit risk. The first program (File "JNT CIPR PEN" Version 1.1, dated July 1, 1998) is for performing a joint CIPR for incurred pension costs, which includes steps for determining compliance with CAS 412 and 413. The second program (File "JNT CIPR SEG" Version 1.0, dated February 20, 1998) is for performing a joint special CIPR for the adjustment of pension cost required by CAS 413-50(c)(12). The programs are guides to establish review steps and assign the CIPR team member responsible for performing each review step identified. The auditor should identify audit steps needed to meet DCAA audit objectives and coordinate with the DCMA pension specialist to establish the responsibility for each CIPR team member.

If the scheduled date for a CIPR cannot be met because of other urgent priorities, the ACO and the DCMA I/PS should be advised accordingly and an alternative date suggested. In view of the interrelationship of auditor, ACO and I/PS responsibilities in the area of insurance and pensions, efforts must be coordinated very carefully to avoid duplication. While the scope of the auditor's program should be responsive to the needs of the ACO and the I/PS, it should also reflect due consideration for previous audit experience with respect to these costs.

a. The designated DCAA auditor will participate on the CIPR team, providing advice and information in a separate report to the CIPR team leader based on the analysis of the contractor's books, accounting records, and procedures. As a minimum, DCAA participation in the performance of a CIPR should include the following:

(1) Meet with the DCMA I/PS and ACO. The meeting should include:

(a) a discussion of how the review will address known problems and concerns,

(b) the planning and scheduling of review steps using the Joint CIPR Program or identifying of review steps that will need to be performed,

(c) identifying the team member responsible for performing the identified review steps, and

(d) the coordination of data requests between the CIPR team participants.

(2) Elevate to the region any differences with respect to the delineation of responsibilities, policies, procedures, and other issues which cannot be resolved locally by the ACO and FAO management.

(3) Participate in an entrance conference with the contractor.

(4) Conduct joint review and discuss findings and concerns among the CIPR team members as the review progresses.

(5) Meet with DCMA I/PS near the end of the review to discuss findings.

(6) Coordinate a draft audit report before providing it to the contractor for comment, and review and provide comment on a draft CIPR report.

(7) Conduct exit conference with the contractor.

(8) Provide a copy of the draft report to the contractor. Request contractor comments.

(9) Issue a separate report (as needed) to the ACO for all CAS and FAR noncompliances disclosed during the CIPR.

b. Auditor performance and supervision will be accomplished in accordance with 5-1302.3c.

c. Reports and working papers will be prepared and processed in accordance with 5-1302.3d.

5-1303.3 Effect of the CIPR on Subsequent Audits

a. The results of CIPRs are an important factor in determining the extent to which insurance and pensions are given audit coverage under Chapter 6, 7-500, and 7-600. The auditor should maintain appropriate follow-up on prior CIPR findings and recommendations (see 14-504). When the CIPR discloses that the contractor's insurance and pension programs are reasonable and effectively maintained, and assuming no significant change in conditions since the previous CIPR, the audit program will be revised to reflect the findings of the CIPR. Conversely, when significant deficiencies had been disclosed by a previous CIPR, the auditor should verify corrective action taken. If corrective action has not been accomplished, the auditor should ascertain the reason(s) for inaction. The ACO should be advised and the audit scope appropriately adjusted. If the scope of the previous CIPR was limited and did not provide an adequate basis for an audit conclusion as to the allowability of the costs generated by the insurance and pension areas in their entirety, the audit program should provide for the additional review necessary to accomplish those objectives. If circumstances indicate that additional review of the contractor's insurance or pension program is needed, the ACO should be requested to initiate a CIPR in accordance with DFARS 242.7301(b) (see 5-1303.1b).

b. In establishing the time frame for cyclic audit coverage of insurance and pension costs, the auditor should contact the I/PS to ascertain the timing of future CIPRs. The planning for audit coverage of insurance and pension costs should be coordinated with the scheduled CIPRs.

5-1400 Section 14 --- Audit of Information Technology Systems Application Internal Controls

5-1401 Introduction

a. This section provides guidance for reviewing application-specific information technology (IT) internal controls to evaluate the adequacy of the contractor's computerized accounting system and subsystems and assess control risk related to the allowability and allocability of costs charged to Government contracts. The guidance in this section is applicable to all application systems and subsystems regardless of the environment in which they operate. It is applicable to application systems and subsystems processing in centralized IT operations, distributed processing environments, local/wide area networks (LAN/WAN), or client/server systems. See the IS Knowledge Base available on DCAA's Intranet for further guidance on reviewing IT systems.

b. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal control and assessing control risk.

c. The guidance should be applied selectively, giving consideration to the unique aspects of the in-place data processing system and areas judged to be relatively high risk.

5-1402 Background Information

a. IT application internal controls are normally divided into three categories: input controls, processing controls, and output controls. To give effect to more specific elements of the overall process, there is a further subdivision of access controls and controls over the error correction and submission process within each specific application system or subsystem.

b. Access controls provide safeguards to insure that IT resources are properly utilized. Effective access controls will assist in the prevention or detection of deliberate or accidental errors caused by improper use or manipulation of data files, unauthorized or incorrect use of a computer program, and/or improper use of computer resources.

c. Data input controls are designed to provide reasonable assurance that data received for processing have been properly authorized, converted into machine sensible form and identified, and that data have not been lost, suppressed, added, duplicated, or otherwise improperly changed. Input controls include controls that relate to rejection, correction, and resubmission of data that were initially incorrect.

d. Processing controls are designed to provide reasonable assurance that electronic data processing has been performed as intended for a particular application.

e. The correction of all errors detected by the system and the resubmission of corrected transactions is a critical process that must be reviewed and controlled. Effective control can be achieved by assigning the responsibility to a specific individual or group. A correction or revision that is entered into the system should be subjected to the same edits and controls that were applied to the original transaction.

f. Output controls are designed to assure the accuracy of the processing results and that only authorized personnel receive the output results. The results of processing can be listings, displays, reports, magnetic files, invoices, checks, or some other electronic media that will serve as input to other systems.

5-1403 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. IT application internal controls meet the definitions of "record" and "data" contained in FAR 52.215-2, Audit and Records- Negotiation, and FAR 52.214-26, Audit and Records- Sealed Bidding. The applicability of these FAR sections is agreed to by contractors when submitting price proposals and executing contracts with DoD components. These

contract clauses give the auditor the right of access to contractor records, including IT internal control data, after contract award. Refer to 1-504, Access to Records of Contractor, and 1-505, Other Access to Records Issues - Transfer of Records from Hard Copy to Computer Medium.

5-1404 Audit Objectives

The purpose of an audit of IT application controls is to evaluate the adequacy of and the contractor's compliance with the application-specific IT system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

5-1405 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The auditor should consider any IT related outstanding deficiencies identified in the IT general internal control review as well as other accounting and management system audits previously performed. The nature of such deficiencies may affect the scope of the specific IT system being audited. For example, a general internal control deficiency involving an inadequate segregation of duties within the IT group may affect the current review of internal controls within the contractor‘s billing system.

c. The following sections contain general guidance for the audit and evaluation of IT application internal controls. This guidance gives the auditor a framework for the audit, regardless of the specific system under audit. However, this guidance is not a substitute for professional judgment. The auditor should adapt this guidance to fit individual audit circumstances.

5-1406 Information Technology System Internal Controls

a. Information and Communication is one of five components of internal control. It is the identification, capture, and exchange of information in a form and time frame that enables people to carry out their responsibilities. Therefore, the information system relevant to cost reporting objectives consists of the methods and records established to record, process, summarize and report entity transactions (as well as events and conditions) and to maintain their accountability.

b. Most information systems involve some computer processing. Although the objectives of computer and manual systems are the same, control activities take on unique characteristics in a computerized environment. The quality of system generated information affects management’s ability to make appropriate decisions in controlling the entity’s activities and in preparing reliable cost data. Therefore, the contractor should include controls in its information processing that check for accuracy, completeness, and proper authorization of transactions.

c. A variety of control activities are performed to check the accuracy, completeness, and authorization of transactions. The two broad groupings of Information Technology System Internal Controls are general controls and applications controls. General controls commonly include controls over data center operations, contingency planning/disaster recovery, system software acquisition and maintenance, access security, and application system development and maintenance. These controls apply to mainframe, minicomputer, and end-user environments. (See 5-400 for a more detailed explanation of general internal controls.)

d. Application controls apply to the processing of individual applications and help ensure that transactions are valid, properly authorized, and completely and accurately

processed. If a system is partially or fully automated, appropriate application controls must be evaluated in order to assess control risk at less than maximum. These applications include controls in the areas of access, data input, processing, error correction and submission, and output.

5-1406.1 Access Controls

Access controls help ensure that only properly authorized personnel have access to specific networks, applications, and application transactions. They are designed to prevent or detect deliberate or unintentional errors caused by improper use or manipulation of data files, unauthorized or incorrect use of a computer program, and/or improper use of computer resources. These controls can be manual (i.e. non-automated), physical access, and/or logical access. If manual controls and physical access controls are weak in some areas, logical access controls can act as a compensating control. This includes restricting unauthorized persons from accessing computer data and program files. Access rules can be defined in terms of who can perform specific functions (e.g. add, modify, delete, query), control when these functions can be performed, and limit the selected devices from where these activities can be performed. The contractor's accounting system and subsystems should include an adequate scheme of access controls to ensure that:

a. A user identification code (i.e. logon id) and password are required to access computer programs and data files. By evaluating a system security profile listing, the auditor can often determine if logon id and password rules exist and whether they are adequate to ensure integrity and confidentiality. The system security profile listing should include, at a minimum, user access requirements and user access rights and privileges.

b. System user access rules and profiles reflect the users' actual job duties and responsibilities. Job descriptions should:

(1) be current,

(2) reflect actual conditions and practices, and

(3) be distributed to employees.

c. An adequate segregation of duties, where reasonably possible, exists between data entry, input/output control, systems development, systems maintenance, systems programming, computer operations, and user departments.

d. Terminated and/or transferred employees are removed from the registry of valid and authorized users defined to the system.

e. When appropriate, users are logged out of sensitive applications or off the network after a workstation has been inactive for a predetermined time limit.

f. The specific accounting system/subsystem is designed to record and report all unauthorized access attempts. If security violations are disclosed, they should be followed up on a regular basis.

5-1406.2 Data Input Controls

Data input controls help ensure that all input data are authorized and complete, and data are consistently recorded, accumulated, processed, and reported in a controlled environment to produce timely and accurate information. Written procedures for originating, authorizing, collecting, preparing, and approving input transactions to the contractor's accounting system/subsystems should be in place to ensure that:

a. Documentation exists to identify all input data and/or files.

b. There are established authorization procedures for all source documents feeding the system.

c. The functions of originating, approving, and converting source documents into machine-readable data are adequately segregated. If anyone in the data input area performs

more than one of the operations related to the origination, entering, processing, or distribution of data, there should be compensating controls for the lack of segregation of duties.

d. All input data is properly authorized, validated, and recorded.

e. All authorized data remains complete, accurate, and valid through the source document origination process.

f. All input data is transmitted in a timely manner.

g. Source documents are periodically reviewed for proper completion and approval.

h. Erroneous source documents are handled appropriately and are not entered into the system.

i. On-line accounting systems/subsystems are designed to address the following additional areas:

(1) The system includes methods to prevent data entry errors such as self-help features, pre-selected formats, menu selections, and operator prompting.

(2) The system includes preventive controls regarding rejection of invalid data (e.g. table lookups, format checks, etc.). The invalid data should be rejected at the point of entry and immediately communicated back to the user.

j. The system includes front-end edits which are automated internal program processing controls in the form of data input, edit, and validation routines. These routines are actually programs that edit the input of data after entry and acceptance by the system, and before processing. The auditor may obtain or prepare a schedule of all appropriate routines currently employed in the system and evaluate them for accuracy and relevancy.

k. An audit trail is maintained during and after data input. The auditor may verify this by tracing a selection of transactions through the system from the point of origination to the point of being captured by the system. Note that in an on-line system the input document may no longer exist. To trace transactions through the system in an on-line environment there must be a transaction trail established. A system-generated Input Log can be used to capture pertinent information for tracing transactions. The Input Log would typically include the following items:

(1) The non-confidential portion of a User ID to identify input operator.

(2) Sequence numbers assigned to each transaction.

(3) An indicator as to type of transaction.

5-1406.3 Processing controls

Processing controls in both mainframe oriented legacy systems and client/server based systems provide reasonable assurance that electronic data processing has been performed as intended for the application. The contractor's accounting system/subsystem should include an adequate scheme of controls within the processing cycle to ensure that:

a. All authorized transactions are processed accurately and properly. Controls typically include:

(1) Input control totals, which facilitate the balancing of processing controls.

(2) A reconciliation between manual batch control totals and automated batch control totals.

(3) A verification of run-to-run control totals from one processing job to another before distribution of reports to users.

(4) Programmed routines that check the input data and processing results for completeness, accuracy, and reasonableness (data processing edit and validation routines such as record counts, line counts, and reasonableness and relational tests) are in use.

(5) A periodic user-review of internal tables (used in master file updating) to ensure the accuracy of their values.

b. The system is designed to prevent processing the wrong file. Controls should include:

(1) File library and processing procedures that ensure the appropriate files are processed properly (this can be determined by evaluating a listing of all programmed routines that check to see if proper data files are being used).

(2) The scheduling of computer processing at appropriate times.

(3) Measures to ensure that file checking routines are prevented from being bypassed. This can be determined by reviewing a listing (i.e. SYSLOG) of abnormal terminations caused by operator action. If abnormal terminations were disclosed, determine how the errors were subsequently resolved.

c. The system is designed to detect errors in normal file manipulation and highlight operator-caused errors. Controls should include:

(1) An evaluation of job accounting reports by computer operations supervisors for detection of unauthorized accesses and acts by users, computer operators, and/or others.

(2) An evaluation of the movement and control of data from one computer processing job to another and between or within user departments (when data are moved or passed from one processing job or step to another, control totals should be generated by the program and verified; data should not merely be moved or transferred from one job or step to another).

d. The system is designed to maintain an audit trail during and after processing. It should include controls that ensure there is no loss of visibility which would hinder audits of transactions. In addition before/after image reporting should be available for all transaction/reference/master file updating activities. These are reports which should show the contents of changed fields before and after each file update. This can be determined by:

(1) Tracing input file after edits to post-processing files.

(2) Comparing, validating, footing and recomputing selected critical data fields or elements with the use of manual and/or automated testing tools.

5-1406.4 Error Correction and Submission

Error correction and submission controls help ensure that the system maintains control over all errors detected until the errors have been resolved. The contractor's accounting system/subsystems should have internal controls in place to ensure that:

a. Procedures related to the identification, correction, and resubmission of rejected data are established and documented.

b. Errors are displayed or printed immediately upon detection to facilitate prompt correction.

c. After invalid data has been rejected (see 5-1406.2) it should automatically be written to suspense files identified by application system. This is especially important when errors are corrected on-line due mainly to the access rights provided to many users and the potential for uncorrected errors going undetected. This suspense file provides an audit trail subject to evaluation and should include information such as (i) codes to indicate error types, (ii) date and time at which an entry is written to the suspense files, and (iii) identification of the user who originated the input. Based on information in the suspense file the system should produce follow-up messages and report the status of uncorrected transactions or errors on a regular basis. User department management should review reports from the suspense files to analyze the level of transaction errors and status of uncorrected transactions. The contractor may also decide to age the suspense file transactions and errors.

d. All corrections are reviewed and approved by supervisors before re-entry.

5-1406.5 Output Controls

Output controls help ensure the accuracy of the processing result, and assure that only authorized personnel have access to and receive the related output, whether it be printed, displayed in electronic form, or recorded on electronic media. Output could also be elec-

tronic input to other related systems. Output controls that could be in use in a typical contractor accounting system/subsystem include the following:

a. Users reconcile input control totals to output control totals via processing control totals. This helps ensure the accuracy of computer program-processing cycle. System generated reports can be used to perform this reconciliation.

b. Data control personnel scan output reports to detect obvious errors such as missing data fields, unreasonable values, and incorrect report format before distributing to users.

c. Verification that adequate identification is made of all reports and items on the reports (e.g., report name and number, date produced, accounting month-end or other effective date, company and department name and number, page number, program number if necessary, end-of-report messages, subtotals, and report totals).

d. Assurance that only authorized users receive the reports. In an on-line environment, ensure that users who are defined to the system have a continuing business need to view the reports.

e. Assurance that output report retention periods are adequate for system backup and recovery, legal, tax, regulatory, management, and audit purposes.

f. Data file integrity is maintained by printing out header and trailer record counts at the end of each output report.

g. Documented output error correction and resubmission procedures ensure error logging and tracking.

h. Periodic user review of the report balancing rules and reconciliation procedures for accuracy and appropriateness.

5-1406.6 Audit Effect of a Weakness in Application Controls

a. The effectiveness of controls in each category should be considered in relation to their impact on the application being reviewed.

b. In evaluating application internal controls, the auditor should consider the following:

(1) The absence of access and input controls may permit transactions to be lost, duplicated, or entered incorrectly. This could seriously affect financial results or cost representations.

(2) Lack of control over the error correction and submission process, as well as other processing control weaknesses, could result in lost or duplicate records or out-of-balance financial records or cost representations.

(3) Output control weaknesses can have serious audit implications. Be aware of increased potential for errors when distribution of output is not adequately controlled, especially when the output consists of checks, invoices, or other sensitive information.

5-1407 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems and subsystems.

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CHAPTER 6

6-000 Incurred Costs Audit Procedures

6-001 Scope of Chapter

This chapter presents general guidance on auditing costs incurred under the broad types of contracts and functional areas of cost incurrence. Chapter 5 provides guidance on systems and internal control structure audits; Chapter 7 provides more specific guidance on auditing selected areas of cost; and Chapter 8 covers specific requirements of the Cost Accounting Standard Board rules, regulations and standards. Section 6-100 includes guidance on the integration of incurred cost audit procedures required by Chapters 1 through 8.

6-100 Section 1 --- Introduction to Incurred Cost Audit Objectives

6-101 Introduction

a. This section provides introductory guidance on the contract audit objectives and approach for incurred costs, including general considerations that apply under all types of contracts and for all cost categories.

b. In conducting incurred cost audits, observe any operations security (OPSEC) measures required by current DoD contracts or requests for proposals, in accordance with 3-205.

c. FAR 42.703-1, 10 U.S.C 2313(d) and 41 U.S.C. 254d require that contracting officers determine whether a previously conducted audit of indirect costs meets the current audit objectives for indirect costs on executed contracts, subcontracts, or modifications. If data can be obtained from an existing source, Federal Agencies are not to conduct duplicative audits of indirect costs. See 1-303e.

6-102 Audit Objectives and Approach for Incurred Costs

6-102.1 Audit Objectives

The auditor's primary objective is to examine the contractor's cost representations, in whatever form they may be presented (such as interim and final public vouchers, progress payments, incurred cost proposals, termination claims and final overhead claims), and to express an opinion as to whether such incurred costs are reasonable, applicable to the contract, determined under generally accepted accounting principles and cost accounting standards applicable in the circumstances, and not prohibited by the contract, by statute or regulation, or by previous agreement with, or decision of, the contracting officer. In addition, the auditor must determine whether the accounting system remains adequate for subsequent cost determinations which may be required for current or future contracts. The discovery of fraud or other unlawful activity is not the primary audit objective; however, the audit work should be designed to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objective. If illegal activity is suspected, the circumstances should be reported in accordance with 4-700.

6-102.2 Audit Approach

a. Incurred cost audits are usually performed on a contractor-wide basis. This approach recognizes the efficiency of addressing the adequacy of management and financial systems and controls combined with transaction testing across all business activities as opposed to contract by contract audits. Only in certain low-risk situations would DCAA audit individual contracts, such as an audit of a small-dollar contract at a multi-million dollar corporation where the small contract represented the company's only business with the Government.

b. For major contractors and contractors with significant negotiated firm-fixed-price contracts, audits of relevant accounting and management systems will be performed on a cyclical basis and form the foundation for determining the nature and extent of transaction testing necessary on individual incurred cost audits. See Chapter 5 for guidance on audits of contractor's internal controls.

c. For nonmajor contractors, separate audits and reports on individual contractor accounting and management systems may not be necessary. An understanding of the contractor's internal control structure may be gained at the time of the final overhead audit or during individual contract audits. The auditor's understanding of the internal control structure gained from these audits should be documented in the permanent file. (See 5-111 for further guidance on auditing internal controls at nonmajor contractors.)

d. Regardless of the audit approach, in all audits emphasis will be on determining the overall acceptability of the contractor's claimed costs with respect to:

(1) reasonableness of nature and amount;

(2) allocability and capability of measurement by the application of duly promulgated Cost Accounting Standards and generally accepted accounting principles and practices appropriate to the particular circumstances; and

(3) compliance with applicable cost limitations or exclusions as stated in the contract or the FAR. To ensure the application of the appropriate cost principles, auditors must consider the dates the contracts were awarded. The FAR Cost Principles Guide (available on the DCAA intranet, under Library) provides a history of each cost principle from the inception of the FAR and enables the auditor to determine the applicable cost principle at a particular point in time.

e. Auditing incurred costs at multi-segment contractors where an incurred cost submission covers more than one contractor location requires cognizant auditors to ensure that audit responsibilities at each location are clearly defined to ensure appropriate audit coverage and reduce the potential for duplication of audit effort. For many multi-segment contractor locations, the cognizant Contract Audit Coordinator (CAC) or Corporate Home Office Auditor (CHOA) may use a Responsibility Matrix (a copy of this EXCEL workbook is in APPS, Other Audit Guidance) to facilitate in identifying the cognizant auditor responsibilities. This matrix serves as a tool to collect information on the multi-segment contractor’s incurred cost proposals (as well as information on internal control systems, CAS, EVMS and offsite locations). The Responsibility Matrix contains an incurred cost worksheet that details the coverage for incurred costs audits company-wide and identifies (1) the locations where an incurred cost proposal is received and certified, and (2) where the books and records are maintained, and the related responsibility of each FAO to perform a complete incurred cost audit, assist audit, and/or MAARS 6 and 13 assignments. The lead FAO will generally be the segment where the proposal is certified and should

promptly notify any impacted FAOs of the costs they are responsible for auditing, if any. FAOs cognizant of segment locations should initiate assist audits from off-site locations as necessary. FAOs cognizant of off-site locations should not self-initiate audits of incurred costs. Assist audit reports should opine only on the audit area (e.g., offsite rate) audited.

6-103 Audit Scope - Incurred Costs

a. The procedures and audit guidance presented in this chapter are applicable to all contract audits. However, the auditor must exercise professional judgment in selecting which procedures and techniques are appropriate in the circumstances. The scope of work necessary is a matter of audit judgment considering the contract auditing and reporting standards in the context of a variety of factors which might be involved in a particular audit. These factors are discussed in Chapter 3. FAOs auditing incurred cost proposals at low risk contractors with $15 million or less of auditable dollar volume (ADV) should follow the guidance at 6-104. Additional considerations are the Mandatory Annual Audit Requirements, which are intended to assist in achieving the appropriate scope of audit (see 6-105).

b. The auditor will normally integrate the audit procedures required by Chapters 6, 7, and 8 with audits of the contractor's policies, procedures, internal controls, and accounting and management systems required by Chapter 5. Also, the Government auditing standards and other procedures covered by Chapters 1 through 4 apply to the audit of incurred costs. See 4-103 for guidance on providing notice to the ACO of the audit.

6-104 Audit Scope - Incurred Costs at Low-Risk Contractors with $15 Million or Less Auditable Dollar Volume (ADV)

a. The annual incurred cost proposals from contractors with ADV of $15 million or less will either be audited or desk reviewed. FAOs will determine which of the two approaches to use based on the procedures set forth below. The procedures call for all high-risk proposals to be audited. Approximately one-third of low-risk proposals will be selected for audit using random sampling techniques. Desk review procedures will be applied to the remaining two-thirds of low-risk proposals.

b. This guidance does not apply to educational institutions and nonprofit organizations subject to OMB Circular A-133. The requirements in Circular A-133 will be followed when performing audits at educational institutions and nonprofit organizations subject to the Circular (see Chapter 13).

6-104.1 - Classifying Proposals as High or Low Risk

a. Each incurred cost proposal received and determined adequate by the FAO will be assessed for risk. On the basis of this assessment, it will be assigned to either the:

(1) high-risk pool of proposals to be audited; or

(2) low-risk pool of proposals to be sampled. The FAO's risk assessment must be adequately documented. Low-risk contractor classifications should be discussed with the ACO and noted in the working papers.

If a preliminary risk assessment was estimated during the program planning cycle because an incurred cost proposal had not been received, the FAO should update the DCAA Man-

agement Information System (DMIS) to reflect the most current risk assessment decision once the incurred cost proposal is received and assessed.

b. If a contracting officer's request identifies significant risk associated with an incurred cost proposal, the proposal will be included in the high-risk pool. If an audit request is issued with no apparent risk, the auditor must contact the requestor to understand the basis for the request. If, after discussion with the contracting officer, no risk is identified, the proposal will be classified as low-risk. The auditor should explain to the contracting officer the desk review procedures that DCAA applies to low-risk proposals not selected for audit.

c. After two consecutive fiscal years at the same contractor are closed out using desk review procedures, the next year's proposal must be assigned to the high-risk pool of proposals to be audited. (However, see 6-104.2c for classification when two or more low-risk proposals are received).

d. For new contractors where we have no prior experience, the incurred cost proposal should be classified as high risk.

e. If a contractor's ADV for a given CFY is less than $500,000; there are no audit leads with a high probability of significant questioned costs (i.e., cost impact of more than $10,000, see 6-104.1f(2) below); and an audit of either of that contractor's last two fiscal year's incurred cost proposals has been performed, then the contractor's incurred cost proposal for that CFY is low risk. No other risk factors need be considered, and the $500,000 threshold applies to all contractors, with whom we have prior audit experience (e.g., preaward accounting system survey, proposal audit, establishment of billing rates).

f. If a contractor's ADV for a given contractor fiscal year (CFY) is between $500,000 and $15 million and meets all of the following criteria, the proposal is low risk:

(1) There were no significant questioned costs in the prior audit. In determining significance, apply these guidelines:

(a) questioned costs with an impact of less than $10,000 on flexibly priced Government contracts are generally not material, and

(b) questioned costs with an impact of $10,000 or more may also be immaterial in certain circumstances (e.g., the item in question is isolated and nonrecurring).

(2) There are no audit leads with a high probability of significant questioned costs. Consistent with the above guideline, the auditor normally will not consider leads with a cost impact on flexibly priced Government contracts of less than $10,000 to be material.

(3) We have incurred cost audit experience with the contractor.

(4) Either of the last two fiscal years' incurred cost proposals has been audited.

6-104.2 - Controls for Sampling

a. Establish controls to ensure that one-third of the low-risk proposals and all high-risk proposals are audited. The controls should also ensure that low-risk contractors are audited at least once every three years. Desk review procedures described in 6-104.5 should be applied to close out the low-risk proposals not selected for audit.

b. Use a random selection procedure to select one-third of the low-risk proposals for audit. FAOs should establish procedures that provide for random selection of the low-risk proposals for audit upon proposal receipt. This will allow application of desk review procedures to low-risk proposals not selected for audit in conjunction with proposal adequacy evaluation. FAOs should document the random selection process.

c. If an FAO has two or more unaudited incurred cost proposals for a contractor and the proposals are high risk, audit all proposals on hand using multi-year auditing techniques (see 6-603.6). If an FAO has two or more proposals from a low-risk contractor and based on the audit/desk procedure cycle an audit needs to be performed on one of them, the FAO should classify the year it believes presents the greatest risk to the Government as the high-risk year and audit that year. Do not disposition the earlier years' proposals, or any others subsequently received and classified as low risk, until completing the audit of the high-risk year. If there are no significant questioned costs found during the audit of the proposal, the prior proposals (if classified as low-risk) may be closed out using the desk review procedures discussed in 6-104.5. If the proposal selected for audit is found to contain significant unallowable costs, audit all proposals using multi-year auditing techniques.

6-104.3 Audit of Low-Risk Proposals

a. If a contractor's low-risk incurred cost proposal has been randomly selected for audit, any incurred cost proposal subsequently received from that contractor and classified as low risk should not be dispositioned until the sample audit is completed. When multiple contractor proposals are awaiting settlement, the audit must be accomplished as soon as practical.

b. If significant questioned costs are found in the sample audit, all other incurred cost proposals on hand for the contractor must be audited using multi-year audit techniques.

c. If immaterial questioned costs are found in the sample audit, close out all other low-risk proposals on hand for the contractor by using the desk review procedures discussed in 6-104.5.

6-104.4 Audit of High-Risk Proposals

a. All high-risk and randomly selected low-risk proposals should be audited using the Standard APPS Audit Program for Nonmajor Contractors Incurred Cost (10100).

b. When a contractor’s ADV cycles between over and under $15 million, the auditor must audit those proposals for CFYs over $15 million in ADV. The auditor should consider the efficiencies gained through use of multi-year auditing techniques (see 6-603.6) before deciding to include the contractor’s under $15 million proposal in the sampling initiative.

6-104.5 Desk Review of Low-Risk Proposals

The following procedures will be performed on proposals in the low-risk pool that are not selected for audit.

(1) Ensure that a "Certificate of Indirect Costs" has been executed by the contractor and a copy is included in the working paper file.

(2) Scan the proposal for unusual items, obvious potential significant questioned costs, and audit leads that need follow up.

(3) Scan the proposal to determine if there are any significant changes from the prior year’s proposal that need follow up.

(4) Verify the mathematical accuracy of the proposal.

(5) Evaluate the incurred cost proposal using the applicable requirements contained in the Federal Acquisition Regulations (FAR); Defense FAR Supplement (DFARS) (if applicable); and Cost Accounting Standards (CAS) (if applicable)

(6) For proposals that include significant corporate or home office allocations, incorporate the corporate/home office audit results (this may require suspending the desk review until the corporate/home office audit is completed).

(7) Execute a rate agreement letter with the contractor for the review-determined rates (see Figure 6-7-2). If the contracting officer will negotiate the rates, proceed with the close-out report discussed below. See 10-506 for distribution.

(8) Issue a review report in accordance with 10-506 to report the review-determined or recommended rates and recommended direct costs. Enclose the rate agreement letter, including the Cumulative Allowable Cost Worksheet (CACWS) with the report.

(9) Direct the contractor to adjust the provisional billing rate for the reviewed year(s) to match the review-determined rates and submit adjustment vouchers. This statement is included in the rate agreement letter (see Figure 6-7-2).

6-105 Mandatory Annual Audit Requirements

Mandatory Annual Audit Requirements (MAARs) are generally necessary to comply with generally accepted government auditing standards (GAGAS) in the incurred cost contract audit environment at major contractors. The MAARs vary greatly in purpose, type of transaction being evaluated, and time frame of accomplishment. Considerations which affect the applicability or extent of effort necessary to satisfy MAARs in particular cases are discussed in 6-105.2 and in 6-1S1.

6-105.1 Overview of MAARs

a. As shown in 6-1S1, the MAARs are described by number and title, objective, purpose, and reference.

b. Updates to the permanent file (MAARs 1, 3, and 7) are accomplished on a continuous basis as audits are performed, and are not necessarily associated with a single contractor fiscal year or exclusively with the incurred cost audit. The permanent file is continuously updated so that auditors may use it to adjust the audit scope based on risk (3-104.3). All audit programs require the auditor to update the permanent files, as necessary. By contrast, MAARs that require reconciliations (MAARs 2, 4, 9, 14, 15, and 19) are usually performed as preliminary steps in the audit of incurred costs. Transaction tests (MAARs 10 and 16) are always historical, but need not be deferred until the year has ended. Concurrent procedures (MAARs 6 and 13) must be applied during the fiscal year being audited. The remaining MAARs (5, 8, 12 and 18) always have concurrent implications. For example, the composition, though not the final value, of the various indirect allocation bases (MAAR 18) may be established during a CAS audit well in advance of the start of the fiscal year.

6-105.2 Accomplishment of MAARs

MAARs will be performed at all major contractors except when such work will fulfill no useful current or future need or the contractor has no costs claimed in one or more cost elements related to specific MAARs. The performance of MAARs should not be omitted on the basis of materiality; however, the extent of audit work to complete each MAAR must be adjusted to reflect appropriate judgment of risk and significance. Appropriate considerations include:

(1) amount of costs claimed,
(2) results of prior audits, and
(3) adequacy of internal controls.

A MAARs Control Log (M-MAARS or M-MAARS - CIC) is required to provide summary documentation of the MAARs coverage. The MAARs Control Log should be prepared for a contractor's fiscal year as soon as any of the MAARs are completed.

6-105.3 Audit Management Considerations

Because of their status as core requirements, the MAARs provide a convenient framework for incurred cost audit management. MAARs 6 and 13 provide for the verification of the existence of prime costs (direct labor and direct materials, respectively) as they are incurred. Therefore, they can be accomplished only during the contractor fiscal year to which they apply. Effective audit planning must consider the performance of these real-time MAARs, as well as other MAARs covered on a historical basis. MAARs completion dates are important milestones in monitoring the progress of audits of incurred costs. During the incurred cost risk assessment process, auditors should determine whether a required MAAR 6 or 13 has been performed. When MAAR 6 or 13 have not been accomplished on a concurrent basis, auditors should ensure other procedures are performed in conjunction with the review of labor and material costs to satisfy the overall audit objectives. While no post year incurred cost audit step can provide the same coverage as a MAAR 6 labor floor check, procedures should be performed as part of MAAR 9 (CAM 6-406) to provide a reasonable basis for the opinion on the labor costs; for example, selecting a sample of transactions from the contractor's labor distribution and tracing those amounts to source documents (i.e., timekeeping records and work authorizations). In determining the level of testing necessary, the guidance in CAM 6-402d(1) through (7) should be used. Auditors can satisfy MAAR 13, Purchase Existence and Consumption, by examining the contractor's internal audit documentation and performing transaction testing on purchased materials and services; for example, tracing a sample of material transactions from the contractor's cost ledger to the source documentation to verify the materials were used and costs charged to the correct contract. Although the performance of these alternative procedures will provide sufficient evidence to render an opinion on the incurred costs, the report should still contain the scope limitation for the nonperformance of the concurrent verification, as discussed in 6-105.4 and 10-504.3b.

6-105.4 Reporting Considerations

Circumstances may arise in which MAARs are not completed. The Scope of Audit section of the report will identify the omission (see 10-504.3). It does not appear in the

"Qualifications" subsection and does not require an opinion qualification, unless the failure to accomplish the MAAR resulted from inappropriate contractor or contracting officer action or inaction.

6-106 General Considerations

The following sections of this chapter provide audit guidance on various types of contracts and categories of direct and indirect costs. However, several overall factors must be considered in every phase of incurred cost audit work. Among the more significant points requiring alertness and special emphasis in all audit areas are the following:

a. Contract provisions which specify unallowable costs or cost limitations. Consideration must be given to the costs properly assignable to each contract (see 3-202 for guidance on briefing contract provisions). For example, losses on one contract are not allowable under another contract. Instances of contractor violation of the requirement to properly assign costs to contracts should be reviewed to determine if the practice is reportable under the provisions of 4-700 as one involving suspected fraud or other unlawful activities.

b. Contracts for major defense special tooling and special test equipment which provide for recovery of a pro rata share of nonrecurring costs when the contractor sells such equipment to buyers outside the U.S. Government (DFARS 245.302(2)).

c. Charges or credits of an unusual nature, whether or not recorded on the contractor's records.

d. Proper reduction of contract costs for material returns, transfers, credits and discounts, and for income items which can more properly be considered as a reduction of costs. The determination to apply such credits in the current or in prior accounting periods will depend upon the period to which the item relates, the significance of the item, and other related factors, including for each period the ratio of Government work to other work of the contractor, and the contract types in effect.

6-107 Concurrent Auditing

a. Concurrent auditing of incurred costs requires performing audit tests and procedures prior to receipt of the contractor’s certified proposal. Concurrent auditing procedures will assist auditors in issuing the final incurred cost audit report soon after receipt of the contractor's incurred cost proposal. This will expedite the process of establishing final indirect rates, thereby achieving more timely closeout of contracts. The guidance contained in this section supplements the information contained in 6-100 through 6-600.

b. The concurrent auditing process includes:

- identifying eligible contractors,
- planning the concurrent auditing procedures,
- timing the audit performance to be as efficient as possible, and
- preparing the audit report and dispositioning the concurrent audit results.

6-107.1 Contractor Eligibility

Concurrent auditing should be performed at contractor locations where concurrent auditing procedures can be applied efficiently. Auditors should not perform concurrent auditing if it would require significantly more resources than traditional incurred cost auditing. Following are the criteria for assessing contractor eligibility:

a. All prior year incurred cost audits must be planned for completion during the current fiscal year before a concurrent audit can be scheduled. Multi-year auditing may be used if the audits will be conducted in an effective and efficient manner; e.g., performing the current year incurred cost audit in conjunction with the other open historical year(s).

b. The auditor must have determined that the contractor's Indirect/ODC System and Accounting System are adequate.

c. The contractor must have adequate point of entry or interim screening to identify and segregate expressly unallowable costs, including costs that are mutually agreed-to-be-unallowable, for most of its accounts. Substantive testing prior to receipt of the contractor's incurred cost proposal can be performed only on those accounts with adequate screening prior to audit. If the expressly unallowable costs applicable to one or more accounts are not adequately screened, those accounts cannot be tested prior to receipt of the proposal. For example, if the contractor’s system for screening unallowable consultant costs is inadequate, auditors should not perform concurrent transaction testing on consultant costs, but may perform concurrent transaction testing on the remaining indirect accounts. Screening costs must remain the responsibility of the contractor.

d. The contractor must agree to support the concurrent audit process through its completion and be timely in submitting its incurred cost proposals. Auditors may also consider a contractor that has developed an acceptable plan to timely submit its incurred cost proposal for the current year even though past proposals may not have been timely.

6-107.2 Audit Planning – Concurrent Auditing

The auditor should initiate the planning process for performing the next fiscal year incurred cost audit once it has been determined the contractor is eligible for concurrent auditing. Planning is the key to successful implementation of an effective and efficient concurrent audit process. Performing concurrent auditing without a certified proposal will require increased emphasis on early FAO planning and coordination with the contractor, contracting officer and other FAOs that will be performing assist audits.

a. The audit scope described in 6-102 and 6-603 applies to audits of incurred costs whether performed before or after the receipt of the contractor’s certified proposal. There are, however, additional items in planning the audit scope in a concurrent incurred cost audit that must be considered.

(1) Concurrent auditing requires planning prior to the beginning of the contractor’s fiscal year. The FAO should gain audit efficiencies by combining the substantive tests in the incurred cost audit with the detailed steps in other planned audits including internal controls (see 5-100) and CAS compliance audits (see 8-300). The key to planning for concurrent audits is developing the audit plan for the types and timing of transaction tests that will be performed while at the same time considering the other planned audits at the FAO to successfully integrate the audit steps. As the year progresses and more information becomes available, the types and timing of transaction tests may require modification.

(2) The auditor should identify elements of cost that require assist audits (e.g., off-site locations, corporate office, Field Detachment cognizant costs, Washington area office, subcontractors, etc.) and coordinate these audits with the cognizant assist auditors. Early identification of these audits will facilitate planning and completion of the audit.

(3) If statistical sampling is used, a sampling plan should be developed as part of the audit planning and modified, as necessary, during the audit. (See B-606 for an explanation on statistical sampling for concurrent auditing.)

b. The following planning topics should be considered and coordinated with the contractor prior to commencing a concurrent audit:

(1) Timeliness of Contractor Support. To avoid delays, the timing of the contractor's submission and the audit steps and anticipated support requirements should be discussed with the contractor. The contractor, auditor, and ACO should agree that issues arising throughout the audit will be addressed and, to the extent possible, resolved on a concurrent basis.

(2) Communication on System Deficiencies. The auditor should inform the contractor of the following:

(a) Concurrent auditing will be suspended on any account when significant internal control deficiencies are identified with that account during the concurrent audit.

(b) Concurrent auditing on all accounts will be suspended if during the audit, the auditor finds that the contractor's systems and/or point of entry screening for expressly unallowable costs are so deficient as to cause the concurrent audit to be inefficient or ineffective.

(c) The contractor will be requested to address and will be provided the opportunity to correct any disclosed deficiencies on a real-time basis (6-107.3.a).

(3) The auditor should request the contractor to provide information on audits or reviews planned by its internal and external auditors. Concurrent auditing may present additional opportunities for coordinated audits with the contractor's internal auditors or independent public accountants.

(4) Coordination with the cognizant ACO during the planning phase of the audit is also important. The auditor and ACO should discuss the concurrent audit plan, address mutual concerns, and arrange to meet periodically to discuss the audit status. The auditor should also solicit ACO support for early resolution of issues.

6-107.3 Timing of Audit Performance

Audit procedures for concurrent auditing of incurred costs are basically the same as those for traditional incurred cost audits. The amount of substantive testing, including transaction testing and analytical procedures, should be based on audit risk and should not be increased or decreased based solely on performing concurrent auditing. If the audit risk disclosed during concurrent auditing differs significantly from the anticipated risk, the amount of substantive testing should be adjusted accordingly. What distinguishes concurrent auditing from the traditional approach is the timing of the audit tests and procedures. Auditors should time-phase the required audit steps and transaction testing plan by account into the following categories:

a. Current Year Auditing Procedures. These procedures represent audit steps that can be performed prior to the end of the contractor's fiscal year and should be performed when they are most effective and efficient. These procedures should be performed on selected

indirect accounts where the contractor has adequate point of entry or interim screening for expressly unallowable costs, including costs that are mutually agreed-to-be-unallowable, and accounts where year-end account balances are reasonably predictable with respect to the amount, composition, and relative significance. If significant expressly unallowable costs are found during the audit of a selected account, the auditor should discontinue auditing the account and request the contractor to address the internal control deficiency. If the contractor implements immediate corrective action, e.g., a more detailed interim scrub of the account, the auditor may continue auditing the account on a concurrent basis. If the contractor does not agree to implement immediate corrective action, the auditor should postpone his/her audit of this account until after the submission is received.

b. Intermediate Auditing Procedures. These procedures are steps that can be performed after the close of the contractor's fiscal year and prior to receipt of the contractor's incurred cost proposal. These procedures should include the following:

(1) A final MAAR 15 (6-608.2) analysis to identify any changes in cost accounting practices, reclassification of costs, or substantial increases or decreases in costs not covered or explained by current year audit steps.

(2) An evaluation of information that was not available during the contractor's fiscal year, e.g., financial statements, tax returns.

(3) Substantive testing (analytical or transaction testing) based on year-end data, including an evaluation of year-end adjusting entries. SAS 45, "Substantive Tests Prior to the Balance Sheet Date," requires that when interim testing is used, year-end audit tests need to be conducted to render an opinion on transactions processed between the date of the interim testing and year-end.

c. Final Auditing Procedures. Final auditing procedures are steps performed after receipt of the contractor's incurred cost proposal and should also be designed to meet the requirements of SAS 45, Substantive Tests Prior to the Balance Sheet Date. As in the traditional audit, final audit procedures should ensure all applicable MAARs are performed prior to completing the field work and issuing the final report. Additionally, auditors should apply DCAA's cycle-time reduction concepts to complete the audit, resolve findings, and issue the audit report as timely as possible. Final auditing procedures should specifically include the following:

(1) Substantive testing on accounts where:

(a) the contractor's point of entry or interim screening for expressly unallowable costs is inadequate for the account or

(b) transaction testing on the account was suspended during current testing due to internal control weaknesses.

The auditor, in coordination with the ACO, should encourage the contractor to establish an adequate point of entry or interim screening process for these accounts so that more accounts may be audited on a concurrent basis in future years.

(2) A reconciliation of the certified proposal to the contractor's books and records (MAAR 14 (6-610)). Any interim accounting data relied upon when performing concurrent auditing procedures should be reconciled to the contractor's proposal. Auditors should evaluate significant variances between the contractor's books and records and the certified proposal, including any variances in the amounts for accounts previously audited, and any other areas requiring follow-up based on the reconciliation.

(3) A verification that the concurred-to questioned costs disclosed throughout the audit are not included in the contractor's final submission.

6-107.4 Audit Report/Disposition of Audit Results

Auditors should follow the guidance in 10-500 for reporting their results of audit with consideration for the following:

a. Since the audit report addresses the contractor's submission, the audit report should not address questioned costs identified throughout the audit that the contractor withdrew from its submission. As part of the concluding audit steps, the auditor should have verified and documented in the working papers that the costs have been withdrawn from the submission. For questioned costs withdrawn, it is critical that the working papers clearly document that our audit was the reason for the withdrawal.

b. The audit report should address questioned costs disclosed throughout the audit that the contractor has not withdrawn from its proposal.

6-1S1 Supplement --
Schedule of Mandatory Annual Audit Requirements (MAARs)

Number and Title	Objectives	Purpose	Reference
1. Internal Control Audit Planning Summary and/or Internal Control Questionnaire (ICQ)	Document/update in the permanent files the internal control audit planning summary and/or the internal control questionnaire and evaluate changes in contractor's internal controls.	Determine the extent of reliance that can be placed on the internal controls for contract costs and the need for and extent of substantive testing that may be required based on the observed strengths or weaknesses of contractor systems.	3-300,5-100, 5-111
2. Contract Cost Analysis and Reconciliation to Books	Evaluate summaries of the contractor's total annual contract costs by major cost element (material, subcontracts, intracompany charges, and credits, etc.), and verify that the auditable contract costs reconcile to contractor accounting records by cost element (typically using work-in-process or other contract control accounts in the general ledger).	To provide an overview and order-of-magnitude frame of reference for direction of audit effort and other audit planning/performance considerations, and to verify that the auditable costs claimed or to be claimed on Government contracts tie in to the amounts produced by the accounting system in the contractor's official books and records.	6-610.1
3. Permanent Files	Maintain/update permanent files for new or changed contractor organizations, operations, policies, procedures, internal controls, software programs, and accounting methods that influence the nature, level, and accounting treatment of costs being charged to Government contracts. Update documentation of contractor contract briefing system or update auditor-prepared briefs.	To provide an efficient and effective repository of current audit information. Permanent file maintenance should help identify the need for further audit and analysis, and help in determining the accounting methods that influence the nature, level, and extent of further testing required in specific cost accounts, functions, operations, and departments.	3-202.1, 3-202.2, 4-405
4. Tax Returns and Financial Statements	Evaluate applicable tax returns, financial statements, and other publicly available data of the contractor.	To highlight possible areas to reduce the extent of DCAA audit effort that might otherwise be required.	3-104.16c
5. General Ledger, Trial Balance, Income and/or Credit Adjustments	Analyze the contractor's general ledger, trial balance, and other income/accounting adjustments (for example, unusual and/or sensitive journal entries).	To help identify any income and credits which the Government may be entitled to obtain or share, and to evaluate the exclusion of any adjustments not reflected by the contractor in Government contract costs.	6-608.2d(5) 6-608.3b(1)

Number and Title	Objectives	Purpose	Reference
6. Labor Floor Checks or Interviews	Perform floor checks, interviews, and/or other physical observations, and related analysis of employee timekeeping on a concurrent basis.	To test the reliability of employee time records, that employees are actually at work, that they are performing in assigned job classifications, and that time is charged to the proper cost objective.	6-402c, 6-404, 6-405
7. Changes in Charging Direct/Indirect Cost	Evaluate changes in procedures and practices for charging direct/indirect cost for consistency with generally accepted accounting principles, the applicable cost principles per contracts, and any applicable CAS requirements.	To verify that changes in charging direct/indirect cost do not have the effect of improperly shifting costs among cost objectives or circumventing cost targets or ceilings of certain contracts or other significant cost categories.	5-911.1, 6-404.6b(4), 6-407.2, 6-504.1, 6-603.4, 6-604.1
8. Comparative Analysis-Sensitive Labor Account	Perform comparative analysis of sensitive labor accounts.	To identify for further examination any sensitive labor changes (for example, indirect charging by direct labor employees) that vary significantly from the prior period and/or budgetary estimates.	5-911.1, 6-404.6b(4)(b)
9. Payroll/Labor Distribution Reconciliation and Tracing	Evaluate the contractor's labor cost distribution.	To test overall integrity of labor cost records at the general ledger and cost ledger levels, and to reconcile payroll accruals and disbursements, making sure that distribution entries trace to and from the cost accumulation records.	6-406.1, 6-406.2a(6)
10. Adjusting Entries and Exception Reports	Evaluate adjusting journal entries and exception reports for both direct and indirect costs. Evaluation for direct costs should include labor, ODCs, purchased services, and material (including subcontract costs and intracompany charges.)	To identify adjustments and/or exceptions that require further audit analysis and explanation.	5-913.1, 6-305.3a(1), 6-404.6b(6), 6-608.2c(2)
11. Reserved			
12. Auditable Subcontracts/Assist Audits	Evaluate auditable type subcontracts and intracompany orders issued by the contractor under auditable type Government contracts and subcontracts, and request any needed independent assist audits.	To protect the Government's interests concerning the ensuing costs.	6-310.1, 6-802.2d &j, 6-802.4a, 6-802.5 6-803, 6-805, 6-806
13. Purchases Existence and Consumption	Make physical observations and/or inquiries on a concurrent basis in addition to documentation verification of contract charges for purchased materials and services.	To test that materials were in fact received (exist or were consumed) and that services were in fact performed.	6-305.3a(2)

Number and Title	Objectives	Purpose	Reference
14. Pools/Bases Reconciliation to Books	Trace claimed pools and bases to accounting records.	To determine that the claimed indirect cost pools and allocation bases under Government contracts reconcile to amounts in the contractor's official books and records.	6-610
15. Indirect Cost Comparison with Prior Years and Budgets	Evaluate the current year's indirect cost accounts and prior years' costs and budgetary estimates.	To identify changes in cost accounting practices, reclassifications of costs, and areas with substantial increases or decreases in cost incurrence that require further audit analysis and/or explanation.	6-608.2(c)
16. Indirect Account Analysis	Evaluate selected indirect cost accounts or transactions, such as sensitive accounts, new accounts, accounts with large variances, etc.	To obtain sufficient evidence to support an opinion on the allowability, allocability, and reasonableness of the costs.	6-608.2
17. Reserved			
18. Indirect Allocation Bases	Evaluate the contractor's indirect cost allocation bases for consistency with generally accepted accounting principles, the applicable cost principles per contracts, and any applicable CAS.	To assure that allocation bases are equitable for allocation of indirect costs to intermediate and final cost objectives.	5-1010d, 6-606
19. Indirect Rate Computations	Evaluate the accuracy of the contractor's rate computations for distributing interim and final indirect costs to intermediate and final cost objectives.	To confirm that contractor's rate computations are accurate for distributing indirect costs to Government contracts.	6-611.1a

6-200 Section 2 --- Special Considerations in Audit of Selected Contract Terms

6-201 Introduction

This section states guidance and special considerations in the audit of selected contract types.

6-202 Precontract Costs, Costs After Completion, or Costs Over Contract Amount

This paragraph states guidance for the audit of reimbursement vouchers covering precontract costs, costs incurred after completion or delivery dates specified in a contract, or costs incurred in excess of the contract amount. See 6-1008 for general guidance on the review and approval of interim public vouchers.

6-202.1 Allowability of Costs Incurred Before Contract Date

Precontract costs are defined in FAR 31.205-32. Such costs, which otherwise meet the tests of allowability, may be approved for reimbursement by the auditor. If the precontract costs are subject to an advance agreement, the auditor should determine whether the costs incurred meet the conditions of the agreement. However, if there is no advance agreement, the auditor should ascertain whether the precontract costs meet all the tests of FAR 31.205-32 and are allowable to the same extent they would have been allowable if incurred after the effective date of the contract. The auditor should obtain the assistance of the Plant Representative/ACO and, where appropriate, the PCO in reaching this decision whenever necessary to clarify the facts and conditions for incurring precontract costs.

6-202.2 Procedure Where Term of Contract Performance Period is Explicit

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 [see 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.

6-202.3 Procedure Where Contract Specifies a 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 [see FAR 16.306(d)(1)]. Also, under FAR 52.249-6(a), the contracting officer could terminate the contract prior to full expenditure of the estimated cost. However, unless the contract is terminated, or exceeds stated contract limitations, the contractor is normally obligated to continue to perform under the contract up to the estimated total contract cost. Therefore, questioning costs based only on the fact that they were incurred after the performance period would be inappropriate.

6-202.4 Costs in Excess of Contract Amount

The auditor will not approve any costs claimed by the contractor in excess of the estimated total amount stipulated in the contract. Such excess costs will be disapproved by the issuance of a DCAA Form 1.

6-203 Credits and Refunds on Cost-Type Contracts

This paragraph states the procedures to be used:

(1) in adjusting allowable contract costs for applicable credits, and

(2) for the collection and disposition of such credits which are refunded by the contractor.

Deduction for Government Accountability Office (GAO) notices of exception is covered in 6-909.

6-203.1 General Audit Policy

A complete listing of types of credits is not practicable; however, some examples of miscellaneous income items and other credits are discussed in 6-608.2d(5).

a. It is not anticipated that any major difficulties will ordinarily be encountered in making the necessary accounting adjustments to allowable contract costs for the applicable credits and refunds discussed in this section. In a few cases, however, because of the timing of disclosure or receipt of these credits, special procedures may be necessary which are discussed in detail in this section.

b. The contractor's accounting procedures should provide for periodic review and the processing of equitable adjustments to operating cost to cover miscellaneous income items and credits, such as wages; unclaimed deposits for tools, safety equipment or clothing; unclaimed payroll deductions for purchases of U.S. Savings Bonds; and unpresented checks other than payroll. Payment of these funds to the state under escheat laws constitutes an actual expenditure and satisfies the refund requirement. Where no escheat laws are applicable, consideration must be given to the ownership of the credits and unclaimed items to determine whether an adjustment is to be made. The Government is not entitled to credits attributable to amounts paid by employees or withheld from their salaries if the amounts were not initially charged either directly or indirectly to the cost of Government contracts and, accordingly, not reimbursed by the Government. If amounts were initially charged to operations and equitably shared by the Government, adjustments should be reflected either in an income account which is deducted from an applicable indirect cost category or else as a deduction directly to the account originally charged. Where a contractor is engaged in work under Government flexibly-priced contracts on a relatively consistent basis, the foregoing periodic adjustment procedure should normally result in equitable consideration of these credit items. Where, however, such consistency is not present, consideration should be given to the direct costing of significant credits and refunds to the specific contracts under which they were generated as the best means of ensuring that the Government obtains the full benefits to which it is entitled.

c. As an alternate to the adjustment of costs for credits and refunds, the contractor may refund the amount by a check, drawn to the order of the Treasurer of the United States. This procedure is in fact required when the refund applies to a contract that has been financially settled since, as a condition precedent to final settlement of a contract, the contractor is required to execute an assignment of credits, refunds, and rebates. Such assignment provides that credits, refunds, and rebates, whatever their origin, attributable to contracts which have been financially settled, should be refunded by the contractor to the Government by check drawn to the order of the Treasurer of the United States. The refund check, together with the details pertaining to the transactions, shall be submitted by the contractor to the ACO by the provisions in the Assignment of Credits, Refunds, and Rebates.

6-203.2 Processing Adjustments for Credits and Refunds

a. During the period of contract performance, credit adjustments made in the contractor's accounting records as a deduction from reimbursable contract costs will normally be reflected in public vouchers submitted for that same period.

b. In the event the contractor fails to make the necessary deductions from current contract costs for applicable credits or to make refunds therefor, the auditor shall effect recovery by the issuance of DCAA Forms 1 and deduct the amounts from current reimbursement claims.

c. When the credits cannot be recovered by deductions from the public vouchers to which they would normally pertain and the contractor declines to make a refund, the auditor will process a DCAA Form 1 set-off deduction from the public voucher(s) submitted by the contractor under any other cost-reimbursement type contracts under the auditor's cognizance. The DCAA Form 1 should show the contract and appropriation to which the credit is applicable. However, it should be noted that where a contract so provides, public vouchers payable to an assignee may not be subject to reduction or setoff for any indebtedness of the assignor arising independently of the assigned contract.

d. In those cases where the applicable contract is closed and collection of credits cannot be effected by the auditor under any of the procedures in subparagraphs a. through c. above, a report should be made to the ACO. The report will identify the contracts, the amount of the credits, their origin, and state the reasons why recovery cannot be accomplished by the auditor through refund or deduction.

6-203.3 Disposition of Refunds Paid by Checks

The auditor should generally not accept checks from contractors for credits due the Government. Contractors should be advised to submit such checks directly to the paying office, with a copy to the ACO, together with a copy of the details comprising the credit, such as the listing prescribed in 6-203.4c., which should agree in total with the amount of the check. Any checks received by the auditor should be transmitted immediately to the ACO together with the required listing.

6-203.4 Special Procedures for Unclaimed Wages, Unclaimed Deposits, and Unpresented Checks

a. Where the balances of unclaimed payroll deductions for U.S. Savings Bonds are insufficient to purchase bonds, Treasury Department instructions permit, but do not require, contractors to transfer the balances to the Treasury Department to be held in custody for the account of the employees concerned. Unless the contractor makes these transfers, such amounts will be included in the cost adjustments described below.

b. Many states have enacted escheat laws governing the disposition of unclaimed wages, unclaimed deposits, and unpresented checks after the expiration of stated periods of time. Escheat laws generally provide for payment of these unclaimed amounts to the state. This subject has resulted in some confusion and several court cases, particularly in regard to disposition of these items where the creditor and debtor are located in different states. It has now been determined, however, that the Federal Government is entitled to recover such unclaimed amounts only if:

(1) they represent sums due to persons or firms whose last known addresses were in states which do not have escheat laws, and

(2) if, in addition, the escheat law of the state in which the contractor is located does not provide for the payment of the amounts to its own (state) account.

Accordingly, where the auditor ascertains credits are due the Government under the foregoing criteria, he or she will discuss the matter with the contractor and ensure that adjustments or refunds are made by the contractor or that DCAA Forms 1 are issued for the applicable amounts.

c. At the time credit adjustments or refunds are processed, the contractor will prepare and retain separate listings of the former employees entitled to the unclaimed amounts, and of the payees of unpresented checks which are covered by the credit adjustment or refund. The listings must be in sufficient detail to permit audit verification of each named payee in the event claims are made to the Government at a later date by virtue of subsequent payments. These lists will be verified by the auditor on a selective test basis as deemed appropriate. Separate lists will be submitted for each category of unclaimed items and for unpresented checks.

d. Subsequent to the Government's recovery from contractors for unclaimed wages, unclaimed deposits, and unrepresented checks, claims may be made by the persons entitled to such funds. These claims should be presented to the contractor and not to the Government, as the latter has no contractual relationship with the claimants.

e. In the case of reimbursements claimed by contractors for any payments made to such persons, a certified invoice, valid receipt of the payee, and any other pertinent information must be submitted with the claim to identify the payment with the applicable item on the listing mentioned in 6-203.4c. In such instances the amounts claimed will be cross-referenced to the public vouchers from which the credit deduction was initially made and, after verification, will be approved by the auditor for reimbursement.

f. In the event that the contract to which the claim relates has been financially settled, the contractor's claim, together with the documentation described in subparagraph c. above, should be submitted after verification and approval by the auditor, to one of the following as appropriate:

Finance Center, U.S. Army, ATTN: FINCS, Indianapolis, Indiana 46249; or U.S. Navy Finance Center, Accounts Receivable and Claims Division, Code FR. Washington, D.C.; or Finance Officer, Air Force Accounting and Finance Center, Symbol CF, Denver, Colorado; or as required by the department or office that placed the contract.

6-204 Time-and-Materials Contracts

6-204.1 General Policy

a. Time-and-materials (T&M) contracts (which term as used herein includes subcontracts) provide for the procurement of supplies or services on the basis of:

(1) direct labor hours at specified fixed hourly rates (which rates include direct labor, indirect costs, and profit) and

(2) material at cost. Material handling costs may be included in the charge for "material at cost," when it can be demonstrated that they were not included in the overhead factor of the hourly rate to be applied to direct labor.

b. The basic auditing procedures in Chapter 6 will be applied, as appropriate, to audit of time-and-materials contracts. The guidelines of Chapter 9 should be used in the evaluation of proposals for time-and-materials contracts. In addition to the foregoing, the audit program should include the considerations discussed below.

6-204.2 Audit of T&M Labor Costs

a. General. An important prerequisite to the audit of labor (salaries and wages) is a good understanding of the contract clauses relating to the classes of labor and types of operations to which the contractual rates apply. Labor rates are normally negotiated during the award of a contract (or subcontract) or exercise of an option, however auditors should be aware that in some instances labor rates subject to the Fair Labor Standards Act or the Service Contract Act may have been adjusted from the initial contractual rates to comply with the Acts [see FAR 22.1006(c)(1) & (2), FAR 52.222-43, and FAR 52.222-44]. Also, since the contract labor rates include indirect labor, indirect costs, and profit, only the hours of workers performing labor directly related to the item produced or service rendered will be considered to be direct labor. The basis upon which the direct labor hours are computed and charged must be acceptable and subject to audit verification. Arbitrary or unsupported allocations of direct labor will not be acceptable.

b. Classes of Labor. Unless otherwise specified in the contract, the direct labor charged by the contractor should include only that which is consistently classified as direct labor with its regularly established practice and is consistent with the labor so classified in the proposal upon which the contract was negotiated.

(1) Wages of personnel such as clerks, material handlers, receiving or shipping personnel, stockroom employees, tool-crib attendants, janitors, maintenance men, packers, contact men, and expediters, as generally defined within the trade, are not acceptable as direct labor unless specifically authorized in the contract.

(2) The time of partners, officers, or supervisors is not acceptable as direct labor unless specifically authorized in the contract. In such event, the time of the individual must be properly recorded and subject to audit verification.

(3) Where separate rates are not established for the various skill levels, the time of apprentices and learners as a direct charge normally should be limited to the ratio of such time considered in the development of the hourly rate included in the contract. Disproportionate use of lower paid employees will be promptly brought to the attention of the contracting officer.

c. Overtime. Only the hours actually worked are acceptable whether regular or overtime. Overtime hours will not be converted to a larger number of regular hours to compensate for any overtime premium payments, nor will the rates charged for overtime hours be increased unless the contract so provides.

d. Floor Checks. Floor checks will be made to determine that direct employees are actually present and working on the job and that their time is being properly charged. The contractor's system of internal control should provide for such checks. Therefore, the frequency and scope of floor checks performed by the auditor will be determined, in large measure, by the frequency and effectiveness of similar checks performed by the contractor (see 6-400)

6-204.3 Material Costs

The material costs should be audited by the terms of the contract and the procedures in 6-300. While all such procedures are applicable, care should be taken to ascertain, when appropriate:

(1) that the method(s) of determining material costs is consistent with the factors included in the determination of labor rates,

(2) that all applicable discounts or expense credits have been included,

(3) that subcontract billings do not exceed rates for such work regularly agreed upon between the contractor and subcontractor unless specifically authorized by the contracting officer or terms of the contract.

6-205 Technical Service Contracts

6-205.1 Introduction

Technical service contracts provide for the contractor to furnish personnel and other services for the performance of the work specified in the contract, with reimbursement for such services usually on the basis of:

a. A fixed rate per hour, day, or month for the services of the assigned technician, which sum may vary depending on whether the technician is on domestic or foreign duty. Such fixed rate should normally provide for treatment of nonworking time (i.e. vacations, illnesses, etc.).

b. An allowance for subsistence and housing at either actual costs, if reasonable, or at specified fixed per diem rates, subject to modification when subsistence or quarters are furnished by the Government.

c. The cost of transportation to and return from the duty station as well as transportation while at the duty station incident to the performance of the contract. Cost of employee dependents will not be at any additional cost to Government.

d. The allowable cost of such other items as are expressly provided for in the contract.

6-205.2 Audit Responsibility – Technical Service Contracts

a. Audits will be performed on those contracts that specifically provide for audit determinations or in response to specific requests made by the procuring activity. In some cases, the provisions for audit, or the submission of reimbursement claims for audit, will be limited to certain items as designated under the contract.

b. When audits are required, arrangements for assist audits required to determine the propriety and reasonableness of cost will be the responsibility of the auditor at the prime contract location.

c. When technical service contracts represent substantial values, normal auditing procedures should provide for a determination that the contractors' procedures for costing the performance of the technical services are consistent with the cost objectives considered in negotiating the billing rate. For example, if a staff-month billing rate provides for inclusion of vacation or other leave as properly billable time, amounts for these leave allowances for other direct employees should not be included in the overhead used for determining the staff-month rate and all such leave should be included in the labor base. Further, the overhead expense factor included in the staff-month rate should represent a reasonable offsite rate which will include only those expenses applicable to the offsite operation.

6-205.3 Audit Reports

Reports will be issued in accordance with the applicable section of Chapter 10 and will be fully responsive to the specific requests. In addition, reports should be issued without a request whenever the auditor encounters information which would be of value in the administration of the contract or in the negotiating of contract prices

6-206 Underuns, etc. on Incentive Contracts

a. In those instances where the actual costs vary widely from the estimated costs which were considered in setting the target cost, the report should contain specific coverage as to the cost element and reasons, if discernible, for the variance. The following are some of the areas which may cause major deviations between actual and estimated costs.

(1) Changes in the "Make-or-Buy" pattern of major components.

(2) Changes in the cost accounting system including basis for allocation of indirect expenses. If the contractor is required to comply with the Cost Accounting Standards Board rules, regulations, and standards, the auditor should refer to Chapter 8.

(3) Provision for contingencies which did not materialize such as forecasted increases in the cost of raw materials; anticipated union demands; or anticipated increases in costs of major components and royalties.

(4) Engineering changes which resulted in extraordinary and unanticipated reductions in costs.

(5) Overstatements of important elements of cost during the initial price negotiations due to subsequent developments which were not foreseen by either the contractor or the Government.

(6) Overstatements of important elements of cost due to defective pricing (see 14-100).

b. It is not intended that the auditor make a detailed analysis of the entire amount of the underrun or an evaluation of the adequacy of the initial price negotiations. Audit programs should, however, be designed to bring any items of significance mentioned in the preceding paragraph to light at the earliest practicable time. If the items disclosed have a material effect on the relationship of actual costs to target costs, they should be brought to the attention of the contracting officer. Items which involve apparent defective pricing or indicate a need for voluntary price adjustments will be reported separately as provided in 14-100 and 4-802, respectively. A reference to such reporting will be included in the report on the finalization of price of the incentive type contract; all other matters will be reported in detail as provided in 6-205.3.

6-300 Section 3 --- Audit of Incurred Material Costs and Purchased Services

6-301 Introduction

This section presents audit guidance and procedures for the audit of direct and indirect material costs and purchased services. The guidelines relate to the audit of the following areas: material costs accounting; physical inventories and adjustments; scrap, spoilage, excess, and obsolescence; determination of requirements; make or buy decisions; purchasing and subcontracting; receiving and inspection; storing and issuing; and intracompany transfers.

6-302 Audit Objectives and Scope of Audit

a. The auditor's examination of transactions and procedures in the functional areas discussed in 6-301 must be sufficient to support an opinion on the allowability, allocability, and reasonableness of costs charged to the contract. In performing this overall test, determine whether the material was:

(1) needed for the contract

(2) charged and billed in a reasonable relationship to its use in the manufacturing process

(3) considered properly for make or buy

(4) purchased in reasonable quantity

(5) purchased at a prudent price

(6) used on the contract

(7) in compliance with contract terms and CAS (particularly CAS 402 and 411)

(8) accounted for properly as to initial charge, transfer in or out, and residual value.

b. Also be alert for restraints on competition attributable to a contractor's director(s) having an interest in a supplier or subcontractor (interlocking directorates). Any suspicion of preferential treatment (such as indications of conflicts of interest, unwarranted sole-source purchases, or kickbacks) should be evaluated for possible reporting under 4-700.

c. Evaluations in this area can be used to satisfy mandatory annual audit requirements related to the applicable portions of updating the internal control audit planning summary (No. 1), adjusting entries/exception reports for purchased services and material costs (No. 10), auditable subcontracts/assist audits (No. 12), and the existence/consumption of purchases (No. 13).

d. Many different functional areas comprise contractor Material Management and Accounting Systems (MMAS). Audit objectives and guidelines for each of the major MMAS functional areas are discussed throughout the remainder of this section and in 5-700. Generally, the audit scope will address whether:

(1) the contractor has established appropriate policies, procedures, and controls

(2) the contractor consistently follows established policies, procedures, and controls

(3) material and related costs are allowable, allocable, and reasonable.

The scope of audit in any of these areas will consider reliance that can be placed on the work of others (4-1000). Particular consideration should be given to adjust, when appropriate, audit scope to give consideration for adequate contractor demonstrations and audits performed under DFARS 242.72 or 244.

e. Chapter 5 presents guidance for evaluating a contractor's policies, procedures, and related internal controls. The Government expects all contractors to have adequate controls to ensure system and data integrity. The auditor's assessment of the effectiveness of these controls (control risk) will influence the extent of testing and verification necessary to express an opinion on the allowability of material costs charged to Government contracts.

f. Major considerations affecting the extent of the testing and verification of material costs include:

(1) the significance of the dollar amount of material costs

(2) the extent of prior audit experience with the contractor involving the same or similar items

(3) the reliability and acceptability of the contractor's management policies, procedures, and system of internal controls

(4) the contractor's use of information technology

(5) the nature, extent, and results of any reviews accomplished by other Government activities.

g. The specific scope of audit for testing and verifying material costs is a matter for judgment in the individual circumstances, subject to established DCAA policy (e.g., the use of statistical sampling techniques). DFARS 252.242-7004 requires contractors to provide sufficient evidence of compliance to the MMAS standards. This contractor testing will significantly affect the scope of the audit based on the guidance in 4-1000.

h. When material costs are significant, consider the following when designing substantive tests:

(1) Audit of all large purchases or system areas in which control risk is assessed as high.

(2) Audit of all sensitive purchases, such as scarce materials, sole-source items, or purchases from vendors suspected of improper practices.

(3) Audit of other items on a selective basis, using the most practical sampling methods available in the circumstances.

(4) Stratify or group the purchases to be audited in some meaningful way, such as by dollar amounts, buyers, contracts, types of material, products, departments, vendors, or a combination of these and other factors.

6-303 Coordinating and Reporting Results

a. Conduct an exit conference in accordance with 4-304 only after approval of the supervisory auditor. Include the contractor's reactions in the working papers and the report.

b. A MEMORANDUM FOR RECORD should be issued to close an assignment for separate functions that support the incurred cost audit for a contractor's fiscal year (e.g. MAAR 13, receiving and inspection) prior to incorporating the results into the final incurred cost report. However, if significant internal control deficiencies are found during these audits, auditors should prepare a flash report in accordance with 10-413 and follow-up these findings in a separate purchasing (5-600) or material management and accounting system audit (5-700). For reporting CAS/FAR noncompliances found during the audit, auditors should follow the format in 10-808. During the course of the audit, the auditor may become aware of conditions which may indicate fraudulent or other suspected irregular activities as defined in 4-702.1b. Promptly report these as described in 4-702.4.

6-304 Evaluation of Policies, Procedures, and Controls

When performing a DFARS 242.72 evaluation or other system audit, the auditor must have a basic understanding of the contractor's policies, procedures, and controls. In many audits, the auditor expresses an opinion on the allowability, allocability, and reasonableness of material costs. Understanding the system and determining the level of reliance that can be placed on existing controls will directly influence the extent of testing and verification necessary to express an opinion. (See 5-700 for guidance on understanding, documenting, and assessing internal controls relating to contractor MMASs). The frequency of a complete material cycle evaluation, or of the evaluation of specific functions within the cycle, will depend on:

- the significance of material costs charged to Government contracts;
- the results of the current evaluation of this area including the number and significance of deficiencies; and
- the frequency with which key contractor personnel, charged with the responsibility for carrying out the functions, are reassigned or are separated from the company.

6-305 Accounting for Material Cost

a. The accounting department is the focal point for material cost control, because it correlates the cost data applicable to requisitioning, purchasing, receiving, storing, issuing, and finally paying for the material. The audit of the accounting system for material costs includes:

(1) an evaluation of the internal accounting controls, including the type of accounting system in use and the methods used to control the level of material costs; and

(2) a determination of the propriety, consistency, and logic of the pricing procedures; the composition and allocation of material charges; and the manner in which payments are made.

b. The distribution of material charges to contracts, accounts, projects, or work orders offers various opportunities for misrepresentation of material costs. Fraud cases have included the following examples: altered vendor invoices, duplicate claims for material on public vouchers and progress payments, fraudulent billings from dummy companies, kickback arrangements, claims for materials not received, claims for materials not required by the contract, and claiming material cost applicable to other contracts because of funding limitations. Suspicions of these or similar practices should be audited for possible reporting under 4-700.

6-305.1 Audit Objectives

The basic audit objectives for the accounting function are to determine the adequacy of the contractor's policies, procedures, and internal controls and the extent to which this function influences the allowability, allocability, and reasonableness of material and purchased service related costs. These objectives include satisfying applicable portions of mandatory annual audit requirements related to purchases adjusting entries/exception reports (No. 10) and purchases existence/consumption (No. 13).

6-305.2 Internal Control

a. The adequacy of the contractor's material management and accounting system will influence the scope of audit and the degree of reliance that can be placed on the results. For example, when standard costs are used, consistency in establishing the standards and in applying the variances should be evaluated. The contractor may be experiencing a high loss factor and significant material price fluctuations in processing materials for commercial production, while losses and fluctuations for the Government operation are negligible. In this situation, the standard material variance should be adjusted for the high losses and price fluctuations before the variances are applied to the Government production. As an alternative, a separate material variance factor could be established for application to Government production.

b. Evaluate the contractor's procedures and internal controls for pricing direct and indirect materials (see 5-700).

6-305.3 Audit Guidelines

In formulating an audit program for evaluating the accounting for material costs, consider the following guidelines:

a. Mandatory Annual Audit Requirements (MAARs)

(1) An evaluation of adjusting journal entries and exception reports related to material purchases should be made to identify adjustments and/or exceptions that require further audit analysis and/or explanation (MAAR 10). Determine the reliability of the contractor's system for processing vendor payments and distributing costs to contracts or other cost objectives. This audit should include the testing and matching of purchase orders, receiving reports, and payments (this may require technical assistance in some cases). Also, a verification should be made of purchase requisitions to contract requirements (such as specifications or bill of materials) to determine whether contract charges for purchases are for materials received and services provided in performance of the Government contracts. Of concern here is that the contractor has valid time-phased requirements and is not acquiring material far in advance of need (see 6-308).

(2) Audit material purchases to test that the materials were in fact received and, if applicable, used on the contract charged (MAAR 13). If purchased services are significant, or of a sensitive nature, the audit should also consider an evaluation of these services to ensure they were performed or are being performed. MAAR 13 is a concurrent MAAR. The audit must be performed for the current year during the first field visit to the contractor facility within the year. This will normally be accomplished during a price proposal audit or annual incurred cost audit, or within a specific material audit assignment. MAAR 13 should be performed annually except at those nonmajor contractors subject to desk review steps as part of the low-risk incurred cost initiative (6-104). For nonmajor contractors subject to the low-risk sampling initiative, MAAR 13 should be performed at least once every three years. Annual evaluations should not be performed unless there are unusual circumstances increasing the risk for the current year. If possible, the evaluation should be performed in the year the full incurred cost audit is planned. Specifically, ascertain that the material was:

- needed for the contract,
- purchased in reasonable quantity,

- purchased at a prudent price,
- used on the contract, and
- properly accounted for as to initial charge, transfer in or out, and residual value.

If during the performance of the MAAR 13 evaluation the auditor finds that selected material parts are not located at the contractor's facilities (e.g., the parts were shipped to an off-site location or directly to a subcontractor), the auditor needs to perform sufficient follow-up effort to verify the existence of the material parts and not automatically substitute other parts for them. Similarly, if selected purchased services are not being performed at the primary contractor's location, sufficient follow-up effort is required to verify the services are being performed. Follow-up effort could include:

- Requesting confirmation of the existence of selected material parts and/or the performance of purchased services from the cognizant offsite auditors,
- Reviewing shipping/receiving documents, and/or
- Making inquiries to contractor and/or Government representatives.

(3) Physical observations and other steps needed to gain evidence of proper usage of material and services purchased may be done as part of an audit covered in 6-306 or 6-312 below.

(4) Appraise the adequacy and usefulness of the stock record cards or other records used to provide information on the location, nomenclature, and quantities of items in inventory. Also, determine whether any inventory algorithms used are based on valid and current data.

(5) Miscellaneous costs associated with material purchases charged directly or as items of indirect costs, such as transportation and material handling charges should be evaluated. In verifying these costs, determine whether the accounting treatment is reasonable and consistent. Circumstances requiring special attention are:

(a) The contractor may charge transportation on material purchased for Government contracts as direct contract cost, and the transportation on material purchased for commercial work to overhead. In this case, the Government will absorb excessive costs if the commercial transportation costs are not eliminated from overhead.

(b) Contractors may add material handling charges to the cost of materials by applying a percentage factor to the invoice cost. When the factor is arbitrarily determined without specific identification of the costs in the records or without eliminating such costs from the overhead, question the costs for the appropriate reason, (e.g., for lack of records or for duplication of costs). When handling costs are computed on a recognized and acceptable accounting basis (such as when a separate pool is maintained for expenses of this nature and the allocation is made on an appropriate basis), then the additional charge for material handling may be accepted by the auditor subject to the test of reasonableness. The auditor's evaluation of material handling costs should determine the reasonableness of the costs and whether they represent specifically identifiable items which are not included in any allocable indirect cost pool.

(6) Materials fraud is often perpetrated by charging inflated material prices to the Government based on fictitious or dummy company invoices. A common method used to make improper charges to flexibly priced contracts is to change the account number to which a vendor invoice is charged. Accordingly, be alert for accounting miscommunication intended to conceal the true purpose of an expenditure.

b. Payment for Materials

The audit of payments for materials should include an evaluation of the internal control activities and the testing and verification of the invoice processing and payment functions. An evaluation of material payments should also verify that the distribution of costs to cost objectives is consistent with payments. In some automated systems, the distribution of costs may be separate from payment allowing the possibility of billing material to Government contracts before the contractor actually makes payment for the materials. In this connection, evaluate the aging of the payables to determine whether there is a large amount of materials or services not paid for but billed on contracts. Conversely, ensure that the contractor is not paying for material (e.g., to take advantage of discounts) unless it has proper proof of receipt (see 6-311).

c. Material Transfers Between Contracts

(1) Material may be transferred at actual cost or standard cost or according to some other generally accepted inventory costing method as long as it is consistently applied, is equitable, and is based on unbiased logic. As to indirect costs allocable to the prime costs, CAS 410.50(i) provides the proper accounting for allocating G&A costs and for transfers. In general, material transfers should be priced using the G&A (or overhead) rate derived when the material was purchased/manufactured. The auditor should ascertain compliance with these standards.

(2) Normally a transfer of parts will also mean that the related cost is transferred within the same billing period. However, in some limited circumstances it may not be appropriate to transfer parts and associated costs within the same billing period. In these cases, use of a "loan/pay back" technique must be approved by the ACO. The loan/payback technique is the movement of materials from one contract to another contract that has a more pressing production requirement without a transfer of cost because the contractor plans to pay back the materials once additional parts are received. When the technique is used, there must be controls to ensure that:

(a) parts are paid back expeditiously

(b) procedures and controls are in place to correct any overbilling that might occur

(c) at a minimum, the borrowing contract and the date the part was borrowed are identified monthly

(d) the cost of the replacement part is charged to the borrowing contract.

(3) When a loan/pay back transfer is made, the audit concerns are that:

(a) borrowed parts are not paid back on a timely basis or never paid back

(b) progress and/or final payments are received by the contractor for the same part on more than one cost objective resulting in double billings

(c) there is no audit trail or evidence providing visibility of the lending or borrowing contract, or when the parts were borrowed and/or paid back

(d) the borrowing contract was not charged for the cost of the replacement parts. Perform appropriate tests to ensure loan/pay backs have been treated properly.

6-306 Physical Inventories and Adjustments

a. Fundamental to the viability of any inventory control system is a requirement that recorded inventory accurately reflects actual, physical inventory. The contractor, therefore, must establish and maintain adequate controls to ensure acceptable levels of record accuracy. Contractors' procedures to verify the quantities and dollar value of physical inventories may include test counts of inventories on hand, comparison of the actual count with the quantity

reflected in the inventory control records, appropriate adjustments for differences between book inventory and the physical count, and verification that inventory pricing factors are determined on an acceptable basis.

b. The Government has an interest in contractors' effective utilization of inventories. Effective utilization of inventories requires that the investment be kept to a minimum and that management knows the quantities, quality, and location of goods on hand.

c. The Government is also interested in whether the contractor makes an adequate investigation of inventory adjustments and whether losses are acceptable as reasonable costs on Government contracts. Adjustments of losses and overages and deterioration of inventory items may indicate inadequate inventory control and storage procedures. Adjustments of items that are surplus or obsolete may indicate the contractor is purchasing excessive quantities.

d. Some contractors' policies, procedures, and practices result in a lack of perpetual inventory records once materials have been physically issued to work-in-process. In these cases, the shop control function must maintain adequate records to manage and account for issued inventory. Specific attention should therefore be given to the procedures governing perpetual inventory records (see 6-312).

6-306.1 Audit Objectives

The audit objectives are to determine whether the:

(1) contractor's policies, procedures, and internal controls relating to physical inventories are adequate

(2) differences between the physical count and book inventories are accounted for and adequately explained

(3) total inventory value represents correct quantities appropriately priced

(4) inventory levels indicate a balanced stockage position.

In addition, these objectives include satisfying applicable portions of the mandatory annual audit requirement related to purchases adjusting entries/exception reports (MAAR 10).

6-306.2 Internal Control

Adequate internal controls provide some degree of assurance on the dollar value and physical quantities of the inventory. Inadequate internal controls may result in excessive charges to Government contracts and the use of erroneous cost data by management (see 5-710).

6-306.3 Audit Guidelines

a. When it is anticipated that the dollar value of the physical inventory adjustments will have a significant effect on Government contract prices, arrange to observe the taking of the inventory. This should include an evaluation of the planning and the adjustment phase which follows and an evaluation of the journal entries adjusting the book inventory to physical inventory.

b. In developing the audit program, consider the following steps:

(1) Evaluate and test the contractor's procedures for establishing an inventory cut-off for inventory in transit during the inventory-taking period to preclude improper treatment of items in transit.

(2) Evaluate the manner in which the physical inventory is reconciled with the book inventory. This audit should include an evaluation of the inventory adjustments and the contractor's investigation of the reasons for the adjustments. It also should determine whether necessary adjustments are acceptable as reasonable costs on Government contracts and whether they result from inadequate internal controls. Adjustments of losses and overages, and deterioration of inventory, may indicate inadequate control and storage procedures. Adjustments of items that are surplus or obsolete may indicate:

(a) the purchase of excessive quantities,

(b) inadequate control of change orders,

(c) weak production scheduling and control, or

(d) another significant cost management problem.

Such matters may need to be checked further in another audit (see DCAA Forms 7640-22a and b, Audit Leads).

(3) Test and evaluate the contractor's records supporting the physical inventory and test areas such as the pricing and the arithmetical accuracy of the computations and footings. A large number of material expediters, substantial excess inventory, and frequent shortages of material to satisfy production needs may indicate that the formal system is not providing accurate information regarding what materials are needed, when materials are needed, and/or what materials are already available in inventory.

(4) Determine whether the contractor segregated any inventory adjustments resulting from price fluctuations due to market conditions.

(5) Determine whether inventory adjustments relate to the performance period of the contracts under audit.

(6) Ensure that the contractor has adequate controls over physically commingled inventories to allow proper charging to contracts.

c. Additional guidance on material handling can be found in 6-312.

d. Performance of the above procedures will satisfy the applicable portions of mandatory annual audit requirement No.10, which requires review of adjusting entries/exception reports related to materials to identify adjustments and/or exceptions that require further audit analysis.

6-307 Spoilage, Excess Scrap, and Obsolete Material

This paragraph presents audit guidance applicable to scrap, and to spoiled, excess, and obsolete materials.

6-307.1 Audit Objectives

The audit objectives are to determine whether:

(1) the scrap, spoiled, excess, and obsolete material generated is reasonable in amount;

(2) the physical property is adequately safeguarded;

(3) the price received through sale or other disposal is equitable; and

(4) the receipts from the sale or other disposal are reasonable and properly credited.

6-307.2 Audit Guidelines-Scrap and Spoilage

There are various methods for accounting for costs of scrap and spoilage. The method which should be used depends in part on the type of plant operation. Costs may be charged as overhead, as a variance to be applied to the material costs, as loading factors to material costs, or direct to a specific contract. When scrap and spoilage costs are associated with material costs, they may be commingled with the regular material costs or may be identified separately. The audit considerations listed below should be included in the audit program for audit of this area:

a. When practicable, scrap and spoiled items resulting from the performance of Government contracts should be segregated physically from scrap and spoiled items resulting from commercial contracts and should be accounted for separately. The auditor should observe the contractor's stock of scrap and determine the cause for any large quantities of scrapped or spoiled items. Particularly be alert to the possibility that the cause of such scrap may be capital equipment that is faulty or inadequate for its current use.

b. When scrap and spoilage costs have been charged direct to contracts, proceeds from the sale of the material as scrap should be credited to the appropriate Government contract.

c. The contractor may maintain statistical records to accumulate scrap and spoilage cost data when these costs are not separately identified in the accounting records. These statistical records should be evaluated for completeness and reliability.

d. When scrap and spoilage costs are not separately identified, or are not separately accounted for in the records, the total proceeds from sales should be allocated in an equitable manner.

e. When the auditor's evaluation indicates that the contractor has incurred excessive scrap or spoilage costs or there is an apparent misuse of Government material, request the services of a qualified Government representative to assist in determining the reasonableness of cost. Also be alert to instances of scrap caused by failure of the production unit to promptly receive and implement engineering changes in the product or failure to suspend production of deficient items pending resolution of the problems involved.

6-307.3 Audit Guidelines-Excess and Obsolete Materials

a. Excess or obsolete items may be from purchased material or parts, or manufactured parts. Evaluate the contractor's policy for recording and recovering obsolescence costs and evaluate the causes that generated the obsolete items. In addition, be alert to those situations in which the contractor:

(1) is reimbursed for the cost of obsolete items but subsequently sells them to a subsidiary or affiliate at significantly reduced prices,

(2) uses the items as a no-cost component on the contractor's commercial work or in performing a firm-fixed-price or incentive contract for the Government, or

(3) scraps items and then buys similar items from surplus or salvage dealers. Practices of this nature should be reported to the contracting officer and should also be considered for possible reporting under 4-700 or 4-800.

b. The contractor's procedures and practices for using or disposing of excess or obsolete items should be evaluated, including:

(1) Screening procedures adopted in order to determine whether parts produced under, but no longer needed for, a particular contract can be used on other contracts. These items should be transferred for use without charge to the Government.

(2) Procedures for obtaining the highest possible prices on items sold or scrapped.

(3) Procedures for ensuring that the Government receives proper credit for proceeds of items sold or scrapped. Related adjusting entries should be evaluated for appropriateness (as required by mandatory annual audit requirement No. 10 (see 6-305.3).

6-308 Determination of Material Requirements

The decision to purchase a standard item, the quantity required, and the timing of the delivery usually are the responsibility of such departments or functions as planning and production control, engineering, storeroom, and office services. Deciding to buy nonstandard items is frequently delegated to a make or buy committee or a similar group. See 5-702 on the use of MRP systems to determine requirements.

6-308.1 Audit Objectives

a. The audit objectives of this area are to determine the extent of coordination between the purchasing function and the departments responsible for determining requirements. Effective coordination may have a significant impact on purchasing economies and production efficiencies and in turn may affect the ultimate cost to the Government. The quality, quantity, and delivery date of materials to be purchased may be based on information generated by:

(1) stock level requirements established for standard items,

(2) bills of material coordinated with production schedules, and

(3) individual purchase requests from departments authorized to requisition material.

b. The need for special tooling or special test equipment is generally established at the proposal or negotiation stage (9-605.2). These special items, which are not part of the deliverable end product under the contract, must comply with the definitions in FAR 2.101b, and the FAR requirements for approval, control, accountability, use, and disposition (see 7-2106 and 14-400).

6-308.2 Internal Control

The material purchases by the contractor's buyers should be based on requests received from departments responsible for material requirements. The audit effort, therefore, should depend on the effectiveness of the contractor's internal control system affecting the requisitioning and buying activities. An evaluation of the internal control system should be made to determine whether all purchase actions are in response to need, supported by properly initiated and approved requisitions, and accomplished in a timely and effective manner. See 5-600 for guidance on performing contractor purchasing system audits.

6-308.3 Audit Guidelines

Of particular concern here are:

- claimed costs not properly traceable to source documents,
- excess material costs being charged to Government contracts,
- no audit trail supporting "no cost" transfers of material,
- loans of materials to other contracts outstanding for an excessive time period, and
- inaccurate material records (see 6-306).

Accordingly, the audit of the interrelation and coordination of the purchasing and requisitioning functions should include, but not be limited to, an evaluation of:

(1) Buying practices to determine whether a pattern of rush, emergency, or premature buying exists which may have resulted in;

(a) increased purchase prices,

(b) excessive use of uneconomical transportation,

(c) delays in production and engineering operations,

(d) excessive obsolescence as a result of subsequent changes, or

(e) premature billing of material costs.

(2) The followup procedures used by the purchasing department to ensure timely deliveries.

(3) Modifications to purchase orders to determine if changes in specifications and quantities have resulted in obsolescence or increased costs and to determine whether changes were due to poor planning and lack of coordination, the untimely processing of purchase orders, or other causes that could have been avoided by better management practices.

(4) Significant increases in material costs charged to Government contracts to determine if increases were due to year-end inventory write-downs and whether write-downs resulted from inefficient requisition procedures and purchasing operations.

(5) Coordination procedures when there are indications of repeated requisitioning of small quantities of the same item with substantial increase in costs to Government contracts.

(6) Controls that prevent requisitioning materials in excessive quantities or premature charging to Government contracts, resulting in unnecessary material costs and in increased storage and material handling charges to the Government.

(7) Trends in transfers from one type of contract to another or significant increases in cost transfers from one month to another that might indicate system control problems.

6-309 Make or Buy Decisions – Incurred Material Costs and Purchased Services

The contractor's make or buy decisions determine which components, assemblies, subassemblies, or parts are to be manufactured and which are to be purchased. These determinations affect contract prices, contract performance, and adherence to Government procurement policies.

6-309.1 Audit Objectives

The objectives when auditing this area are to determine whether make or buy decisions:

(1) are reasonable in concept,

(2) are applied effectively,
(3) are in compliance with FAR 15.407-2, and
(4) generally result in the lowest cost to the Government.

6-309.2 Internal Control

5-600 contains detailed guidance for auditing contractor purchasing systems including make-vs-buy decisions. The guidance in 14-700 on economy and efficiency audits of capital investments is equally applicable in the audit of make or buy determinations.

6-309.3 Audit Guidelines

a. FAR Subpart 15.407.2 generally requires contractors to submit make or buy programs for negotiated acquisitions requiring cost or pricing data with an estimated value of $11.5 million or more (see exception at FAR 15.407-2(c)). It also allows, for monitoring purposes, the incorporation of the program in negotiated cost-reimbursable contracts, some cost sharing contracts and major systems contracts and subcontracts for monitoring purposes. The contract clause at 52.215-9 requires notification of any changes in the program as incorporated in the contract. Alternates 1 and 2 requires adjustment of incentive fees if during performance the contractor reverses a make or buy categorization which initially was economically detrimental to the Government. Determine the effect of and compliance with any agreements resulting from these requirements.

b. The contractor has the basic responsibility for make-or-buy decisions. Therefore, its recommendations should be accepted unless they are inconsistent with Government interests or policy. Evaluate the contractor's decisions in the make or buy area which may have been motivated by considerations other than economies or efficiencies for the Government operation. For example, the contractor may desire to gain experience in a particular manufacturing or fabricating process. Another consideration which may influence a contractor's make or buy decisions involves the extent of available idle facilities. The contractor's decision to manufacture in lieu of purchase may be in the best interests of the company, but not in the best interests of the Government. When a contractor decides to manufacture a part or component not normally within its experience or production capabilities or which had been purchased in the past, determine whether the decision results in additional costs to the Government.

6-310 Purchasing and Subcontracting

a. The purchasing and subcontracting function includes make or buy decisions (6-309) the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administration of orders, and expediting delivery of materials.

b. When DCAA internal control audits or FAR required contractor purchasing system reviews (CPSRs) are regularly performed at a contractor location, the auditor will make maximum use of the work performed and the conclusions reached during these reviews in establishing the extent of any separate coverage and audit tests to be undertaken in this area (see 5-600). In addition, the auditor and the cognizant Government procurement office have related responsibilities regarding purchasing and subcontracting. It is imperative

that the auditor coordinate planned reviews with the procurement office to avoid duplication of effort (see 5-1302 and FAR Part 44).

6-310.1 Audit Objectives

The audit objectives of this area are to determine whether the contractor: made reasonable make or buy decisions (see 6-309 and 5-608); ensures the purchase of only properly determined requirements (see 6-306 and 5-710); obtained maximum competition; made a proper analysis of quoted prices; made a reasonable attempt to negotiate with the vendors; had a reasonable basis for vendor selection; has reasonable internal controls over placement and administration of orders (5-600); and is expediting delivery of materials where appropriate. In addition, these objectives include satisfying applicable portions of mandatory annual audit requirements related to auditable subcontracts/assist audits (MAAR 12).

6-310.2 Internal Control

An adequate internal control system for purchasing and subcontracting activities requires, as a minimum, effective management policies, implemented by written procedures which will allow the contractor to control the level of costs. Effective internal controls require that the most recent policies and procedures related to the purchasing and subcontracting function be made available to all personnel concerned. All purchasing department personnel should understand their assigned responsibilities, authority, and limitations. Section 5-600 contains detailed guidance on auditing and reporting on contractor purchasing system internal controls.

6-310.3 Audit Guidelines-Basic Procedures

In formulating an audit program for evaluating purchasing and subcontracting, consider the reliance to be placed on the internal control structure. The specific scope of audit for testing and verifying the purchasing system is a matter of auditor judgment. When material costs are significant, the auditor should consider the following when designing the substantive testing:

a. Testing Methods. The auditor should consider testing:

(1) all large purchases;

(2) all sensitive purchases, such as scarce materials, sole-source items, or purchases from vendors suspected of improper selection; and

(3) all other items on a selective basis, using the most practical sampling methods available in the circumstances. For example, stratify or group the purchases to be audited in some meaningful way, such as dollar amounts, buyers, contracts, types of material, products, departments, vendors, or a combination of these factors.

b. Sufficient Competition. Evaluate whether there were bid solicitations from a sufficient number of prospective sources to promote effective competition commensurate with the nature and dollar value of the purchase action.

c. Basis for Selection. Factors to be considered when evaluating purchases involving noncompetitive items are whether:

(1) the vendor was designated by the contracting officer who awarded the prime contract and

(2) the purchase, if made from a sole source supplier, was approved by a responsible company official.

d. Negotiation. The auditor should:

(1) identify those awards made to other than the low bidder and determine whether the purchase files reflect the justification for the rejection of the low bidder and the basis for the selection,

(2) ascertain if the contract files contain sufficient evidence of negotiation when it is necessary to establish a reasonable price because the item is nonstandard or an insufficient number of bids have been received,

(3) determine the extent of the audit given the supporting data submitted by the prospective vendor,

(4) ascertain if the type of subcontract issued meets the requirements of FAR Part 16 and includes all clauses required by the prime contract,

(5) determine if awards have been made to other than the low bidder on the basis of delivery, the purchase order should provide for a downward price adjustment if delivery schedules are not met, and

(6) determine if there is sufficient justification for awarding intracompany purchases or work orders.

e. Unallowable Procurement. Determine whether the contractor issued any cost-plus-a-percentage-of-cost subcontracts (FAR 44.203(b)(2). Under this type of procurement, the subcontractor would receive payment for, and the prime contractor would pass on to the Government as cost of its contract, the costs incurred in performing the contract, plus a specified percentage of such costs as a profit or fee. Thus, the fee would increase in direct proportion to any increase in cost.

6-310.4 Audit Guidelines-Subcontracts

a. Analysis of Case Files. Evaluate the upper-tier contractor's subcontract files to ensure that all required subcontract cost or pricing data was obtained and all analysis work made by the upper-tier contractor was properly provided to the Government in any price negotiations with the Government.

b. Subcontract Changes. In evaluating subcontract changes which affect cost or price, consider:

(1) reasons for the change,

(2) reasonableness of the adjustments to the subcontract price or cost,

(3) complexity or risk involved, and

(4) reasonableness of profit or fee adjustment compared to the estimated cost of the change.

When the cost of the subcontract before the change has exceeded or is expected to exceed original estimates, be alert to changes which have been overpriced to avoid an overall loss or to provide total profit or fee in accordance with original contract estimates.

c. Administration of Subcontracts. The auditor should determine whether the upper-tier contractor expedites delivery where appropriate, and meets the FAR requirements for change orders, modification notices, and overall costs (refer to purchasing system section 5-600).

d. Repricing. The auditor should determine whether:

(1) revised contract prices are negotiated or arrived at as provided by contractual requirements;

(2) cost or pricing data which was used as the basis for repricing is accurate, complete, and current; and

(3) results of the repricing action are in the best interests of the Government.

e. Purchases from Debarred Companies. Debarred or suspended contractors are excluded from receiving contracts; and agencies shall not solicit offers from, award contracts to, or consent to subcontract with these contractors, unless the acquiring agency's head or a designee determines that there is a compelling reason for such action, as explained in FAR 9.405-2, 9.406-1(c) and 9.407-1(d). An important criterion in determining the propriety and allowability of payments for material purchases or subcontracts is the "consent" requirement of specific contracts. FAR 52.244-1 through 52.244-5 are the pertinent solicitation provisions and contract clauses which, if included in a contract, delineate the "consent" requirements by types and categories of contracts. If by the terms of the contract, prior consent is required of the ACO in subcontracting/purchasing, the ACO is prohibited from consenting to award to a debarred contractor. "Consent" here means to consent to contract with a particular entity or person; not consent to make a purchase. If prior consent is not required or if it is required for approval to make purchases only, a prime contractor is free to solicit from any sources available, including debarred, suspended, or ineligible contractors.

When the prime contractor has failed to comply with the "consent" requirements of a contract, consult with the contractor to determine if any additional data exists to preclude the suspension of costs. If the contractor cannot provide an adequate explanation or documentary support for audit approval of payments on public vouchers, the costs should be suspended and brought to the attention of the ACO.

6-310.5 Audit Guidelines-Breakout of Material Purchases

a. An evaluation of this area should determine whether material or component parts purchased by the contractor for incorporation in the contract end item include common items of high-cost major components or subassemblies. When common items are included, analyze the material cost to determine if a "breakout" (Government direct purchase) of common items would reduce costs charged to Government contracts. When warranted, consult with the contracting officer and point out the possible desirability of acquisition of items directly and furnishing them to the prime contractor as Government-furnished material.

b. In addition to breakout of common items, the contractor may purchase other items which would be more economical for the Government to purchase directly. Spare parts procurement is an area which deserves special attention because, in some instances, the prime contractor may perform only the procurement function; and it may be more economical and practical for the Government to procure parts directly from the supplier. The extent to which drop shipments are made by manufacturers to the Government using activities will provide an indication of the extent of prime contractor efforts relative to the spare parts. Special attention should also be given to pricing formulas or accounting methods that allocate/assign unreasonable or unwarranted costs to spares or for indications of excessive profits on spares contracts.

6-311 Receiving and Inspection

The receiving activity is responsible for the receipt and inspection of incoming materials and the movement of these materials to the areas where the storage and usage functions are carried out. Common responsibilities include:

(1) unloading, unpacking, identifying, sorting and verifying that the quantity and quality of materials received agree with purchase order requirements;

(2) noting shortages, damage, and defects;

(3) reporting receipts and discrepancies;

(4) moving materials to storage or other appropriate activities; and

(5) providing appropriate transaction inputs to the inventory requirements and accounting systems.

6-311.1 Audit Objectives

The audit objectives in evaluating the contractor's receiving and inspection function are to determine whether this area has effective policies, procedures, and internal controls and whether it helps ensure that allowable, allocable, and reasonable costs are charged to Government contracts.

6-311.2 Internal Control

Receiving and inspection controls are typically evaluated as part of an MMAS audit. If an MMAS audit has been performed, the auditor should refer to the MMAS portion of the ICAPS to obtain an understanding of the control risk related to this area. If an MMAS audit has not been performed, the auditor may want to perform audit steps to assess control risk relating to the receiving and inspection function (see 5-710.1). In any case, the auditor's assessment of control risk should be noted in the working papers and reflected in the scope of the audit.

6-311.3 Audit Guidelines

In developing an audit program for evaluating the receiving and inspection function, consider the following guidelines.

a. The auditor should physically observe the receiving and inspection functions and examine selected transactions to test whether key internal accounting control requirements are being carried out correctly. Also be alert to any inefficiencies caused by poor work layout or poorly planned and executed movement of materials. Attention should be given to signs of bottlenecks, idle personnel, excess or slow-moving materials, poor material handling practices, and inadequate protection of material from theft and the elements.

b. The contractor may establish sampling techniques to be applied to the quantitative and qualitative receipt and inspection of material. The auditor must ascertain whether the sampling techniques are formalized and will permit an evaluation of the propriety of both the techniques applied and the results. Also ascertain whether there is adequate supervision during the counting and inspection phases.

6-312 Storing and Issuing

The storing and issuing function is responsible for:

(1) the protection and preservation of material in storage, including appropriate safeguards for items of a sensitive nature and items subject to deterioration by the elements;

(2) accessibility of fast-moving items;

(3) the examination of material requisitions for the appropriate stock number, nomenclature, and authorized usage;

(4) a knowledge of items, to permit substitution if appropriate when a requisitioned item is not available;

(5) the timely issuance of material when presented with an authorized requisition;

(6) initiating purchase requisitions when stock levels reach the reorder point or when authorized requisitions cannot be filled, duly noting due-ins and due-outs;

(7) reviewing stock or slow-moving items and items in long supply and initiating appropriate action for consumption or disposal; and

(8) providing appropriate transaction inputs to the inventory requirements and accounting systems.

6-312.1 Audit Objectives

The major audit objectives in evaluating storage and issuing are to determine:

a. If accounting documentation is properly prepared/controlled and the material is properly stored and protected from pilferage, the weather, and other hazards. Material should be issued from stores as required, with proper documentation, and support the production schedule.

b. Storerooms are arranged to promote economy and efficiency in storing, locating, and issuing material.

c. If the movement of material from receiving and inspection to storage and then to production is reported for proper entries in the accounting records. When material flows directly from receiving and inspection to production (bypassing storage), equivalent accounting control is likewise maintained.

6-312.2 Internal Control

Storage and issuance controls are typically evaluated as part of an MMAS audit. If an MMAS audit has been performed, the auditor should refer to the MMAS portion of the ICAPS to obtain an understanding of the control risk related to this area. If an MMAS audit has not been performed, the auditor may want to perform audit steps to assess control risk relating to the storage and issuance function (see 5-710.2). In any case, the auditor's assessment of control risk should be noted in the working papers and reflected in the scope of the audit.

6-312.3 Audit Guidelines

The auditor should consider the following in developing an audit program.

a. Determine by observing, evaluating, and testing the practices and documentation in the warehouses, storerooms, and factory whether the amount of merchandise withdrawn from stores is adequate but not in excess of current needs.

b. Determine the accuracy of the records of materials in transit from the warehouse or storeroom area to the production area.

c. Make physical observations and tests of documentation in production areas to determine whether material is being used in a timely manner and for the purposes for which it was issued.

d. Test the application of procedures for (1) returning material to the storeroom, (2) replacing material in stock, and (3) correcting the inventory and cost records to reflect the return. Change orders and cutback in production schedules usually require the return of material issued to production.

e. Verify the delivery of requisitioned items and evaluate the procedures for handling replacement orders for material lost in delivery.

f. Test effectiveness of inventory controls and management by examining a representative number of contractor-acquired Government-owned (excluding Government furnished material) and contractor-owned items in order to audit the:

(1) basis for establishing stock levels and reorder points,

(2) causes for any items in short supply, and

(3) actions taken in response to data shown in inventory and stock status reports prepared by the contractor.

g. Test the flow of accounting data to the accounting department.

6-313 Intracompany Transfers

a. Careful consideration should be given to items or services transferred at amounts other than cost. Of particular importance is whether the price charged for the item has been established by a competitive market place. If the item is:

(1) proprietary,

(2) sole source, or

(3) produced solely or substantially for Government end use, it may be concluded that it does not meet the requirement for acceptance at price.

Under these conditions, amounts in excess of actual or estimated cost should be questioned.

b. For a contractor to obtain reimbursement on a basis other than cost, for items or services sold or transferred between divisions, subsidiaries, or organizations under common control, certain requirements of FAR 31.205-26(e) must be met. The initial requirement is that the transferring organization have an established practice of pricing interorganizational transfers of materials, supplies and services at other than cost for commercial work of any division, subsidiary, or affiliate of the contractor under a common control. The existence of an established practice should be readily determinable from evidence such as catalogs, sales information, and delivery records.

c. Once the auditor is satisfied that the transferring organization has such a practice, a determination should be made as to whether reimbursement for the item under consideration is being requested based upon an exception from cost or pricing data at FAR 15.403-1(b). These exceptions include:

(1) adequate price competition,

(2) catalog or market price,
(3) prices set by law or regulation,
(4) commercial item exception and
(5) modification to a commercial contract.

A waiver from the cost or pricing data requirements does not qualify as an exception. (See 14-907 for a detailed discussion of these exceptions). This information should be determinable from the contract file.

d. The final requirement for the interdivisional transfer to be allowed at price is that the contracting officer must not have determined the price to be unreasonable. There could be a situation where the auditor has evidence that the price of the item being transferred is unreasonable. In this case, amounts in excess of actual or estimated cost should be questioned.

6-314 Special Considerations for Auditing Purchased Services Acquired from Service Organizations

In recent years, there has been a proliferation in the number of service organizations, and in the number of contractors using service organizations to process certain accounting transactions. Service organizations may provide services ranging from performing certain tasks under the direction of the user organization to replacing entire functions within the user organizations. The services provided range from checking accounts and payroll processing to providing complete information technology services. Because many of the functions performed by the service organizations affect the user organization's financial data, FAO auditors performing audits at the user organization may need to obtain information about the services being provided, the related service organization's controls, and their effect on the financial data being audited (see 3-104.19 and 5-102h).

The cost of obtaining services from a service organization is usually accounted for in an indirect cost pool. If significant, the costs of obtaining these services need to be evaluated during the incurred cost audit (see 6-608 for indirect cost transaction testing plan). All claimed costs must be supported by adequate evidence of the nature and scope of the services furnished. The auditor should review the contract to determine the nature of the services to be provided. Also, the auditor should review the invoices or billings submitted by the service organization which should include sufficient detail of the time expended, the rate of compensation, and the nature of the actual service provided. Purchased services should be reviewed for reasonableness and allocability per FAR 31.201-3 and 31.201-4.

6-400 Section 4 --- Audit of Incurred Labor Costs

6-401 Introduction

This section contains audit guidance applicable to the evaluation of incurred labor costs by area. The evaluation of contractor's policies, procedures, and practices and internal controls which influence labor costs are covered in 5-900. The results of the audit of the labor system and related internal controls and assessment of control risk provide the basis for determining the extent and frequency of testing to be performed in each labor cost area. The auditor should review the control risk assessment and related internal control audit planning summary (ICAPS) to determine whether the audit of the contractor's labor system and related internal controls identified a specific risk area and that the relevant labor costs are material in amount/impact before planning for substantive tests. Discussion is presented in the following areas:

(1) scope of audit,
(2) evaluation of labor cost charging and allocation,
(3) observations of work areas (floor checks),
(4) evaluation of payroll preparation and payment,
(5) evaluation of personnel policies and procedures,
(6) evaluation of recruitment costs and practices,
(7) evaluation of overtime, extra-pay shifts, and multi-shift work,
(8) evaluation of uncompensated overtime,
(9) evaluation of labor standard cost systems and sole proprietors' and partners' salaries, and
(10) evaluation of quantitative and qualitative utilization of labor.

6-402 Audit Objective and Scope of Audit

a. Accomplishment of the audit objectives will require consideration of each of the labor system areas listed in 6-401 above. The audit cycle and the level of testing will be based on the control risk assessment and the vulnerability and materiality of the labor area involved. Substantive testing may be greatly reduced when the contractor effectively maintains an adequate and compliant system of internal controls, including monitoring and testing of the system. Substantive testing should be focused in the high risk areas.

b. In carrying out the primary audit objectives, the auditor should be alert to any condition which raises reasonable suspicion of unlawful or fraudulent activities.

c. MAAR 6 may be accomplished by conducting a labor cost charging and allocation evaluation (interviews) and/or observations of work areas (floor checks). These evaluations may appear similar but vary in the overall objective and the techniques and procedures used. The decision as to whether to perform interviews or floor checks or a combination of both approaches depends on the level of risk associated with the recording and accumulation of labor costs. The audit objectives of a labor cost charging and allocation evaluation (interviews) (6-404) are to evaluate the contractor's compliance with its labor charging policies, procedures, and internal controls; compliance with and reliability of the contractor's labor cost accounting system and the accuracy of contractor employee (salaried and/or hourly) labor hour charges to contracts, indirect accounts, or other cost objectives. Interviews are designed to evaluate employee labor charging over a recent period of

time and are most often appropriate in auditing high risk areas. The audit objectives of an observations of work areas evaluation (floor checks) (6-405) are to verify the existence of employees, evaluate compliance with timekeeping internal control procedures, and evaluate employee labor charging at the time of the floor check. Floor checks are most appropriate when no high risk areas have been identified.

(1) Major Contractors. An annual assessment of conditions influencing labor charging practices (6-404.6) should be performed at major contractors to identify any high risk areas requiring a more detailed audit, e.g. labor interviews. If high risks are not disclosed, labor floor checks (6-405) should be performed. It may be necessary to perform a combination of these audit procedures, e.g. perform employee interviews for high risk departments and floor checks for low risk departments.

(2) Nonmajor Contractors Not Subject to Low Risk Sampling Initiative (6-104). MAAR 6 (if deemed material) should generally be accomplished by conducting labor floor checks at nonmajor contractors. Detailed labor interviews should generally not be performed unless “hard” leads have been disclosed from prior audits that suggest significant risk exists.

(3) Nonmajor Contractors Subject to Low Risk Sampling Initiative (6-104). Generally, floor checks should be performed at low risk contractors every three years. Annual floor checks should not be performed unless there are unusual circumstances increasing risk for the current year. If possible, floor checks should be conducted in the year the full incurred cost audit is planned.

d. The auditor should also be concerned with the contractor’s compliance with its policies and procedures relating to payroll and personnel, recruitment, overtime, and labor standards. The extent of audit effort in testing and verifying labor costs will be influenced by:

(1) the adequacy and reliability of the contractor's system and related internal controls,
(2) the nature and significance of labor and related expenses,
(3) prior audit experience with the contractor,
(4) the reliability and acceptability of the contractor's labor policies and procedures,
(5) the audit objectives,
(6) the contractor's mix of contracts and nature of contract provisions, and
(7) the nature of the contractor's organization and operations.

6-403 Coordinating and Reporting Results

a. Conduct an exit conference in accordance with 4-304 only after approval of the supervisory auditor. Include the contractor's reactions in the working papers and the report.

b. A MEMORANDUM FOR RECORD should be issued to close an assignment for separate functions that support the incurred cost audit for a contractor's fiscal year (e.g. MAAR 6, timekeeping procedures) prior to incorporating the results into the final incurred cost report. However, if significant internal control deficiencies are found during these audits, auditors should prepare a flash report in accordance with 10-413 and follow-up these findings in a separate labor system audit. For reporting CAS/FAR noncompliances found during the audit, auditors should follow the format in 10-808. For guidance on coordinating and reporting results on assist audits of offsite locations, auditors should refer to 6-805. During the course of the audit, the auditor may become aware of conditions

which may indicate fraudulent or other suspected irregular activities as defined in 4-702.1b. Promptly report these as described in 4-702.4.

6-404 Evaluation of Labor Cost Charging and Allocation (Employee Interviews)

6-404.1 Audit Objectives

a. The primary objective of a labor cost charging and allocation evaluation is to determine the accuracy of contractor employee (salaried and hourly) labor hour charges to contracts, indirect accounts, or other cost objectives. The auditor should determine if the recorded labor hour charges are a fair representation of the actual work performed. Hours recorded on an employee's timecard or electronic record must be adequately supported/documented if they are to be accepted as the basis for reimbursable labor costs on Government contracts.

b. An underlying principle of an effective labor charging and allocation evaluation is that it must be performed on a current basis. Experience has shown that long lapses of time between when labor effort is expended and when it is audited tend to diminish the effectiveness and productivity of the audit. Ideally, labor allocation evaluations should be performed on a real time basis, i.e., labor effort is assessed at the time of occurrence. From a practical standpoint, however, labor should be assessed as close as possible to the date of occurrence. This approach has many benefits. The employee should be better able to remember recent events, and sufficient, competent evidential matter to support audit conclusions should be more readily available.

c. Because audit resources are limited, it is impractical to audit an entire labor system at the same time. Efforts must be concentrated on those areas requiring immediate attention. To do this, it is necessary to perform an analysis on the contractor's current labor system. The analysis should help the auditor identify those problem areas most likely to result in a significant adverse cost impact to the Government (risk) and the extent of Government exposure to suspected irregular conduct (vulnerability). The analysis consists of preliminary audit effort, an evaluation of the adequacy of and compliance with internal controls (see 5-900), and consideration of other conditions which may influence the contractor's labor charging practices.

6-404.2 Analysis of Labor Charging and Allocation Procedures

The objective of the analysis of the contractor's labor charging and allocation procedures is to identify specific areas or situations where there is high risk of labor mischarging. This will usually result in the identification of specific cost or profit centers, departments, contracts or cost objectives, or employees or groups of employees where the potential for mischarging is high.

6-404.3 Preliminary Audit Effort

Because the effectiveness of the audit depends on the auditor's knowledge of the contractor's labor charging and allocation procedures, the auditor should become familiar with available background information on the contractor's organization, budgetary controls, direct/indirect labor charging policies and procedures, and results of the labor internal

controls audit (see 5-900). Obtain pertinent information from up-to-date permanent files, coordination with procurement officials, and discussions with the contractor.

a. Contractor organization charts and listings of current Government contracts are very useful sources of information and should be examined and referenced often during the audit. In addition, the auditor should update the labor portion of the permanent file to help satisfy the mandatory annual audit requirement relating to permanent files (MAAR 3).

b. Coordinate the planned audit with the ACO and other contracting officer representatives to:

(1) Ensure that adequate, but not duplicate, coverage of time-and-materials contracts is provided by the auditor and the contracting officer's technical representative (COTR).

(2) Solicit any input that may affect the audit.

(3) Establish procedures for requesting needed technical assistance (see Appendix D).

(4) Determine if the audit is to be conducted as a joint CAO/DCAA review.

(5) Establish target dates for status meetings to keep the ACO informed of the audit progress. Bring any difficulties to the ACO's attention for prompt resolution.

(6) Invite the ACO to attend the entrance conference and to suggest conference agenda items.

c. The auditor should hold an entrance conference in accordance with 4-302 to exchange preliminary information about the audit and to enable the contractor to provide a briefing about its direct/indirect labor charging and allocation policies. During the entrance conference the auditor should:

(1) Discuss the general area(s) to be covered and the general period of audit performance.

(2) Advise the contractor that the audit will include a series of unannounced employee floor checks/interviews. The contractor should designate a representative to accompany the audit team during the floor checks/interviews. A primary and alternate representative should be designated for each of the contractor's locations.

(3) Set the ground rules for the interviews; e.g., the interviews will be unannounced, the team usually will be comprised of two DCAA auditors and a contractor representative, and the representative will not be allowed to interpret the employee's responses nor be allowed to "coach" the employees in their responses.

(4) Request a contractor representative to act as coordinator for discussing audit progress and findings.

6-404.4 Evaluation of the Adequacy of Internal Controls

a. Consideration of the contractor's internal control structure is an important part of the labor audit. An adequate internal control structure is essential if the labor system is to be relied upon for cost reimbursement and as a basis for future estimates. The evaluation of the internal control structure is covered in 5-900 and must encompass both IT and manual processes that are used in the accumulation and recording of labor costs. The result of the internal controls audit will enable the auditor to determine the effectiveness of labor functions and the reliability of labor records. When combined with appropriate tests of amounts included in cost representations, internal control evaluations will provide a basis on which the auditor can render an opinion as to whether the contractor's labor cost representations are acceptable.

b. Start and Stop Time Recording

Recording of start and stop times is necessary only when the lack of such a control results in a risk of a material labor cost misallocation. Determining the need to record start/stop time is made on a case-by-case basis. The factors that should be considered in assessing the appropriateness of recording start/stop times include:

(1) nature and variety of tasks worked on each day,

(2) significance of employees working on multiple tasks compared to total work force, and

(3) mix of contracts.

After considering these factors, the DCAA auditor must exercise professional judgment as to whether there is sufficient risk to warrant recommending recording start/stop time. Inherent in determining risk is the concept that the benefit of the control --- in this case recording start/stop time---must exceed the cost of implementation.

c. Carefully consider the possible consequences when internal control inadequacies are significant. Document corrective action taken by the contractor and consider when planning the extent of testing required.

6-404.5 Evaluation of Compliance with Internal Controls

Inadequate internal controls or noncompliance with those controls greatly increase the risk that labor mischarging could be occurring. The scope of the audit should be adjusted in accordance with the risk determined in the audit of the labor system of internal controls (See 5-900).

6-404.6 Evaluation of Conditions Influencing Contractor Labor Charging Practices

a. Proper analysis requires a working knowledge of not only the contractor's operations, policies, and procedures, but also many conditions that may influence management decisions. Normally no one factor should become the sole determinant of whether an audit should be continued, expanded, or terminated. High risk and vulnerability are usually the effect of the relationships among several conditions.

b. Several conditions and appropriate evaluation procedures are presented in this section. The evaluation of these conditions may identify areas (e.g., cost/profit centers, departments, groups of employees, employee labor classifications, or contracts or cost objectives) where the potential for labor mischarging is high. When high risk exists, the auditor must also be alert to the possibility of fraud, and should conduct transaction tests which include a determination that records examined are not falsified. Give special consideration to unusual transactions. Journal entries and other special adjustments may provide leads for discovering improper transactions. Many fraud cases involve deliberately falsified labor distribution, payroll, and other records. Examples include fraudulent charges to cost-type contracts of costs applicable to firm-fixed-price work and fraudulent charges to direct and indirect activities of unrelated labor costs when projects, budgets, contract ceilings, or advance agreement limitations are about to be exceeded. Although no list can be all-inclusive, the following factors are examples of conditions which may influence labor charging practices. The auditor should identify the specific risk area(s) associated with such conditions by designating them as high, medium, or low risk.

(1) Mix of Contracts

Determine the Government contract mix (cost vs. fixed-price/commercial). A contractor whose contracts are all fixed-price or all cost-type would have relatively little incentive to mischarge between contracts. On the other hand, a contractor with a mix of cost-type and fixed-price/commercial work would generally have a much greater motivation to charge effort allocable to fixed-price or commercial work to a cost-reimbursable contract.

(2) Overrun Contracts

When contract costs have exceeded or are projected to exceed contract value, contractors may divert these excess costs to other cost objectives such as indirect labor, overhead accounts, other contracts, etc. Request the contractor to provide a listing of all contracts that are currently in an overrun position or projected to be in an overrun position. The ACO can also often provide information on "trouble contracts."

(3) Restructuring Costs

Evaluate the contractor's labor charging practices for its restructuring activities. Determine if the contractor is properly classifying restructuring activities in accordance with established agreements and DFARS 231.205-70. As actual restructuring expenditures near the negotiated restructuring cost ceiling, there is a risk that restructuring costs may be mischarged to other accounts. Determine if the incurred and projected restructuring costs are near or in excess of the negotiated ceiling.

(4) Significant Increases in Direct/Indirect Labor Accounts

(a) Trend analyses may disclose instances where charges to direct or indirect labor accounts have increased significantly. Sufficient analysis should be performed to determine the nature of the increase. The auditor should evaluate changes in procedures and practices for charging direct/indirect cost for consistency with generally accepted accounting principles, the applicable contract cost principles, and any applicable Cost Accounting Standards requirements.

(b) The auditor should also perform comparative analysis of sensitive labor accounts. When the comparative analysis indicates a possible misclassification of direct labor cost or some other condition that cannot be adequately explained, the auditor should pursue the matter further, (e.g. the contractor may be misclassifying direct contract costs to selling and marketing or IR&D/B&P costs.) Analysis in this area may satisfy the mandatory annual audit requirements relating to changes in charging direct/indirect cost and analysis of sensitive labor accounts (MAARs 7 and 8). An example of a sensitive labor account is standby labor. Standby labor is generally defined as the unproductive time caused by and limited to idle time, capability retention, and waiting for special customer security clearance (Additional examples of sensitive labor accounts are presented in other sections of 6-400).

(5) Reorganization/Reclassification of Employees

The organizational structure of the contractor should be analyzed to determine if it permits inconsistent treatment of similar labor. In some instances, reorganizations and reclassifications are implemented to achieve an accounting objective that was not possible under the previous structure. Sufficient review should be performed to determine if the changes will have an impact on Government contract costs.

(6) Adjusting Journal Entries/Exception Reports (Labor Transfers)

Determine if there are any unusual labor transfers made via adjusting journal entries. Adequate rationale and supporting documentation should be available for all significant labor transfers. Evaluations in this area require the auditor to be knowledgeable about how adjusting entries are put into the system, either manually and/or by computer. If

some significant entries appear to be more than just normal corrections, the Government risk and vulnerability is high and the area should be reviewed. Evaluations in this area may satisfy the mandatory annual audit requirement relating to labor adjusting entries (MAAR 10).

(7) Budgetary Controls

Many contractors operate management systems that require strict adherence to budgetary controls. If the system is inflexible, labor charges may have a tendency to follow the identical route of the budgeted amounts, especially if managers' bonuses or incentives are determined based on performance against some predetermined budget. Rigid budgetary control systems can result in predetermined labor charges. Refer to the audit of the contractor budgets as described in 5-500.

(8) Contract Definition Contracts

Contract Definition (CD) contracts are generally fixed-price contracts for a short duration. They are usually awarded to several contractors who will compete for a major follow-on prime contract. The procurement activity will use the results delivered under the CD contracts to help define exactly what it wants in the prime contract and then issue an informative RFP. Since the contractor's performance on the CD contract will have a direct bearing on its chance of winning the prime, there may be a tendency to spend more than the established contract value. Therefore CD contracts are highly susceptible to labor mischarging and the auditor should evaluate to make sure all allocable effort is being charged.

(9) Contract Provisions

Any contract or contract modification may contain certain provisions which increase the incentive for labor mischarging. A common example of such a provision is one which puts ceilings on certain cost elements or rates. Similarly, Time-and-Materials/Engineering and Technical Services contracts may include task order funding ceilings which are enforceable when contract language so provides. These ceilings prohibit the contractor from recovering any costs incurred above these preestablished limits. The existence of costs incurred in excess of ceiling limitations should alert the auditor to possible improper cost transfers. Another example of a contract provision which increases the risk of labor mischarging is a "Cost Sharing Clause." Such clauses may require the contractor to deliver goods and/or services at no costs to the Government.

(10) Labor Accounting by Funding

Labor accounting by funding is the controlled management and charging of labor costs to cost objectives on the basis of available funding rather than where the labor efforts are actually performed. Time-and-Materials/Engineering and Technical Services contracts possess a risk of labor accounting by funding. The availability of contract funds often controls where labor costs are charged. To the extent that this practice is employed, the procedures utilized in risk and vulnerability analysis will have to be adjusted because extensive labor accounting by funding often results in no "red flag" conditions since all cost objectives will show labor costs at or below funded levels. The auditor must be alert to this type of situation and consider factors other than cost in determining the existence or extent of this practice. For example, a review of recent deliveries made on Government contracts could reveal that no labor costs were charged to a contract during the period when deliveries occurred. Auditor initiative and imagination are important ingredients during an assessment of possible labor accounting by funding problems.

(11) Related/Similar Cost-Type and Fixed-Price Procurements

This situation is fairly common and occurs when procuring agencies award contracts for the same or similar items using different contract types. It represents a high risk condition and should be closely monitored. This situation can often result in some form of "labor accounting by funding," i.e., labor cost to the contracts involved are charged based on contract funding and ceilings regardless of where they are incurred.

(12) Offsite Locations

Significant amounts of labor costs may be incurred at contractor offsite locations where little or no audit effort has been expended. The auditor should determine if an assist audit is required based on the level of risk at the offsite location, (risk assessment factors to consider are included in 6-405.3(a)). Floor checks or labor interviews should be performed at every significant offsite location at least every three years. The assessment of risk and vulnerability will require coordination between the primary and offsite auditors. In some complex, sensitive, or high risk situations, it may be more timely, efficient, and effective for the primary site auditors to perform the offsite labor floor checks/interviews. In these situations, teaming among the primary site and offsite auditors should be considered. Requests for assist audits should be prepared and tracked in accordance with 6-805.

(13) Labor Charging versus Estimating

An evaluation in this area may reveal that the contractor is charging certain categories of labor directly to Government contracts contrary to the manner in which the cost was reflected in the bid proposal or the treatment accorded commercial contracts. The auditor should ascertain the reason for any divergence in policy. Such practices should be further analyzed.

(14) Fixed-Price Sole-Source Follow-On Contracts

Contractors may be motivated to charge effort allocable to commercial work to their sole-source contracts in order to increase the cost of these contracts, which are then used as a basis for projecting the cost of follow-on work.

6-404.7 Determining Additional Audit Effort

a. Use the results of the audit of the contractor's labor charging and allocation practices and related internal controls, including the contractor's own monitoring and testing efforts, to determine the nature and extent of further audit effort.

b. The analysis of the conditions in 6-404.6, together with the results of the audit of internal controls, may identify areas with a high risk of labor mischarging. To best utilize available audit resources, focus audit effort on those areas in which the Government's vulnerability and risk are high. For high-risk areas, sufficient analysis should be performed to assure that the Government's interest is protected. Discuss the results of the analysis with the audit supervisor and adjust the scope of the audit appropriately. As an example, the analysis may reveal the following conditions indicating high risk areas.

(1) The contractor has an overrun/behind-schedule fixed-price contract that is being worked on by a department that also has responsibility for a cost-type contract. The cost-type contract is currently under budget. The effort expended under the two contracts is similar. The ACO and PCO have expressed their concerns and dissatisfaction with the contract performance to the contractor. In addition, the department manager's bonus is dependent upon adherence to contract budgets. In this case, the risk area is all employees assigned to the department.

(2) The contractor has an offsite facility that has two fixed-price contracts and one cost-type contract. One program manager is responsible for the three contracts. The program manager's labor effort on the cost-type contract is charged direct to the contract, while the effort on the two fixed-price contracts is charged indirect to overhead. There is reason to believe that this practice is prevalent throughout the company. In this case, the area of risk is all program manager labor effort regardless of department or cost/profit center.

c. If high risk areas warranting further audit are identified, preinterview analysis and employee interviews should be performed in accordance with the procedures in 6-404.8.

d. If the analysis has not revealed any high-risk areas, the auditor should consider performing a floor check to satisfy the mandatory annual audit requirement for labor interviews/floor checks (MAAR 6), as discussed in 6-405.3.

6-404.8 Preinterview Analysis

Once high risk areas have been identified for audit, perform a preinterview analysis to identify the population of employees associated with the high risk areas, e.g., a cost/profit center, department, contract or cost objective, class of employees, etc., and to select employees to be interviewed. The employee population is usually all employees charging and/or assigned to the risk area. From this population, specific employees will be selected for interviews. Sufficient data must be gathered so that an informed decision can be made on the selection of employees. The employees with the most questionable labor charges are normally interviewed. Just as the risk and vulnerability analysis started with the contractor's entire labor system and narrowed the audit scope to selected areas of risk, preinterview analysis starts with all the employees charging/assigned to the risk area and narrows selected employees with the most questionable time charges within that risk area.

a. To determine what the high risk population is, the following steps should be performed for each high risk area identified:

(1) Review labor distribution documents and payroll runs to identify all employees charging labor effort or assigned to the risk area. Consider using data retrieval program for this. (See 4-504 for additional guidance.) Prepare a schedule of employees charging a major portion of their time to the risk area.

(2) Obtain additional evidential matter by reviewing other relevant available documentation related to the risk area, e.g., organization charts, travel reports, contract files, work authorizations, Material Inspection and Receiving Reports (DD Form 250), contract status reports, etc. Gather as much information regarding the risk area as possible before performing any interviews. For example, if the identified risk area is a certain contract, evaluate enough available documentation to gain an understanding of the scope of contract work, contract delivery schedules, special contract provisions, etc. This evaluation may also identify employees who have worked on the contract but have not charged labor effort to it.

(3) For employees identified in (1) and (2) schedule labor time charges for an appropriate recent period of time. The appropriate time period will vary with each audit. Determine if any significant trends exist. Identify all employees with irregular or inconsistent charging patterns. Focus attention on those employees with the most questionable time charging patterns.

(4) For employees identified in (3), physically inspect timecards (or other source document) starting with the most current time period. Review each timecard for:

(a) consistent time splitting (be especially alert to employees working multiple jobs in a day),

(b) changes in charging patterns, and

(c) corrections, alterations, white-outs, or indications that someone else is completing the timecard.

(5) For employees identified above, review travel expense reports and compare travel charges to labor distribution charges. Look for inconsistencies.

(6) Gather additional pertinent information on each employee's time charges by reviewing other available documentation. Obtain an understanding of the nature of the work for each contract/cost objective charged during the review period, the time spent on each job including accurate time charging when multiple jobs are worked on a daily basis, and any other relevant information. Also, review 5-914 and 5-915 for additional examples or risk areas.

b. Selection of employees for interview should be made as a result of the above evaluation. Select employees whose time charges and review of other documentation indicate a high probability of mischarging. There should be a strong indication that the selected employees have mischarged their labor effort.

c. If no employees in the risk area appear to have questionable time charges, discuss terminating the audit of the risk area with the audit supervisor.

d. An important phase of preinterview analysis techniques is the preparation of adequate working papers. Careful preparation of working papers is critical to the establishment of a basis for effective interviews. Consistency in working paper preparation should be maintained throughout the evaluation. The working papers should include the employee name and ID number, date of interview, the attendees, the reason for employee selection, an interview summary, and audit conclusion.

e. Data gathered during the preinterview analysis forms the basis for questions asked during the interview. Formulate the questions to be asked each employee and anticipate the responses. The questions should be designed to confirm the employee's suspected mischarging. Keep questions factual in nature; avoid questions which solicit the employee's opinion. Develop a "game plan" for each interview.

6-404.9 Detailed Employee Interviews

Effective interviews and an evaluation of the labor system of internal controls (see 5-900) can provide sufficient information to form an opinion on the adequacy of, and compliance with internal controls and the propriety of the recorded labor charge. Justification for performing detailed employee interviews is provided by GAGAS (see 2-302.3). The second standard of field work requires that sufficient competent evidential matter be obtained through inspection, observation, inquiry, and confirmation to afford a reasonable basis for an opinion on costs recorded. (See 2-302.3).

a. The conduct of employee interviews will vary according to the amount and quality of pre-interview data gathered. Certain basic steps should be followed when conducting interviews:

(1) Interviews should be performed on a current basis to be effective. Recent events are fresh in the employee's mind and responses to questions on current time charges will usu-

ally produce the most reliable audit evidence. However, the auditor is not precluded from asking questions about general time charging patterns that may have occurred over an extended period of time.

(2) All interviews should be conducted at the employee's work location because documentation is readily available.

(3) The interview team generally should be comprised of two DCAA auditors: one interviewer, one recorder. The recorder is expected to ask pertinent questions overlooked by the interviewer. In addition, a contractor representative should accompany each team (see 6-404.3c(3)).

(4) The contractor should not be advised ahead of time about the specific department or individuals to be interviewed. Advance notice of time of the interviews or the employees to be interviewed will not be given.

b. The length and complexity of the interview will vary with the number and types of discrepancies disclosed during preinterview analysis. There is no questionnaire used because questionnaires may raise problems regarding distribution to employees and access requests by contractors. However, below is a list of certain general information that will be elicited from each employee interviewed and documented on a labor floor check worksheet to facilitate recording of the employee responses:

(1) Employee's name and identification number.

(2) Employee's current job title, position description, and nature of his or her work.

(3) Employee's current projects and the period of performance.

(4) Description of the nature of work performed during the period being evaluated.

(5) Percentage of time worked on each project.

(6) The charge numbers/accounts used to record their effort on each job.

(7) How and from whom work authorizations and charge numbers are obtained.

(8) Employee's timekeeping procedures, including maintenance of informal logs.

(9) Any other relevant information resulting from employee responses or observations at the employee's workstation.

c. Listen and record the employee's complete response and be alert to any comments or reactions that seem inconsistent. Ask appropriate follow-up questions.

d. Obtain any available documentation from the employee substantiating the labor effort. Documentation may include final reports, trip reports, drawings, working papers, inventory tags, etc.

6-404.10 Development of Findings

a. Data gathered during the interview, compared with information obtained in the preinterview analysis will either confirm the employee labor mischarge or establish the propriety of the charge. Labor mischarges confirmed during interviews should be discussed with the audit supervisor and, if an assist audit, with the requesting FAO. Sufficient analysis should be performed to determine if the mischarge represents an isolated instance or is indicative of a more widespread condition. Determine if more audit effort (interviews) is needed to support the audit conclusion. All conclusions must be fully documented.

b. Each risk area should be treated independently. This approach results in a more effective evaluation and diminishes the chance of wasting time during the evaluation.

c. Determine any costs questioned related to labor mischarges. Costs questioned should be specifically identified (contract, department, cost center, etc.) to each risk area.

6-405 Observations of Work Areas (Floor Checks) Procedures

6-405.1 Audit Objectives

a. The audit objectives include: (1) an evaluation of the contractor's compliance with its internal controls and procedures to insure the reliability of employee time records and (2) the physical observations (floor checks) of work areas to determine that employees are actually at work, that they are performing in the assigned job classification, and that the time is charged to the appropriate job.

b. Floor check procedures are appropriate when there is limited Government risk or vulnerability. If conditions indicating a high probability of mischarging exist, a comprehensive analysis of labor charging and allocation, including employee interviews, as described in 6-404 is appropriate.

c. The performance of floor checks will satisfy the mandatory annual audit requirement relating to labor floor checks (MAAR 6). This MAAR is classified as concurrent and must be performed for the current year during the first field visit to the contractor facility within the year. This will normally be accomplished during a price proposal audit, or annual incurred cost audit, or within a specific labor audit assignment. Floor checks (or labor interviews) must be performed at least annually except for contractors subject to the low risk sampling initiative (6-104). See 6-402c.(3) for frequency of floor checks required at these low risk contractors.

d. The extent and frequency of additional floor checks should depend upon the adequacy and reliability of the contractor's system for controlling the accuracy of time charges, materiality, internal controls, the frequency and effectiveness of floor checks by contractor personnel, and the results of previous floor checks. (See 6-405.3(a) for audit coverage at off-site locations).

e. Floor check procedures include evaluating the contractor's timekeeping procedures, selecting employees to be floor checked, gathering background data, performing the floor checks, and summarizing the results.

6-405.2 Procedures for Evaluating Timekeeping Controls

Obtain an understanding of the contractor's timekeeping procedures prior to performing floor checks. Consider the results of the audit of the control risk assessment documented in the internal control audit planning summary and the audit of internal controls relating to timekeeping (see 5-900). The evaluation of timekeeping procedures should include the following procedures:

a. Establish the validity of the time records by observing the contractor's timekeeping system in operation. This includes an observation and evaluation of the method for recording time and periodic physical observations of the work areas.

b. Determine whether employee attendance is controlled by clock cards, timecards, or other suitable time and attendance records and review contractor's procedure for checking employee early leave and late arrival.

c. Review and evaluate the system by which employee time records are controlled at each timekeeping station, including assignment of job numbers for tasks performed. If job cards are completed by employee, evaluate procedures for notifying the worker of the

assigned job number. Determine whether procedures provide that all changes are properly initialed by the employee who initially prepared the time ticket or job card and the approving supervisor.

d. Determine whether hours shown on time tickets or job cards are reconciled periodically with the hours recorded on attendance records and the total hours recorded on the payroll.

e. Determine whether there is a division of responsibility between personnel responsible for the preparation of time and attendance records and those responsible for the preparation and distribution of the payroll.

f. Determine whether there is a division of responsibility between personnel having a part in the preparation of time and attendance records and those responsible for operating within budgets.

g. Determine whether procedures have been established for coding and recording idle time. The auditor should review or prepare an analysis of idle time according to the reasons for idle time such as waiting for inspection, lack of materials on hand, etc., and ascertain whether the contractor has taken corrective action to reduce the idle time.

h. Determine whether records of piecework and work performed under wage incentive plans are checked and controlled independently as to production counts, approvals for allowances, and other operations.

i. Perform independent floor checks and test employee attendance and the accuracy in recording the work performed for all shifts.

j. When appropriate, request representatives of the contracting officer to accompany the auditor on floor checks.

k. Scan batches of labor distribution documents for obvious errors or arbitrary allocations of time to contracts.

l. Determine if the contractor has an employee work at home program and assess the materiality of the costs incurred by employees in the program.

6-405.3 Procedures for Performing Physical Observations

Floor checks should be conducted in a manner which will least disturb the normal operations of the contractor. When appropriate, other Government personnel or contractor representatives may accompany the auditor during the floor checks. The extent and frequency of floor checks should depend upon the adequacy and reliability of the contractor's system for controlling time, internal controls, the frequency and effectiveness of floor checks by contractor personnel, and the reliability of the records indicated as a result of floor checks. Consider the procedures described below in conducting a floor check.

a. Identify the population of employees by obtaining a control list of persons assigned to the department or area to be checked. A listing of employees by location will be helpful in determining any necessary assist audits (see 6-805). As part of the annual planning process, auditors need to consider the risk at off-site locations. If only minimal risk is indicated, the FAO does not need to select the location to perform a floor check at this time. However, as a minimum, floor checks should be performed at significant off-site locations at least every three years. To the extent possible, the assist audit requests should be made at the beginning of the contractor’s fiscal year to allow sufficient time for the FAO(s) cognizant of the off-site location(s) to plan and perform the audit(s). Some risk assessment factors to use for selection of the off-site locations are:

- Results and currentness of prior audits
- Headcount at each site
- Pattern of direct vs. indirect charging
- Number and mix of contracts at the site
- Contract overruns
- Contract values at the respective sites
- Facility dedicated to a specific contract/program vs. a facility that supports multiple contracts/programs
- Audit leads and discussions with the contracting officer cognizant of the off-site locations.

When a common area is used to perform Government and other production, a floor check of the Government work alone is not sufficient. To establish over-all control, check the entire department, work area, or specific labor category, but when circumstances warrant, emphasize the Government portion of the operation.

b. Select employees to be floor checked. Employees may be selected either randomly or judgmentally, depending upon the audit circumstances and objectives. If chosen randomly, procedures described in Appendix B should be followed.

c. Gather background data relating to the selected employees. Appropriate data may include:

(1) Employee identification numbers.

(2) Employee job classifications.

(3) Nature of the work usually performed by the employee and by the department or cost center to which he or she is assigned.

d. Offer the contractor an opportunity to designate a representative to accompany each audit team during the floor checks. A primary and alternate representative should be designated for each of the contractor's locations.

e. Determine the make-up of the floor check team. The auditor should use judgment in determining the makeup of the team; however, the team generally should include two people. Possible other team members include an ACO representative such as a technical specialist or contract specialist, or a contractor representative such as an internal auditor. In more sensitive situations, (e.g. contractor frequently challenges floor check findings), two auditors: one interviewer and one recorder may be appropriate.

f. Ensure that all team members are thoroughly briefed on the overall audit objectives and that they have the necessary background knowledge to contribute to the floor check.

g. Obtain a plant layout and note the location of employees selected for questioning.

h. Floor check the employees selected. The employee's manager should not be present unless it will facilitate accomplishment of the objectives. Try to question all selected employees in a given work area before moving to another. If a particular employee cannot be located, obtain contractor assistance. Note, however, that seeking such assistance has the effect of providing advance notice of the floor check.

i. Identify each selected employee at work in the department or area being observed and check to the control list, showing the time observed. Determine whether the employee is performing in the proper capacity as direct or indirect labor and whether time is being charged correctly by discussing the nature of the work being performed with the employee and observing the actual work performance. If an employee's time for the prior period was charged to a cost code or work project other than the one he or she is working on during

the floor check and the nature of his or her work is not such that it obviously entails frequent job changes, the employee should be queried regarding his or her work assignment in the prior period. This procedure may disclose errors, adjustments, or alterations to the prior period labor distribution records which require further analysis.

j. Discuss the employee's timekeeping procedures to determine compliance with established internal controls and to determine if the employee has received adequate orientation and training. Question the employee to ascertain the following:

(1) Procedures for receiving the timecard.

(2) Procedures for receiving work assignment charge numbers and descriptions.

(3) Procedures for completing and submitting the timecard.

k. Listen patiently and attentively to the employee's complete responses to questions. Do not interrupt or answer for the employee nor allow the contractor's representative to do so.

l. Record the employee's complete response and be alert to any comments or reactions that seem inconsistent with question responses.

m. Compare responses with previous data gathered. If inconsistencies arise or further clarification is required, ask appropriate follow-up questions.

n. Obtain explanations promptly (before the close of the shift whenever possible) concerning all questionable procedures or practices observed during the floor check. Determine the reasons for any timekeeping discrepancies noted on the control list, such as: employees at work who are not on the control list, employees on the control list who could not be located, reasons for time being charged to work which is not being performed, reasons for working at other than assigned labor classifications, and reasons for idleness. When employees selected for interviews are unavailable, follow-up effort is required to verify the existence of the employee. Auditors should attempt to interview the employee at a later date. It is acceptable to limit the follow-up interview to satisfy this single objective, i.e. employee existence, if sufficient steps were already accomplished to satisfy the other audit objectives of the labor floor check. If a follow-up interview is impractical, other audit steps should be conducted to verify employee existence. These steps could include, but are not limited to a review of personnel /security files; observations of the employee’s work area; follow-up telephone interviews; and/or video teleconferencing. The extent of the additional audit steps to be accomplished should be based on auditor judgment.

o. Determine whether the observations made during the floor check are properly reflected on the payroll and labor distribution records. Advance planning may be required to assure that the records are available in sufficient detail to make this check possible. When the contractor's timekeeping system is automated, special print-outs may be required. For assist audits conducted at off-site locations, the auditors at the primary location are responsible for reconciling the time charges collected at the time of the employees’ interviews to the labor distribution records when the official books and records are maintained at the primary location. Prime and off-site auditors should effectively communicate to assure adequate supporting documentation is provided for the prime auditors to perform this reconciliation.

p. With automated timekeeping procedures, additional care must be taken in the design of the floor check and the subsequent comparison to labor distribution records. An automated system uses remote data entry terminals to record labor charging data directly to the computer for processing. Supporting documentation normally consists of machine printouts showing data that, in a manual system, appears on source docu-

ments. A computerized system can be programmed to alter the labor cost distribution and prepare printouts to support it. The effect is the same as a manual alternation of records. The computer, however, can do the job more efficiently and without involving large numbers of people. If internal controls over the automated system are weak, consideration should be given to expanding the floor check into an audit of labor cost charging and allocation (6-404).

q. Be alert to unusual situations such as employee idleness, extensive use of labor for rework or remake operations, excessive number of workers or inefficient use of workers assigned to Government work, lack of appropriate protection of property from theft or the elements, use of maintenance supplies to construct capital assets, unused floor space or equipment, or assignment of the more efficient workers to commercial work while similar Government work is being performed by less efficient workers receiving substantially the same rate of pay. Information to substantiate the use of less experienced workers on Government contracts may be developed from an examination of personnel records (length of service and background experience), labor tickets, and payroll. When a situation as described above exists, ascertain the reasons for the condition, whether it is permanent or temporary, and whether corrective action is necessary.

r. Discuss the results of the floor checks with the audit supervisor and summarize the results of audit.

6-405.4 Access to Restricted Areas (Floor Checks)

Occasionally during the course of a floor check an auditor is denied access to an employee, documentation regarding the employee's work, or an area of the contractor's facility due to security reasons. The floor check audit team should not automatically omit selected employees because of these security restrictions. When access is denied, the auditor should work with the FAO security control officer and the contractor to make arrangements for obtaining special access in accordance with 1-503.1. If it is determined that another audit organization has cognizance of the area, an assist audit request to that organization should be considered.

a. At contractors where both the regular and Field Detachment DCAA FAOs have audit workload, annual coordination meetings are held between the two FAOs to determine the cognizant FAO and discuss the responsibilities of each FAO. During this meeting, the FAOs should discuss suggested procedures to follow where access is denied during a floor check because of security clearance reasons.

b. If there is reason to believe that the denial of access to the restricted area is not based on a Government-imposed security restriction and the auditor has the appropriate clearance to obtain access, carefully consider the guidance in 4-803 and 4-708 to determine whether this condition should be reported as an unsatisfactory condition or an obstruction of audit. If the auditor is denied access to documents or records required in the audit, carefully consider the guidance in 1-504 to determine whether the procedures cited in DCAA Instruction No. 7640.17 are applicable.

6-405.5 Contractor Employee Work at Home (WAH) Programs

With the advancement of information technology, defense contractors are establishing employee work at home programs. The following are the minimum internal controls

necessary for a contractor's work at home policies to be considered acceptable for Government contract costing.

a. Materiality

(1) When a WAH program is identified, auditors should first assess the materiality of the costs associated with the contractor's employees who work at home. The determination of materiality should consider factors such as the total number of contractor employees, the number of employees under the WAH program, the dollar amount of WAH labor, and the mix of contracts.

(2) If costs associated with the WAH program are determined to be material, the contractor's policies and procedures covering the program should be evaluated to determine if adequate internal controls over the WAH program are in place. If the contractor does not have adequate written policies and procedures, the contractor should be cited for a labor accounting system deficiency, usually under the Labor Authorization/Approval or Timekeeping control objectives.

(3) If the costs of the WAH program are not material and the contractor does not have written policies and procedures, the auditor should notify the contractor in writing that if WAH costs become material, the Government will require a demonstration of the adequacy of the internal controls over the WAH program. In addition, the auditor should establish acceptability of the employees' labor costs by other means.

b. Audit of Internal Controls

Good internal controls over the WAH program should address at a minimum:

(1) Eligibility and status. These programs are usually offered to employees on an exception basis for situations where attendance at the company facility is a hardship such as when an employee is injured. However, adequate policies should include a description of the type of work that may be performed at home. The auditor should evaluate the reasonableness of performing this work at home. For example, work that must be closely supervised, requires access to non-portable equipment or depends on the frequent interaction with others, cannot be performed at home. The contractor's policies should also include the status of employees working at home (e.g., full time, part-time, temporary, etc.) and the employee's eligibility for benefits such as insurance and leave.

(2) Approval policy, employee performance, work schedule and attendance. Contractor policies and procedures should require:

- proper advance approval by appropriate management officials,
- continuing evaluation of the participating employee's performance in completing assigned tasks,
- written documentation of the specific tasks to be performed along with expected completion dates,
- that WAH employees attend periodic meetings at the contractor's work site to allow the employee and supervisor to discuss work progress, assign new tasks, and evaluate work performed, and
- that WAH employees work a mutually agreeable set of core hours to allow management to have access to the WAH employee at designated times.

(3) Timekeeping Requirements. WAH employees should be required to submit timecards in accordance with the company-wide timekeeping system. Copies of the timecards should be kept at the company facility.

c. Floor Check Procedures

(1) When an employee selected to be floor checked is not present at the normal work-site due to a WAH program, the employee's supervisor should be interviewed. Discussions with the supervisor should concentrate on obtaining evidence of the employee's work, and documented evidence of supervisory control over the employee's WAH schedule.

(2) The auditor should also communicate with the employee by telephone to determine if the employee has knowledge of WAH procedures, and discuss specific type of work being performed along with the related labor charge numbers.

(3) If the employee has a regularly scheduled meeting with the supervisor in the near future, any questionable procedures or practices identified in steps (1) and (2) can be discussed and verified with the supervisor and employee at that time. In addition, the individual's employment should be verified to the payroll/personnel records.

6-406 Evaluation of Payroll Preparation and Payment

6-406.1 Audit Objectives

a. The basic audit objectives are to determine:

(1) the contractor's compliance with its policies, procedures, and internal controls for the preparation of payroll,

(2) whether payroll payment procedures afford adequate protection to payroll checks and cash,

(3) whether distribution is made to employees named as payee on payroll check or pay envelope,

(4) whether there is adequate control over undelivered payroll checks or cash,

(5) whether these activities are accomplished in an economical manner, and

(6) the integrity of payroll and labor cost records by reconciling payroll accruals and disbursements to cost distribution records.

b. Accomplishment of the above objectives will satisfy the mandatory annual audit requirement related to payroll/labor distribution and tracing (MAAR 9). The extent of audit in this area will depend on the effectiveness of the contractor's accounting procedures. Thus the early identification of system weaknesses is of prime importance to efficiently satisfy this MAAR.

6-406.2 Audit Procedures

a. Payroll Preparation. The auditor should evaluate: the results of the labor internal controls audit, 5-900; and organizational responsibilities to ascertain whether the payrolls are prepared by personnel independent of persons responsible for the timekeeping operation and for the actual payroll payment. In evaluating compliance with the internal controls for payroll preparation, the auditor should be guided by the following procedures:

(1) Ascertain the accuracy of the basic payroll records (clock cards, job tickets, assignment records) and evaluate the method for processing the data.

(2) Evaluate the methods used to reconcile the totals of clock cards and job tickets and note changes made in time recorded on clock cards.

(3) Ascertain whether all time adjustments, other than apparent and obvious arithmetical errors, indicate evidence of supervisory review and control.

(4) Ascertain whether pay rates in effect are supported by written authorization from the personnel department or other authorized source.

(5) Determine whether suitable cross checks are maintained within the payroll department for verifying the accuracy of names, rates, hours, extensions, deductions, footing, and accounting distribution.

(6) Reconcile payroll totals (dollar value and hours) with totals of related labor cost distribution records. This reconciliation attests that the labor charges to contracts represent actual paid or accrued costs and that such costs are appropriately recorded in the accounting records. Completion of this will help satisfy the mandatory annual audit requirement relating to payroll/labor distribution reconciliation and tracing (MAAR 9). Under certain circumstances, the auditor should request the contractor to reconcile total labor to the payroll tax returns, IRS Form 941. This additional reconciliation should be requested as part of:

- a major contractor incurred cost audit when a contractor's labor system has been determined to be inadequate due to deficiencies found in the contractor's payroll preparation and payment control activities, or
- a nonmajor contractor incurred cost audit except when the auditors have performed a labor system audit and determined the payroll preparation and payment control activities to be adequate.

(7) Determine the adequacy of procedures to assure that payroll advances are not charged as a direct or indirect expense.

(8) Test pay rates by reference to labor union or other employment agreements, applicable contract provisions, and contracting officer approvals.

(9) Evaluate the methods used for reconciling over-all payments to labor cost distribution records.

(10) Evaluate the periodic reconciliations performed by the personnel department from the information submitted by the payroll department.

b. Payroll Payments. In verifying payroll payments, the auditor should observe, on an unannounced basis and in selected areas on a test-check basis, the actual distribution of checks or cash to employees, including the method used to identify employees. The auditor should determine the methods for safeguarding pay checks or cash for persons absent on the regular pay date and the procedures for subsequent payment to employees. The auditor should be guided by the following procedures in examining payroll disbursements:

(1) Determine whether all employees are paid by prenumbered checks and whether the contractor accounts for all numbers.

(2) Ascertain whether checks prepared in error are voided by permanent notation and are filed in numerical sequence with the canceled checks. The contractor's procedures should provide for obsolete or surplus checks to be destroyed in the presence of authorized personnel and the destruction evidenced by their signature.

(3) Ascertain the disposition made of unclaimed payroll checks. Where the Government has been charged for the cost represented by unclaimed checks, the auditor should determine that costs to the Government are properly adjusted, either by payment to the Government, by a credit to the accounts originally charged to an overhead account, or in some other equitable manner.

(4) Compare selected names on the payroll with personnel records to establish authenticity of employment and pay rates.

(5) Determine whether the contractor's internal audit staff observes the distribution of payroll checks at unannounced intervals.

(6) Evaluate the manner in which the reconciliation of the payroll bank account is performed, and determine whether it includes:

(a) examination of endorsements on paid checks,

(b) accounting for the numerical sequence of checks,

(c) a comparison of checks with the payroll records, and

(d) appropriate action to cancel long-outstanding checks.

The reviews and reports of this function by the contractor's public accountant and internal auditors should be considered.

6-407 Evaluation of Personnel Policies and Procedures

Evaluation of the contractor's personnel policies and procedures should assist the auditor in determining the extent of verification and testing required.

6-407.1 Evaluation of Management Policies

a. The evaluation of the contractor's policies and internal controls for:

(1) hiring, assigning, dismissing, and controlling the labor force,

(2) establishing pay rates, rate changes and any additional compensation,

(3) establishing attendance and time keeping controls,

(4) authorizing and monitoring overtime and multi-shift work by hourly paid personnel,

(5) authorizing, controlling, and disposing of compensatory time worked by salaried personnel, establishing vacation, sick leave, and holiday allowances, and

(6) establishing and maintaining surveillance over categories for direct and indirect labor classifications is covered in 5-900.

b. The auditor should obtain an understanding of the internal control for personnel records. Effective controls should include as a minimum, the following practices and procedures:

(1) Hiring and dismissal of employees should be approved by responsible company officials.

(2) The personnel department should exercise control over all absences.

(3) Reasonable ranges of compensation should be established for each salary and wage grade.

(4) Payroll increases or decreases should be approved by a responsible official of the personnel department.

(5) Procedures should be established in the personnel department for the prompt reporting to the payroll department of all changes affecting payroll, such as new hires, rate changes, dismissals, and other employee separations.

(6) Personnel records should be maintained for each employee. The records should be independent of the payroll department and should include information such as the date of employment, pay rate, classification, terms of employment, personal history, and approval for hire.

(7) The payroll department should compile a listing of all employees by class, department assigned, and pay rate. This information should be forwarded periodically to the personnel department for reconciliation with its records.

6-407.2 Evaluation of Advance Planning Procedures

The auditor should evaluate the contractor's plan for establishing the proposed level of operations and should review all significant contemplated increases or decreases in labor costs. When marked increases in production are planned, the auditor should review the contractor's plans for lead time in hiring, training, and utilizing additional personnel. When necessary, the auditor should seek the opinion of qualified Government technical personnel. Improper lead time may generate unwarranted costs either by hiring personnel in advance of need (considering the training period) or by not hiring soon enough and thereby disrupting the production line. When the contractor contemplates a cut-back in production, and a consequent decrease in personnel, the auditor should evaluate the contractor's plan for decreasing personnel and determine whether the contractor is retaining the higher salaried technical and supervisory personnel beyond the required period at an increased cost to the Government. The auditor should ascertain that direct labor personnel who should be terminated are not transferred to duties of an indirect nature without justification. This is particularly important when the Government is sharing substantially in the contractor's indirect expenses. These procedures will satisfy the mandatory annual audit requirement relating to changes in charging direct/indirect cost (MAAR 7).

6-407.3 Evaluation Guidance

In evaluating the contractor's personnel practices, the auditor should include, but not limit his or her evaluation to the following:

a. An analysis of the corporate minutes generally record top-management decisions which affect personnel policies. (In multi-plant operations, this analysis is usually made by the Contract Audit Coordinator or the auditor of the corporation home office.) This will help satisfy the mandatory annual audit requirement relating to charging direct/indirect cost (MAAR 7).

b. An evaluation of the current written operating procedures which apply to personnel activities.

c. An analysis of the actual practices followed at the operating levels and a comparison of these practices with the written procedures.

6-407.4 Evaluation of Procedures for Determining Personnel Requirements

The auditor should evaluate the procedures by which the contractor determines the required number and classification of personnel. When contractors have been producing under Government contracts over an extended period of time at approximately the same level of operations, requirements usually are based on personnel turnover experience. When a program is undergoing expansion or when the contractor has been awarded a contract for the first time, determination of the number, type, and quality of personnel required is usually based on the contractor's estimates. The auditor's evaluation of the contractor's basis for determining personnel requirements should include, as a minimum, ascertaining:

(1) that the policies are sound, clearly stated, and generally applicable to a prudently operated business,

(2) that the request for personnel is approved by a responsible executive, and

(3) that when a request for additional personnel is submitted it is supported by valid reasons and management has considered all other alternatives before granting the request.

6-408 Evaluation of Recruitment Costs and Practices

6-408.1 Area of Coverage

The recruitment of most employees is a function of the personnel department. Costs incurred include:

(1) help wanted advertising,
(2) salaries and travel expenses of company personnel engaged in recruiting efforts,
(3) travel and living expenses of applicants and new employees,
(4) expense of moving household effects of new employees, and
(5) fees paid to employment agencies.

6-408.2 Audit Objectives

The audit objectives are to establish whether:

(1) the contractor's recruiting policies, procedures, and practices are acceptable,
(2) the program is effectively administered, and
(3) the total cost is reasonable in comparison with the results achieved and appropriately allocated.

6-408.3 Audit Procedures

In accomplishing the audit objective, the auditor should be guided by the procedures described below:

a. Evaluate the prescribed duties and responsibilities assigned to the organizational unit responsible for recruitment activities and ascertain that they are clearly established to accomplish the assigned mission.

b. Evaluate recruitment activities for the most recent operating period and obtain, among other information, data on:

(1) Employment changes during the period under evaluation (new hirings, transfers, separations) to determine the rate of turnover by classes of employees.

(2) Recruitment efforts (applicants interviewed and employment offers made, accepted, and rejected).

(3) Sources of new hires (advertising, referrals, and employment agencies).

(4) Total costs of recruitment (advertising, salaries, travel expense of contractor personnel and recruits, relocation expense, and employment fees). The auditor should review or develop data on the cost per hire, and by type of hire, such as engineers or executives.

c. Evaluate the various types of payroll allowances or fringe benefits to employees. Determine whether allowances are in accordance with established company policy and whether they are reasonable in view of standard industry practices and criteria for determining reasonableness contained in procurement directives.

d. Ascertain the nature and extent of budgetary controls exercised over the cost of different types of recruiting methods used and allowances paid employees.

e. Compare employee turnover rates being experienced for various categories of personnel with prior years' rates and with rates anticipated by management. Consider the effect of the turnover rates on the continued need for large scale recruitment activities; or conversely, the need to reduce these activities significantly. Ascertain if measures are being taken to identify and eliminate the causes of the turnover.

f. Determine the extent to which recruitment is controlled by manpower forecasts, specific job requisitions, and by management approval.

g. Evaluate procedures used to recruit qualified technical personnel to meet work requirements.

6-409 Evaluation of Overtime, Extra-Pay Shifts, and Multi-Shift Work

The auditor should evaluate the contractor's policies, procedures, and internal controls on overtime, extra-pay shifts, and multi-shift work, and the accounting and distribution of the premium costs. The auditor should be familiar with the provisions of FAR 22.103, which includes definitions and conditions under which overtime costs may be approved under Government contracts. When overtime work is required, the contractor's policies and procedures should comply with FAR 22.103 and insure that the operations will be limited to the actual need for the accomplishment of specific work. The auditor should ascertain that the amount of work performed at premium rates is equitably divided between Government and commercial operations.

6-409.1 Audit Objectives

The objectives of audit are to determine whether:

(1) management is properly authorizing, scheduling, and controlling overtime, extra-shift, and multi-shift work,

(2) the contractor is obtaining the contracting officer's written approval when required by contract provisions,

(3) the premium costs are reasonable and properly allocable to the Government contracts,

(4) adequate control is exercised over productivity in the extra-pay periods, and

(5) compensatory overtime work by salaried personnel is properly authorized, and application against subsequent working hours is properly monitored.

6-409.2 Audit Procedures

Audit procedures should include the following:

a. A determination as to whether the contractor's practices are consistent with the Government's interests. Effective procedures should include:

(1) acceptable standards to determine the need for overtime and premium shift work,

(2) the establishment of categories of employees eligible to receive premium pay,

(3) the proper levels of management authorization, approval, and continuing control over these operations,

(4) the establishment of adequate procedures for authorizing compensatory overtime and effective monitoring of compensatory overtime credits against subsequent working time not actually worked, and

(5) the continual review of overtime and shift data by management to control overtime and shift premium costs.

b. An evaluation of contracts, when overtime and shift work is applicable, and an examination of the bid proposal and negotiating memorandum to ascertain the extent to which the contract price provided for overtime premium and shift premium expenses. If overtime and shift premiums were not considered in the contract price, the auditor should ascertain and evaluate the reasons for the overtime and shift premiums.

c. A determination that premium labor costs charged to the contract have been approved by the contracting officer, when required, and have been incurred in accordance with the contractor's normal policy.

d. A periodic review of the continuing need for the exception types of overtime operations cited in FAR 22.103-4/DFARS 222.103-4.

e. An evaluation of the accounting treatment accorded overtime premium pay and the method of cost distribution. Overtime premium pay may be treated as indirect expense or as a direct charge when it is the contractor's regularly established policy and when appropriate tests clearly demonstrate that this policy results in equitable cost allocations. Irrespective of the practices disclosed by a contractor, the question of whether or not, or the extent to which, overtime premium pay is allowable, allocable, and reasonable under a contract remains for consideration in each specific instance considering contractual requirements and applicable Government regulations.

f. An evaluation of the accounting and distribution treatment accorded shift premium pay.

g. An evaluation of the contractor's procedures for compensatory overtime work to determine that this type of work is properly authorized and performed according to an acceptable company policy and that proper monitoring is exercised by management in applying an employee's compensatory overtime to subsequent scheduled working time in which the employee does not work.

6-410 Evaluation of Uncompensated Overtime

6-410.1 Introduction

a. The Fair Labor Standards Act (FLSA) requires employers to compensate hourly workers for hours worked in excess of 40 hours per week, but the FLSA does not require employers to pay overtime to salaried employees. Salaried or exempt employees are paid a salary to provide a service. The salary (weekly, monthly, or annual) is based on providing that service in whatever time is required. Therefore, exempt employees are compensated for all hours worked including those worked beyond the normal 40-hour week. However, because most contractors' accounting systems account for labor based on a 40-hour week, the hours worked in excess of the normal 40 hours per week are commonly called uncompensated overtime. In October 1997 a new solicitation provision and contract clause, FAR 52.237-10, Identification of Uncompensated Overtime, was issued which defines uncompensated overtime as "hours worked without additional compensation in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act." See 9-505.

b. Many contractors' accounting systems do not assign costs to those hours worked by exempt employees in excess of 8 hours per day or 40 hours per week. In some cases, labor costs are distributed only to cost objectives worked on during the first 8 hours of

the day. In other cases, employees are permitted to select the cost objectives to be charged when more than 8 hours per day are worked or the contractor has an informal policy as to how employees should select the objectives to charge. For example, when a contract and B&P project are worked on the same day, the actual hours incurred on the contract might be charged first and the balance up to 8 hours might be charged to the B&P project. Obviously, there is serious risk of mischarging costs to Government contracts under such circumstances.

6-410.2 Audit Objectives

The basic audit objectives are to determine:

(1) whether the contractor is accounting for all hours worked;

(2) whether the contractor is allocating an equitable share of salary costs paid to all effort performed in accordance with FAR 31.201-4; and

(3) whether all work accomplished, including that using excess hours worked by exempt employees, is included in the base for distribution of overhead costs in accordance with CAS 418.

6-410.3 Basic Audit Procedures

a. Evaluate the contractor's policies and procedures relative to work performed by exempt employees in excess of 8 hours per day or 40 hours per week. For service contracts to be awarded on the basis of the number of hours to be provided, FAR 52.237-10 requires an offeror to submit a copy of its policy addressing uncompensated overtime with its proposal. In addition, this FAR requires that an offeror's accounting practices used to estimate uncompensated overtime be consistent with its cost accounting practices used to accumulate and report uncompensated overtime hours. See 9-505.

b. Determine whether the contractor is recording all hours worked by exempt employees. If a review of the employee time records discloses that exempt employees consistently record only 8 hours per day/40 hours per week, conduct floor checks and/or employee interviews to see whether exempt employees work in excess of 8 hours per day or 40 hours per week. If they do, discuss with contractor representatives the need to record all hours worked by exempt employees in order to ensure that salary and applicable indirect costs are being equitably allocated to all effort performed by the employees during the period. If the contractor refuses to record all hours worked by exempt employees, expand the floor checks and employee interviews to determine whether the failure of the contractor to record all time worked results in a material difference in the allocation of costs to final cost objectives. Obtain the assistance of the contracting officer in requiring the contractor to record all hours worked when a material difference in allocation of costs is determined.

c. Determine whether the contractor is allocating salary costs paid to exempt employees to all effort performed in accordance with FAR 31.201-4 and CAS 418.

d. If it is determined that Government contracts are being over charged by a material amount due to an inequitable allocation of costs because the contractor does not record all time worked, the contractor should be cited as being in noncompliance with FAR 31.201-4 and CAS 418. Any material excess allocation of costs to Government contracts should be questioned or disapproved as applicable. Materiality is the govern-

ing factor when determining whether noncompliances should be cited and whether a contractor should be required to implement a total-hour accounting system. (See 6-410.6)

6-410.4 Acceptable Accounting Methods

Accounting for excess hours worked by exempt employees may be accomplished by a variety of methods, including:

a. Computing a separate average labor rate for each labor period, based on the salary paid divided by the total hours worked during the period, and distributing the salary cost to all cost objectives worked on during the period based on this rate.

b. Determining a pro rata allocation of total hours worked during the period and distributing the salary cost using the pro rata allocation. For example, if an employee was paid on a weekly basis and worked 25 hours on one cost objective and 25 hours on another cost objective, each cost objective would be charged with one-half of the employee's weekly salary.

c. Computing an estimated hourly rate for each employee for the entire year based on the total hours the employee is expected to work during the year and distributing salary costs to all cost objectives worked on at the estimated hourly rate. Any variance between actual salary costs and the amount distributed is charged/credited to overhead.

6-410.5 Other Possible Accounting Methods

Other methods of accounting for excess hours worked by exempt employees may be used by the contractor. Some of these are unacceptable and others require further evaluation to determine acceptability. Examples of methods that would require further evaluation are:

(1) distributing the salary cost to all cost objectives based on a labor rate predicated on an 8-hour day/40-hour week and crediting the excess amount distributed to overhead; and

(2) determining a pro rata allocation of hours worked each day and distributing the daily salary cost using the pro rata allocation (use of daily distribution increases the possibility for "gaming").

Evaluation should be made of the method used by the contractor to determine the significance of any inequities which may result.

6-410.6 Materiality Considerations

a. During the evaluation of uncompensated overtime, the risk that the unrecorded uncompensated overtime will materially impact the allocation of labor and overhead costs on Government contracts is an important consideration in deciding whether or not to require a contractor to record all hours worked. Auditors should make two basic determinations as part of their preliminary evaluation of uncompensated overtime:

(1) Does the risk that contractor labor cost allocations could be materially impacted by the existence of uncompensated overtime justify an expanded evaluation (e.g., number of contracts, contract mix, etc.)?

(2) Does significant uncompensated overtime exist?

b. If the preliminary evaluation of uncompensated overtime determines that:

- uncompensated overtime could materially impact labor cost allocations and
- a significant amount of uncompensated overtime exists

a determination must be made as to whether requiring the contractor to account for uncompensated overtime would have a material impact on the contractor's allocation of labor costs to Government contracts. This determination is necessary for:

(1) Recovering any costs due to the Government as a result of the unrecorded uncompensated overtime, and

(2) Supporting a recommendation to modify the contractor's labor system to account for all hours worked.

c. Determining the impact of a contractor's unrecorded uncompensated overtime can be difficult and time consuming and, in certain circumstances, the effort required to determine the impact may not be justified in view of the low risk. These low-risk situations should be documented in the Labor and Accounting System Internal Control Audit Planning Summary (ICAPS) sheet, specifically under the Labor Distribution Control Objective of this ICAPS. In those situations where sufficient risk is present and the unrecorded uncompensated overtime is significant, the auditor must take appropriate steps to determine the cost impact. Reliance on a contractor's assertion that the unrecorded uncompensated overtime is not material, in lieu of an independent and timely assessment of the situation, does not satisfy the auditor's responsibility. At a minimum, in situations when both risk and significant unrecorded uncompensated overtime have been identified, steps similar to those stated below need to be performed to determine if recording and accounting for the uncompensated overtime would have a material impact on the contractor's allocation of labor and overhead costs to Government contracts:

(1) Identify the contractor department/operation presenting the highest risk that significant unrecorded uncompensated overtime could have a material impact on the allocation of labor and overhead costs to Government contracts. In judging risk, consider the factors and conditions noted in 6-404.6, "Evaluation of Conditions Influencing Contractor Labor Charging Practices." Examples include contract mix and overrun contracts.

(2) Concentrate the floor checks/employee interviews in this department. Focus the interviews on distinguishing between the work that is performed during the hours for which time charges are recorded, and the work that is performed during the unrecorded hours.

(3) Determine if findings support the conclusion that there is a material difference in the allocation of costs because the contractor does not account for uncompensated overtime. If findings support this conclusion, perform one or more of the following steps:

(a) Expand the evaluation to other departments/operations.

(b) Discuss the situation with the ACO and determine his/her reaction to a recommendation that the contractor modify its labor accounting system to record and account for all labor hours worked.

(c) Determine the nature and extent of any further audit effort to be performed in accordance with 6-404.7.

(4) If the findings from the uncompensated overtime evaluation of the highest risk department/operation do not support the conclusion that a material difference in the allocation of costs exists, document the reasons for this conclusion in the working papers and curtail or close-out the audit accordingly.

6-411 Evaluation of Other Labor Systems (Standard Costs and Proprietor/Partner Salaries)

a. Standard Cost System. The use of standard costs (when variances are appropriately applied) to record direct labor costs for Government contracts is acceptable, particularly when the operations among several Government contracts or the operations between Government and commercial production are similar and are so intermingled as to unduly complicate the actual cost accounting processes. Use of a standard cost accounting system to cost Government contracts is permitted only when it meets the criteria in CAS 407 (see 8-407).

(1) In accepting standard labor costs, the auditor should determine the extent to which collateral labor costs such as overtime, shift premium, sick leave, and vacation pay are included in the established standard.

(2) The auditor should determine whether standards are based on formal, scientific and reasonably current studies representative of actual operations performed. The auditor should trace standard labor charges from distribution sheets to the payroll records to determine whether recorded standard operations for a given date or period conform to the actual operations for which payment was made to employees.

(3) The auditor should test related variances to product line to determine whether standards and variances approximate actual costs.

(4) The auditor should also analyze variances, preferably by examining contractor's own analyses, to find the causes of variances (for example, rate, efficiency, down time, or setup). This may disclose improper charges to direct labor through the variance accounts.

b. Sole Proprietors' and Partners' Salaries. Sole proprietors' and partners' salaries usually are included in overhead. However, when owners or partners are personally engaged in performing under Government contracts, particularly in research and development contracts, their compensation may be charged as direct labor. The evaluation of time charged directly should be coordinated with the screening of other direct and indirect labor to prevent duplication of charges in direct and indirect labor. It may be more appropriate in some instances to treat the compensation of proprietors and partners as Other Direct Costs without overhead. The auditor should evaluate the reasonableness of the compensation charged on the basis of services rendered. Proprietors and partners time charged direct will also influence consideration of profit or management return. When the rate of pay has not been stipulated in the contract, the auditor should evaluate the reasonableness of the rate. The auditor should ascertain whether acceptable time records are available to substantiate the time charged to the contract. When the amount of time spent on the contract is significant, all of the individual's time should be accounted for and not only that portion of time charged to the contract. The services of a Government technical representative should be solicited when the auditor is unable to evaluate the reasonableness of the charge because of technical considerations.

6-412 Evaluation of Quantitative and Qualitative Utilization of Labor

6-412.1 Audit Objectives

The basic audit objectives are to evaluate the internal controls instituted to assure prudent utilization of staffing in the performance of Government contracts, to determine whether the costs are commensurate with the benefits derived, and to determine the reasonableness and efficiency of the labor utilization.

6-412.2 Audit Procedures

To accomplish the audit objective, the auditor should be guided by the procedures described below. The evaluation of the quantitative and qualitative utilization of labor may require the assistance of qualified Government technical personnel. The auditor should go as far as he or she can in each audit step pending technical review and analysis. When the issuance of an audit report would otherwise be unduly delayed because the technical analysis is not available, a qualified report should be issued. The auditor should identify manpower utilization reviews performed by the contractor or others and consider the results in completing the following audit procedures.

a. Evaluate the contractor's functions and related activities for quantitative and qualitative utilization of labor. The evaluation should disclose organizational and functional areas that require audit emphasis.

b. Ascertain whether the work performed by the contractor is required by the terms of the contract, properly authorized, and directed to the appropriate operational unit.

c. Determine whether there are unwarranted variations between staffing budgets allocated by upper management and staffing budgets actually used by operating or middle management. (See 5-500 for guidance on contractor budgeting procedures.)

d. Determine whether the contractor maintains adequate control over the expenditure of the technical effort to assure maximum productivity, whether this control includes the evaluation of actual work assignments and target completion dates, and whether comparisons are made with staffing budgets and staffing tables approved by management.

e. When salaries and wages constitute a significant portion of contract costs, evaluate, on a selective basis, personnel files of employees assigned to Government contract work to determine whether qualifications of workers performing the contract are commensurate with the rates charged and all other requirements of the contract.

f. Evaluate the contractor's personnel practices during start-up and phase out periods to determine whether the cost of excess personnel is charged to Government contracts in the build-up period and whether the Government contracts are unduly burdened with the retention of unnecessary personnel in the phase out period.

g. Evaluate the contractor's basis for assigning and phasing out technical personnel for both Government production and commercial operations. Audit emphasis should be accorded the phase out portion of the contract to determine the reasons for retaining certain classes of technical personnel to complete the contract. The auditor should also determine whether the contractor is assigning technical personnel in accordance with their skills. The use of highly trained personnel to perform routine work which could be performed by lower paid personnel is not economical. The use of less than qualified

personnel to perform difficult work may result in higher costs to the Government because more time and greater supervision may be required. The type of contract should be a guide to the auditor in determining the extent of verification in these areas.

h. Examine the contractor's staffing and labor control practices to determine the effectiveness of controlling idle time. If unreasonable idle time is perceived or controls are judged to be inadequate, conduct a preliminary work sampling (probe). Work sampling is described in Appendix I.

i. Compare labor classifications charged to the contract with those proposed to ascertain whether the contractor is utilizing the type of personnel for which the Government has contracted.

j. Determine whether engineering, technical writing, etc. on Government work is subcontracted rather than performed by the contractor and whether such practice results in unreasonable costs to the Government. Among the factors to be considered is whether, under the prevailing conditions, there is any necessity for subcontracting other than to meet temporary or emergency requirements. (See 7-2100 for further guidance in this area.)

k. Evaluate manual labor procedures for possible mechanization (capital investment opportunities, 14-600) which will result in increased efficiencies and economies of the contractor's operation and less cost to the Government.

6-413 Reasonableness of Compensation Costs

The guidance contained in this subsection is designed to assist the auditor in determining the reasonableness of employee compensation costs in accordance with the criteria set forth in FAR 31.205-6, Compensation for personal services. The audit of the compensation system and related internal controls is covered in 5-800. The scope and extent of any testing for reasonableness should be based on the control risk assessment and results of the audit of internal controls over compensation. Refer to 5-808.9b(1) for specific guidance on when the auditor must perform tests of reasonableness of non-bargaining unit employees.

6-413.1 Compliance with FAR 31.205-6(b)(1), Compensation pursuant to labor-management agreements

a. All costs of compensation established under an "arm's length" labor-management agreement negotiated under the terms of the Federal Labor Relations Act or similar state statues are considered reasonable unless the provisions of the agreement are either unwarranted or discriminatory against the Government in accordance with FAR 31.205-6(b)(1). That is, it will not be tested for reasonableness under FAR 31.205-6(b)(2). But it must, nonetheless, satisfy any specific compensation element allowability criteria elsewhere in FAR 31.205-6.

b. Unwarranted or discriminatory provisions exist when, under unique circumstances, the work conditions vary significantly from those contemplated by the negotiating parties or the collective bargaining agreement contains provisions that are inequitable to the Government as a class of customer by the character and nature of the work.

c. Arm's length agreements refer to those agreements between independently organized labor groups, such as labor unions, and contractor management for the purpose of establishing wage increases, hours, benefits, and working conditions.

d. Provisions of an agreement designed to set pay rates based on a given set of circumstances and conditions of employment, such as work involving extremely hazardous activities, are unwarranted if the work on Government contracts is less hazardous.

e. Provisions of an agreement are considered discriminatory against the Government as a class of customer when the agreement mandates pay provisions for work of the same character and nature that exceed those comparable to similar commercial work. Therefore, an agreement with provisions which require higher pay levels for contractor employees who work on Government contracts than for those contractor employees performing under the same conditions on commercial contracts is discriminatory. For example, a union agreement that provided for higher wage rates for construction work on a Government installation than for rates applicable to commercial construction in the same area under similar circumstances would be considered discriminatory.

6-413.2 Evaluation of the Reasonableness of Non-Bargaining Unit Compensation in Accordance with FAR 31.205-6(b)(2)

a. The auditor should apply the tests of reasonableness, in accordance with FAR 31.205-6(b)(2), in those circumstances where (1) the auditor has performed the audit procedures contained in 5-800 and has determined that the contractor’s internal control system cannot be relied upon to demonstrate reasonable levels of compensation, and (2) the auditor has identified the potential for unreasonable levels of compensation. However, when system deficiencies are of such a nature that they prevent a determination of the reasonableness of wages and salaries, follow the guidance presented in 5-808.9b(2). Before taking exception to compensation costs, consider the reasonableness test procedures as discussed in this subsection.

b. Compensation costs of owners, some executives, and other employees having a higher risk of unreasonable compensation will not be accepted on the basis of a compensation system audit without some specific testing to substantiate the reasonableness of the compensation. Refer to 6-414. These types of employees are considered to be outside the reach of established control activities.

c. When evaluating wage increases, if the compensation system is adequate, and the contractor's established practice is to provide wage increases to certain non-bargaining unit employees comparable to those given bargaining unit employees, no tests of reasonableness need be applied.

d. Compensation for each employee, job class of employees, or job grade of employees must be reasonable for the work performed. Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total per FAR 31.205-6(b)(2). In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition to the provisions of FAR 31.201-3, in testing the reasonableness of compensation, consider factors determined to be relevant by the contracting officer. Factors that may be relevant include general conformity with the compensation practices of other firms of the same size, in the same industry, in the same geographic area, and engaged in similar non-Government work under comparable circum-

stances. [For compensation paid in accordance with a labor-management agreement, refer to 6-413.1].

6-413.3 Determination of Reasonableness for Non-bargaining Unit Employees

To determine the reasonableness of total compensation, each allowable element making up an employee's total compensation (refer to 6-413.2d) is to be compared with the compensation data of other firms that meet the criteria described in subsection 6-413.2. The most likely medium for obtaining the compensation data will be market pay surveys. When market pay survey data are used in making the FAR comparison tests, identification of the firm participants and their qualifications to meet the FAR criteria is required and should be documented in the audit working papers.

a. FAR 31.205-6(b)(2) states that in determining the reasonableness of individual compensation elements consideration should be given to all potentially relevant facts. These facts include general conformity with the practices of firms of the same size, in the same industry, in the same geographic area, and engaged in similar non-Government work under comparable circumstances. The appropriate factors for evaluating the reasonableness of compensation depend on the degree to which those factors are representative of the labor market for the job(s) being evaluated.

(1) Geographic area refers to comparisons made with firms in the same locale or regional area as that of the contractor.

(2) Size pertains to comparisons with firms of relatively the same size in terms of number of employees or sales volume. Sales volume is also a factor in evaluating executives' compensation.

(3) Industry means comparisons with firms producing similar products or providing similar services. For instance, the compensation levels for a contractor whose principal product is shipbuilding should be compared to other shipbuilders. Other industries include aerospace, electrical/electronics, office equipment and computers, or research and development. The contractor's specific industries may be identified by reference to the Government's North American Industry Classification System (NAICS) codes, which are used to classify companies by industry. It should be noted that compensation survey data for several related NAICS codes is often aggregated to represent a group of industries commonly categorized, for example, as aerospace industries.

(4) Contractors engaged in similar non-Government work under comparable circumstances refers to comparable services from sources outside of the contractor.

b. All factors may not be relevant to the same extent. The extent to which each of the factors must be considered depends on the degree to which each of the factors is representative of the labor market for the job being evaluated. Relevance is directly tied to a contractor's circumstances, as explained in 5-808.8c(1). Rationale for the determination of the significance of the relevant factors to be applied must be sufficient to address the considerations of reasonableness, as set forth in FAR 31.201-3.

c. Acceptable compensation surveys to be used for applying the FAR tests should provide the appropriate relevant factor data, as outlined above, to make the comparisons, and should be determined reliable, as provided in 5-808.8c. An acceptable survey may include firms that represent more than one of the relevant factors, such as firms that are of the same size, geographic area, and industry as the contractor. If the auditor determines that the contractor’s pay surveys do not represent the relevant market for the jobs to be bench-

marked, and the auditor does not have access to additional pay surveys that adequately represent the contractor's relevant market, the auditor will refrain from performing an independent test of reasonableness. In this circumstance, the auditor will follow the guidance at 5-808.9b(2), cite the contractor for significant system deficiencies in an audit report, and allow the contractor to take corrective action. At the end of the corrective action time-frame, the contractor shall demonstrate the reasonableness of their compensation costs through the use of adequate pay surveys.

d. In those circumstances where the auditor has determined that acceptable pay surveys exist and are available for audit use, the auditor will make comparison tests with benchmarked jobs within a pay structure job class (see 5-808.2) or grade (see 5-808.3), depending upon the circumstances. However, as noted in 5-803.1c, top executive positions are unique and must be audited individually. This is true regardless of the individuals' assignment to a job class, grade or pay structure (see 6-414). All comparison tests are to be made by comparing the weighted average (or median) wage or salary of a job class or grade with those provided in an acceptable survey. Update survey(s) to a common data point for each year through the use of appropriate escalation factors. The use of external pay surveys is discussed in 5-808.8c(2).

e. More than one survey may be required to consider the significance of the relevant factors in the circumstance. If determined reliable and applicable, use the contractor's market comparison studies (see 5-808.8) wherein the contractor has selected jobs to be benchmarked and has compared them with survey job pay rates.

f. When an independent test of reasonableness is required, as provided for at 5-808.9b(1), the auditor will coordinate with the ACO to determine whether the tests are to be performed at the level of job classes of employees or by job grade. FAR 31.205-6(b)(2) provides that compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Offsets between individual compensation elements are implied in this concept in order to determine total reasonableness. In most circumstances, it will be more efficient for the auditor to test at the level of job grade of employees; however, coordinate this determination with the ACO. The auditor's independent test of reasonableness should select a sufficient number of jobs to test to establish a sufficient basis to demonstrate the reasonableness of compensation for the pay structure, whether by job class or by job grade, depending upon at what level the testing will take place. To test the reasonableness of compensation costs by job class, the auditor should compare sufficient individual jobs within the job class to comparable jobs in external pay surveys to determine compensation reasonableness. For example, to determine the reasonableness of compensation costs of the engineer job class, the auditor should compare sufficient individual jobs (junior engineer; intermediate engineer; senior engineer; lead engineer) within the job class to appropriate external pay surveys to determine that compensation for the engineer job class is reasonable. An example of testing the reasonableness of compensation costs by grade level is shown in Figure 6-4-1. The auditor must exercise judgment when making a determination on the number of jobs to test so that all significant findings are adequately supported. The auditor should consider the following before performing extensive benchmarking:

(1) In the audit of the contractor's internal controls, the auditor should have previously determined whether the contractor has a market comparison process adequate to demonstrate the reasonableness of compensation (5-808.8). Accordingly, where possible, the auditor should rely on the contractor's benchmarking effort as a baseline for determining

reasonableness. Additional audit effort will then be directed at supplementing, where necessary, the contractor's work.

(2) Because FAR 31.205-6(b)(2) provides that compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total, and offsets by job class or by grade are implied in this concept, it is likely that contractors will be able to demonstrate that compensation costs are reasonable in accordance with the FAR. Therefore, the auditor should have the contractor make a preliminary assessment of the aggregate of compensation elements that may be available prior to expending considerable resources in performing an independent test of reasonableness.

(3) A contractor with a majority of commercial and competitively awarded Government fixed price work in its business base may be under considerable pressure from its product market competitors to keep compensation costs low. This may reduce the risk of unreasonable compensation where compensation for employees working commercial/fixed priced work and employees working on negotiated Government flexibly priced work are administered the same.

6-413.4 Determination of Reasonableness of Compensation Costs

a. A compensation element is considered unreasonable if the contractor's compensation for that element exceeds the survey data weighted average (or median) rates by 10 percent. This judgment factor considers that a determination of unreasonable compensation results from material compensation system deficiencies or unjustified pay policies. A large difference between the average and median can be the result of a few atypical cases skewing the average, especially in small sample sizes. When sample sizes are small and there are material differences between average and median (e.g., executive salaries), the median should be used.

b. Each allowable element of an employee's compensation for jobs within a job class or grade is benchmarked to survey data. The benchmarking of jobs to determine reasonableness for the salary element of compensation is explained in 6-413.3f. The determination of the reasonableness for the fringe benefit element is made at the total payroll level for all jobs within a compensation system, as explained in 6-413.5. An example of determining unreasonable compensation at the grade level for the salary and fringe benefit elements of compensation is shown in Figure 6-4-1.

c. A contractor's pay structure may include jobs that cannot be compared to market survey data because of a low number of incumbents or the jobs are unique to the organization. Nonbenchmarked jobs within the same grade or job class as the benchmarked jobs are to be considered unreasonable to the same degree as the benchmarked jobs because they are of relative value based on the contractor's job evaluation system (see 5-808.7).

d. Individual elements of compensation (such as wages and salaries, bonuses, fringe benefits, and deferred compensation) may each be subject to the FAR tests and be considered unreasonable if they exceed the market survey weighted average data by 10 percent. Unreasonable costs are computed by applying the percent difference between the amount that the compensation element exceeds the survey data to the element amount. However, the aggregate of allowable elements of compensation should be considered to determine reasonableness. See 6-413.7 for guidance.

6-413.5 Fringe Benefits

FAR 31.205-6(m) states that fringe benefits are allowable to the extent that they are reasonable and required by law, employer-employee agreement, or an established contractor policy. The auditors should evaluate the contractor's compliance with the FAR criteria as outlined below and make a determination of reasonableness (see 6-413.3(a)). Benefits are considered reasonable to the extent that the total allowable (see 6-413.2) benefit package rate calculated as a percentage of payroll does not exceed the average rate of the comparison data by more than 10 percent. If the total benefit package rate is determined unreasonable, only then conduct an analysis of each of the individual elements comprising the total benefits package.

a. Legally Required. Those benefits that are required by statutory law are workers' compensation, social security, and unemployment compensation. The costs of these benefits are dependent upon the level of wages and salaries.

b. Pensions, Life and Health Insurance. An evaluation of a contractor's insurance and pension programs is normally performed as a Contractor Insurance/Pension Review (CIPR) as set forth in DFARS 242.73 (see 5-1303). The results of these reviews should be considered in the scope of the benefits program review. Refer to 4-1000 for guidance for relying upon the work of others.

c. Pay for Time Not Worked. Benefits within this category include paid vacations and payments in lieu of vacation, payments for holidays and for holidays worked, paid sick leave, and payments for National Guard, Army, other reserve duty, or jury duty. Policies necessary for the control of these benefits include:

(1) eligibility rules,

(2) the size of the benefit, such as how many holidays the company will pay for or how much vacation an employee is entitled to receive,

(3) the effect of holidays or sickness which occurs during a vacation,

(4) the degree vacation and unused sick leave time can be banked and carried over to another pay period or paid at time of termination, and

(5) circumstances for extra pay rather than paid time off.

d. Other. Other benefits include severance pay, thrift savings plans, deferred compensation plans, stock bonus plans, and employee stock ownership plans (ESOPs). The contractor's policies and procedures for these benefits should be documented, include authorization procedures, requirements for monitoring and reporting the results to management, and control ranges on amounts of benefits to be provided.

e. Allowability of Costs. The cost principles provide specific restrictions on the allowability of some of these benefits, as follows:

(1) Severance Pay - FAR 31.205-6(g), refer to 7-2107 for guidance on the evaluation of these costs.

(2) ESOP – FAR 31.205-6(q), refer to 7-2114 for guidance on the evaluation of these costs.

(3) Bonuses, including sign-on, relocation and retention bonuses, and incentive compensation, including compensation based on changes in the prices of corporate securities or corporate security ownership - FAR 31.205-6(f), (i), and (k), refer to 7-2123 for guidance on the evaluation of these costs.

6-413.6 Justification

a. Although the contractor's compensation is determined to be unreasonable, as described in Figure 6-4-1, the contractor may provide justification for the excessive compensation. Examples of this are compliance with Federal or state laws, employee relation concerns, or labor shortages. However, the contractor should provide sufficient documentation to establish a sound basis for any exceptions.

b. The contractor's justification should address the following considerations for reasonableness, as provided in FAR 31.201-3:

(1) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.

(2) The cost is generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance.

(3) Consideration should be given to generally accepted sound business practices, arm's length bargaining, and Federal and state laws and regulations.

(4) Consideration should be given to the contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large.

(5) Any significant deviations from the contractor's established practices should be considered in determining the reasonableness of a cost.

6-413.7 Offsets – Compensation Costs

a. FAR 31.205-6(b)(2) provides that compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Offsets between individual compensation elements are implied in this concept. By using offsets, the contractor can provide proof that, in total, the cost of the compensation package is reasonable.

b. An element of compensation proposed as an offset must be an otherwise allowable element of compensation, and it must be quantifiable for comparison with the compensation elements deemed unreasonable. For example, deferred compensation introduced as an offset must be based upon an allowable deferred compensation plan. Compensation based on changes in the prices of corporate security ownership, such as stock options, SARs, phantom stock plans, and junior stock conversions cannot be introduced as an offset because they produce costs which are unallowable for Government contracts. The offset items must be evaluated in accordance with the same FAR 31.205-6(b)(2) criteria used to evaluate the elements found to be unreasonable in amount; i.e., the offset compensation element must be shown to be from a similar industry, a similar sized firm, the same geographical area, etc.

c. Offsets are calculated by comparing the amount by which one element of compensation exceeds 110 percent of the survey weighted average to the amount by which the offsetting element is less than 110 percent of the survey weighted average. For example, an executive's unreasonable salary which exceeded the survey weighted average by 15 percent could be offset by a bonus that exceeded the survey weighted average by only 5 percent.

d. Offsets can be proposed at the employee’s job grade or level or by the employee’s job class. For example, compensation for any jobs in grade 8 that exceed the external pay survey weighted average by more than 10 percent could be offset by other grade 8 jobs’ compensation that is less than 110 percent of the external pay survey weighted average.

Offsets by job class, senior engineers' compensation that exceeds the external pay survey weighted average by more than 10 percent could be offset by any compensation for other jobs in the same job class (i.e., junior engineer; intermediate engineer, and lead engineer) that is less than 110 percent of the external pay survey weighted average. In evaluating the propriety of offset(s), the auditor shall coordinate with the ACO and with the regional technical programs division specialist on compensation costs.

e. An example of a test comparison by grade with offsets is shown in Figure 6-4-1. In the example, the grade compensation elements consist of salary and fringe benefits. The other elements of compensation (bonuses and deferred compensation) are either not material or not paid at the grade level.

Figure 6-4-1
Example of Determining Unreasonable Compensation at the Grade Level

Part 1 - Determining Reasonableness of the Salary Element

Grade 4 Job Title No.	(1) No. of Employees	(2) Total Salaries	(3) Average Base Salary	(4) Total Salaries of Benchmarked Jobs	(5) Survey Weighted Average Salaries	(6) Extend Survey Average (1 x 5)
0023	4	$ 108,000	$27,000	Not Benchmarked		
0026	20	550,500	27,525	$ 550,500	$21,000	$ 420,000
0045	5	140,000	28,000	Not Benchmarked		
0049	3	87,000	29,000	Not Benchmarked		
0056	6	169,200	28,200	169,200	28,000	168,000
0077	7	200,200	28,600	200,200	29,750	208,250
0084	3	81,600	27,200	Not Benchmarked		
0087	4	108,000	27,000	Not Benchmarked		
0104	4	114,000	28,500	Not Benchmarked		
0123	15	420,000	28,000	420,000	22,000	330,000
Total	71	$1,978,500		$1,339,900		$1,126,250

Extended Survey Averages	$1,126,250	
Level of Significance	1.10	Multiply
Survey Level of Significance	$1,238,875	
Total Salaries of Benchmarked Jobs	1,339,900	Subtract
Amount Exceeding Level of Significance	$ 101,025	
Total Salaries of Benchmarked Jobs	$1,339,900	Divide
Ratio	.0754	
Grade 4 Total Base Salary Dollars (Column 2)	$1,978,500	Multiply
Total Base Salary Unreasonable Cost	$ 149,179	
Variable Benefits Rate - 15%	1.15	Multiply
(see Explanatory Notes below)		
Total Unreasonable Salary with Variable Benefits	$ 171,556	

Figure 6-4-1

Part 2 - Calculation of Fringe Benefit Element for Offset Purposes

The jobs in Grade 4 have a total fringe benefit rate (variable plus fixed) of 41% for the fiscal year. (See 6-413.5 for guidance on how to evaluate the fringe benefit rate for all grades within a payroll structure.) Comparison with the U.S. Chamber of Commerce Survey Data (or a similar survey) shows the fringe benefit rate for the contractor's industry to be 40%. The contractor's fringe benefit element of compensation is 1% above the survey rate and can be used as an offset to the Part 1 unreasonable salaries. It is calculated as follows.

Survey Fringe Benefit Rate	40%	
Level of Significance	1.10	Multiply
Survey Level of Significance	44.0%	
Contractor Fringe Benefit Rate	41.0%	Subtract
Amount Under Level of Significance	3.0%	
Grade 4 Total Base Salary Dollars	$1,978,500	Multiply
Total Fringe Benefit Offset	$ 59,355	

Part 3 - Determining Total Unreasonable Compensation

Unreasonable Salary with Variable Benefits	$ 171,556	
Fringe Benefit Offset	59,355	Subtract
Total Unreasonable Compensation		
(see Explanatory Notes below)	$ 112,201	

Explanatory Notes to Figure 6-4-1

Column 1 and 2 amounts posted from contractor payroll records.
Column 3 amounts equal column 2 amounts divided by column 1 amounts.
Column 4 amounts are extensions of column 2 amounts for the benchmarked jobs. The contractor benchmarked 4 of the 10 jobs within Grade 4. This is an acceptable amount to determine the overall reasonableness of Grade 4 (see 6-413.3f).
Column 5 amounts are from commercial or contractor-prepared wage and salary surveys for the benchmarked jobs.
Variable Benefits Rate includes costs that vary directly with payroll such as FICA, pension costs, and certain insurance costs.

Total Unreasonable Compensation in this example includes a fringe benefit offset. Other elements of compensation may also be proposed as offsets. The auditor should deal with these proposed offsets in a manner similar to that above.

6-414 Reasonableness of Compensation Costs of Owners, Executives, and Other Employees Having a Higher Risk of Unreasonable Compensation

6-414.1 Introduction

a. FAR 31.205-6(a)(6) provides for special consideration of compensation costs for certain individuals. Principally, the special circumstances pertain to individual owners of closely held corporations, partners, sole proprietors, or members of their immediate families. Also included are persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. In general, the special circumstances criteria include those employees who can exercise influence over their own compensation, either directly or indirectly through the authority of a family member. The ability to influence their own compensation creates a higher risk that such employees could pay themselves unreasonable compensation.

b. Because of their ownership or family position, such persons are often company executives. However, in many cases, employees who are executives or members of a corporate board of directors, but who are not owners, have been delegated ownership type authority to act without being subject to significant oversight. Such non-owner employees should also be considered as higher risks for unreasonable compensation. Such persons would normally include officers of the company.

c. The reasonableness of compensation of owners, executives, and other high risk employees should be evaluated in incurred cost audits, if the compensation costs are considered material and no compensation system internal control audit has been performed.

6-414.2 Compensation System Review (CSR) Considerations

a. CSRs are performed to evaluate the systems utilized by the contractor to set compensation for its employees. To the extent that the systems are well designed and properly operated, the audit of compensation costs can rely to a greater degree upon the costs generated by the system. A well-designed compensation system must have internal controls included in its design which will ensure that its provisions are carried out.

b. Within organizations, there are usually employees whose decisions are not evaluated or controlled due to their positions within the organization. A CSR type audit of costs should not accept the compensation of such individuals based upon system design since there can be no assurance that the design has been or will be adhered to other than actual testing of the costs for reasonableness. Audits of compensation of employees falling into the higher risk categories should include sufficient testing to determine if the compensation of each such employee is reasonable for the period covered by the audit.

6-414.3 Ownership and Substantial Financial Interest

If an employee owns less than 100 percent of a company, the employee may still exercise influence over the decision making process. By definition, all partners in a partnership arrangement have substantial influence. Many authorities (e.g., the SEC) quantify the ownership necessary to influence a corporation's decisions as 10 percent of the voting stock. The auditor should consider all sole owners, partners, and persons meeting the 10 percent standard to have influence over their own compensation. The auditor should also consider the combination of corporate voting power held by one family in determining if those family members who are employees can influence their own compensation.

6-414.4 Review for Unreasonable Compensation

a. In general, the evaluation procedures in 6-413 apply to compensation of owners, executives, and other employees who pose a higher risk of unreasonable compensation. However, the reason such employees are considered high risk is that they are not subject to the contractor's normal internal controls over compensation. Therefore, the auditor may not rely on those normal internal controls.

b. Such higher risk employees may nominally be part of a class of employees. (The president's son may be an engineer in the design department, or an owner of 25 percent of the firm may be one of several scientists working in research.) The auditor should not accept their compensation as reasonable because the class is reasonable as a whole without checking to assure that the higher risk employees have substantially equal duties and compensation as the other members of the class. Especially in the case of family members of owners or executives, such an employee may be overgraded considering the duties actually performed or simply paid more than others doing the same work.

c. Executive positions within a company are usually unique positions within that company. Only the largest of firms have the potential for a class of employees performing vice-presidential level duties, which can be described as having similar rank, function, and responsibility. Normally, executives are not part of a class of employees and must be evaluated individually.

d. Such positions are best evaluated by comparison to positions with comparable rank, function, and responsibility in other firms of similar size. If the firm changes in size, prior determinations of reasonable compensation amounts will need to be reevaluated.

e. As provided in FAR 31.205-6(a)(6)(ii), compensation to owners must be reasonable for the personal services rendered, and not be a distribution of profits (which is not an allowable contract cost). However, payments made to owners are not automatically unallowable if the payments are a distribution of profits on the accounting records of the enterprise. Some smaller firms, including sole owners and partnerships, regularly compensate owners through distribution of profits. These amounts should be questioned only if the total compensation paid to an individual exceeds an amount reasonable for the services performed.

f. For closely held corporations, compensation, including bonuses, will not be recognized in excess of the costs that are deductible as compensation under the Internal Revenue Code (IRC) (26 U.S.C.) and regulations under it. However, the fact that an executive’s or owner’s compensation has not been challenged by the Internal Revenue Service (IRS) does not indicate that the claimed amounts are reasonable.

(1) To be deductible under the IRC and regulations, the total compensation paid must meet the test of reasonableness. In general, reasonable compensation under the Code and regulations is the amount that would be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date of agreement with the employee for the services, not those existing at the date when the amount is questioned.

(2) Excess compensation received by a shareholder is considered by the IRS to be constructive dividends. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

g. The Techplan ASBCA Case No. 41470, 96-2, BCA 28426, cited the steps to be taken to evaluate the reasonableness of executive compensation. The following process was the ASBCA's interpretation of how compensation experts would market price executive compensation. This process should be followed to the extent practical. The auditor should rely on the contractor's market pricing when available, unless the contractor used free internet surveys to develop labor costs as these surveys are not independent or objective. The auditor should ascertain that the contractor's market pricing is compliant with FAR 31.205-6 and the process cited in the Techplan Corporation ASBCA Decision.

(1) Determine the position to be evaluated.

(2) Identify survey(s) of compensation for the position to be evaluated that match the company in terms of revenues, industry, geographic location and/or other relevant factors.

(3) Update the surveys to a common data point for each year through the use of escalation factors.

(4) Array the data from the surveys for the relevant compensation elements at various levels of compensation, such as the average (mean) or selected percentiles, and develop a composite number for each. Note: Use of other percentiles is necessary only if the contractor's performance (see 6-414.4h below) is quantitatively and measurably above or below average. The Information Systems & Networks Corporation ASBCA Decision clarified that for companies with performance that was below average, below average levels of compensation could be utilized as the reasonable level of compensation for market pricing.

(5) Determine which of the numbers to use for comparative purposes. In most cases average or median data will be utilized as an initial position prior to performing a detailed financial performance analysis.

(6) Apply a range of reasonableness, such as 10 percent, to the number or numbers selected. It is DCAA policy to use 10 percent as the range of reasonableness. A 10 percent range of reasonableness (ROR) was also supported by the ASBCA in the Information Systems & Networks Corporation ASBCA Decision.

(7) Adjust the actual total cash compensation for lower than normal fringe benefits. (Calculate an offset.)

(8) Compare the adjusted compensation to the range of reasonableness. Differences should be questioned as unreasonable.

h. Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by com-

parable firms for executives with similar duties. Above average levels of compensation are usually identified by percentiles, such as the 75th percentile. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance as documented by financial performance that significantly exceeds the particular industry's average. The ASBCA, in their decision on Information Systems & Networks Corporation ASBCA No. 47849, “capped” executive compensation at the 75th percentile when justified by performance.

(1) Examples of financial performance measures may include the following:

- Revenue Growth
- Net Income
- Return on Shareholder's Equity
- Return on Assets
- Return on Sales
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share

(2) The contractor must show that the measure chosen is representative of the executive’s performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard which is not affected by the executive’s performance, and certainly there should be no extra compensation due to performance which results primarily from the contractor’s status as a Government contractor. Performance is typically measured using more than one criterion of performance. For example, a contractor may have significant sales growth through acquisitions and mergers while operating at a loss. In this situation, the contractor would not be considered to have superior performance based on the lone measure of sales growth.

(3) Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measures reflected in the changes to compensation claimed as reasonable.

6-414.5 Reporting on Compensation Paid to Higher Risk Employees

a. Compensation system audits should exclude positions or individual employees not effectively covered by the compensation system's controls from any opinion that the contractor's compensation system is adequate.

b. For incurred costs, opinions on such employees' compensation should be limited to recommendations on the acceptance of specific compensation amounts claimed which are found to be allowable and reasonable for the services rendered and disallowance of amounts found to be unallowable or unreasonable.

c. For forward pricing, the determination of reasonableness is based on an evaluation of projections made by the contractor.

d. When compensation of employees becomes unreasonable due to changed circumstances after some period of time during which the Government considered compensation paid to be reasonable, the contractor is generally afforded a period of time to adjust its compensation levels before the costs are questioned. However, compensation of owners and executives is more flexible and is generally dependent on circumstances as they occur.

Thus, compensation of owners and executives should generally be questioned for all periods if it is found to be unreasonable. Of course, any increased compensation should be questioned immediately if it is unreasonable due to a change in the previously audited compensation system or a failure to follow that system. Also, compensation determined to be unallowable because it is in excess of the compensation ceilings discussed at 6-414.8 should be questioned for all applicable periods.

6-414.6 Termination Payments to Owners and Executives

a. It would be unreasonable for an owner to terminate himself/herself and claim compensation for the termination. Allowable severance payments must be for involuntary termination. All other termination payments must make economic sense to be allowable. If a payment makes economic sense, then the profit motive should be sufficient reason for the owner to retire. Owners receive their payment through the profit from their decisions.

b. The auditor should also be alert to termination agreements made with retiring owners and executives to pay them for consulting services for some period of time after retirement. The payments should be commensurate with services expected from the retiree. Such payments may represent unallowable compensation payments.

6-414.7 Bonuses Resulting From Business Combinations

a. Costs for bonuses or other payments in excess of the employee's normal salary that are part of restructuring costs associated with a business combination are unallowable under DoD contracts funded by FY 1996 or subsequent appropriations per DFARS 231.205-6(f)(1).

b. This DFARS limitation does not apply to severance and early retirement incentive payments. Reasonable payments for these types of costs are allowable subject to the provisions in FAR 31.205-6(g), “Severance pay,” and (j)(7), “Early retirement incentive plans.”

6-414.8 Compensation Ceilings - General Policy

Congress has established statutory limitations on annual allowable individual compensation since 1995. The regulatory limitations and factors to consider when auditing the allowability of compensation are discussed below. A summary of the compensation ceilings by year follows:

FY	Ceiling	Applicability	FAR/DFARS
1995	$250,000	DoD contracts after 4/15/95	DFARS 231.205-6(a)(2)(i)(A)**
1996	200,000	DoD contracts after 7/1/96	DFARS 231.205-6(a)(2)(i)(B)**
1997	250,000	DoD contracts after 12/12/96	DFARS 231.205-6(a)(2)(ii)**
1997	250,000	All contracts after 1/1/97 *	FAR 31.205-6(p)
1998	340,650	All contracts	FAR 31.205-6(p)
1999	342,986	All contracts	FAR 31.205-6(p)
2000	353,010	All contracts	FAR 31.205-6(p)
2001	374,228	All contracts	FAR 31.205-6(p)
2002	387,783	All contracts	FAR 31.205-6(p)
2003	405,273	All contracts	FAR 31.205-6(p)
2004	432,851	All contracts	FAR 31.205-6(p)
2005	473,318	All contracts	FAR 31.205-6(p)
2006	546,689	All contracts	FAR 31.205-6(p)
2007	597,912	All contracts	FAR 31.205-6(p)
2008	612,196	All contracts	FAR 31.205-6(p)
2009	684,181	All contracts	FAR 31.205-6(p)
2010***	693,951	All contracts	FAR 31.205-6(p)

*	Limitation applicable only for costs incurred during Government fiscal year (GFY) 1997
**	These references have been deleted from the DFARS, effective March 26, 1998, but they are still applicable for the periods identified
***	The $693,951 cap amount is to be used for calendar year 2010, and subsequent calendar years, until revised by the Office of Federal Procurement Policy.

a. DFARS Compensation Ceiling for 1995

DFARS 231.205-6(a)(2)(i)(A) implements provisions of the 1995 DoD Appropriations Act (Section 8117 of Public Law 103-335; the "Act"), limiting the allowability of individual compensation on covered DoD contracts. Covered contracts are DoD contracts, entered into after April 15, 1995, that are funded by the Act. They do not include modifications, whenever executed, to contracts entered into on or before April 15, 1995. They also do not include separately priced line items of contracts entered into after April 15, 1995, if those line items are not funded by the Act. The DFARS provision imposes an allowable compensation ceiling of $250,000 for each individual employee. This $250,000 ceiling includes the total of all elements of compensation (as defined in FAR 31.205-6(a)) provided to an individual employee.

b. DFARS Compensation Ceiling for 1996

DFARS 231.205-6(a)(2)(i)(B) implements provisions of the 1996 DoD Appropriations Act (Section 8086 of Public Law 104-061; the "Act"), limiting the allowability of individual compensation on covered DoD contracts. Covered contracts include DoD contracts, entered into after July 1, 1996, that are funded by the Act. They do not include modifications, whenever executed, to contracts entered into on or before July 1, 1996. They also do not include separately priced line items of contracts entered into after July 1, 1996, if those line items are not funded by the Act. The DFARS provision imposes an allowable compensation ceiling of $200,000 for each individual employee. This $200,000 ceiling in-

cludes the total of all elements of compensation (as defined in FAR 31.205-6(a)) provided to an individual employee.

c. DFARS Compensation Ceiling for 1997

DFARS 231.205-6(a)(2)(ii), effective December 13, 1996, implements provisions of the 1997 DoD Appropriations Act (Section 8071 of Public Law 104-208; the "Act"), limiting the allowability of individual compensation charged to covered DoD contracts. Covered contracts are new DoD contracts funded by the Act. The DFARS provision imposes an allowable compensation ceiling of $250,000 for each individual employee. Compensation is defined in DFARS as the total amount of "taxable wages paid to the employee for the year concerned" plus "elective deferred compensation earned by the employee in the year concerned."

d. FAR Compensation Ceiling for 1997

FAR 31.205-6(p) implements provisions of the 1997 National Defense Authorization Act (Section 809 of Public Law 104-201), limiting the allowability of individual compensation on Government contracts. Covered contracts include contracts awarded after January 1, 1997. The FAR provision imposes an allowable compensation ceiling of $250,000 on the five most highly compensated individual senior management positions at each company segment, including corporate home office and any intermediate home offices. However, the ceiling is applicable only to costs incurred from October 1, 1996 through September 30, 1997. The definition of compensation is identical to the 1997 DFARS definition, i.e., the total amount of "taxable wages paid to the employee for the year concerned" plus "elective deferred compensation earned by the employee in the year concerned." This new FAR rule does not affect DoD contracts since DoD contracts are subject to the more restrictive provision in DFARS (discussed in paragraph c. above).

e. FAR Compensation Ceiling for 1998

The FY 1998 Defense Authorization Act (Section 808 of Public Law 105-85) established a new executive compensation cap that supersedes all prior caps for 1998. The Act further directed the Office of Federal Procurement Policy (OFPP) under the Office of Management and Budget (OMB) to set the amount of the cap. The OFPP set the cap amount at $340,650 for 1998. This cap applies to costs incurred after January 1, 1998 and before January 2, 1999 and to all defense and civilian agency contracts covered by the FAR cost principles, including those contracts awarded prior to the enactment of the new cap.

(1) The executives covered by the cap include:

(a) the contractor's CEO or any individual acting in a similar capacity and the four most highly compensated management employees other than the CEO, and

(b) if organizationally subdivided into intermediate home offices and/or segments, the five most highly compensated employees at each contractor home office or segment provided that those home office or segment employees report directly to the contractor's corporate headquarters.

(2) The cap-covered compensation includes:

(a) the total amounts of salary, bonuses, deferred compensation, and employer contributions to defined contribution pension plans, and

(b) earned in and accrued for 1998, and otherwise allowable on Government contracts.

Only the components of compensation listed in (2)(a) above (see FAR 31.205-6(p)(2)(i)) are to be included in determining the total amount of a senior executive's compensation for application of the annual compensation cap. All other components of compensation,

e.g., severance pay and early retirement incentive pay, should be separately evaluated for reasonableness.

f. FAR Compensation Ceiling for 1999. The OFPP set the 1999 cap amount at $342,986. This cap applies to costs incurred after January 1, 1999 and before January 2, 2000 and to all defense and civilian agency contracts covered by the FAR cost principles, including those contracts awarded prior to the enactment of the cap.

(1) The coverage of executives for 1999 was changed by the FY 1999 Defense Authorization Act (Section 804 of Public Law 105-261) to include:

(a) the contractor's five most highly compensated employees in management positions, and

(b) if organizationally subdivided into intermediate home offices and/or segments, the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters.

(2) The cap-covered compensation includes:

(a) the total amounts of salary, bonuses, deferred compensation, and employer contributions to defined contribution pension plans, and

(b) earned in and accrued for 1999, and otherwise allowable on Government contracts.

Only the components of compensation listed in (2)(a) above (see FAR 31.205-6(p)(2)(i)) are to be included in determining the total amount of a senior executive's compensation for application of the annual compensation cap. All other components of compensation, e.g., severance pay and early retirement incentive pay, should be separately evaluated for reasonableness.

g. FAR Compensation Ceilings for Contractor Fiscal Years (CFY) 2000 through 2009. The OFPP set the CFY 2000 through 2009 cap amounts as shown in the tables above. These caps apply to contract costs incurred after January 1 of each year and to all defense and civilian agency contracts covered by the FAR cost principles, including those contracts awarded prior to the enactment of the cap. The method for applying the cap is the same as for 1999.

h. FAR Compensation Ceiling for CFY 2010, and subsequent years. The OFPP set the 2010 cap amount at $693,951. This new cap applies to costs incurred after January 1, 2010, and to all defense and civilian agency contracts covered by the FAR cost principles, including those contracts awarded prior to the enactment of the new cap. The $693,951 cap amount is to be used for 2010 and subsequent years, until revised by OFPP. No escalation is warranted because the language of OFPP's memorandum states that the $693,951 cap is for all subsequent years until revised. The method for applying the cap is the same as for 1999.

6-414.9 Compensation Ceilings - General Audit Considerations

a. If an employee's compensation exceeds the ceiling amount for the year, the amount in excess of the ceiling charged (directly or indirectly) to any contract covered by the FAR or DFARS limitation must be disallowed. If the entire amount of an employee's compensation is charged to an indirect cost pool, the disallowance may be effected by disallowing the amount in excess of ceiling amount. If the employee charges both direct and indirect and the excess compensation charged direct to contracts is material, then the auditor should calculate unallowable compensation applicable to specific contract(s) separately.

b. A contractor may have contracts subject to the FAR and/or DFARS limitations, and contracts not subject to the limitations. Contractors may, at their option, propose separate sets of labor and indirect rates for contracts covered and not covered by the limitations. If the contractor proposes separate rates for contracts not subject to any limitations, those rates should be evaluated using the cost principle provisions at FAR 31.205-6(a) through (o).

c. Since the FAR and DFARS limitations establish an expressly unallowable category of cost, any costs in excess of the limitations included in the final indirect cost settlement proposal are expressly unallowable and subject to penalty provisions at FAR 42.709 (previously at DFARS 231.70). It is the contractor's responsibility to identify the contracts subject to any of the compensation limitations.

d. Executive compensation subject to the specific FAR and DFARS limitations is also subject to the reasonableness provisions of the FAR. Compensation that does not exceed the specific limitations may still be unreasonable when compared to other positions with comparable rank, function, and responsibility in other firms of similar size. The smaller the firm, the more likely this will be the case. Therefore, auditors should consider tests of reasonableness even when executive compensation is below the ceiling.

6-414.10 Compensation Ceilings - Audit Considerations for FY 1995 and FY 1996 Ceilings

a. Presented below are three significantly different methods for implementing the FY 1995 and FY 1996 compensation caps and DCAA's position on the acceptability of each method. Examples comparing each method are provided in Figure 6-4-2.

(1) Multiple Rate Method (Acceptable). Contractors establish two sets of G&A rates (or other indirect cost rates, as appropriate) -- one for covered contracts, and one for contracts not subject to the cost limitation. Under this method, all of the unallowable compensation is appropriately applied to the contractor's cap-covered contract work. The disadvantage of this approach is that considerable resources may be required to develop, propose, audit, negotiate, and apply two sets of rates based on different fiscal year appropriated funds.

(2) Representative Contract(s) Adjustment Method (Acceptable with ACO Coordination). Contractors continue to charge compensation as if there was no cost limitation. Contractors calculate the total excess compensation allocable to flexibly-priced covered contracts. The excess amount is then credited to a representative mix of flexibly-priced, cap-covered contracts (i.e., to the extent practical, one or more cap-covered contract(s) in proportion to the cap-covered contract work from each funding source). The adjustment would be a dollar-for-dollar credit against otherwise allowable contract costs. The ACO needs to authorize application of the representative contract(s) adjustment method, and for this reason the auditor must appropriately coordinate its actions with the ACO regarding implementation of this method.

(a) Example of crediting out excessive compensation for different funding sources. Excessive compensation totaling $300,000, applicable to FY 1995 DoD cap-covered contracts, could be credited to individual Army, Navy, and Air Force contracts as follows, assuming this is in proportion to cap-covered work from each funding source.

Representative Mix of Flexibly-Priced Cap-Covered Contracts by Funding Source	Credited Amount
Army R&D Contract	$ 60,000
Air Force R&D Contract	120,000
Navy Production Contract	120,000
Total Excessive Compensation	$300,000

(b) Advantages of the representative contract(s) adjustment method. Resources would likely be saved because only one set of rates is developed and proposed by the contractor, audited by DCAA, and negotiated and applied by all parties. Each funding source would also receive credit for its proportional share of all unallowable compensation in compliance with Title 31, Money and Finance, of the United States Code. Title 31 governs the Appropriations Act which applies to cap-covered contracts. (See Blended Rate Method for further discussion of Title 31.)

(3) Blended Rate Method (Unacceptable) - Contractors calculate the total excess compensation applicable to flexibly priced covered contracts. The excess amount is credited out of the contractor's G&A (or other) indirect cost pool. A blended G&A rate is then developed and applied to both cap-covered and uncovered contracts. This method has two disadvantages which make it unacceptable for allocation of allowable costs.

(a) Under the blended rate method, the blended rate is applied to both cap-covered and noncovered contract work. This is in violation of Title 31 of the United States Code, section 1301(a), herein referred to as the Purpose Statute, and section 1341(a)(1), herein referred to as the Anti-Deficiency Act. Section 1301(a) (Purpose Statute) requires that appropriations shall be applied to the objects for which the appropriations were made. Section 1341(a)(1) (Anti-Deficiency Act) places limitations on officers or employees of the United States Government expending and obligating amounts exceeding amounts available in the appropriation. Both sections would be violated at most contractor locations since use of a blended rate would result in a predominant misallocation of the unallowable compensation credit to the contract work that is not subject to the cap or authorized by the appropriation.

(b) If contractors do not carry out or expand their blended rate calculation to an appropriate number of decimal places, the impact of the unallowable compensation may not be significant enough to lower the G&A rate. As a result, unallowable compensation costs will not be recovered by the Government.

b. FFRDC's. Federally funded research and development centers' GFYs 1995 and 1996 funding have been further restricted as to compensation allowability. Those restrictions were to be imposed by contract clauses. Both the contract clauses and the DFARS restrictions may apply to an FFRDC's contracts, depending on the date of the contract.

Figure 6-4-2
Comparative Examples of Multiple Rate, Representative Contract(s) Adjustment, and Blended Rate Methods

This Figure illustrates three significantly different methods that contractors are using to implement the FY 1995 and FY 1996 compensation caps. Simple, but representative, examples of each method, using data for the hypothetical ABC Corporation for FY 1995, are provided below. The first method is the "multiple rate" method, acceptable to DCAA. The second method is the representative contract(s) adjustment method, also acceptable to DCAA. The third and final method, termed the "blended rate" method, is unacceptable to DCAA.

Relevant Performance Data for ABC Corporation's CFY 1995 (Jan 1 - Dec 31, 1995)

ABC Contract Data:		
Award Date	Value Added G&A Base Costs thru Dec 31, 1995	($000s)
Before April 16, 1995	Total contract work not covered by cap	$333,000
After April 15, 1995	Fixed-priced contract work (cap impact already considered in pricing)	2,000
Subtotal - G&A base not subject to unallowable/excess compensation costs		$335,000
After April 15, 1995	Flexibly-priced contract work covered by the FY 1995 compensation cap:	15,000
Total G&A base		$350,000

Figure 6-4-2

Compensation Data for ABC Executives (all are indirect and total compensation is included in the G&A expense pool):

CFY 1995 G&A Pool	Total ($000s)	Compensation Over FY 1995 Cap but Otherwise Allowable/Claimable ($000s)
Executive 1 compensation	$ 2,750	$ 2,500
Executive 2 compensation	1,750	1,500
Executive 3 compensation	1,250	1,000
Executive 4 compensation	1,000	750
Executive 5 compensation	500	250
All other G&A compensation	10,000	1,000
All other G&A expenses	17,750	N/A
Total in G&A Pool	$35,000	$ 7,000

I. "Multiple Rate" Calculation for Unallowable Compensation (acceptable to DCAA)

		($000s)
A.1	Total G&A expense pool	$35,000
A.2	Total G&A base	$350,000
A.3	Full G&A rate for CFY 1995 (A.1 / A.2)	10.00%*
B.1	Total G&A expense pool	$35,000
B.2	Less: Total CFY 1995 compensation costs over the cap	$7,000
B.3	G&A expense pool less unallowable compensation costs	$28,000
B.4	Total G&A base	$350,000
B.5	Cap-adjusted G&A rate for CFY 1995 (B.3 / B.4)	8.00%*
C.1	G&A base not subject to unallowable/excess compensation costs	$335,000**
C.2	Full G&A rate (A.3)	
C.3	Line C.1xC.2: G&A on contracts not subject to unallowable comp costs	$33,500
C.4	G&A base subject to unallowable/excess compensation costs	$15,000**
C.5	Cap-adjusted G&A rate (B.5)	8.00%
C.6	Line C.4xC.5: G&A on contracts subject to unallowable compensation costs	$1,200
C.7	Total allowable G&A allocable to all ABC contract work (C.3 + C.6)	$34,700
C.8	Less: A.1, Total G&A expense pool	$(35,000)
C.9	Unallowable/excess compensation for CFY 1995	$300

Explanatory Notes. In this example:

Figure 6-4-2

* The difference between the two G&A rates is significant and ABC would choose to apply them separately. In cases where the difference is less significant, contractors may simply choose to apply the lower rate across all work.

** In most cases, identifying the cap-covered contracts and related amount of a contractor's G&A allocation base will not be an easy task. Therefore, depending on the materiality level of the excess compensation and the number of contracts involved, some flexibility should be permitted in the contractor method for determining the covered contract base. Reasonable and supportable estimating techniques, such as sampling, may be appropriate in some circumstances.

II. Representative Contract(s) Adjustment (RCA) for Unallowable Compensation (acceptable to DCAA with ACO coordination)

		($000s)
A.1	G&A allocable to all ABC Government contracts	$35,000
A.2	Total ABC G&A value added base for CFY 1995	$350,000
A.3	Single (full) G&A rate to be applied to all Government contracts (A.1 / A.3)	10.00%
B.1	Unallowable/excess compensation costs for CFY 1995 (from I.C.9)	$300
B.2	Amount of A.1 proportionately credited out of ABC's flexibly-priced cap-covered contracts	$(300)
B.3	Amount of unallowable compensation still owed the Government	$0

III. "Blended Rate" Calculation for Unallowable Compensation
(Unacceptable to DCAA)

		($000s)
A.1	G&A base subject to unallowable/excess compensation costs	$15,000
A.2	Total G&A base	$350,000
A.3	Percent G&A base subject to unallowable/excess comp costs (A.1/A.2)	4.29%
B.1	Total CFY 1995 compensation costs over cap	$7,000
B.2	Multiplied by percent of G&A base subject to excess comp costs (A.3)	4.29%
B.3	Unallowable/excess compensation costs for CFY 1995	$300
C.1	Total G&A expense pool	$35,000
C.2	Less: B.3, unallowable/excess compensation costs for CFY 1995	$(300)
C.3	Total allowable G&A allocable to all ABC contract work	$34,700
C.4	Total G&A base	$350,000
C.5	Single "Blended" G&A rate (C.3 / C.4)	9.91%
D.1	Total G&A base	$ 350,000
D.2	Multiplied by blended G&A rate (C.5)	9.91%
D.3	Total allowable G&A allocable to all ABC contract work (rounded)	$ 34,700
D.4	Less: Total G&A expense pool	$(35,000)
D.5	Unallowable/excess compensation costs for CFY 1995)	$300

Reason why ABC's use of the blended rate method is unacceptable.
In this example, use of the blended rate allocates over 95% (100% - 4.29%) of the $300,000 of excess compensation to contracts covered by the appropriations statute limitations. This would be a violation of Title 31 of the United States Code, sections 1301 (Purpose Statute) and 1341(a)(1) (Anti-Deficiency Act). ABC's non-covered contract work (which could include commercial and fixed-priced contracts, resulting in no recovery of unallowable costs) gets over 95% of the $300,000 disallowance.

6-414.11 Compensation Ceilings - Audit Considerations for FY 1997 Ceilings

a. Definition of Compensation Applicable to FY 1997 Ceilings

(1) Taxable Wages paid in the year should be the amounts shown in box 1 of the employee's Form W-2. Taxable wages paid include such items as wages, salaries, bonuses, sales commissions, and other compensation (e.g. previously earned, but deferred for later payment) that are paid during the current year. This amount could be greater than taxable wages paid for the year concerned as specified in FAR and DFARS, since it may include compensation for services performed in prior years.

The amount of compensation claimed by a contractor for Government contract costing purposes may be different from the amount of compensation actually paid to employees which is the basis for determining the allowable amount under FAR 31.205-6(p) and DFARS 231.205-6(a)(2)(ii). For example, under a deferred long-term-incentive compensation plan (LTIP) a contractor will claim the annual accrued amount in the year in which the employee earned the benefit under the plan for Government contract costing purposes. However, these accruals, if paid to the employee in 1997, are not subject to the FY 1997 limitation. Only the amount earned for the current year that was paid-out to the employee would be subject to the limitation. Compensation earned in prior periods but paid-out in 1997 are not subject to the limitation.

(2) Elective Deferred Compensation is defined in IRC § 402(g)(3). In general, elective deferred compensation is a 401(k) type plan where the employee has voluntarily elected to contribute a portion of pay to his or her retirement plan instead of being paid in the current year. Tax exempt organizations may have elective deferred compensation plans, known as 403(b) plans. Elective deferred compensation plans specifically designed for small businesses (100 or less employees) are provided under simplified employee pension plans (408(k)) and simplified retirement account (408(p)). These types of deferrals are basically taxable wages that would have been included in an employee's pay check, but for the employee's voluntary election. These types of deferrals are subject to the $250,000 limitation in the year the employee earned such wages. In contrast, contractor contributions to an employee's retirement plans are not subject to the $250,000 limitation.

(3) Figure 6-4-3 below illustrates how to calculate allowable compensation based on the 1997 definition of compensation.

b. Five Most Highly Compensated Senior Management Positions. The FAR compensation cap applies only to the five most highly compensated senior management positions at each company segment including the corporate home office and any intermediate home offices. (The DFARS compensation cap applies to all employees.) Because the FAR limitation
does not apply to all employees it is possible that some employees with taxable wages and elective deferred compensation in excess of $250,000 will not be subject to the ceiling. All compensation costs, whether or not subject to the ceiling limitation, are subject to the specific allowability provisions contained in FAR 31.205-6(a) through (o).

Figure 6-4-3
Example of How to Calculate the 1997 Compensation Limitation

		1995	1996	1997
		(All Amounts 000's)		
Government Contract Costing				
A.	Wages	$200	$200	$200
B.	401K Plan (employee portion only)	15	15	15
C.	Bonus	10	0	10
D.	Health Care	20	20	20
E.	Pension Plan Contribution	10	10	10
F.	Accrued Long Term Incentive Plan (LTIP)	100	100	100*
	Total	$355	$345	$355
Taxable Compensation				
A.	Wages	$200	$200	$200
B.	401K Plan	0	0	0
C.	Bonus	10	0	10
D.	Health Care	0	0	0
E.	Pension Plan Contribution	0	0	0
F.	Paid-Out LTIP Compensation	0	0	300*
	Total	$210	$200	$510

Computation of Allowable Compensation	
Taxable Wages Paid "In" the Year (Form W-2, Box 1)	$510
Less LTIP Accrued and Charged in Prior Years	-200*
Taxable Wages Paid "For" the Year [FAR 31.205-6(p)(2)(i)(A)/DFARS 231.205-6(a)(2)(ii)(A)]	$310
Plus Elective Deferred Compensation [FAR 31.205-6(p)(2)(i)(B)/DFARS 231.205-6(a)(2)(ii)(B)]	+ 15
Compensation Subject to Ceiling	325
FAR/DFARS Limitation/Cap	-250
Unallowable Costs	$ 75

*The contractor only claims the accrued amount of $100K on Government contracts in 1997, even though the employee will be paid and taxed on the $300K actually paid out. The $200K not claimed in 1997 does not represent amount earned for the year and was previously accrued and charged to contracts in 1995 and 1996.

Note: The FAR ceiling applies only to costs incurred from October 1, 1996 through September 30, 1997 for contracts awarded after January 1, 1997. The corresponding FAR references would be FAR 31.205-6(p)(2)(i)(A) and 31.205-6(p)(2)(i)(B), which are deleted from the FAR by FAC 97-04, dated February 23, 1998, but are still applicable for the period identified.

6-500 Section 5 --- Audit of Incurred Other Direct Costs and Credits

6-501 Introduction

This section presents audit guidance for the evaluation of other direct costs and credits. In addition to direct labor and material (prime costs), which can be readily identified with a specific job, there are other types of expenses which under certain circumstances may be charged directly to a specific job. These are generally referred to as "other direct costs." Examples are:

(1) special tooling, dies, jigs, and fixtures;
(2) plant rearrangement;
(3) packaging and packing;
(4) consultant's fees;
(5) outbound freight;
(6) expediting;
(7) royalties;
(8) travel;
(9) long distance telephone;
(10) scrap sales; and
(11) deposit returns.

Costs of this nature may be charged direct to jobs, allocated on some representative basis, or charged partially direct and partially by allocation.

6-502 Audit Objectives

a. The objectives in auditing other direct costs are to determine whether:

(1) the contractor's cost representations are reliable and accurate,

(2) the amounts charged to Government contracts are reasonable and are allocable to Government contracts,

(3) costs have been accumulated in accordance with generally accepted accounting principles appropriate in the circumstances, and

(4) the contractor has been consistent in allocating such costs to commercial and Government work.

b. Of special concern in the other direct cost area is the differentiation between direct and indirect cost. Therefore, the audit should provide assurance that when items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner.

6-503 Audit Approach

The auditor should determine whether the audit could be more efficiently performed by expanding transaction testing (maximum control risk) or evaluating the internal control structure. This assessment will be based on auditor judgment considering the factors in 3-104 and documented in the working papers and permanent file, if applicable.

6-503.1 Systems Audit

The same procedures as are identified in 5-1000 should be used:

(1) to gain an understanding of the contractor's internal control structure (5-100),

(2) document in the working papers and permanent files, the understanding of the indirect cost system internal control structure (5-106),

(3) test the operational effectiveness of the contractor's internal controls (5-108), and

(4) assess control risk as a basis to identify factors relevant to the design of substantive tests (5-109).

Transaction testing may be required based on the results of an audit of the internal control structure. The extent of the testing required should be based on the assessed control risk (5-109) as documented in the permanent file (MAAR 1).

6-503.2 Transaction Testing

When transaction testing is more economical than an audit of the internal control structure or when warranted based on the internal control evaluation, judgmentally or statistically select transactions for evaluation following the guidance below and in 3-104, 6-603, 6-605 and 6-800.

6-504 Scope of Audit

The audit should provide for the accomplishment of MAARs and may include an evaluation of the contractor's internal control structure. The scope of the audit should be based on the factors discussed in 3-104 and 6-503 above. Special scope considerations are:

6-504.1 Interrelated Reviews

a. Other direct costs are incurred on the basis of management decisions in a manner similar to the incurrence of indirect costs and are subject to the same internal controls. Whenever practicable, apply the scope of audit described in 6-603 to other direct costs and perform the audit in conjunction with the audit of indirect costs. For example, the contractor's policies and procedures regarding the segregation of unallowable travel costs should be the same for both direct and indirect travel.

b. Similarly, when an item is purchased, documents such as the purchase requisition, purchase order, receiving report, and inspection report should identify the contract for which the cost was incurred. When the contractor manufactures components or parts, the work orders and all documents serving as a basis for charges to the work order, such as requisitions and job tickets, should be identified with the contract. Internal controls over accounting, purchasing, subcontracting or make/buy decisions may impact the audit of other direct cost.

c. The audit should provide assurance that when items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner, CAS 402 or MAAR 7 evaluations may provide sufficient documentation to reduce scope.

6-504.2 Evaluation of Bid Proposals and Contract Provisions

a. When the contractor's accounting procedures provide for the accumulation of other direct costs, or the cost representations include other direct costs, the auditor should review negotiation memorandums and the contract provisions to ascertain whether it was the intent of the contracting parties to treat certain costs as direct rather than as indirect costs. Contracts awarded on a firm-fixed-price basis generally do not contain provisions concerning costs to be charged to the contract. However, if there is information that a category of cost was considered as a direct charge during the negotiation of a firm-fixed-price contract, the auditor should determine that other Government contracts do not share the same cost through an indirect cost allocation.

b. When auditing costs of special tooling or special equipment, review the terms of the contract to determine whether the costs are to be treated as other direct costs. If so, evaluate the contractor's controls to determine whether they ensure the appropriate disposition of specialized items upon completion of the contract. When a contract is silent concerning these types of costs, seek the assistance of the contracting officer and ascertain the necessity for the acquisition of the equipment and the propriety of treating the costs as a direct charge to the contract. (See 3-200, 7-1906, and 14-402).

6-504.3 Disclosure Statement

The auditor should be alert to inconsistencies in the treatment of other direct costs which may result in inequitable charges to Government contracts. Part 3 of the disclosure statement delineates the contractor's policy regarding differentiation between direct and indirect costs, identifies contractor's other direct costs, and explains deviations from the contractor's normal direct charging policy. Because a primary concern regarding other direct costs relates to consistency of treatment, an evaluation of disclosed practices may indicate areas for audit. When such inconsistencies are noted, advise the contracting officer to take corrective action. When the amounts are significant and consistent treatment cannot be attained, it may be necessary to establish special indirect cost rates for the contracts affected to avoid inequitable charges to those contracts.

6-504.4 Selected Areas of Cost

The auditor should evaluate the contractor's presentation for new, unusual, or miscellaneous types of ODC. Guidance on audit methods and techniques for selected areas of costs are provided in 7-000.

6-505 Audit Procedures

The auditor should determine that all items of other direct costs are readily identifiable with the contract to which they have been charged. The audit of other direct costs should include an evaluation of:

a. The reasonableness of the amount incurred in relation to the benefits to be derived;

b. The allocability of the cost to the product, service, activity, or contract to which it was charged, and the consistency of application; and

c. The allowability of the cost in accordance with FAR/DFARS and the provisions of the contract.

6-505.1 Reasonableness of Accounting Costs in Relation to Benefits

Apply the guidelines in FAR Part 31 to determine whether other direct costs are reasonable in amount in relation to the contractual benefits to be derived. When the amount is not significant in comparison to the total costs, determine whether the cost of additional time expended by cost clerks, voucher examiners, payroll analysts, and others to accomplish the refinements are commensurate with the benefits the Government may expect to derive from maintaining such precise accounting.

6-505.2 Allocation Methods and Consistency of Application

a. Evaluate the contractor's methods for identifying other direct costs and determine whether such methods result in an equitable distribution of costs to both Government and other work. When items are charged to a Government contract as other direct costs, the contractor's procedures should provide for like or comparable items to be similarly charged to other work. When the contractor has not been consistent, eliminate those comparable or similar cost items applicable to all other work from the indirect expense pool prior to allocation. Make sufficient tests to determine consistency of accounting treatment.

b. Under certain circumstances, it is appropriate to treat certain types of costs as direct charges and as overhead. For example, all travel directly applicable to Government contracts or other work may be charged direct, while travel, such as for recruitment and general administration, may be treated as overhead.

c. When a contractor manufactures special tools, evaluate the propriety of allocating overhead to the in-house manufacturing process. When special tools are manufactured in a separate department which is considered a production department, the indirect costs of the department and any prorations from other service departments constitute tooling overhead allocable to tooling labor costs. However, when the contractor considers the special tooling department as an indirect department, overhead would not be allocable because the overhead generated remains in the expense pool and is subsequently prorated to production. Consider the equity of this method as part of the evaluation of the contractor's procedures for accounting for indirect costs.

6-505.3 Allowability of Costs

Certain categories of cost (FAR Part 31-Appendix A of this manual) are not allowable in pricing Government contracts whether charged direct or through allocation. Further, the terms of a contract may specifically preclude the contractor from classifying certain classes of costs as "direct," and conversely, the contract may permit the contractor to reflect certain classes of costs as direct costs. However, in all instances, the allowability of costs under Government contracts is subject to the tests of allocability and reasonableness.

6-506 Coordination with Government Technical Personnel

The auditor should request technical assistance to determine the need as well as the reasonableness of the costs in areas outside his or her technical competence and for which the auditor cannot make an independent assessment. For example, technical advice may be required when the contractor manufactures special tools or incurs plant rearrangement costs which are charged to other direct costs, or, when packaging costs represent a significant amount of other direct costs, in which event the auditor should seek the services of Government packaging experts to determine the need as well as the reasonableness of the costs for packaging. Guidance on requesting and using the work of technical specialists is in Appendix D. See 4-103 for incorporating the request for technical assistance into the acknowledgment/notification letter.

6-600 Section 6 --- Audit of Incurred Indirect Costs

6-601 Introduction

This section presents audit guidance and procedures for the audit of indirect costs used in establishing final indirect cost rates for other than firm-fixed-price type contracts. Refer to Section 5-1000, Indirect/Other Direct Cost Systems, for guidance and procedures on the evaluation of the contractor's policies, procedures, and internal controls which affect indirect costs. The guidance is also to be used for the determination of allowable indirect costs under other circumstances such as audits of terminated contracts (12-304.15), audits of progress payment requests (14-200), and for interim evaluations of incurred costs.

a. An indirect cost is any cost that is not directly identified with a single final cost objective, but is identified with two or more final cost objectives or an intermediate cost objective (FAR 31.203 (b)). Indirect costs are to be accumulated by logical groups and distributed on the basis of benefits accruing to the several cost objectives. The numbers and composition of cost groupings should be governed by practical considerations.

b. Procedures for settling final indirect cost rates are presented in 6-700. Guidance for audits of the base costs to which the rates apply is provided in this section.

6-602 Audit Objectives

a. The audit objectives are to evaluate and determine:

(1) the allowability, allocability, and reasonableness of the costs charged to Government contracts;

(2) the propriety of the methods used to allocate indirect costs to Government contracts;

(3) the correctness of the bases used to apportion indirect costs;

(4) the appropriateness of the indirect cost period;

(5) the consistency of the application of policies and procedures to the Government and to other operations; and

(6) the mathematical accuracy of the computed final indirect cost rates.

b. The discovery of fraud or other unlawful/improper activity is not the primary audit objective, but the auditor must be attentive to any condition which suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with 4-700.

6-603 Scope of Audit

a. The audit should provide for the accomplishment of MAARs (see 6-603.2 below) and should include:

(1) an evaluation of the contractor's system of internal control, including the means by which all echelons of management control the level of indirect costs (see 5-1000);

(2) an evaluation of the composition and suitability of the allocation bases;

(3) an evaluation of the composition of the various indirect cost pools to ascertain whether they are logical and bear a reasonable relationship to the bases used for apportioning expenses to operations;

(4) an evaluation of selected indirect cost accounts;

(5) a verification to the financial records; and

(6) a verification of the mathematical accuracy of the rate computation.

b. The extent of audit effort should be influenced by:

(1) the adequacy of the contractor's policies, procedures, and internal controls, including the contractor's monitoring and testing efforts (see 5-1000);

(2) the mandatory annual audit requirements (MAARs);

(3) the types of Government contracts and the percentage of participation (the total dollar value of the indirect costs allocated to Government contracts);

(4) the adequacy of the records based on past experience and the impact of changed conditions; and

(5) the contract terms.

6-603.1 Types of Contracts and Government Participation

a. For discussion, contracts other than firm-fixed-price, time-and-materials, or labor-hour are referred to as cost-reimbursable. The various types of contracts are more fully defined in FAR Part 16. Audits of incurred indirect costs are performed only at contractors with cost-reimbursable contracts. The higher the value and percentage of reimbursable costs, the greater the need to analyze management decisions and internal controls over costs and the greater the depth of evaluation of selected accounts. The higher the percentage of firm-fixed-price or commercial work, the greater the need to evaluate the allocation of costs between Government and other contracts. An analysis of participation may result in reduced scope for the whole audit or only certain pools. For instance, pools with high Government participation may require detailed account analysis, whereas pools with no Government participation may require only a determination that the allocation base is appropriate to assure absorption of all allocable costs.

b. The scope of audit may also be affected by the percentage and amount of subcontract or interdivisional work performed. Prime contractors have a responsibility to audit their subcontractors. The auditor cognizant of the prime or higher tier contractor is responsible for obtaining adequate audit coverage of subcontracts, either from the prime contractor or from the cognizant Government auditor (MAAR 12) (see 6-310.4 for guidance on subcontract coverage by the prime auditor).

c. Contractors may have both DoD and non-DoD contracts which may affect the scope of audit because of differences in procurement regulations. Some non-DoD agencies request and reimburse DCAA for audit services; others do not. The requirement for our services on non-DoD contracts should be confirmed by a review of the contract terms or discussion with the appropriate contracting officer or Office of the Inspector General (see 1-300 and 15-100 for guidance on audit services for non-DoD agencies).

6-603.2 Mandatory Annual Audit Requirements (MAARs)

a. MAARs represent basic core audit requirements which should be accomplished along with the other procedures discussed in this section to complete the audit of incurred costs. MAARs must be performed at all contractors when warranted by materiality and/or significance. At major contractors it should always be presumed that materiality necessitates accomplishment of all MAARs. At nonmajor contractors, auditors are expected to independently make such judgments on the basis of specific circumstances in each audit.

General guidance on MAARs is provided in 6-105. Descriptions of the MAARs are provided in 6-1S1.

b. The extent of audit necessary to accomplish any MAAR is a matter of auditor judgment, subject to supervisory review. Because of the dollar value of cost reimbursable work at major contractor locations, all MAARs will be accomplished for each year. Considerations of materiality, based on Government participation and other factors, may result in a decision to perform minimal transaction testing.

6-603.3 Procedures and Internal Controls

The adequacy of the contractor's policies, procedures, and internal controls increases the auditor's reliance on cost representations and reduces the extent of testing and verification which might otherwise be required to express an opinion on the acceptability of indirect costs. Refer to section 5-1000 for guidance on auditing contractor indirect/other direct cost systems and related internal controls. The permanent files should also provide information on the contractor's internal controls and problem areas disclosed during ongoing audits and should be reviewed during determinations of audit scope.

6-603.4 Past Experience and Changed Conditions

a. Past experience can be a significant determinant of scope. Reviews of prior audits not only provide the accounts where costs have been questioned in the past, but also the accounts where costs have been voluntarily deleted. If past experience indicates good internal control over unallowable costs and minimum costs questioned, transaction testing can be reduced if the auditor can determine that the controls are still in place. A comparative analysis of cost accounts by year provides an indication of significant changes in cost account activity or changes in methods of allocation.

b. Changed conditions (MAAR 7) affect the reasonableness of costs and the equitable distribution of indirect costs. Changes in conditions may significantly affect the development of indirect cost rates. These changes may include the award of a significant cost-reimbursement contract when prior Government contracts were primarily of the firm-fixed-price type; a shift in emphasis from research to production, which may require reclassifying indirect costs into different departments; or changing the method of allocating and distributing indirect costs. Further, significant variations in levels of production and technological modernization of manufacturing facilities (14-800) may require an evaluation to determine the effect on facilities, labor, and indirect costs.

6-603.5 Contract Terms

a. As discussed in 6-603.1(c) above, a mixture of DoD and non-DoD contracts may result in increased scope to accommodate the differences in procurement regulations. The contract briefs state the procurement regulations which are applicable and they may also indicate special contract terms or conditions on cost allowability or allocability which may increase scope. The contract briefs may indicate advance agreements made by the contracting officer affecting allowability or allocability, the most common of which are IR&D/B&P agreements and precontract costs (see FAR 31.109 for a discussion of advance agreements).

b. The auditor must identify the contractor's status with respect to CAS; i.e., not covered; subject to modified coverage (CAS 401, 402, 405 and 406); or fully covered and required to file a disclosure statement. DMIS CAS Compliance Testing Reports maintained for each CAS-covered contractor (see 8-305) identify the status of a contractor's compliance with CAS and pinpoint specific areas requiring consideration in establishing the audit scope.

6-603.6 Multi-Year Auditing

a. The auditor should consider multi-year audit techniques when establishing the audit scope. At nonmajor contractors, the auditor may determine it would be efficient to include in the audit scope two or more fiscal years' incurred costs. Also, at major contractors, it may be efficient to audit certain accounts on a multi-year basis.

b. Multi-year auditing techniques should be based on the following guidelines:

(1) Perform all MAARs for each year being audited, except for MAARs 10 and 16.

(2) Perform transaction testing for MAARs 10, and 16 in accordance with the following guidance. Normally, transaction testing will be performed across all years. However, transaction testing can be limited to one year if account balances and conditions are similar for all years and no significant exceptions are identified. If significant exceptions are found, transaction testing should then be expanded across all years. The auditor should document in the risk assessment the decision to limit transaction testing to one year, when no exceptions are found. When account balances vary significantly or conditions have changed from year to year, transaction testing must be performed across all years.

(3) Transaction tests of any new accounts should be performed in the year they first appear, if the accounts are material.

c. Some of the possible advantages of multi-year auditing include increased efficiency in transaction testing and the use of one set of working papers to audit more than one year's costs. Also, one audit report may be used to cover the years audited.

6-604 Audit and Evaluation of Contractor's Policies, Procedures, and Internal Controls

a. Chapter 5-100 presents general guidance for the audit and evaluation of a contractor's policies, procedures, and internal controls. Guidelines applicable to the audit and evaluation of policies, procedures, and internal controls as they relate to indirect/other direct costs are discussed in 5-1000.

b. Sources for the audit of internal controls are found in the permanent files (see 4-405.1). The Internal Control Audit Planning Summary, Disclosure Statements, and DMIS CAS Compliance Audits and CAS Tracking of Noncompliances reports should be evaluated for incurred cost audits. Inadequate internal controls found during incurred cost audits should be annotated on the Internal Control Audit Planning Summary. Noncompliances with CAS should be reported in a separate report (activity code 19200) as discussed in 8-302.7.c.

6-604.1 Effect of Changed Conditions

The auditor should evaluate changes in procedures and practices for charging direct or indirect costs. Such changes could result in circumventing cost targets or ceilings or produce inconsistencies in the treatment of direct and indirect costs, especially between cost reimbursable and other contracts or between Government and other contracts. The evaluation of changes in charging direct and indirect cost satisfies MAAR 7.

a. Determining Changed Conditions. A review of corporate minutes, which generally record top management decisions, may disclose changes having an impact on indirect cost. Discussions with contractor personnel and physical plant observations (see 6-608.2a) also provide information on changed conditions. Today, physical plant observations take on a new importance in view of contractors' current trend toward modernization of manufacturing facilities (5-108d, 14-800). In addition, comparisons of the current claim with prior year amounts (see 6-608.2c) and a review of the permanent files may disclose changes.

b. Reporting Changed Conditions. As a continuing audit responsibility, the auditor should test the internal controls and procedures for reporting changed conditions which affect indirect costs. When a change in indirect cost method is proposed by a contractor, the effect (in dollars) on existing contracts should be studied and presented by the contractor as a part of its overall support for the change. The contractor should have a procedure requiring this support and identifying any required reporting. For CAS-covered contractors, the reporting requirements for accounting changes are in 8-303.3 and FAR 52.230-6(a). There is no similar requirement for non-CAS-covered contractors; however, a similar analysis will assist the auditor in evaluating the proposed change. Every effort should be made to obtain this information from the contractor; otherwise, the auditor should estimate the impact.

c. Evaluation of Changes. When changes are identified, they should be evaluated to determine that:

(1) they comply with CAS (see 8-303.3), if applicable, and

(2) they do not have the effect of improperly circumventing cost targets or ceilings of certain contracts or other significant cost categories.

6-604.2 Voluntary Management Reductions

Contractors with weak or ineffective controls to separately identify and exclude unallowable costs frequently attempt to reduce their risk of noncompliance by using alternative procedures. The most common procedure is the application of bottom line reductions to estimate the amount of unallowable costs. These reductions, generally referred to as voluntary management reductions, are often unsupported estimates and do not identify specific unallowable costs. The use of this type of reduction is not an acceptable alternative to an effective system of controls. Cost Accounting Standard 405 and FAR 31.201-6 (accounting for unallowable costs) require contractors to specifically identify and exclude unallowable costs from incurred cost proposals submitted to the Government. The auditor should not offset any unallowable costs found during the audit with voluntary management reductions. Since the auditor does not audit all transactions, the probability exists when contractors have ineffective controls that the actual amount of unallowable costs may exceed the management reduction.

The auditor should evaluate the contractor's reasons for using a management reduction factor and determine if any weaknesses exist in the contractor's internal control screening process, including the failure to provide for the identification of directly associated unallowable costs (see 8-405.1). The auditor should also prepare appropriate CAS/FAR noncompliance and internal control deficiency reports when the contractor uses management reductions in lieu of having adequate controls to identify and segregate unallowable costs.

6-605 Indirect Cost Base Period

a. The contractor must select a time period to be used as a base period (cost accounting period) for accumulating and reporting costs. The base period for the allocation of indirect expenses to operations is generally the period during which the expenses were incurred (matching principle) and usually represents a calendar year or a fiscal year.

(1) For non-CAS-covered contracts, the base period for allocating indirect costs must be determined in accordance with FAR 31.203(g)(2). The base period will be the contractor's fiscal year used for financial reporting purposes in accordance with generally accepted accounting principles.

(2) For contracts subject to full or modified CAS coverage, the criteria and guidance in CAS 406 (8-406) must be used for selecting the cost accounting periods used in allocating indirect costs (FAR 31.203(g)(1)). Instances of noncompliance with CAS 406 should be reported to the cognizant Federal agency official (CFAO) immediately (see 8-300 for guidance on reporting noncompliances).

b. Quick-closeout procedures which allow the final period of a contract to be closed at other than final rates for the full year are discussed in 6-611.2 and 6-1010.

6-606 Indirect Costs Allocation Methods -- Bases and Pools

6-606.1 General

a. Indirect costs should be accumulated by logical (homogeneous) cost groupings (pools), with due consideration of the reasons for incurring such costs, and allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pool costs to the final cost objective (FAR 31.203(c)). To satisfy MAAR 18, the auditor should determine that the allocation bases used by the contractor for the allocation of indirect costs are equitable and consistent with any applicable CAS requirements, generally accepted accounting principles, and applicable provisions of the contract. Guidance on the verification of the activity base is in 6-610. Guidance on verification of the rate computation is in 6-611. Guidance on the transitional method for G&A expense under CAS 410 is provided in 8-410a.

b. Knowledge obtained from an audit of the internal control structure (see 5-1005) may reduce the extent of audit effort. The auditor must make a thorough study of the indirect cost activity, including the activity bases used for allocation and the costs to be allocated, to determine whether the activity base chosen by the contractor is appropriate for cost allocation and results in a reasonable measure of the activity. The base should:

(1) be a reasonable measure of the activity,

(2) be measurable without undue expense, and, except for residual G&A expense,

(3) fluctuate concurrently with the activity which is the source of the cost.

c. When the methods of allocation have been tested over an extended period and determined to be satisfactory, the auditor presumes that these procedures and methods are still satisfactory. However, when the nature of a business changes substantially because of a change in volume of commercial or Government business, or because of technological modernization of the manufacturing facilities (14-800), the existing methods of allocating indirect costs may not be appropriate and the auditor must evaluate them in accordance with existing conditions. If the contractor's method appears to be sound and produces equitable and objective results, it should be accepted as provided for in FAR 31.203 or applicable CAS (403, 410, 418.50(c)). Conversely, a more appropriate basis for allocation purposes should be used when it is determined that the contractor's method produces inequitable results and the amounts involved are significant. Such a condition would result in a FAR 31.203(c) or applicable CAS noncompliance (see 8-300).

d. Part IV of the contractor's disclosure statement provides information on the contractor's bases and pools, including a functional or departmental breakdown of indirect expenses. An audit of the disclosure statement (or equivalent data from non-CAS-covered contractors) will frequently assist in determining whether cost allocations are equitable. Any differences or inadequacies should be identified and reported to the cognizant Federal agency official (CFAO) in accordance with 8-200. If the contractor is not required to disclose its practices, a comparison should be made between the claim and the contractor's written policies or procedures.

6-606.2 Number and Composition of Pools

a. The number and composition of pools should be governed by practical considerations (FAR 31.203(c)) and/or CAS (418, 403, and 410).

(1) Proper allocation of manufacturing overhead generally requires the use of departmental or burden center rates. However, the use of a single plant-wide rate may be acceptable when it can be demonstrated that its use will result in equitable allocations: for example, when a single product is manufactured; when several products are manufactured but each requires proportionately the same amount of overhead work; or when the contract activity is so small that costs of such segregation outweigh the benefits received.

(2) When the contractor's accounting system does not provide for the segregation of engineering expenses from the total manufacturing pool, and when engineering costs represent significant costs to the Government, the auditor should make appropriate tests to determine the equity of the combined allocation. If the combined allocation is not equitable, the auditor should determine separate rates. For example, engineering effort may not be required on commercial or Government contracts, or it may not apply to contracts in the same ratio as manufacturing labor.

(3) Contractors modifying their accounting systems to an advanced cost management system are adopting well thought out plans for distributing and identifying costs to objectives. The shift to an increasing number of cost pools is not for the purpose of fragmenting the existing pools and bases but to portray more accurate product cost. During the accounting system development phase, contractors should consider the cost benefit relationship between a large number of cost pools and better costing in striking a reasonable balance. Auditors should consider and, if necessary, discuss the cost benefit analyses at progress briefings conducted during the implementation period.

b. When a contractor's activities are decentralized, the use of separate indirect cost rates for each geographic location will normally produce more equitable allocations of indirect cost than the use of composite or company-wide rates. Overhead rates determined for offsite activities should be based on eliminating from the overhead pool those types of indirect costs which do not benefit offsite activities. For example, occupancy costs may be eliminated from offsite pools because the contractor uses Government facilities.

c. The manner in which contract prices were negotiated may have a significant bearing on the method for absorbing costs on individual contracts or groups of contracts. Advance understandings or "ground rules" may be established by agreement between the contracting officer and the contractor to facilitate final cost determination. (See FAR 31.109 for a description of advance agreements.)

d. The cost of money (CAS 414) is an imputed cost which is identified with the total facilities capital associated with each indirect cost pool and is allocated to contracts over the same base used to allocate the other expenses included in the cost pool. The cost of money may be considered to be an indirect expense associated with an individual cost pool but should be separately identified. The cost of money is subject to all of the same allocation procedures as any other indirect expense (see 8-414).

6-606.3 Allocation Bases For Overhead and Service Centers

a. Overhead ordinarily includes costs incurred to support direct labor or acquisition, storage, and issuance of direct materials. Therefore, overhead is ordinarily allocated to final cost objectives without any intermediate allocations. Service centers are departments or other functional units which perform specific technical and/or administrative services for the benefit of other units. Their cost can be allocated partially to specific final cost objectives as direct costs and partially to other indirect cost pools, usually based on units of output.

(1) When CAS is applicable, the auditor should refer to the requirements of CAS 418 and implementing audit guidance in 8-418 in addition to this section. Even though CAS does not apply, the auditor will find the guidance in CAS 418 to be useful in evaluation of allocation bases; however, FAR, not CAS, must be cited as a reason for questioning the appropriateness of the base.

(2) In the evaluation of an allocation base for overhead or service center costs, the auditor should refer to the guidance in CAS 418.50e for pools which do not contain material amounts of the costs of management or supervision of the base activities and CAS 418.50d for those which do. CAS 418.50e recommends a hierarchy of bases, the most preferred being measures of resource consumption followed by measures of output and finally by a surrogate measure which varies in proportion to services received. Since neither consumption nor output of managerial and supervisory effort can be measured in terms of the relative benefit conferred on differing elements of the activity base, CAS 418.50d(1) merely requires that the base be representative of the activity being managed or supervised. CAS 418.50d(2)(i) requires that direct labor hours or direct labor dollars be used for overhead allocation except under special circumstances as noted below, and that selection between the two should be based on which is the more likely to vary in proportion to the costs included in the pool.

b. Acceptable activity bases for apportionment of overhead and service department costs include among others, direct labor hours, direct labor costs, direct labor plus

fringe benefits, prime costs, direct material cost, value or units of production, floor space, cubic content, meter readings, and machine hours. Any one or a combination of these may be acceptable in a particular case and unacceptable in another. The following paragraphs contain guidance to assist the auditor in evaluating the more common methods of allocating overhead and service center costs.

(1) Direct Labor Hours. Direct labor hours is an acceptable base for allocation of overhead costs when the employees are largely interchangeable such as in a manufacturing operation. The basic data for using direct labor hours usually are available through job tickets. However, if the cost of accumulating the data is prohibitive, the use of this basis is not recommended.

(2) Direct Labor Cost. This activity base is used for allocating overhead because data are readily available and the method is simple and economical. Labor costs are usually controlled by payroll records and the general books of account, and the base is subject to audit verification. This basis is usually acceptable at a manufacturing location when labor rates are relatively uniform and when production labor is a significant element of the product cost.

(a) This basis is often used at non-manufacturing locations. Employees at such locations have widely differing skills and salaries which are correlated to their technical expertise, which in turn is the subject matter of contracts with such locations. Related overhead is primarily supervision and occupancy, both of which tend to vary directly with the cost of professional labor.

(b) When direct labor cost is the basis for allocating costs, the auditor should normally eliminate all overtime and shift premium costs from the base. However, overtime and shift premium costs need not be excluded from the base when:

(i) the amount of audit work required does not warrant it or

(ii) equally equitable results will be obtained even though these additional costs are included.

(c) When direct engineering labor cost is the base for allocating the related engineering costs at a manufacturing location, adequate tests should be made of the salary or wage levels of employees engaged on Government contracts compared to the overall engineering salary and wage structure. If the average wage of employees engaged on Government contracts is substantially different from the overall average, the direct labor cost method ordinarily will not be acceptable. In such instances, the auditor should consider recommending a direct engineering labor hour base.

(3) Direct Material Cost. Direct material cost may be used to allocate costs of material handling (purchasing, receiving, or shipping) departments. It is particularly important that the auditor analyze the pool and base relationship. For example, total material cost may not be an appropriate base if it includes significant costs for items which are not received at the contractor's plant but are drop shipped directly to the end user.

(4) Unit of Product. The unit of product method is perhaps the simplest form of allocation because it distributes overhead equally to each unit of product manufactured during the period. However, the use of this method is limited to companies producing a single product, or a few products which contain elements such as weight, dimension, or other measure common to all the products produced.

(5) Floor Space, Cubic Content, and Meter Readings. Floor space area, value of space, cubic content, or meter readings may be used to allocate certain types of indirect costs on a

plant-wide basis. One or more of these bases may be used to allocate service department expenses to producing departments or to cost centers.

(6) Machine Hours. The use of machine hours as the basis for allocating indirect costs may be appropriate when the principal factor in production is the use of machinery. It is most frequently used to allocate the indirect costs of a manufacturing department or service center using large machines. Today's trend toward technological modernization of manufacturing facilities tends to intensify machine orientation on the factory floor (14-800). As a result, careful consideration must be given to the suitability of overhead allocation bases. With the movement toward a machine orientation, the use of machine hours and other machine oriented bases (such as process time and operation movements) is likely to become relatively more appropriate. Objections to the use of machine hours as a basis for allocating overhead costs include the expense of accumulating special cost data not otherwise required. However, with the advent of machinery encompassing the ability to accumulate performance data, these objections may not continue to be applicable.

c. Some advanced cost management systems will place a stronger focus on the activities of a business. For businesses that made technological progress, this means a shift to more machine oriented allocation bases, such as machine hours, process time, and operational movements. In other areas of the business operations, appropriate allocation bases may be transaction volume or services rendered, such as space utilization, plant layout, engineering change notices, and purchase requisitions. Selection of appropriate allocation bases which have a causal or beneficial relationship with the pooled costs is no different for an ACMS (see 14-800) than for traditional accounting and is compatible with the requirements of CAS 418.50(e).

6-606.4 Allocation Bases for General and Administrative Expense Other Than Corporate/Home Office Expense

a. G&A expenses are any management, financial, and other expenses which are incurred by or allocated to a business unit and which are for the general management and administration of the business unit as a whole. When CAS 410 applies, the auditor should refer to the requirements of the standard and implementing audit guidance in 8-410. When CAS 410 does not apply, the auditor may refer to CAS 410 in conjunction with the guidance in this section. Audits of corporate/home office expense allocations, and G&A expense allocation under facilities contracts are discussed in 6-606.5 and 6-606.6.

(1) The pool grouping should be assessed using the principles set forth in FAR 31.201-4, Allocability, and 31.203, Indirect Costs. The expenses in the G&A pool should represent only the cost of those activities that are necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown. The cost of those activities incurred specifically for a contract or that can be distributed to both Government and other work in reasonable proportion to the benefits received should be removed from the G&A pool and distributed to the final cost objectives on a more appropriate basis. Expenses which are not G&A expenses but are insignificant in amount may be included in the G&A expense pool.

(2) The distribution base should be evaluated to assure that it is common to all cost objectives to which the G&A pool is to be allocated. As stated in CAS 410.50(b)(1), the G&A allocation base should be a cost input base representing the total activity of the business unit. Cost input bases are discussed in 6-606.4b(1) and include total cost input, value

added and single element. CAS also permits special allocations under certain conditions (CAS 410.50(j)) and permits variants of the foregoing cost input bases if they are representative of the total year's business activity and produce an equitable distribution of the G&A expenses to all final cost objectives (CAS 410 supplement). A more appropriate basis for allocation purposes should be used if it is determined that the selected base does not adequately represent the total year's business activity or results in an inequitable distribution of the G&A expenses to final cost objectives, and the amounts involved are significant. Such a condition would result in a FAR 31.203(c) or applicable CAS noncompliance (see 8-300). For reporting CAS/FAR noncompliances found during the audit, auditors should follow the guidance in 10-808.

(3) FAR 31.203(c) requires that the contractor accumulate indirect costs by logical cost grouping so as to permit use of an allocation base that is common to all cost objectives to which the cost grouping is to be allocated. The FAR further states, "The base selected shall allocate the grouping on the basis of the benefits accruing to intermediate and final cost objectives." If a contractor which is not CAS-covered has a single pool, the auditor must evaluate its allocation base against this requirement.

b. The subparagraphs below provide comments on distribution bases which may be proposed for allocating G&A expense to contracts/jobs where Cost Accounting Standards do not apply.

(1) Cost Input. Cost input is the cost, except G&A, which for contract cost purposes is allocable to the production of goods and services during the cost accounting period. The most often used bases are: total cost input (TCI), all costs excluding G&A; value-added cost input, all costs excluding material, subcontracts, and G&A; and single element cost input. Cost input bases are generally acceptable for Government contracts because they express the causal and beneficial relationship between G&A expenses and all of the final cost objectives of a cost accounting period (matching principle).

(2) Cost of Goods Sold. The cost of goods sold base is often identical to TCI, and when identical it is acceptable. Its advantage is that the amount is generally available from the accounting records and does not require separate computation. Cost of goods sold bases may be unsatisfactory when the G&A expense allowable under Government contracts is more closely related to production for the period than to products distributed and sold. Distortions are most likely to result when some of the contractor's products require a long manufacturing cycle, or when commercial items are produced for stock or leasing rather than to fill sales commitments. G&A expenses which are not clearly a part of production may not be applied to inventory because to do so would violate generally accepted accounting principles. Distortion may also result if a contractor classifies all costs incurred under cost-type contracts as sales when the costs are incurred, but does not record sales under fixed-price contracts and other work until shipment of the completed product.

(3) Cost of Sales. Cost of sales includes selling costs whereas cost of goods sold does not. The cost of sales base is inequitable because the contractor is precluded from recovering allowable selling costs and must allocate G&A to all selling costs. All other considerations affecting cost of goods sold apply to cost of sales.

(4) Cost of Goods Manufactured. Costs of goods manufactured equates to costs of goods sold before the adjustment for the difference between the beginning finished goods inventory and the ending finished goods inventory. Cost of goods manufactured is generally not an acceptable allocation base for G&A expense under Government contracts because it does not adequately represent the cost of production for the accounting period. Cost of goods manu-

factured includes prior period costs applicable to goods in process at the beginning of the accounting period and excludes current period costs applicable to goods remaining in process at the end of the accounting period. Distortions are most likely to result when the contractor's products require varying manufacturing cycles, some longer than others, or inventories of raw materials and work in process vary significantly between the beginning and end of the accounting periods.

(5) Total Sales. Total sales as a basis for allocating G&A expense is generally not acceptable for Government contracts because:

(a) the concurrence of sales with production usually varies between the items produced for the Government and those produced commercially,

(b) the margin of profit may vary appreciably among contracts and between Government and other work, and

(c) the final selling price of incentive type contracts or other contracts which contain price revision terms is not known until the work has been completed and the price negotiated.

6-606.5 Allocation Bases for Corporate/Home Office Expense

a. When CAS 403 applies, reference should be made to the requirements of the standard and implementing audit guidance in 8-403. When CAS 403 does not apply, it may be used as general information in conjunction with the guidance in this section.

b. Home office expense is the cost of administering the overall operations of a multi-plant or multi-segment company. Home offices typically establish policy for and provide guidance to the segments in their operations. They usually perform management, supervisory, or administrative functions, but may also perform service functions in support of the operations of the various segments. The costs may include:

(1) those incurred for the benefit of a specific segment, such as specialized consulting services or leases for specific facilities;

(2) those incurred for the benefit of several but not all segments, or for several segments in differing proportions, such as a central computer center or similar service operations or fringe benefit costs such as pensions and insurance;

(3) those incurred for the common benefit of all segments, such as board of directors expenses or top executive salaries.

Costs of the third type, often referred to as "residual" corporate/home office expense, are typically allocated to all segments over a common allocation base except as discussed in d. below. Costs of the first two types, where significant, require separate allocation for equitable costing of Government contracts at the various segments.

c. The segment auditor should identify all type (1) and type (2) expenditures allocated or charged to the segment, and should request audit assistance simultaneously with the request for verification of the corporate (type (3)) allocation. Whether or not assist audit requests have been received, the corporate auditor should initiate the audits of charged and allocated expense without delay. The corporate auditor is also required to audit and report on significant matters contained in the corporate financial statements, minutes, SEC filings, and tax returns, and to furnish an information copy of the published financial statements to the segment auditors.

d. To evaluate the bases used by the contractor to distribute home office expenses, the auditor should carefully evaluate the organizational structure and operations of the corporate office and each corporate segment, including details of the type of service and support

rendered by the corporate office to each segment. This may require close cooperation among the contract auditors cognizant of the company sites. (See 15-200 for information on the contract audit coordinator (CAC) program which has been established to facilitate this coordination within DCAA.) In addition, the corporate/home office auditor is responsible for the necessary audits of segments not involved in Government contract work. The objective is to see that the contractor's allocations proportionately distribute home office costs to all segments of the business on the basis of the relative benefits received. Use the applicable contract cost principles (such as FAR 31.201-4, 31.202, and 31.203) as criteria to evaluate the contractor's method.

e. Residual expenses generally have no discernible direct benefit to a particular segment but are necessary to the overall business operations. They may be categorized as costs relating to the prudent management of all resources at the disposal of the corporation. Residual expenses may include the salaries, fringe benefits, occupancy costs, taxes, and other administrative expenses of the board of directors, executive committees, corporate officers, and administrative/executive management officials. The basis of allocation of residual expenses should reflect the total activities of all segments of the business. However, certain segments may require special allocations of residual expense if their operations are relatively self-contained or self-sufficient and/or require minimal administrative support from the corporate/home office. Conversely, a segment may require special allocation in amounts greater than the average rate if it is highly dependent upon the home office staff for general administrative support. (See 6-606.6 regarding allocations to GOCO activities.)

f. The form of the business (foreign or domestic), the extent of ownership (wholly- or partially-owned), or the accounting treatment for financial accounting purposes (consolidated or unconsolidated) are not basic criteria for determining whether a particular segment should be included in or excluded from the residual allocation base. Also, the fact that an individual contract or group of contracts does not permit recovery of corporate office expenses is not a reason to exclude the operating segment performing the contract(s) from the base of allocation. Once an appropriate base for distributing indirect costs has been accepted, it should not be fragmented by removing individual elements (FAR 31.203(d)). Also see CAS 410.50j for a discussion of special allocations. To the extent that the home office provides necessary support for the segment, a proportionate share of the residual expenses should be allocated to that segment.

6-606.6 Allocation Bases for Residual Corporate/Home Office Expense to GOCO Activities

a. Special attention should be given to the appropriate allocation of residual corporate/home office expense to Government-owned contractor-operated (GOCO) plants. Contractor's GOCO activities are usually conducted on a basis substantially independent of supervision by higher corporate echelons. In addition, less administrative support is usually received from the central office since many corporate administrative services are paralleled by the GOCO administrative activity. In such circumstances, it would not be equitable to distribute a share of all the higher level supervisory or administrative expenses to these plants on a proportionate basis by any of the methods commonly used to allocate residual corporate/home office expense to segments.

b. Each auditor at a GOCO plant will provide the corporate/home office auditor information on the nature and extent of administrative functions performed at the GOCO plant. The home office auditor and the contractor will reach agreement on whether administrative functions performed at the GOCO duplicate home office functions, so that a suitable corporate allocation structure is developed for GOCO activities.

c. If it is appropriate to allocate less residual expenses to a GOCO, the contractor may accomplish this by developing two expense rates as follows:

(1) a basic rate reflecting those corporate expenses which apply to all work of the contractor including GOCO plant operations, and

(2) a rate in addition to the basic rate reflecting those corporate expenses which apply to all work of the contractor except GOCO plant operations. Figure 6-6-1 is an example of the development of such rates.

d. Where CAS 403 applies, any special allocations of residual corporate/home office expenses to GOCO activities are established by agreement between the contractor and the Government in accordance with CAS 403.40(c)(3) and 403.50(d). Only a contracting officer may execute such an agreement, but the contract auditor will normally evaluate the proposed method before an initial agreement. The auditor will evaluate the continuing appropriateness of the contractor's method during each audit cycle, and advise the contracting officer if any formal agreement warrants revision.

Figure 6-6-1 (Ref. 6-606.6)
Sample Of Corporate Expense Rates --- GOCO Activities

		Rate Calculations	
	Totals	Basic	Additional
Residual Corporate Expenses:			
Basic (applicable to all segment activities)	$ 20,000	$ 20,000	—
Balance (applicable to non-GOCO segment activities)	$ 40,000	—	$ 40,000
	$ 60,000	$ 20,000	$ 40,000
Base of Allocation:			
GOCO segment activities	$ 200,000	$ 200,000	—
All other segment activities	$ 800,000	$ 800,000	$800,000
	$1,000,000	$1,000,000	$800,000
Rates	—	2%	5%
Note: In this illustration, the corporate expense rate applicable to GOCO activities is 2%; the rate applicable to other activities of the contractor is 7%.			

6-607 Reserved

6-608 Indirect Costs Transaction Testing Plan

6-608.1 General Guidance

a. Indirect costs are incurred as a result of business decisions made at all levels of management. These decisions may be based on established policies or may be a manager's choice among several options for achieving an objective. The auditor should consider the reasons underlying management decisions when a specific cost item and the Government's interest in the total allocated portion of indirect costs is significant.

b. The audit objectives are to:

(1) ascertain the extent to which the contractor's policies are being implemented at the operating level,

(2) determine whether the contractor is maintaining adequate control over the level of indirect expenditures,

(3) ascertain and evaluate significant fluctuations in the ratios of the accounts to the allocation base, and

(4) determine whether the contractor has excluded from expense pools costs which are unallowable because of the provisions of law, regulations, or the contract; unrea-

sonable in nature or amount; inapplicable to the Government operations; or inapplicable to the indirect cost pool or period being audited.

This section provides guidance on the techniques for selecting accounts to be analyzed and the basis for questioning costs.

c. A transaction testing plan should be prepared to document evaluation of the contractor's annual incurred cost proposal. This plan should fully consider all significant costs, both direct and indirect. The auditor should ensure that all MAARs that require transaction testing and any other MAARs not accomplished during the preliminary steps of the annual incurred cost audit or other field work are addressed in the transaction testing plan. The extent of required transaction testing should be based on consideration of all the following factors:

(1) assessment of control risk,

(2) prior audit experience (including the documented risk shown on the ICAPS),

(3) materiality,

(4) reliance on the work of others, and

(5) results of the preliminary audit procedures

d. Regardless of the assessed level of control risk at a major contractor, the auditor should perform substantive tests for significant account balances and transaction classes. Substantive tests include both analytical procedures such as the comparative analysis MAARs (e.g., 8 and 15) and transaction testing. The auditing standards do not envision any circumstance where the assessed level of control risk would be low enough to eliminate the need for substantive testing, however, the level of substantive testing should be tailored based on the criteria discussed in c. above. Accounts/transactions to be tested can be selected considering the techniques described in 6-608.2. Sensitive accounts should be audited frequently, or on an annual basis as appropriate, while less sensitive accounts should be selected on a rotating basis.

e. At nonmajor contractors, transaction testing of significant indirect expense account balances and transaction classes that are considered medium or high risk should be completed for each contractor fiscal year that is audited. At nonmajor contractors subject to low risk sampling, transaction testing is required for proposals selected for audit in accordance with 6-104.2. Transaction testing is required to determine and document that the contractor’s incurred cost proposals should continue to be classified as low risk. The level of transaction testing performed should be based on the auditor’s assessment of materiality and other risk factors and must be documented in the working papers. When multi-year auditing techniques are used, transaction testing should be performed in accordance with 6-603.6b. Transaction testing should not be performed on contractor fiscal years classified as low risk and not selected for audit.

f. Movement to an ACMS (see 14-800) can encompass a large number of cost pools (see 6-606.2). Successful accomplishment of audits encompassing a large number of pools depends upon the application of the basic audit concepts of materiality and risk assessment during the audit planning stages. First, look for the strength of internal controls over the system itself (see 5-1000 Audit of Indirect and Other Direct Cost System Internal Controls). Then, determine the areas of risk and materiality. Are they concentrated in several pools, or are they concentrated in several key accounts spanning all pools? Place audit resources where a vulnerability assessment indicates the greater risk and materiality. Using a combination of auditor judgment and statistical sampling techniques, evaluate the high-risk/materiality pools. Consider auditing the high-risk/materiality pools more frequently and the low-risk pools on a

rotating basis. As an alternative, determine if there are sensitive accounts which span all pools, and perform the audit focusing on these accounts.

In addition, determine if the contractor's internal auditors will also be performing reviews on the cost pools. Coordination with these auditors, after determining the coverage and reliability of their efforts, may provide assistance and minimize potential duplication. Finally, audit tools, such as downloading information from the contractor's computer to assist the audit process, hold great promise as an effective approach to manage an audit of a larger number of cost pools efficiently.

6-608.2 Techniques for Account Selection

The basis for determining the specific areas to be selected for detailed evaluation and testing and the scope of the audit should be determined by plant observations, consideration of management decisions, and account analysis.

a. Plant Observation. Plant observations are an integral part of the audit of indirect costs. They provide valuable indicators of accounts to be analyzed and/or areas of high risk. In performing the observations of a contractor's plant, the auditor should consider the following:

(1) When the contractor maintains segregated cost centers, the auditor should observe the manner in which physical and accounting segregation is accomplished, particularly when Government contracts and commercial production are performed in the same general area. The extent of observation should be influenced by the degree of control established by the contractor to preclude the interchange of operations. The observations should assist in ascertaining which pools, cost centers, and accounts require the greatest emphasis during the audit.

(2) The auditor should determine the manner in which the contractor establishes new production lines and should inquire into all aspects of a new line, noting any similarity between the contemplated production and the production currently in process. Again, this will assist in determining the pools, cost centers, and accounts requiring the greatest emphasis during audit.

(3) The auditor should observe the existence of idle facilities and determine whether idleness results from ordinary maintenance, lack of work, temporary machinery breakdown, or faulty production planning. Guidance on the allowability of idle facilities and capacity is provided in FAR 31.205-17.

(4) The auditor's physical observation program should include inquiries into the reasonableness of rework and scrap generated. When it is determined that there is an unreasonable amount of rework or scrap, the auditor should ascertain the causes. The audit of rework and scrap costs may require the assistance of Government technical personnel.

(5) The auditor should observe the contractor's manufacturing facilities to develop a better understanding of the contractor's manufacturing processes and monitor the trends in manufacturing practices and processes (5-108d). Some contractors have accomplished substantial technological advancements on the factory floor. These changes in manufacturing operations can cause changes in the flow of costs. Factory observations should assist in identifying the expense pools requiring further evaluation.

b. Effect of Management Decisions. The auditor should review executive or directors' minutes, company newsletters, and internal and external audit reports for indicators of accounts to be audited. These may disclose audit leads, such as the following:

(1) a lag in reducing indirect costs during periods of declining production, including the retention of supervisory and technical personnel when their services are not required at that time or in the foreseeable future,

(2) unwarranted increases in the number of and in the salaries of executives, indirect personnel, and engineers,

(3) the imposition of additional tiers of supervision without apparent need except as a means of retaining technical and supervisory personnel,

(4) continuing liberalization of fringe benefits as a means of recruiting and retaining technical and administrative personnel,

(5) increased depreciation costs, attributable to high-cost plant expansion or changes in the method of computation,

(6) the inclusion of depreciation of idle or excess facilities during a declining production period,

(7) the leasing of facilities under "sale and leaseback" or "lease in lieu of purchase" agreements in excess of ownership costs,

(8) unusual increases in expenses such as plant rearrangement, rehabilitation, relocation, and leasehold improvements,

(9) expansion of training programs, recruitment programs, and public relations expenses,

(10) unusual increases in contractor initiated research and development programs and bid proposals, particularly during periods of declining production,

(11) investments in automation, modernization of manufacturing facilities, or mechanization,

(12) a major shift in the nature of or the methods used in the production processes,

(13) increasing costs for maintaining or overhauling old productive equipment in lieu of investing in new equipment, and

(14) internal control weaknesses disclosed by internal or external audits. In addition, unallowable, unreasonable, excessive, or incorrectly classified costs may be generated as a result of a contractor's policies and management decisions underlying the policies. (See 6-604 for comments on the evaluation of policies, procedures, and internal controls.) For example, a contractor's policy for recording costs may be designed to provide flexibility in charging engineering costs directly to contracts, IR&D and B&P, or to overhead depending on monetary limitations of contracts or advance agreements. When a contractor's policy is questioned, the auditor should evaluate the probable consequences of continuing the questioned policy and make appropriate recommendations. Such cases may be reportable under the provisions of 4-700 (detection and reporting of fraud, other unlawful activity, or improper practices).

c. General Account Analysis

(1) Nomenclature Review. Using a copy of the contractor's post-closing trial balance, which has been reconciled in accordance with the guidance in 6-610, the auditor should select for thorough analysis those accounts which are new and/or significant in amount, vary from developed trends, or which on the basis of nomenclature review or past experience appear to be sensitive in nature and likely to contain questionable costs. However, categories of indirect expense should not be accepted or rejected solely on the basis of a nomenclature review. The actual content of accounts being evaluated must be established through testing of transactions.

(2) Comparative Analysis. The auditor should also compare the claimed amounts of the various accounts with the amounts claimed and/or expended in prior years and the amounts shown in the current year's budget. The comparisons should disclose:

(a) whether there have been significant changes in the dollar amount of claimed individual expense items which may not be comparable to a change in the level of operations;

(b) whether there are unexplained differences which may require a more intensive evaluation, additional testing, and verification;

(c) whether management is maintaining control over expenditures by periodic comparisons with budgeted amounts;

(d) whether there have been reclassifications of costs or changes in cost accounting practices; and

(e) whether the expense is recorded in the proper account identified with the cost center, department, or expense pool which derives the benefit.

When the pattern indicates a tendency for indirect costs to increase in comparison to direct costs, the auditor should determine the factors which are contributing to the increases (see the list of factors affected by management decisions in 6-608.2b above). These comparative analysis procedures will satisfy MAAR 15. Follow-up and resolution of discrepancies noted in the foregoing analyses and the related testing of transactions satisfies MAAR 16. The audit of account detail and individual transactions must include a determination of the sources of journal entries and testing to ensure propriety. Significant and sensitive adjusting entries should be evaluated (e.g., journal entries reclassifying direct to indirect costs). These procedures will satisfy the indirect adjusting entries portion of MAAR 10.

(3) Quantitative Methods. The use of graphic and computational analysis techniques can be helpful in the audit of incurred costs. The auditor may be able to detect trends or correlations which permit the focus of attention on indirect expense accounts, pools, departments, or other segments of cost which appear to be unreasonable or out of line. Further, sampling and IT techniques (such as DATATRAK and other data retrieval software) will assist the auditor in selecting transactions for evaluation. Consideration should be given to the use of these techniques during incurred cost audits.

d. Specific Account Analysis. In addition to the areas discussed below, Chapter 7 discusses items of cost and accounting methods requiring special attention. This chapter should be reviewed to assure adequate coverage of any applicable items. Special attention should be given to the discussion of IR&D and B&P costs because of its general applicability at most locations.

(1) Contingent Expenses. Items charged to indirect expenses, not representing actual costs but rather a provision for contingencies, should be excluded from allowable costs. The auditor should refer to FAR 31.205-7.

(2) Indirect Labor. The audit of labor costs is discussed in Section 4 of this chapter. Recruitment costs are also discussed in Section 4 because they are closely related to the budgeting of labor costs and the determination of personnel requirements.

(3) Indirect Material. Priced or quantitative year-end inventory records should be audited to determine whether increasing costs indicate a trend towards a buildup of supply inventories. When contractors account for supply items as an expense at time of purchase, a comparison should be made of the amounts expended for various categories of supplies for the current and several preceding periods. Further discussion of the audit of material costs is contained in Section 3 of this chapter.

(4) Miscellaneous Charges. Miscellaneous charges to indirect costs may result from transactions of earlier or future periods. Included in this category are depreciation expenses, amortization of prepaid costs, and accruals of liabilities. Entries representing the write-off of prepayments or the establishment of accrued liabilities should be tested for propriety, reasonableness, allocability to the period, accuracy of computation, correctness of account distribution, and sufficiency of documentary support. The extent of verification should depend on the significance of the dollar amount and the extent to which the Government participates in the cost.

(5) Miscellaneous Income and Credits. The auditor should evaluate the contractor's financial statements, tax returns and adjusting entries in the general ledger or other subsidiary ledgers to identify any income or credits in which the Government should share as well as to evaluate the exclusion of any adjustments not reflected by the contractor in contract costs. (See 6-610 for guidance on the verification of the base and pool to the accounting records.)

(a) The auditor should identify the nature of all income received from sources other than the sales of the contractor's normal products. It is preferable that income, refunds, or credits applicable to a Government contract, such as purchase discounts, income from sale of scrap, and rental income, be credited directly to the contract. However, if the income, refunds, or credits are not significant and the contractor's accounting treatment is equitable, these may be apportioned between commercial and Government work through reduction of indirect cost pools or some other equitable method. The extent of audit in this area will depend on the effectiveness of the contractor's accounting procedures. Thus, the early identification of system weaknesses is of prime importance.

(b) Additional items which may be pertinent as credits or refunds under Government contract costing include: refunds of various state and local taxes such as franchise, personal property, and income taxes; royalty expenses which have been accrued but remain unpaid; workers compensation rate adjustments; and credits or reduction in rates of employer contribution to pension plans, death benefit plans, and similar group insurance plans, following accumulation of reserves built up through excessive rates, reversionary credits, or in some other manner. Accomplishment satisfies MAAR 5 at the segment level; corporate level steps appear at 6-608.3b(1).

6-608.3 Basis for Questioning Costs

Expenses may be questioned based on allowability, allocability, and/or reasonableness.

a. Allowability. Certain costs are rendered unallowable by provisions of pertinent laws, regulations, contract clauses, or mutual agreement and cannot be included in prices, cost reimbursements, or settlements under Government contracts to which they are allocable. The contractor must certify that its indirect cost claim contains no unallowable costs. The contractor's claim should be examined to ensure that all directly associated costs have also been removed. (See 1-504.4a.)

(1) When certain costs are specifically identified in the contract as being unallowable, the contract may also provide criteria that must be met before a cost is considered allowable or limitations that cannot be exceeded. For example, the contract may state that subcontracts or travel must be approved by the contracting officer prior to the incurrence of the cost or it may state that overtime is allowable up to a specific dollar amount only. Contract briefs should be prepared to identify these clauses.

(2) CAS 405.40(a) requires that contractors affirmatively "exclude" costs which are either "expressly unallowable," as defined in CAS 405.30(a)(2), or mutually agreed to be unallowable. FAR 31.201-6 repeats this requirement for non-CAS-covered contracts. Examples of costs declared expressly unallowable, with limited exceptions for specified circumstances, by Federal statute or regulations are:

(a) contingent fees (except payments to bona fide representatives),
(b) entertainment expenses,
(c) fines and penalties,
(d) costs of organizing or reorganizing a business enterprise,
(e) contributions,
(f) interest on borrowings,
(g) losses on other contracts,
(h) certain types of advertising and business meetings, and
(i) Federal income taxes.

When the auditor's questioned cost is based on a selected cost principle criterion, the auditor must reference the applicable provision of FAR 31.205. A description of these and other items and the criteria for a determination of allowability are provided in FAR Part 31 (see Appendix A), 6-700, and 8-405.

(3) Certain costs or portions of cost may be identified as unallowable based on advance agreements negotiated by the ACO, such as use charges for fully depreciated assets (FAR 31.205-11(1)).

(4) If the contractor included expressly unallowable costs in the final indirect cost settlement proposal, the auditor should question the costs and recommend to the ACO that the costs be subject to the penalty provisions at FAR 42.709. Expressly unallowable costs are defined in FAR 31.001 (see 6-609.1e.). The term "expressly unallowable costs," as it is used in the penalty regulation includes only those costs that are expressly unallowable under FAR 31.205 or applicable agency supplement.

b. Allocability. Costs may be questioned because they are not allocable to Government contracts. Cost Accounting Standards provide criteria on the allocability of costs for CAS-covered contracts. For non-CAS-covered contracts FAR provides certain criteria. The following are examples of allocability issues.

(1) Out-of-Period Costs. In addition to recognizing the relationship of an incurred expense to its objective, the auditor must relate the time factor (period to which the expense is applicable) in the manufacturing process. Not all expenses incurred during a given period may be allocable in their entirety to the items produced during that period. Therefore, the audit effort should be directed to ascertaining whether costs such as indirect labor, payroll taxes, vacation expense, retirement accruals, bonuses, insurance, maintenance and repairs, depreciation, amortization of leasehold improvements, and similar indirect expenses included in the indirect cost accounts have been properly accrued or deferred. The object of the test is to disclose those indirect costs which have been assigned to a current period when the cost was incurred for the purpose of benefiting a future or past period. Year-end adjustments and adjustments involving prior cost periods must be evaluated to determine materiality and applicability to current costs. Year-end adjustments may have a significant effect on the expense pool or bases for the allocation of indirect costs. The auditor's evaluation should insure that the contractor's year-end adjustments actually result in a more precise allocation of indirect expenses. This analysis and the segment level steps at 6-608.2d(5) satisfy MAAR 5.

(2) Consistent Classification. Consistency in the composition of indirect cost pools must be considered in determining the validity of the indirect cost pool as a whole. When the contractor's procedures provide that specific items of costs are charged directly to Government contracts, the auditor must, prior to accepting the residual costs (6-606.5b) in the indirect cost pool, ascertain whether similar costs are also charged directly to the commercial work. Items which can be identified directly with other classes of work must be excluded from the expense pools if items identifiable with Government contracts are charged directly (see FAR 31.202 and 31.203 or CAS 402).

c. Reasonableness. FAR 31.201-3 defines reasonableness. A cost may be considered unreasonable because it was not incurred in the most cost-effective manner. For example, the contractor may be providing its own guard service when outside vendors may be able to provide the service at a lesser cost. Tests of economy and efficiency are performed during operations audits.

6-609 Penalties on Unallowable Costs

6-609.1 Statute and Regulation

a. Penalty provisions for the submission of expressly unallowable costs are included in 10 U.S.C. 2324(a) - (d) and 41 U.S.C. 256 (a) - (d). FAR 42.709, implementing this statutory penalty provision, requires that penalties be assessed if a contractor claims an expressly unallowable indirect cost in (1) an indirect cost settlement proposal, or (2) the final statement of costs incurred or estimated to be incurred under a fixed-price incentive contract, on covered contracts. Covered contracts include all cost type and fixed-price-incentive contracts in excess of:

- $500,000, issued on or after October 1, 1995 and before January 19, 2005,
- $550,000, issued on or after January 19, 2005 and before September 28, 2006,
- $650,000 for contracts issued on or after September 28, 2006 and before October 1, 2010,
- $700,000 for contracts issued on or after October 1, 2010.

b. Level of Penalties. There are two levels of penalties to be assessed.

(1) The first-level penalty (FAR 42.709-1(a)(1)) applies to costs that are expressly unallowable. This penalty is equal to the amount of expressly unallowable costs plus interest on such costs which were paid to the contractor.

(2) The second-level penalty (FAR 42.709-1(a)(2)) applies to costs which were determined to be unallowable before the indirect cost settlement proposal submission. This penalty is equal to twice the amount of such disallowed costs.

c. Definitions

(1) Expressly unallowable costs are defined in FAR 31.001. The term "expressly unallowable costs," as it is used in the penalty regulation, includes only those costs that are expressly unallowable under FAR 31.205 or applicable agency supplement (such as DFARS 231.205). It does not include any costs that are unallowable because they violate any other regulatory requirement or contract term, unless such regulation or contract term is also included in the cost principles. In addition, expressly unallowable costs do not include costs which are unallowable solely because they are unreasonable or unallocable.

(2) "Cost determined to be unallowable before proposal submission" means (for purposes of the second-level penalty) that the contractor had a formal written determination describing the particular unallowable costs that became final prior to the submission. FAR 42.709-3(b) provides four examples evidencing prior determination of unallowability: (i) an unappealed DCAA Form 1; (ii) unappealed contracting officer’s final decision, (iii)

court or Board of Contract Appeals decisions involving the contractor (precedents involving other contractors or similar costs will not be sufficient to sustain a second-level penalty); and (iv) a determination of unallowability of cost, or "mutually agreed-to-be-unallowable costs" under FAR 31.201-6.

(3) "Mutually agreed-to-be-unallowable costs" must be specifically designated as unallowable by an agreement between the Government and the contractor. Generally, the agreement would be in writing and describe the costs in sufficient detail to conclusively identify the costs in future proposals or claims. Mere agreement or concession by the contractor to a reduced overhead rate in the settlement process does not constitute agreement on the treatment of specific elements of cost, unless those elements of cost are specifically identified in the agreement and determined to be unallowable costs.

d. Waiver of Penalty. FAR 42.709-5 provides that there are certain circumstances where the ACO is required to waive penalties. Among these are: (1) when the contractor withdraws its overhead proposal submission before formal initiation of the audit, (2) when the amount of unallowable costs subject to penalty that are allocable to covered contracts is $10,000 or less, or (3) when the unallowable cost was inadvertently included in the submission and the contractor has established an adequate internal control system.

e. Formal Initiation of Audit. Since the regulations allow the contractor to withdraw its overhead submission before formal initiation of the audit in an effort to avoid penalties, it is important that the auditor establish verifiable evidence that the contractor is aware when the audit begins. FAR 42.709-5(a) provides that an audit will be deemed to be formally initiated when the Government provides the contractor with written notice, or holds an entrance conference, indicating that audit work on a specific final indirect cost proposal has begun.

6-609.2 General Guidance

a. Penalties are assessed based upon inclusion of unallowable costs in a proposal without regard to whether the Government has actually reimbursed the unallowable costs. The penalties are collected from the contractor in addition to recovery of any indirect cost previously paid in excess of the final rates. Even if an audit report has been issued or the rates have been negotiated, the Government may still assess a penalty if it is subsequently determined that the claim included unallowable cost subject to the penalty provision. Any such information which becomes known to DCAA should promptly be reported to the contracting officer. The submission claiming the unallowable costs establishes the contractor's liability.

b. General Responsibilities. Regardless of whether the rates are audit-determined or procurement-determined, the ACO determines whether or not a penalty should be assessed and issues a demand letter to the contractor for the amount determined. The auditor is responsible for:

- reporting all unallowable costs subject to penalties identified during the audit, regardless of dollar amount;
- making recommendations concerning the appropriateness of penalties when the contracting officer specifically requests that assessment; and
- providing assistance in computation of simple interest due the Government.

The auditor has no authority to impose the penalty, recover it against subsequent public vouchers, recommend the supplemental penalty, or waive the penalty. This authority rests with the ACO.

c. The penalty statutes and implementing regulations do not flow down to subcontracts. Auditors should not recommend penalties for subcontracts, even though their prime contracts include the penalty clause.

d. When a contractor division submits an indirect cost settlement proposal that includes unallowable costs subject to penalty, any such costs allocated to interdivisional work performed under another division's covered contracts are also subject to penalty.

e. When a contractor uses statistical sampling to identify unallowable costs, FAR 31.201-6(c)(3) specifically provides that when any of the sampled items are subject to penalty, as defined in FAR 42.709, the projected amount from those sampled items are also subject to the same penalty provisions. FAR 31.201-6(c)(3) applies when the contractor fails to exclude the projected amount associated with sample cost items subject to penalty from its proposal.

f. Voluntary Management Reductions. A contractor may not avoid a penalty by applying a voluntary management reduction that does not specifically identify the unallowable costs excluded from the proposal (see 6-604.2).

g. Both CAS 405 and FAR 31.201-6 require a contractor to identify and exclude any expressly unallowable costs from its final settlement proposal. If a contractor submission includes a significant amount of expressly unallowable costs, the audit report should address the contractor's failure to identify and remove those unallowable costs from its certified final indirect cost proposal; i.e., was the failure a one time occurrence or a systemic deficiency. If there is a systemic deficiency in the contractor's internal controls or its process for screening unallowable costs, a separate report should be issued detailing the unsatisfactory condition. See 5-110 & 5-111.

h. Whenever a significant penalty is recommended, the circumstances of the questioned cost and its inclusion in the final indirect cost settlement proposal should be considered to determine if it is appropriate to issue a DCAA Form 2000. See 4-700 for guidance on DCAA Form 2000.

6-609.3 Audit Requirements

a. The auditor should request that the contractor identify all contracts that contain or should contain the FAR penalty clause (FAR 52.242-3) in the submitted schedule of auditable contracts. Absence of the penalty clause in a contract does not prevent the Government from assessing the penalty. A contractor is bound by the required clause even though the clause is inadvertently omitted, because the statutes make it a mandatory clause.

b. The corporate indirect cost proposals include home office expenses allocable to the divisions. Each division’s allocable portion of the home office expenses is also included in the division's incurred cost proposal. Since the divisions have the contracts that include the penalty clause, the penalty recommendation on the allocated home office expenses should be made in the audit report on the division's annual incurred costs. To assist the divisional auditor in making penalty recommendations, the corporate auditor should identify those costs subject to penalty in the corporate audit report.

c. If the contractor has contracts that contain or should contain the penalty clause, the auditor must report questioned costs identified during the audit that are subject to penalty. The auditor has no authority to waive penalties; therefore, all questioned costs subject to penalty must be reported. The report note should contain sufficient information to show the factual basis for the penalty recommended. If a second-level penalty is recommended, the report should cite the specific prior determination relied upon for the recommended penalty. The reporting objective is to provide the ACO with the information necessary to determine which unallowable costs are subject to penalties and to allocate the penalties to covered contracts. Since the ACO determines whether a penalty is to be imposed, the auditor should not calculate the amount of penalty until requested by the ACO.

d. Recommendation of penalties based on statistical sampling. If a statistical sampling application is used to project questioned cost and the sample includes unallowable costs

subject to penalty, that portion of the sample subject to penalty shall be projected to determine the total recommended costs subject to penalty. The total recommended costs subject to penalty should be the point estimate of that projection. The audit report presentation of statistical sampling results should be in accordance with 4-605.

e. Reporting requirements are further discussed in 10-500. Sample paragraphs to include in the summary of audit results appear in 10-504.5c, and the required information to include in the exhibits and schedules is discussed in 10-504.5e(6). An exhibit should be included identifying questioned costs by penalty level, amount, and percent of base subject to penalty (see Figure 10-5-1). To assist in the application of penalties for unallowable home office expenses, the audit report on the corporate costs should include a schedule showing the costs subject to penalty for each division (an example is included in Figure 10-5-2). The exhibit listing all auditable contracts should identify those contracts that contain or should contain the FAR penalty clause.

f. There is a provision requiring the ACO to waive the penalty if the allocable costs subject to penalty are $10,000 or less (see 6-609.1d). If it is clear that the waiver will apply, the auditor, after coordination with the ACO, may reduce the reporting requirements to the minimum necessary to alert the contracting officer that there are costs subject to penalty and that the amount is $10,000 or less and is below the threshold for the waiver. Since the contracting officer has the responsibility to determine if the waiver applies, the auditor should coordinate with him or her prior to issuance of the report to ensure that the report will include the necessary information for the contracting officer to make the determination. The audit working papers should include the calculation supporting the FAO's conclusion that the penalty waiver would apply. For example, the reduced reporting requirement might be satisfied by a paragraph in the results of audit section that states:

> The examination found expressly unallowable costs subject to penalty of $80,000 in the G&A Pool. Of that amount, $8,000 was allocable to the contracts specified in FAR 42.709(b). This amount is recommended for penalty, but is less than the $10,000 waiver threshold discussed in FAR 42.709-5. As coordinated with Mr. Jones of your office on January 15, 20XX, additional information regarding the penalty will be provided upon request.

g. Computation of Penalty. When the ACO advises the auditor of his or her decision on disposition of a recommended penalty, the auditor should provide assistance, as requested, to calculate the actual penalties to be assessed to applicable contracts including the recommended period, rate, and base for assessment of interest using data gathered during the audit of the final rate settlement proposal.

(1) Cost Portion of Penalty. The cost portion of the penalty is associated with indirect costs that were proposed as part of indirect cost pools to be allocated over specified allocation bases. The penalized costs may be expressed as a rate applicable to the same allocation bases. Calculation of the assessed penalty requires identification of the portion of the allocation bases applicable to covered contracts (see 6-609.1a).

(2) Interest Portion of Penalty. In calculating the interest portion of the penalty, consider the following:

(a) Period. If the unallowable costs subject to penalty were incurred and paid evenly over the fiscal year, calculate the applicable interest assuming all unallowable costs were paid at the midpoint. If the unallowable costs were not incurred and paid evenly over the year, the interest would have to be computed using weighted average techniques. If a demand letter was issued by the ACO, interest should not be computed after the date of the

letter or the date of repayment by the contractor, whichever is earlier. The ACO uses different interest calculation procedures for the time period after the demand letter is issued.

(b) Rate. The rate specified by the Secretary of the Treasury according to Public Law 92-41 (Cost-of-Money rate, see 8-414.2) is the interest rate to be used. If the end point of the interest computation period is unknown at the time the auditor is making the calculation, provide the simple interest incurred to the end of the current month and the monthly interest rate applicable to the outstanding balance of paid penalized costs so that the ACO may adjust the calculations as necessary when the ending date is known.

(c) Base. The base subject to interest penalty depends on the amount of penalized indirect cost that has been paid by the Government. If the total amount of interim billings paid for the period is less than the total claimed indirect expenses, assume the contractor was reimbursed for its incurred indirect expenses in the following order:

(i) the allowable indirect costs agreed upon in the final rate settlement,

(ii) costs disallowed from the contractor's rates as part of the settlement process that are not subject to a penalty, and

(iii) costs disallowed in the rate determination that are subject to penalty.

6-610 Direct and Indirect Cost Verification

Guidance on the selection of the allocation (activity) bases is in 6-606. Guidance on the audit of the costs included in these bases (labor, material, other direct costs, and indirect costs) is in this and the following sections of this manual: 6-400, 6-300, 6-500, and 6-609. Guidance on the policies, procedures, and internal controls is in Chapter 5 (accounting system, allocation methods, preparation of submissions, etc.). Guidance on the verification of the base and pool is provided in this section.

6-610.1 Reconciliation to Records

The auditor should examine incurred cost proposals to verify that the costs claimed reconcile to the contractor's job cost subsidiary ledgers or other comparable records by major cost element (material, subcontracts, intracompany charges, other purchases, labor, indirect, other charges and credits, etc.). The subsidiary ledgers should be reconciled to general ledger control accounts, certified financial statements, labor reports, tax returns, factory records, depreciation schedules, and any other financial, statistical, or management reports or records which will provide assurance that the costs have been properly presented. Accomplishment of this examination satisfies MAAR 2 and a portion of MAAR 14.

6-610.2 Verification of the Base

Completion of the following evaluations in conjunction with 6-610.1 above will satisfy MAAR 14.

a. The auditor must be assured that the costs (or hours or other factors) included in the activity base comprise all costs (or hours or other factors) contemplated when the base was selected, and no other. For example:

(1) If direct labor cost is selected as a base for distribution of manufacturing overhead, the following items should be considered: Is the total overtime pay to be included or is the base

to include straight-time pay only? If the company pays a bonus for night shift work, is this bonus included in the base? Does offsite labor take a full share of the allocation? Is "purchased labor" in the base, if worked at the contractor's plant? If worked at the vendor's plant? Is premium pay for hazardous duty excluded?

(2) Does the base for distribution of home office expenses include the activity of subsidiary companies (domestic and foreign) when applicable?

(3) Has the contractor charged salaries or wages of engineering personnel devoted to its own engineering projects to overhead accounts, or otherwise excluded them from engineering direct labor bases? If so, such costs should be reclassified to the direct engineering labor base.

(4) For CAS-covered contractors, a comparison should be made with the Disclosure Statement, section 4, to assure the adequacy of the description of the bases. Disclosure Statement inadequacies and noncompliances should be reported in accordance with the guidance in 8-208g and 8-302.7, respectively.

b. Composition of the bases should be compared with the preceding period. If there are differences, the effect of the changes should be determined and the reasonableness and equity of the results evaluated.

c. Once an appropriate base for distributing indirect costs has been accepted, it should not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs (FAR 31.203(d)). For example, unallowable overhead costs, including those voluntarily deleted by the contractor, must remain in the cost input base so that they absorb their portion of the G&A cost.

d. The portion of the base which applies to cost-type Government contracts should be reconciled with the contractor's billings (interim and final reimbursement claims). This is significant because the adjustments resulting from the determination of actual indirect costs will be based on the data contained in the claims submitted (see 6-1000 for guidance on interim and final reimbursement claims). The preparation of cumulative cost summaries will facilitate this reconciliation. These cumulative cost summaries should be provided with the contractor's indirect expense proposal.

e. Movement to an ACMS (see 14-800) can encompass the use of new types of allocation bases (see 6-606.3). During review of an allocation base, determine what the base measures (resource consumption, output), and then determine if the contractor is capable of objectively measuring the base now and in the future. Because the proposed base may represent a totally new method of cost allocation, the contractor may not be able to support the proposed base with accumulated historical data. The contractor may have to support the proposed base with a combination of documentation such as production projections, historical data, employee interviews, manufacturer machine capability and specifications, and engineering analyses. Auditors should be open to verifiable forms of documentation which may be generated by the new system. Next, determine if the base provides for an equitable distribution of cost and if there is a beneficial or causal relationship between the pool and the base. Given the evolution to a strong technological orientation, the auditor may require technical assistance in evaluating the appropriateness of the proposed allocation bases. For example, one contractor proposed to allocate fabrication costs on operation movements. The operation movements encompassed functions which varied in difficulty and process time. However, with technical assistance it was determined that operation movements were an equitable base.

6-611 Indirect Cost Rate Calculation and Cost Distribution - Quick-Closeout

6-611.1 General Guidance

a. When the indirect cost pools have been verified and the activity bases for distribution have been accepted, the auditor should then verify the accuracy of the rate calculation and the distribution of indirect costs to Government contracts. Completion of this evaluation satisfies MAAR 19.

b. Contractors may develop indirect cost rates (pool/base) for application to the contract base, or may distribute indirect cost on a percentage basis (contract base/total base). Both methods produce the same results. There is no specific criterion for the number of decimal places by which to extend the rate. Generally, rates are extended to two places past the decimal point; however, if the costs are significant, the rates may need to be extended further.

6-611.2 Quick-Closeout Procedures (See 6-1010)

a. During the course of a fiscal period, many contractors perform numerous Government contracts as a continuing part of their activities. The direct and indirect costs incurred on an individual contract in the last fiscal period of its performance may be relatively small in amount, particularly if the contract is physically completed in the early portion of the fiscal period. In such cases it is generally mutually advantageous to the Government and the contractor to expedite the indirect cost settlement and close such contracts as soon as possible without waiting until after the end of the fiscal period and the subsequent final determination or negotiation of indirect cost rates for the entire period. Certain special conditions and requirements for closing terminated and completed cost-reimbursement type contracts on an expedited basis are presented in 12-407 and 6-711, respectively.

b. Because of the small amount of contract costs involved, the use of these procedures should result in only an insignificant difference in the amount of indirect cost applied to the contract for the closeout period as compared with the amount which would have been applied if the contract were not closed until after the annual or other periodic rate was established. Consequently, except as stated in paragraph 12-407, no adjustment to compensate for any such difference need be made in computing the periodic indirect cost rate to be applied to other contracts performed during the period.

6-700 Section 7 --- Administrative Procedures for Establishing Indirect Costs

6-701 Introduction

This section describes the administrative methods and procedures commonly used to establish interim billing rates and final indirect cost rates. Because indirect costs can only be definitely established at the end of the contractor's fiscal accounting period, special procedures are needed to reimburse contractors on an interim basis for the approximate indirect costs incurred and then to finalize the indirect cost rates after the end of the contractor's accounting period.

6-702 Definition of Terms

a. The term indirect cost means any cost not directly identified with a single final cost objective (i.e., a function, contract or other work unit for which cost data is measured), but identified with two or more final cost objectives or an intermediate cost objective. It includes, but is not limited to, the general groups of indirect cost such as those generated in manufacturing departments, engineering departments, tooling departments, general and administration departments and, if applicable, indirect costs accumulated by cost centers under these general groups. For contractors using fund accounting systems (mainly educational institutions), the term includes, but is not limited to, the general groups of expenses such as general administration and general expenses, maintenance and operation of physical plant, library expenses and use charges for buildings and equipment. (See FAR 31.203 for further discussion of indirect costs.)

b. The term final indirect cost rate means a percentage or dollar factor which expresses the ratio of the allowable indirect expenses to the direct labor, manufacturing cost, cost incurred or other appropriate base for the contractor's fiscal period customarily used for the computation of indirect cost rates. Unless subject to a qualification related to an ASBCA case or similar item, once established and agreed upon by the Government and the contractor, an indirect cost rate is not subject to change. Final indirect cost rates are usually established after the close of the applicable fiscal period under one of the methods described in 6-703.

c. A billing rate is an indirect cost rate established temporarily for interim reimbursement of incurred indirect costs and is adjusted as necessary pending establishment of the final indirect cost rates. Billing rates are intended to approximate the expected final rates. The contracting officer or auditor responsible for determining the final indirect cost rates ordinarily will also be responsible for determining the billing rates.

6-703 Approaches to Establish Indirect Costs

In general, billing rates and final indirect cost rates are used in reimbursing indirect costs under cost-reimbursement contracts and in determining progress payments under fixed-price contracts. Except for cost-sharing contracts, contracts with rate ceilings, and use of the quick-closeout procedures (see 6-711.1), methods commonly used to establish indirect costs are as follows:

a. By Audit Determination-The actual final indirect cost rates are determined by the auditor as a result of audit. Under this method, the auditor's determination is definitive,

subject to the appeal procedures available to the contractor. The procedures for audit determination are in FAR 42.705-2/DFARS 242.705-2.

b. By Contracting Officer Determination-The final indirect rates are arrived at by negotiation between the Government and the contractor based on a proposal submitted by the contractor and an advisory indirect cost audit report issued by the contract auditor. The locations at which rates will be determined by contracting officers, the procedures for the conduct of negotiations and the applicable contract clauses are stated in FAR 42.705-1/DFARS 242.705-1.

c. As an alternative to b. above, research contracts with educational institutions may provide for predetermined fixed rates and/or negotiated fixed rates with carry forward provisions. As in b. above, the rates are established by negotiation and contractual agreement between the Government and the contractor to cover a specified future period (see Chapter 13).

d. Special Procedures for Changing the Rate Settlement Process from Contracting Officer Determined to Audit Determined:

(1) For all uncompleted audits of contractor indirect cost rates that satisfy the conditions below and are set to be negotiated by a DCMA Administrative Contracting Officer (ACO), the auditor will meet with the ACO to discuss changing the rate settlement process to audit determined when:

(a) the impact of the costs questioned resulting from the incurred cost audit will not exceed $300,000 on flexibly priced Government contracts, based on the costs questioned reported in DMIS, not in the audit report, and

(b) the risks associated with the incurred cost audit indicate that the audit issues and rates can be settled with little difficulty. Generally, this means that the audit issues are clear-cut and limited to the audited segment/company, e.g., non-precedent setting (FAR 42.705-2a(2)).

In some cases, more than one meeting with the ACO may be needed to finalize a change to audit determined rates. For example, the DCMA One Book calls for meeting on this matter 90 days before the close of the contractor fiscal year to be audited. At this time, the ACO and auditor may be able to rely on past audit history and known facts to make a change decision. In other cases, however, they may want to wait until the field audit work is nearly finished (and prior to holding the audit exit conference) to make their final change decision. Once the final decision is made to change to audit determined rates, the auditor should ensure that the contractor has been notified of the change.

(2) The preceding guidance also applies to contractor fiscal years (CFYs) for which the incurred cost report has already been issued if the following conditions are met:

(a) ACO negotiations of the CFY rates have not started, and

(b) the ACO and the auditor believe that changing the CFY over to the audit determined rates and supplementing/replacing the original audit report will save collective time and effort.

6-703.1 The DoD Approach

Until August 1985, each DoD contract would, by its terms, prescribe the method (usually either audit determined or negotiated indirect cost rates) to be used in reimbursing the contractor for its indirect costs. At that time authority and responsibility for settling all DoD final indirect cost rates (except those related to educational institutions, nonprofit organizations, and state or local governments) were transferred to DCAA. In June 1988, responsibility for settling final indirect cost rates at major contractor locations was re-

turned to contracting officers. Procedures for establishing indirect cost rates for DoD contracts related to educational institutions, nonprofit organizations, and state or local governments are in FAR 42.705-3 through 42.705-5. Essentially, these rates are established by contracting officer negotiation using applicable Office of Management and Budget guidelines.

6-703.2 Non-DoD Procedures

FAR 42.7 provides that final indirect cost rates on non-DoD contracts will be established by either audit determination or contracting officer negotiation as provided by the terms of the applicable contract. Audit recommendations concerning non-DoD contracts are usually advisory in nature as most of these contracts give the contracting officer responsibility for establishing the final indirect cost rates. The guidance in 10-212 and 10-506 pertaining to the distribution of indirect cost audit reports should be followed to ensure that all interested non-DoD parties receive a copy of the report. Additional comments on special administrative procedures related to non-DoD agencies are given at 15-100.

6-704 Effect of Contract Type on Indirect Cost Recovery

6-704.1 Cost-Reimbursement Contracts

a. Cost-reimbursement contracts provide for payment of the allowable incurred costs (including interim/final indirect costs) to the extent prescribed in the contract. These type contracts establish an estimate of total cost for obligating funds, which also serves as a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer. These contract provisions are set forth in an "Allowable Cost and Payment" clause (FAR 52.216-7) as provided in FAR 16.307. A major portion of this clause discusses the administrative procedures to be used in paying interim indirect costs and establishing final indirect cost rates. In general, this portion of the clause provides that:

(1) Final indirect cost rates will be established as detailed in FAR 42.7.

(2) The contractor shall submit within the six-month period after the close of its fiscal year, an adequate final indirect cost rate proposal. Reasonable extensions, for exceptional circumstances only, may be requested in writing by the contractor, and granted in writing by the contracting officer.

(3) The proposed rates shall be based on the contractor’s actual cost experience for that period.

(4) Once agreement is reached, a written understanding shall be executed setting forth the final rates.

(5) If agreement is not reached on the final cost rates, this shall be a dispute within the meaning of the Disputes clause.

b. In addition to the "Allowable Cost and Payment" clause, FAR 42.802 provides that cost-reimbursement type contracts will also include the clause at FAR 52.242-1, Notice of Intent to Disallow Costs. This clause gives the procedures that can be used in disallowing costs if the Government questions a cost.

c. Indirect costs may be reimbursed under cost-type contracts either by:

(1) the actual cost method (audit determination),

(2) negotiated rate method (contracting officer determination), or

(3) negotiated fixed rates with carry forward of under or over-recovery provisions under R&D contracts with nonprofit educational institutions (see Chapter 13).

Under certain conditions, prospective indirect cost fixed rates may be used under a cost-sharing contract. In addition, indirect cost rates may be negotiated and used for stated periods of time in determining the amount of indirect expenses to be included in cost proposals for negotiated cost-type and fixed-price type contracts, contract change orders, man-month rates for technical service contracts, and other similar contracts.

6-704.2 Fixed-Price Contracts

The provisions of FAR 42.7 (Indirect Cost Rates) also apply to fixed-price contracts if the contractor requests progress payments or its fixed-price contracts include price adjustment provisions (e.g., incentive contracts). In these cases, the billing and final indirect rates will be established using the same administrative procedures as for cost-reimbursement contracts.

6-705 Interim Cost-Reimbursement Billings

6-705.1 Provisional Billing Rates

a. The Government allows interim payments, if authorized by the contract, during contract performance by use of either the SF 1443 (progress payments) for fixed-price contracts, or by an SF 1034 (public voucher) ("Cost Voucher" in Wide Area Workflow) for cost-type contracts. The contract itself will designate the manner of billing. Reimbursement of indirect costs in these payments is generally made through billing rates that are established to approximately equal the expected final indirect cost rates. These billing rates are used for interim reimbursement purposes until settlement is reached on final rates after the end of the contractor's fiscal year. Once the final rates are established, an adjustment is made for any variance between the billing and final rates. (Before final rates are established, the billing rates may be prospectively or retroactively revised by mutual agreement, at either the Government's or contractor's request, to prevent substantial overpayment or underpayment.)

b. In some cases, billing rates require adjustment to assure certain costs are not paid in interim payments. Adjustments are required for:

(1) accrued indirect costs that the contractor is delinquent in paying in the ordinary course of business per FAR 52.216-7 (b)(1)(ii)(F);

(2) accrued costs of pensions, post retirement benefits, and profit-sharing or employee stock-ownership plans that have not been paid at least quarterly (within 30 days after the end of the quarter) per FAR 52.216-7 (b)(2) and 52.232-16 (a)(3);

(3) amortized restructuring costs that have not been certified per DFARS 231.205-70; and

(4) costs covered by advance agreements.

c. Where a change in billing rates is indicated, prompt action should be taken to obtain adjustment. In evaluating any proposed changes in billing rates, the auditor must, of course, give due consideration to any access to records problems, possible mischarging, more recent indications of unacceptable costs, etc. To simplify interim indirect cost claim computations, billing rates should be calculated using the least number of decimal places

that will properly consider the impact of the rates on contract costs. The auditor's rate calculations will be appropriate to the circumstances regardless of how the contractor submits its rates.

d. FAR 42.704 provides that the contracting officer or auditor responsible for determining the final indirect cost rates shall usually also be responsible for determining the billing rates. In addition to FAR 42.704, guidance related to evaluating and establishing billing rates and reporting on them is in 9-704 and 10-505.2.

e. After the end of the contractor's fiscal year, the auditor needs to compare the interim billing rates with the year-end recorded allowable rates (considering any historical audit exceptions) to determine if the billing rates need to be adjusted. The auditor should not wait to receive the final indirect cost submission which is not due until six months after the end of the fiscal year to make these comparisons. At contractors where DCAA has a resident or suboffice, the comparison should be done as soon as practicable after the year-end closing. At smaller contractors where DCAA does not have an in-plant office, the auditor should request that the contractor mail copies of the summary cost records showing the year-end recorded allowable indirect expense rates. These records should be verified during the next scheduled field visit to that contractor. After the final indirect cost submission has been received, the guidance contained in 6-707.4 should be followed.

6-705.2 Adjustment of Interim Indirect Cost Reimbursement

a. Upon receipt of the certified final indirect cost rate proposal, FAR 42.704(e) provides that the Government and the contractor may mutually agree to revise billing rates to reflect the certified proposed indirect cost rates. The proposed indirect rates will be adjusted to reflect historically disallowed amounts from prior audits until the proposal has been audited and settled. The historical decrement will be determined by either the contracting officer or the auditor responsible for determining final indirect cost rates. If claimed costs as adjusted to reflect historical disallowances exceed billed costs, advise the contractor to submit an interim claim for the difference. If billed costs exceed claimed costs, the contractor must appropriately adjust the next voucher or remit or otherwise credit the Government for the difference.

b. After the establishment of final indirect cost rates for the period (see 6-708 and 6-709), the contractor may claim reimbursement for amounts due over and above the interim reimbursements previously obtained. The reimbursement claim should be submitted on separate public vouchers which should not include any other costs or fee. The amount of the adjustment will be shown on the SF 1035 (continuation sheet for the public voucher) in the "current period" column, and the "cumulative to date" figures will be adjusted accordingly. (See DCAAP 7641.90 for the format to be used on the SF 1035.)

c. Where the contractor submits a correctly computed reimbursement voucher for any additional amounts due under the contract on the basis of the final indirect cost rates established either by negotiation or audit determination, the auditor will be in a position to approve the adjustment voucher as submitted by the contractor. If the contractor does not agree with the established final indirect cost rates and the amounts claimed in its adjustment voucher are in excess of the amounts acceptable to the Government, the auditor will then issue a DCAA Form 1 in accordance with the procedures in 6-905, to effect adjustments to amounts acceptable based on the established final indirect cost rates. Where final indirect cost rates are established by negotiation (see 6-703), the DCAA Form 1 will be

supported by a copy of the indirect cost rate agreement signed by the contractor and the contracting officer, or by a copy of the contracting officer's unilateral decision where the parties fail to agree (FAR 33.211).

d. If the total interim indirect cost previously claimed for the period exceeds the amount due pursuant to the final indirect cost, the contractor should deduct the excess from the amount otherwise due on a current public voucher under the contract. The deduction must be shown as a separate figure in the "current period" column of the SF 1035. The cumulative figures will be adjusted in the same manner as described above. If the contractor fails to make the adjustment within a reasonable time (usually considered to be 30 days), the auditor will prepare an appropriate DCAA Form 1 to suspend the excess.

6-705.3 Reimbursement of Indirect Costs on Fixed-Price Contracts

As with cost-type contracts, the established billing rates (whether by submission of the certified indirect cost rate proposal or final settlement of indirect rates through negotiation or audit determination) will be used by the contractor in calculating its progress payments. Progress payments, however, are usually limited to a stated percentage of total cost. On establishment of the final indirect rates, little additional effort is required other than ensuring that the total incurred cost to date and the estimated costs to complete amounts on the next progress payment request have been properly adjusted for any changes in the rates.

6-706 Indirect Cost Certification

6-706.1 Final Indirect Cost Rates

a. The clause at FAR 52.242-4 requires contractors to certify that all costs included in a proposal to establish final indirect cost rates are allowable in accordance with contract requirements, FAR, and the agency’s cost principles. The certification requirements are applicable for all solicitations and contracts issued on or after October 1, 1995. The Federal Acquisition Streamlining Act of 1994 (FASA), Public Law 103-355, Section 2151, codified the certification requirement at 10 U.S.C. 2324(h) and 41 U.S.C. 256(h). This certificate must be submitted before the proposal will be accepted by the Government and must be signed by an individual at a level no lower than a vice president or chief financial officer of the business segment that submits the proposal. A new certificate is required whenever the contractor changes the proposed rates and submits a revised proposal. A new certificate is not required if the contractor agrees to lower indirect rates as a result of our audit of a previously certified proposal. As a result of the certification process, some contractors have incurred extraordinary costs for screening overhead costs prior to certifying their proposals (see 7-2109.2).

b. Prior to October 1, 1995, the certification requirements were contained at DFARS 242.770-2 and were applicable only to solicitations and contracts issued by DoD contracting agencies. Accordingly, only DoD contractors are required to certify final indirect rates related to contracts issued prior to October 1, 1995.

c. When a contractor does not certify its proposal, FAR 42.703-2(c) requires the contracting officer to unilaterally establish the rates. The auditor's role is to provide rate recommendations which preclude reimbursement of potentially unallowable costs. In arriving at his/her rate recommendations, the auditor may use audited historical data, such as per-

centage disallowance factors computed from the results of prior audits, or any other supporting data obtained from the contractor which show that unallowable costs have been excluded. The scope of audit and the supporting data on which the rate recommendations are based will have to be determined by the auditor on a case-by-case basis. However, the following steps should be considered:

(1) Advise the contractor in writing that its uncertified proposal cannot be used to establish rates, and that a detailed account-by-account analysis is required to be submitted identifying all unallowable costs.

(2) Review historical audited cost to determine if it is representative of allowable cost for the period being audited. Give consideration in this assessment to the degree that organizational, procedural, programmatic, or business volume changes may have affected either the incurred expenses, allocation bases, or nature or level of unallowable costs.

(3) If the contractor does not submit the detailed expense account analysis, which identifies all unallowable costs, and historical audited cost data does not appear to be representative, notify the contracting officer that no audit means exist to advise him/her on what unilateral rates should be established. Provide whatever information the auditor has developed on prior audit history, including why it is not considered representative of allowable cost for the period being audited.

(4) In no case should the auditor develop an alternative contractor proposal or complete an audit of the contractor's incurred cost when the contractor has not submitted a properly certified proposal. Either action would relieve the contractor of its contractual requirement to submit a proper proposal that excludes all unallowable cost. As described in 6-706.2 however, certain MAARs can be performed before submission of the certified proposal.

(5) If requested by the contracting officer, prepare an advisory audit report on the auditor's rate recommendations and attach Forms 1 as appropriate. Although the rates for the fiscal year involved may be subject to audit determination, the auditor is not required to enter into the resolution process with the contractor. Upon receipt of the audit report, the contracting officer will issue a unilateral decision. At this point, the contractor may choose to proceed in accordance with the disputes clause.

d. In the event a contractor withdraws or indicates it will withdraw its proposal, consider discontinuing the audit effort, request that the contractor explain why the proposal is being withdrawn, and promptly notify the ACO in writing of the situation. Also, when applicable, advise the ACO that the contractor's proposal was initially submitted late, the withdrawal will delay the audit and settlement of indirect expense rates, and that the withdrawal may result in the loss of appropriated funds. You should seek assistance from the ACO to establish a firm date for the contractor's resubmittal of the proposal. If the contractor refuses to resubmit a certified proposal in a timely manner, the FAO should follow the procedures outlined in 6-706.1c and d. A model pro forma memorandum addressed to the ACO is shown in Figure 6-7-1. Modify it as appropriate to suit each situation.

6-706.2 Performance of MAARs Without a Certified Proposal

a. Auditors should exercise their judgment when there is an opportunity to perform certain MAARs and they have not received a certified proposal. Factors that the auditor should consider include:

(1) The MAAR must be performed on a real-time (concurrent) basis before the certified proposal is submitted or the opportunity to perform that MAAR is lost.

(2) MAARs relating to the audit of indirect expenses are generally not performed prior to the receipt of a certified proposal because the contractor usually concentrates on reviewing indirect expense accounts and eliminating unallowable costs prior to certifying the proposal.

(3) The contractor has good internal controls related to the audit area covered by the MAAR and there is very little probability that unallowable costs will be found.

(4) Audit techniques such as multi-year auditing can be used to more efficiently accomplish the MAAR for more than one year in the same audit.

b. Generally, the MAARs that can be performed without a proposal relate to internal control and risk assessment steps, certain reconciliations, concurrent audits of labor and material costs, requests for assist audits, and tests of adjusting entries. The MAARs that would not normally be performed are the MAARs related to determining the allowability and reasonableness of indirect costs and those reconciliation steps which require a submission.

In most cases, the timing on the accomplishment of the MAARs can be categorized as follows:

(1) Proposal not needed to perform:

MAAR No.

1. Internal Control Audit Planning Summary and/or Internal Control Questionnaire (ICQ)
3. Permanent Files
4. Tax Returns and Financial Statements
5. General Ledger, Trial Balance, Income, and/or Credit Adjustments*
6. Labor Floor Checks or Interviews
7. Changes in Direct/Indirect Charging
8. Comparative Analysis-Sensitive Labor Accounts
9. Payroll/Labor Distribution Reconciliation and Tracing
10. Adjusting Entries and Exception Reports*
12. Auditable Subcontracts/Assist Audits
13. Purchases Existence and Consumption
15. Indirect Cost Comparison with Prior Years and Budgets

*If these MAARs were accomplished before the certified proposal is provided, supplemental audit work would need to be performed after the proposal is received to determine if additional adjusting entries were made during the preparation of the proposal.

(2) Proposal needed to perform:

MAAR No.

2. Contract Cost Analysis and Reconciliation to Books
14. Pools/Bases Reconciliation to Books
16. Indirect Account Analysis
18. Indirect Allocation Bases
19. Indirect Rate Computations

6-706.3 Corporate, Group, or Home Office Expenses

a. The certification requirement is predicated on the idea of a knowledgeable corporate official accepting individual responsibility for the allowability and allocability of costs included in indirect cost proposals. All corporate indirect cost submissions used to allocate costs to divisions for establishment of final overhead rates must be certified at the corpo-

rate level. These costs need not be certified again at the division level, and the divisional certification would only cover indirect costs arising from that division. This requirement is based on a clarification memorandum issued by the Deputy Assistant Secretary of Defense for Procurement in January 1990.

b. If a contractor refuses to certify a proposal made at this level, the FAO should follow the procedures outlined in 6-706.1c.

6-707 Audits of Indirect Cost

6-707.1 Submission of Indirect Cost Proposal

a. The contractor is to submit (within the six-month period after the end of the applicable fiscal year) its final indirect cost rate proposal with supporting incurred cost data (required by FAR 52.216-7) to the ACO and the auditor. The submission must include an executed Certificate of Final Indirect Costs (required per FAR 42.703-2; a copy of the certificate is shown at FAR 52.242-4). This certificate, signed by no lower than a contractor vice president or chief financial officer, is required for all final indirect rate submissions, except CAS 414 (cost of money) factors, regardless of whether the rates will be established by auditor determination or contracting officer negotiation. For multidivisional contractors, the proposal for each segment is to be submitted to the divisional ACO and the auditor responsible for conducting audits of that division, with a copy to the corporate auditor and ACO. The submission time limit does not preclude the auditor from receiving elements of incurred cost data or supplemental information from the contractor as it becomes available. (See 6-706.2 for the types of data that can be used in performing MAARs without a certified proposal.)

b. Auditors should evaluate a contractor's incurred cost proposal upon receipt and immediately notify the contracting officer and contractor of significant inadequacies. If there are inadequacies, the auditor should pursue the appropriate course of action, which may include requesting additional information from the contractor or returning the submission as inadequate.

c. An adequate final indirect cost rate proposal will include the proposed rates and supporting incurred cost data. If the extent of some supporting incurred cost data makes it impractical to include, its location should be identified in writing. In the case of new contractors or contractors where we have experienced past problems with inadequate submissions, the auditor should coordinate with the contractor and contracting officer as early as practical to discuss the supporting cost data required for the final indirect cost rate proposal. It is suggested that the auditor ensure that contractors are provided a copy of DCAAP 7641.90 "Information for Contractors" and be requested to submit the final indirect cost rate proposal in that format to expedite the audit. The basic data contained in the example schedules is that which is generally required to begin most audits in a timely manner. During the course of the typical audit, the contractor will be called upon to submit additional data to support various elements of the proposal. Contractors should be encouraged to submit pertinent portions of their final indirect cost rate proposals and supporting cost data in compatible electronic media whenever possible. Variations in the size of the firm, type of business, accounting systems, and auditing procedures mandate judgment and flexibility in requirements for form, format, and contents of proposal components.

d. Delinquent submission of a final indirect cost proposal may be an indication of weaknesses in the contractor's accounting system and controls. If an audit confirms systemic problems, the auditor should report them to the contractor and the ACO for corrective action. (See 5-110, 10-200, and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems).

6-707.2 Obtaining Indirect Cost Proposals

a. The contracting officer is responsible for obtaining interim billing and final indirect rate proposals from the contractor within the six-month period after the end of its fiscal year. As stipulated by FAR 52.216-7(d), extensions for exceptional circumstances are permitted provided the contractor requests an extension from the contracting officer in writing and the extension is granted in writing by the contracting officer. The auditor does not have the authority to grant an extension, even in cases where the indirect rates are audit determined. To assist the contracting officer, auditors should provide summary status reports on overdue indirect cost proposals to cognizant ACOs every January 31st and July 31st. In addition, the auditor should take the steps described below to obtain final indirect cost rate proposals. The auditor should discuss the process with the contractor and coordinate with the contracting officer to avoid any duplication of effort. This process should be used for contractors with audit determined final indirect cost rates, as well as contractors with contracting officer determined final indirect cost rates. Sample letters and memorandums are available in the APPS.

(1) Three months after the end of the contractor's fiscal year, the auditor should remind the contractor of its contractual responsibility to submit an adequate indirect cost rate proposal. The contractor should be encouraged to submit its proposals as promptly as possible after the close of the fiscal year, in an electronic format whenever possible. The auditor's reminder letter should inform the contractor that helpful information on preparing an incurred cost proposal is available at the DCAA public web site (www.dcaa.mil) in DCAAP 7641.90, Information for Contractors, and the Incurred Cost Electronic (ICE) software. The contractor should be informed that requests for extensions should be addressed in writing to the contracting officer, as required by FAR 52.216-7(d). Auditors should advise contractors that one of the criteria for direct billing is the timely submission of an adequate indirect cost rate proposal, and that the failure to comply with the FAR requirement may result in the rescission of the contractor's authority to direct bill (6-1007.7a (1)). This process of reminding contractors in writing of their contractual obligation to submit an adequate incurred cost proposal, along with the referenced assistance, should facilitate the timely submission of the proposal. The contracting officer should be furnished a copy of the letter. A sample letter is available in the APPS under NMLTR.

(2) When a contractor submission is 30 days overdue (i.e., 7 months after CFY end), the auditor should notify the contractor that its submission is past due and reiterate the contractual requirement for timely submission of an adequate indirect cost rate proposal. The auditor should warn contractors that have been approved for direct billing that one of the criteria for direct billing is the timely submission of an adequate indirect cost rate proposal and that their failure to comply with the FAR requirement results in the rescission of their authority to direct bill (6-1007). Following the issuance of this letter, the auditor should review the contractor's direct billing authority. As with the 3 month reminder letter, the contractor should be informed that requests for extensions should be addressed in

writing directly to the contracting officer. The letter should also reiterate that assistance is available on the DCAA public web site in DCAAP 7641.90, Information for Contractors, and the ICE software. The letter should request a written response from the contractor within 10 days of the date of the letter as to the date on which the proposal will be submitted. The contracting officer should be furnished a copy of the letter. A sample letter is available in the APPS under NMLTR30DAYS.

(3) When a contractor submission is 3 months overdue (i.e., 9 months after CFY end), the auditor should request the contracting officer's assistance in obtaining the submission. The memorandum should state the auditor's actions to obtain the contractor's overdue submission(s) (e.g., the 3-month reminder letter, 30-day overdue letter). A sample memorandum is available in the APPS under NMLTR3MON.

(4) When a contractor submission is 5 months overdue (i.e., 11 months after CFY end), the auditor should notify the contractor that its submission is past due and advise that we will recommend that the contracting officer unilaterally establish the indirect cost rates or contract costs unless a submission is provided, or the contractor receives an extension from the contracting officer within 30 days. A sample letter is available in the APPS under NMLTR5MON.

(5) When a contractor submission is 6 months or more overdue (i.e., 12 months or longer after CFY end) and relates to a DoD contractor, the auditor should request that the contracting officer exercise his/her authority under FAR 42.703-2(c)(1) and FAR 42.705(c)(1) and unilaterally establish indirect cost rates or contract costs for the subject CFY. In the memorandum, the auditor should explain the efforts taken to obtain the overdue submission (e.g., the 3-month reminder letter, 30-day overdue letter). DCAA does not have the authority to make a unilateral determination, even for contractors whose rates are audit determined. The auditor’s role in this process is to provide a recommendation that precludes the reimbursement of potentially unallowable costs. The basis for the recommendation should be fully explained. The contractor should not be provided a copy of the memorandum that contains our recommendations, since the contracting officer may have other information available that would result in a unilateral determination different from our recommendation.

(6) When a contractor submission is 6 months or more overdue (i.e., 12 months or longer after CFY end), and relates to a non-DoD contractor, the auditor needs to coordinate with the civilian agency contracting officer, as identified below.

(a) A letter should be sent to the civilian agency contracting officer that: (i) informs the contracting officer that the submission is overdue and requests their assistance in obtaining the submission; (ii) recommends that if the contracting officer is unable to obtain an adequate submission, the contracting officer should exercise his/her authority under FAR 42.703-2(c)(1) and FAR 42.705(c)(1) and take unilateral action to establish indirect cost rates or contract costs; (iii) advises the contracting officer that if he/she is unsuccessful in obtaining the submissions in the prescribed timeframe and/or unable to make a unilateral decision, we will no longer actively pursue obtaining the submission and will remove it from our inventory of open contractor fiscal years requiring audit, and; (iv) advises that we will prioritize a subsequent audit of that contractor’s submission only after receipt of the contracting officer’s request, together with an adequate submission. A sample letter is available in APPS under Letter to Non-DoD on Overdue Submissions.

(b) If, based on the response from the contracting officer, the auditor determines it is appropriate to remove the contractor fiscal year from DMIS, the assignment should be canceled or deleted in accordance with current DMIS User Guide procedures.

b. When providing unilateral recommendations for the contracting officer, the auditor should consider the following:

(1) When recent relevant historical data exists, the auditor should develop recommended rates based on that history. The auditor should recommend the contracting officer apply the unilateral rates to physically complete and active contracts for the subject CFY. A sample memorandum is available in APPS under NMLTR6MONHIST. Recent, relevant historical data exists when all of the following criteria are met:

(a) The prior CFY has been audited,

(b) All contractor submissions received have been audited and settled (e.g., no outstanding Forms 1),

(c) The indirect cost pool and base data for the subject CFY is readily available in the contractor books and records,

(d) There have been no significant changes in the contractor's business base between the last audited CFY and the overdue CFY (e.g., no new products or no discontinuance of products),

(e) There has been no significant reorganization of the contractor between the last audited CFY and the overdue CFY (e.g., the contractor has not sold or acquired any business segments), and

(f) There have been no changes in the indirect cost rate structure between the last audited CFY and the overdue CFY (e.g., the contractor has not added any new rates or discontinued any rates).

(2) When recent relevant historical data does not exist, the auditor should recommend the ACO apply a 20 percent decrement factor to total contract costs (direct and indirect) for any physically complete and active contract for the subject CFY. Contractors that are delinquent six months or more in providing their final indirect cost rate proposals and have not been granted an extension by the contracting officer are obviously high-risk contractors. These contractors have not complied with contract clause FAR 52.216-7 (Allowable Cost and Payment) or FAR 52.216-13 (Allowable Cost and Payment - Facilities), which requires contractors to submit an adequate final indirect cost rate proposal to the contracting officer and auditor within the six-month period following the end of their fiscal year. A sample memorandum is available in APPS under NMLTR6MON20%.

(3) The auditor should not provide the contracting officer with recommended contract costs by contract at this time. Once the contracting officer makes the unilateral determination (whether on indirect cost rates or total contract costs), the auditor should assist the contracting officer in developing costs by contract based on the contract costs identified in the contractor's books and records. Regardless of which of the above approaches is used, under no circumstances is the auditor to develop the contractor's proposal or perform an audit of uncertified contractor costs. The auditor is to merely use direct and indirect cost data identified in the contractor books and records.

(4) Regardless of the method used for the unilateral recommendation, if the contractor does not submit an adjustment voucher on active contracts within a reasonable period of

time (usually considered to be 30 days) after the contracting officer's decision, the auditor should prepare a DCAA Form 1 to suspend the excess costs.

c. When a contractor has multiple overdue CFYs (e.g., 2001, 2002, 2003), the auditor is to use recent relevant historical data, when available, for the earliest CFY only (e.g., 2001) and use the alternative approach of an Agency-wide 20 percent decrement factor for the remaining overdue CFYs (e.g., 2002 and 2003). Since the earliest CFY that is overdue would not have been audited (e.g., 2001), the remaining overdue CFYs would not have recent relevant historical data to develop recommended unilateral indirect cost rates. In these circumstances, the auditor will need to combine the content of the example memorandums to address the use of both types of decrements.

6-707.3 Requests for Audit

a. Generally, receipt of the contractor's submission establishes the audit requirement without need for a specific contracting officer request. If such a request is received, it should be promptly acknowledged in writing using the format and contents described in 4-103. If a request is not received, notify the cognizant contracting officer at the beginning of the audit as discussed in 4-103. The processing of non-DoD agency requests is discussed in 1-303.

b. Failure to receive a contracting officer request is not a basis to defer indirect cost audits when such audits are in the best interest of the Government.

6-707.4 Timeliness of Final Indirect Cost Audits

It is DCAA policy that all indirect cost submissions will be audited as promptly as practical after receipt of the contractor's proposal. When an audit or a desk review (see 6-103a) cannot be performed within a reasonable period, care must be taken to minimize the impact on the contractor's cash flow. If there is a significant disparity between billing and actual rates, the procedures in 6-705.2a should be followed.

6-707.5 Audit Objectives and Procedures

a. This section provides the administrative procedures that should be used in establishing billing and final indirect cost rates. Section 6 of this chapter states the audit procedures to be considered in the examination of indirect expenses incurred and claimed in the performance of contracts. Chapter 9 sets forth the procedures for the evaluation of indirect expenses included in price proposals. The procedures and objectives in these chapters should be applied as appropriate when performing the indirect cost audit.

b. The cost principles in FAR Part 31 should be used as the basis for determining the allowability, allocability, and reasonableness of indirect expenses in billing/final indirect cost rates whether these rates are negotiated by the contracting officer or determined by audit. These same cost principles, as appropriate, should be considered in the evaluation of indirect expenses included in cost proposals used for the negotiation and award of contracts, or amendments to existing contracts.

6-708 Establishment of Final Indirect Cost Rates by Audit Determination

a. When the FAR provides for audit determination of final indirect cost rates, the contractor, after the close of its fiscal year, will furnish the contracting officer and auditor with a copy of its final indirect cost rate proposal for the period (see 6-707.1). Auditors will encourage contractors to submit their proposals as promptly as possible after the close of the fiscal year. The auditor will promptly perform an audit and will issue an incurred cost audit report (per 10-500) to the cognizant ACO.

b. During the course of the audit, significant audit findings should be brought to the attention of, and discussed with, the contractor, and when appropriate with the cognizant principal ACO and CAC, as soon as possible so as to expedite the resolution process (See 6-902e). The discussions are to ensure that the auditor's conclusions are based on a proper understanding of the facts and to ascertain whether the contractor/ACO/CAC has any additional information which would support or modify the audit findings. This will enable resolution of the findings to take place prior to the completion of the audit. If agreement on an issue cannot be reached, the contractor should be requested to prepare a rebuttal for inclusion in the audit report. The process outlined above will result in an efficient audit that will conserve both audit and contractor personnel resources.

c. Significant procedural and control deficiencies, or CAS/FAR noncompliance(s), should be reported immediately using the procedures in 10-413 or 10-800. When a Form 1 is appropriate, it should be issued immediately in accordance with procedures in 6-900 (See 6-708.1f). If the auditor believes that the billing rate(s) should be adjusted, an appropriate recommendation (including cost impact calculations) should be made to the contracting officer. When there are no findings that require an immediate report or Form 1, individual working paper packages, which are part of the final overhead audit, may be closed using a "MEMORANDUM FOR RECORD" (See 10-202). See 15-100 for additional comments related to non-DoD agencies.

6-708.1 Actions Taken at Completion of the Audit

a. Upon completion of the audit field work necessary to audit local costs, and supervisory approval, the auditor will hold an interim exit conference. At that time, the auditor will provide the contractor with the results of the audit in writing and seek the contractor's agreement. These results will be presented in such a manner that the contractor will clearly understand the reasons for disapproving any costs, and the basis for any additional audit recommendations. Since significant audit findings have been brought to the attention of, and discussed with, the contractor and ACO during the audit process, a final exit conference should merely be a summary of issues and resolutions. If unresolved issues exist, the contractor should have already prepared a rebuttal for the audit report.

b. Upon presentation of the final audit results in written form, the contractor may be given, if unresolved issues remain, a reasonable amount of additional time to furnish any new information that may help in resolving open issues. This time should be minimal since the audit results were provided to and responded by the contractor during the audit. The time should be predicated upon the number of issues and number of prior discussions with the contractor, but should not exceed 30 days. If the contractor requests fact-finding sessions, it is acceptable for the auditor to participate in discussions

with the contractor to clarify factual matters. However, the auditor has not been delegated the authority to "negotiate" final indirect cost rates. The auditor's responsibility is to determine the final indirect cost rates based on audit of the contractor's records, applicable Government regulations, and contract terms.

c. For multidivisional contractors, the auditor responsible for conducting the audit is responsible for seeking agreement with that contractor. The corporate home office auditor (CHOA) or contract audit coordinator (CAC) is responsible for seeking agreement with the contractor on corporate home office costs. The CAC network shall be used to the fullest extent to ensure uniformity and consistency in arriving at audit recommendations. At a minimum, the divisional auditor shall provide a copy of the audit results to the CAC prior to discussions with the contractor.

d. If the contractor was given additional time to furnish further information on unresolved issues, the auditor will have 30 days to thoroughly analyze the contractor's response, notify the contractor of any changes to the audit exceptions, and issue the audit report (see 6-708.2). If changes are made, the reasons for all changes will be thoroughly documented in the working papers. After the auditor has completed reviewing the additional data and making any necessary changes, a final meeting shall be scheduled to advise the contractor of any changes to the original audit recommendations. During this meeting, the auditor should seek the contractor's agreement on any remaining areas of difference. The ACO will not ordinarily attend any of the audit determination meetings with the contractor; however, the auditor should keep the ACO informed of developing areas of disagreement which may lead to a DCAA Form 1. This need for communication becomes even more imperative at contractor locations where responsibilities for establishing final rates and authority for negotiating forward pricing rate agreements (FPRAs---an ACO responsibility) with the contractor are divided between the auditor and the ACO.

e. Settlement of the indirect rates may be delayed because of unresolved CAS noncompliances. When an initial determination of noncompliance is in effect, the CAS administration procedures should be allowed to proceed. The issuance of an audit determined indirect rate report or a DCAA Form 1 should be deferred to the extent practicable until a final determination on the CAS noncompliance is made. Extended delays should be escalated in a manner similar to that specified in 4-803.4. If delays are not resolved, the report should be issued, including the effects of the initial finding of noncompliance and the report should be qualified if the ACO's final determination could materially impact the audit determined rates. Where a final determination of noncompliance has been issued, the audit determined indirect rate report should include the effects of the CAS noncompliance.

f. Although the audit report cannot be issued until all required audit work has been completed, the issuance of a Form 1 should not be delayed until the audit report is issued. If the contractor does not agree with the disapproved costs, the auditor may prepare and issue a Form 1 at that point, even though the final report is not due to be issued until other items are completed. (Also see 6-708.3 and 6-900 for further comments on issuance of Forms 1.)

g. Should the contractor fail to provide its agreement or rebuttal comments within the time period allotted (including the 30-day extension, if granted by the auditor), the audit report shall be issued together with applicable DCAA Forms 1. The working papers and audit report should state that the contractor failed to comply with the time requirement.

6-708.2 Actions Taken if Agreement is Reached

a. If agreement is reached, the auditor will prepare a written rate agreement/understanding setting forth the final indirect cost rates. This document will automatically be incorporated into the contracts upon execution, as provided by the Allowable Cost and Payment clause.

b. Guidelines for the content of the written understanding are contained in FAR 52.216-7(d)(3). A pro forma rate agreement is included as Figure 6-7-2. The contractor should be given a maximum of 10 days to sign and return the agreement to the auditor. This is because the final meeting (per above requirements), and the 10-day period for the contractor to sign the written agreement, shall be scheduled to allow the audit report to be issued within 60 days from the date the auditor received the contractor's rebuttal comments. A copy of the signed rate agreement shall be attached to the annual audit report.

c. The rate agreement should include a Cumulative Allowable Cost Worksheet (CACWS) showing the cumulative allowable costs (inception-to-date) by contract (see Figure 6-7-3). This will facilitate both the contractor's preparation of closing documents and the ACO's contract closing procedures. If not practical (e.g., if the schedule would be too voluminous), identify the location of the specific records that contain the allowable costs by contract and subcontract.

d. The CACWS should be attached to the audit report, along with the signed rate agreement letter. The report should state that (i) the CACWS should be used by the ACO to close contracts and (ii) individual contract audit closing statements (CACS) will not be issued unless specifically required by the ACO.

6-708.3 Actions Taken if Agreement is Not Reached

a. If agreement is not reached, the auditor will issue notices of costs suspended and/or disapproved (DCAA Form 1 or equivalent non-DoD forms, where applicable). These notices will detail the items of difference and advise the contractor of its right to:

(1) request, in writing, the cognizant contracting officer to consider whether the unreimbursed costs should be paid and to discuss his or her findings with the contractor or

(2) submit a claim to the ACO for any disapproved costs.

Under this procedure, the contracting officer does not negotiate final indirect rates, but issues written determinations or final decisions on specific issues with which the auditor and the contractor do not agree. Accordingly, it is extremely important that the applicable DCAA Forms 1 are prepared so the contracting officer is able to obtain a thorough understanding of the issues involved (see 6-900). The Forms 1 issued shall accompany the audit report as prescribed in 10-503c and should be cross-referenced. However, both the Form 1 and the audit report should contain sufficient detailed explanations so that each can stand alone.

b. If the inclusion of initial findings of CAS noncompliance prevents agreement on final indirect rates, the audit report should be forwarded to the ACO or CFAO for resolution, in accordance with FAR 42.705-2(b)(2)(iii). If the contractor appeals the final determination of noncompliance under the Disputes clause, the resolution of the CAS noncompliance is now subject to litigation and beyond DCAA's control. In this in-

stance, the audit determined indirect rate report should include the effects of the unresolved CAS noncompliance.

c. If agreement is not reached, the auditor should follow the guidance at 6-711.3 in deciding when to update the Cumulative Allowable Cost Worksheet to incorporate the results of audit. The CACWS should be updated to reflect the most current audited information at the time of issuing the incurred cost audit report. In the interim, this information may be helpful in making recommendations to the ACO for using quick-closeout procedures.

6-708.4 Reporting Audit Results

a. Regardless of the outcome of the determination process, an audit report shall be submitted to the ACO. Prepare and distribute the formal audit report on the audit-determined rates as described in 10-500. Any necessary DCAA Forms 1 should be attached to the report. Once the report is issued, the contractor may request ACO reconsideration or file a claim for the disapproved costs as explained in 6-908.

b. A qualified audit report may be issued before completion of the assist audits of the subcontract or intracompany costs if all of the following conditions are met:

(1) The request for annual incurred cost audits of the subcontract has been sent (see 6-802.5b) and the report is expected to be received before the planned date of the final audit (Contract Audit Closing Statement or final CACWS) on the prime contract. The requesting audit office should have a system to (i) monitor receipt of the subcontract assist audit reports, (ii) follow-up on those audits not promptly received, (iii) compare subcontractor costs included in the assist audit report(s) with those included in the upper tier contractor incurred cost proposals, and (iv) issue any needed supplemental audit reports, if they will serve a useful purpose.

(2) There are no known audit leads or significant risks relating to the subcontractor's accounting or billing systems.

(3) The upper tier contractor has adequate internal controls over its subcontractors.

(4) The subcontract or intracompany costs do not have a material impact on the indirect cost allocation bases.

c. Reports on audit determined final indirect cost rates should not be issued until the results of corporate/group home office allocations, intermediate cost center allocations, Washington D.C. area office audits, and Field Detachment input are incorporated, except when the costs being audited by the assist auditor do not significantly impact the proposed indirect cost rates.

d. Indirect cost rates should not remain open awaiting the resolution of BCA cases, technical problems, and other items beyond DCAA's control. The report should be issued with appropriate qualifications and be supplemented, as necessary.

6-709 Establishment of Final Indirect Cost Rates by Contracting Officer Determination

a. Where FAR provides for contracting officer-determined final indirect cost rates (other than predetermined rates), the contractor, after the close of its fiscal year, will furnish the contracting officer and auditor with a copy of its final indirect cost rate proposal for the period (see 6-707.1). Auditors will encourage contractors to submit their proposals as promptly as possible after the close of the fiscal year. The auditor will promptly perform an audit and will issue an advisory incurred cost audit report (per 10-500) to the cognizant contracting officer for use in the rate negotiations.

b. During the course of the audit, significant audit findings should be brought to the attention of, and discussed with, the contractor, and, where appropriate, with the principal cognizant ACO and CAC, as soon as possible so as to expedite the resolution process (see 6-902e). The discussions are to ensure that the auditor's conclusions are based on a proper understanding of the facts and to ascertain whether the contractor/ACO/CAC have any additional information which would support or modify the audit findings.

c. Significant procedural and control deficiencies, or CAS/FAR noncompliances, should be reported immediately using the procedures in 10-413 or 10-800. When a Form 1 is appropriate, it should be issued immediately in accordance with procedures in 6-900. If the auditor believes that the billing rate(s) should be adjusted, an appropriate recommendation (including cost impact calculations) should be made to the contracting officer. The contracting officer should immediately forward these findings to the contractor with a request to respond within 30 days (one 30-day extension may be granted). When there are no findings which require an immediate report or Form 1, individual working paper packages, which are part of the final overhead audit, may be closed using a "MEMORANDUM FOR RECORD" (See 10-202). See 15-100 for additional comments related to non-DoD agencies.

6-709.1 Actions Taken at Completion of the Audit

a. Upon completion of the audit field work necessary to audit local costs, and supervisory approval, the auditor will hold an exit conference. The contracting officer will be given an advance briefing on the audit findings and invited to attend the exit conference with the contractor. The auditor will provide the contractor with a written summary of the audit results at the exit conference. The summary must clearly state the reasons for questioning costs, if any, and the basis for any additional audit recommendations.

b. The contracting officer should request the contractor to respond to all findings within 30 days (one 30 day extension may be granted). Contracting officer concurrence is not a precondition to holding the exit conference. However, the contracting officer should understand the findings and participate in the resolution process.

c. Should the contractor fail to provide its agreement or rebuttal comments within the time period allotted (including the 30-day extension if granted by the contracting officer), the auditor will promptly issue the audit report. The working papers and audit report should state that the contractor failed to comply with the time requirement.

6-709.2 Reporting Audit Results

a. Upon receipt of the contractor's rebuttal, the auditor will have 30 days to seek contractor concurrence and issue the final audit report. In order to provide the ACO as much assistance as possible in deciding open issues, the auditor should logically and fairly address the contractor's rebuttal to the audit position. If the auditor is unable to present a strong, logical defense to the contractor's rebuttal, he/she should consider withdrawing the finding. Each open issue in which there is not concurrence should be presented in the audit report in the following format:

(1) A clear, concise description of the audit finding must be provided.

(2) The contractor's rebuttal should be summarized immediately following the description of the audit finding and attached in its entirety as an enclosure to the audit report.

(3) The auditor's rejoinder to the contractor's rebuttal should defend the audit position in light of the contractor's comments and fully explain in logical terms why the contractor's argument is flawed or otherwise inappropriate. If the auditor has modified the finding as a result of considering the contractor's comments, this fact should be disclosed.

b. When assist audits are required, the requesting auditor will coordinate with the assist auditor when establishing due date requirements. The assist auditor should make every effort to complete the audit within the time frame established. Should the requesting auditor encounter protracted delays in obtaining assist audit results and is unable to reach a resolution, the situation should be elevated to the region for resolution.

(1) A qualified audit report may be issued before completion of assist audits on corporate or home office costs. The report should show the corporate or home office costs as being unresolved, and upon receipt of the assist audit reports, a supplemental audit report should be issued, if requested by the contracting officer and/or if it would serve a useful purpose.

(2). A qualified audit report may also be issued before completion of the assist audits of the subcontract or intracompany costs if all of the following conditions are met:

- The request for annual incurred cost audits of the subcontract has been sent (see 6-802.5b) and the report is expected to be received before the planned date of the final audit (Contract Audit Closing Statement or final CACWS) on the prime contract. The requesting audit office should have a system to (i) monitor receipt of subcontract assist audit reports, (ii) follow-up on those audits not promptly received, (iii) compare subcontractor costs included in the assist audit report with those included in the upper tier contractor incurred cost proposal, and (iv) issue any needed supplemental audit reports, if they will serve a useful purpose.
- There are no known audit leads or significant risks relating to the subcontractor's accounting or billing systems.
- The upper tier contractor has adequate internal controls over its subcontract costs.
- The subcontract or intracompany costs do not have a material impact on the indirect cost allocation bases.

c. The audit report should state that a CACWS will be provided within 60 days of settlement of the rates, if applicable to that contractor (see 6-711.3).

d. After the audit report is issued, the contracting officer will attempt to reach a settlement with the contractor as promptly as possible. The auditor should be invited to attend all meetings between the contracting officer and contractor during which open items are formally discussed.

6-710 Indirect Costs Advance Agreements

a. The contracting officer may enter into advance agreements with the contractor concerning the allowability of special cost elements, ceilings for IR&D/B&P, etc. The auditor shall abide by properly executed advance agreements that are in effect for the fiscal year when determining final rates. Should the auditor find that an advance agreement is not in the best interest of the Government, he/she will follow established procedures for recommending to

the contracting officer, in writing, that the advance agreement be rescinded. Any steps taken to recommend rescinding the advance agreement will be thoroughly documented in the working papers.

b. A recommendation to rescind the advance agreement should not unduly delay issuing the audit report. If the ACO does not provide a timely response, the auditor will proceed with the formal exit conference and present the audit results to the contractor. The audit recommendations will incorporate the terms of the advance agreement. The report exhibit(s) will indicate that the auditor relied on the terms of the advance agreement. The circumstances involving the advance agreement, including the auditor's actions with respect to the advance agreement, shall be included in Appendix 2 of the audit report as provided in 10-505.1.

6-711 Expediting Settlement of Indirect Costs

6-711.1 Expediting Settlement of Indirect Costs on Completed Contracts

a. The final period of performance under a contract is generally less than a full fiscal year, and some contracts will in fact, be completed early in the year. The indirect cost rate determination for the contractor's fiscal year in which a contract is physically completed may not occur for a considerable period of time thereafter, since the contractor's indirect cost proposal may not be submitted up until six months after the end of its fiscal year. It is recognized, therefore, that in many cases the expeditious settlement of indirect costs and the prompt close out of physically completed contracts have considerable administrative advantage to both the Government and the contractor.

b. Accordingly, FAR 42.708 provides for quick-closeout procedures. These procedures allow the contracting officer to negotiate a settlement of indirect costs for a specific contract, in advance of the determination of final indirect rates. Use of the quick-closeout procedures for a specific contract will be binding on that contract and no adjustment will be made to other contracts for the over- or under recovery of costs that may result from the agreement. Likewise, using the quick-closeout procedures will not be considered as a precedent when establishing final indirect rates for other contracts.

c. Use of these closeout procedures is discretionary. The auditor should, therefore, obtain the approval of the cognizant negotiating contracting officer before applying these procedures to an individual contractor. The contracting officer will normally approve their use since it is the Government's policy to encourage contractors to close completed contracts promptly. (See 6-1010 for further information on use of quick-closeout procedures.)

d. Where a cost reimbursement type contract is to be so closed, an agreement should be reached by the contractor, the auditor, and the contracting officer as to the indirect cost to be allocated for the final period. Audit guidance for the allocation of indirect cost in these situations is stated in 6-605a. The agreement should be reached prior to contractor's submission of its final voucher so that this voucher can be processed without requiring any further adjustment.

6-711.2 Expediting Settlement of Indirect Costs on Terminated Contracts

As discussed in 12-407, settlement of a terminated contract may be unduly delayed if settlement is held until final indirect rates are established. Accordingly, FAR 49.303-4 permits negotiation or use of the billing rates as final rates to expedite closing a terminated contract. Aside from ensuring that allocated indirect costs to the terminated contract are reasonable (12-304.15), the other main concern when using this closeout procedure is to ensure that the subsequent final rate proposal is consistent with the amounts used to closeout the terminated contract (e.g., items included as settlement expenses which would normally be part of indirect costs, like salaries related to preparing the settlement proposal, are eliminated from the proposed indirect cost pools).

6-711.3 Cumulative Allowable Cost Worksheet (CACWS)

a. The Cumulative Allowable Cost Worksheet (CACWS) is a summary schedule of cumulative allowable contractor costs for each open flexibly priced contract through the last contractor fiscal year for which indirect cost rates have been settled. The CACWS also notes which contracts are physically complete and other key information needed for closing contracts. The worksheet should contain sufficient detail so that the ACO can use it to close contracts in lieu of individual Contract Audit Closing Statements. It is preferable to have an electronic CACWS or comparable summary report prepared by the contractor. The contractor may include a CACWS with its indirect cost rate proposal using claimed rates, which will be updated after settlement of rates, or agree to provide a CACWS within 60 days of rate agreement. Alternatively, the auditor may prepare the CACWS from data provided by the contractor in Schedules I and O (as shown in the Model Incurred Cost Proposal, Chapter 6, of DCAAP 7641.90, Information for Contractors), or equivalent contractor-prepared schedules from the incurred cost proposal. The auditor will update the CACWS as more current information becomes available. A current copy of the CACWS containing the allowable inception-to-date costs for each open contract as of the end of each contractor fiscal year must be maintained in the FAO's permanent audit file.

b. To facilitate the preparation of the CACWS, the auditor should perform the following steps:

(1) Upon receipt of the incurred cost proposal, verify that the cumulative cost and closing data contained in Schedules I and O (or equivalent contractor-prepared schedules) are provided as part of the incurred cost proposal or made readily available. This data should be provided in the same level used for billing costs (e.g. by delivery order, task order, CLIN, etc.). Lack of availability of the data contained in Schedules I and O would generally render the proposal inadequate for audit. If the contractor provides a proposal that is inadequate for audit, the auditor should inform the contracting officer of his/her concerns and pursue an appropriate course of action (6-707.1(b)).

(2) The auditor should adjust the scope of audit and verification of the contractor data on Schedules I and O to reflect the strengths/weaknesses of the contractor's billing system. The contractor's billing system should be capable of providing cumulative cost data by contract. Cumulative costs are necessary to assure that the cumulative amounts billed do not exceed the total estimated ceiling costs on the contract and/or the current contract maximum funding levels (5-1107.5). If the contractor's billing system is unable to produce cumulative cost data,

this should be viewed as a significant billing system internal control deficiency and reported on, in accordance with 5-110.

(3) Contractors who have not been providing cumulative cost data may agree to provide the information prospectively, but may be unwilling or unable to provide it retroactively. Auditors should work with their contractors in these cases to establish a mutually agreeable process for closing old contracts for which prior years' cumulative cost data has not been provided.

(4) FAOs should be flexible regarding the format of the cumulative allowable cost data. CAM Figure 6-7-3 is an example of the cost data required, and the columns have been annotated to show the source of the data. Strict adherence to that format is not required, as long as all the required information is included. In most instances, the CACWS should be acceptable to the ACO to close contracts, provided this arrangement has been coordinated with the ACO in advance.

(5) The CACWS should be included as an attachment to the rate agreement letter for auditor-determined rates. It should be made clear to the contractor that signing the rate agreement letter also indicates concurrence with cumulative costs and other information (e.g., contract limitations, fee) shown on the attachment and that the data on the CACWS will be used to close out contracts. The contractor and the auditor should adequately review the CACWS to eliminate errors.

(6) The signed rate agreement letter with the CACWS should be an attachment to the incurred cost audit report (see 10-504.5d and .5e(8)). If there is not full agreement on the audit exceptions or the rates are contracting officer determined, the audit report should state that the CACWS will be provided within 60 days of the settlement of the indirect rates. Once the CACWS has been updated to incorporate the final rates, it should be transmitted by memorandum to the cognizant ACO, with a copy provided to the contractor.

c. The CACWS should be updated on at least an annual basis (except when using multi-year auditing techniques), in conjunction with the incurred cost audit. If the contractor's rates are audit determined and the contractor concurs with the audit exceptions, the auditor should use the Schedule I and O information and the results of audit to prepare the CACWS. The CACWS may be updated more frequently (e.g., upon receipt of subcontract assist audits) if it will expedite significant contract closing actions. The auditor should perform the following steps to update the CACWS:

(1) When assist audits of subcontracts have been requested (see 6-802.5b), information should be included in Section II of the CACWS that identifies the prime contract number, subcontract number, subcontractor name and address, and claimed subcontract costs (as provided in the prime contractor's Schedule J, or equivalent, from its submission), for each prime contractor's fiscal year.

(2) Cumulative claimed costs on subcontracts, where assist audits have been requested, should be provided in the column on the CACWS Section I (Figure 6-7-3) entitled *Assist Audit Amounts Included in Total* and updated in conjunction with each year's incurred cost audit.

(3) Subcontract assist audit reports received should be included in the files for the applicable fiscal year incurred cost audit of the prime contractor.

(4) Update Section II of the CACWS to reflect the amount of subcontract costs allowable per the assist audit report(s). Perform a comparison of the cumulative allowable amounts from the assist audit(s) to the amounts claimed by the prime contractor. Significant differences should be investigated further.

(5) When the subcontractor CACWS or assist audit report identifies a subcontract as physically complete and ready to close: (i) reconcile the final cumulative allowable costs from all assist audit report(s) or associated CACWS to the cumulative amount claimed by the prime contractor for that subcontract, (ii) ensure the allowable subcontract amount is reflected

in the *Total Direct & Indirect Costs Using Settled Rates* column in Section I, and (iii) exclude those subcontract costs from the *Assist Audit Amounts Included in Total* column.

(6) When the assist audits of all subcontracts associated with a particular prime contract indicate the subcontracts have been completed, and the prime contractor's submission reflects the final billings, there should be no amount remaining in the *Assist Audit Amounts Included in Total* column and the prime contract should be annotated as ready to close on the prime contractor's CACWS.

(7) On contracts identified as ready to close, ensure that final contract ceilings/limitations, fee, and actual level-of-effort (LOE) hours, if applicable, are identified in Section I of the CACWS.

d. The CACWS or its equivalent should be prepared for all incurred cost audit reports used to establish indirect rates. If completion vouchers and the accompanying closing documents are received by the FAO, they should be handled in accordance with 6-1009.1, Receipt-Completion Vouchers. When a CACWS has been prepared that covers the entire period of performance, generally, contract audit closing statements should be issued only when requested by the ACO. However, for closing contracts other than CPFF, it may be necessary to report on those other types of contracts (e.g., CPIF, FPI, T&M, termination, etc.) by issuing a separate contract audit closing statement.

Figure 6-7-1
Notification of Contractor Withdrawal
of Indirect Expense Rate Proposal

[*Date*]

MEMORANDUM FOR THE ADMINISTRATIVE CONTRACTING OFFICER,
[*insert the cognizant ACO organization*]

Attention: Mr./Ms. [*insert name*]

Subject: Contractor Withdrawal of Indirect Expense Rate
Proposal for FY 20XX, [*insert the contractor name*]

We are in the process of auditing [*or plan to audit*] the [*insert the contractor name*]'s final indirect expense rate proposal for FY 20XX. On [*month/day 20XX*] the contractor notified our office that the submission for FY 20XX is being withdrawn. [*Describe the reasons for contractor withdrawal; e.g., We understand the contractor's withdrawal is due to recent stories in the press regarding possible changes to the current law on penalties for unallowable costs.*] As you know the FY 20XX claim was already submitted [*insert # of months*] months late based on contract requirements.

We are concerned that the contractor's withdrawal of the indirect expense rate proposal(s) is unduly delaying the settlement of rates and could have adverse funding consequences. If contracts cannot be closed before cancellation of the appropriations under the terms of the FY 1991 Authorization Act amendment on appropriated funds, any subsequent payments would have to be made with current year funds.

Your assistance is requested to establish a firm date for the contractor's resubmittal of the proposal(s). This will enable us to plan to have the necessary audit staffing in place to complete the audit(s) as expeditiously as possible. If the contractor is not responsive, we would encourage consideration of the available remedies including unilaterally established rates (FAR 42.703-2).

We appreciate your continued support of our joint objective to establish final rates and close out contracts in a timely manner. If you would like to discuss this matter further, please contact Mr./Ms. [*insert name*], Supervisory Auditor, at [*insert the telephone number*] at your convenience.

John A. Smith
FAO Manager

Figure 6-7-2 Pro Forma Final Indirect Cost Rate Agreement

XYZ Company, ABC Division
1985 Main Street
Any City, State 00000

Gentlemen:

This letter sets forth the agreed upon final indirect cost rates established by auditor determination in accordance with FAR 42.705-2(b)(2)(ii) *[insert if the contractor has DoD contracts entered into before November 9, 1999, "and DoD FAR Supplement 242.705-2(b)(2)(ii)."] (DFARS 242.705-2(b)(ii) was removed November 9, 1999 because that language was incorporated into FAR 42.705-2(b)(ii).)*

The final annual indirect cost rates for fiscal year ended December 31, 20XX are as follows:

		Allocation Base	
Cost Center	Rate (%)	Amount	Description
Material Burden	5.5	$2,569,400	(a)
Manufacturing Overhead	146.4	5,156,300	(b)
Engineering Liaison	95.2	1,207,900	(c)
G&A Expense	12.1	18,056,300	(d)

(a) Total direct manufacturing costs, exclusive of materials drop shipped to offsite locations.
(b) Total direct manufacturing labor dollars exclusive of overtime premium pay.
(c) Total direct engineering labor dollars.
(d) Total incurred cost exclusive G&A expense.

These rates are applicable to the base costs specified for each of the contracts performed during your fiscal year ended December 31, 20XX. The allowable costs by contract for the indicated fiscal year and from inception are shown in Attachment 1, Schedule of Cumulative Allowable Cost by Contract.

This indirect rate understanding shall not change any monetary ceiling, contract obligation, or specific cost allowance or disallowance provided for in the contracts listed in Attachment 1. This understanding is incorporated into each of the affected contracts upon execution.

Specific indirect cost items treated as direct costs in the settlement of the subject rates are discussed in Attachment 2. (The subject rates do not include any specific indirect cost items which were treated as direct costs in the settlement of the subject rates.) Contracts containing advance agreements or special provisions rendering these rates inapplicable, in part or whole are identified in Attachment 3, with the applicable special rate(s) noted.

Please confirm your acceptance of the terms of the indirect cost rate agreement by signing and returning this letter to me. A duplicate of this letter is enclosed for your records.

In accordance with FAR 52.216-7, you are directed to promptly submit adjustment vouchers or final vouchers for all flexibly priced contracts. Audit adjustments should be clearly delineated so as to be readily identifiable for verification by this office. Care should be taken that amounts claimed do not exceed contract limitations or contract indirect cost rate ceilings.

Sincerely,

Encls
Attachment 1 — Schedule of Cumulative Allowable Cost by Contract
Attachment 2 — Schedule of Specific Indirect Cost Items Treated as Direct in the Settlement of CFY 20XX Rates
Attachment 3 — Schedule of Special Indirect Cost Rates for Contracts Containing Advance Agreements or Special Provisions

The XYZ Company accepts the above stated final indirect cost rates.
NAME: James E. Contractor SIGNATURE_____
TITLE: Vice-President DATE_____
CONTRACTOR XYZ COMPANY, ABC DIVISION

Figure 6-7-3
ACC, Inc.
Cumulative Allowable Costs/Amounts
Through 12/30/2004
For Flexibly Priced Contracts and Subcontracts
SECTION I

Contract Number	Order	Subject To Penalty Clause	Prior Audited Years w/Settled Rates	Direct & Indirect Costs Using Settled Rates FYE 12/30/2004	Subtotal	Less: Contract Limitations	Total Direct & Indirect Costs Using Settled Rates	Assist Audit Amounts Incl. in Total	Ready To Close	Actual LOE Cum Hours	Fee	Note
Sch I/Sch O	*Sch I*	*Sch I*	*Sch I*	*Results Of Audit*		*Sch O*		*Per Assist Audit Requests*	*Sch O*	*Sch O*	*Sch O*	
		(1)	(2)			(3)	(4)	(5)				
Cost Type												
N00039-99-C-0069		Yes	$298,389	$8,250	$306,639		$306,639	$150,000	No			
N00040-99-C-0075		Yes	128,878	12,295	141,173	$1,915	139,258		Yes		$9,574	
DASW01-99-D-0075	017	Yes	1,035,278	615,725	1,651,003		1,651,003		Yes		112,000	
F0609-98-C-0001		Yes	509,235	1,245,860	1,755,095		1,755,095		No			
T&M												
N00024-99-D-0986	002	No	137,329	386,715	524,044		524,044		Yes			
Subcontract ABC-001		No		69,900	69,900							(6)

Figure 6-7-3
ACC, Inc.
Cumulative Allowable Costs/Amounts
Through 12/30/2004
For Flexibly Priced Contracts and Subcontracts
SECTION II

Contract No	Subcontract No	Name	Address	Claimed Subcontract Costs (Note 7) FY 2002	FY 2003	FY 2004	FY 2005	Total	Allowable Subcontract Assist Audit Amts Thru FY 2003 (Note 8)	SubK Compl?
N00039-99-C-0069	0069-SUBKA	Subcontractor A	1234 Any Street							
			Town, USA	$25,000	$25,000	$25,000		$75,000	$60,000	No
	0069-SUBKB	Subcontractor B	567 Road							
			City, USA	$25,000	$25,000	$25,000		$75,000	$80,000	No
N00039-99-C-0069 Total								$150,000	$140,000	

NOTES:
(1) FAR 42.709 implements 10 U.S.C. 2324(a) - (d) and 41 U.S.C. 256 (a) - (d), which requires that penalties be assessed if a contractor claims an expressly unallowable cost in an indirect cost settlement proposal on covered contracts. Covered contracts include all cost type and fixed-price-incentive contracts in excess of $500,000, issued on or after October 1, 1995 and before January 19, 2005. Covered contracts also include all cost type and fixed-price-incentive contracts in excess of $550,000, issued on or after January 19, 2005 and before September 28, 2006, and in excess of $650,000 for contracts issued on or after September 28, 2006.
(2) These costs, by contract, are computed using the negotiation or rate agreement document. Direct costs are subject to adjustment until final payment.
(3) Contract limitations include costs incurred that are (i) in excess of contract ceiling rates, (ii) unallowable per contract terms, (iii) outside the period of performance, or (iv) in excess of contract ceiling amounts that are not already excluded, for contracts identified as ready to close.
(4) The cumulative allowable amounts in this column are not-to-exceed contract ceiling amounts and are subject to the resolution of subcontract assist audits identified in Note 5.
(5) Costs in this column are considered unresolved pending subcontract completion and receipt of final cumulative allowable subcontract costs. See Section II for details of subcontracts included in this amount.
(6) Subcontract under Prime Contract No. DASW01-94-D-0038 awarded to XYZ Company.
(7) Costs in these columns represent the subcontract costs claimed as shown in Schedule J (or equivalent) of the prime contractor's incurred cost submissions for each fiscal year.
(8) Costs in this column represent the cumulative costs from the subcontract assist audits through the date shown. The amounts in this column and the Total claimed costs column are expected to be different due to timing differences in the prime versus subcontractor billing cycles or submissions of rate adjustment vouchers, subcontract fee or withholds, or different fiscal year end dates. At the completion of the subcontract closing actions, these two amounts should be the same.

6-800 Section 8 --- Assist Audits of Incurred Costs

6-801 Introduction

This section presents audit policy for the performance of assist audits of incurred costs on subcontracts, interplant billings, corporate/home office expenses, at offsite locations, and Washington D.C. area offices. For purposes of this section, assist audits refer to the situation where a contract auditor at one location is furnished assistance by a contract auditor at another location.

6-802 Subcontract Incurred Costs

6-802.1 Definitions

a. For the purpose of this section, the term "subcontract" means an auditable subcontract, purchase order, or other form of agreement under which materials or services are to be furnished on a flexibly priced basis to a prime contractor under a flexibly priced contract subject to DCAA audit. Flexibly priced contracts include all cost-type, fixed-price-incentive, and fixed-price-redeterminable contracts, orders issued under indefinite delivery contracts where final payment is based on actual costs incurred, and portions of time-and-material and labor-hour contracts.

b. The terms "prime contractor" and "subcontractor" as used in this section also relate to a higher-tier subcontractor and the next lower-tier subcontractor, respectively.

6-802.2 Basic Responsibilities

a. The responsibility of the prime contractor for managing its subcontracts is stated in FAR 42.202(e)(2). The prime contractor is primarily responsible for subcontract award, technical and financial performance monitoring, ensuring that indirect rate proposals and annual rate adjustments are submitted on a timely basis, and payment to the subcontractor for the work accomplished under subcontract terms. To accomplish this responsibility, the prime contractor should have adequate internal controls to identify and notify the Government of auditable type subcontracts and intracompany orders under auditable type Government contracts, and to assure that subcontract/intracompany costs are allowable, allocable, and reasonable.

b. The contractor's notification to the Government of awards of subcontracts and intracompany orders should be made as soon as practicable after award, and as part of the prime contactor’s annual incurred cost proposal submission. The schedule of subcontracts/ intracompany orders submitted with the proposal should include the prime contract number, subcontract/intracompany order number, subcontract/intracompany order amount, subcontract/ intracompany order type (CPFF, T&M, etc), subcontractor/intracompany name and address, and subcontract/intracompany costs recorded by the prime for that year.

c. The contractor's internal control system over subcontracts and intracompany orders should also provide for including appropriate flow down clauses into the subcontract/intracompany order, such as clauses that:

(1) provide either the Government or the contractor access to the subcontractor's/intracompany books and records for the purposes of performing the annual incurred cost audit,

(2) require that billings include only allowable costs pursuant to FAR 52.216-7, and

(3) require the subcontractor/intracompany entity to submit annual incurred cost proposals pursuant to FAR 42.7.

If the contractor does not have adequate controls over its subcontracts/intracompany orders, and has no plans to establish adequate controls, consideration should be given to excluding the prime contractor from the direct billing program, and an internal control deficiency report should be issued (see 5-110c.).

d. DCAA policy is to examine auditable subcontracts and intracompany orders issued by the contractor under auditable Government contracts and subcontracts, and to request or perform assist audits of incurred costs whenever such audits are of potential benefit to the Government and necessary to assure adequate and effective audit coverage of a contractor's operations or cost representations. Assist audits of incurred costs can be used to satisfy mandatory annual audit requirements related to auditable subcontracts/assist audit requirements (MAAR 12).

e. Under certain conditions, it is desirable that DCAA audit the subcontractor. Examples of these conditions are:

(1) the subcontract dollar value is significant in amount and in relation to the prime contract dollar value,

(2) a subcontractor objects, for competitive reasons, to an upper-tier contractor auditing its records,

(3) a DCAA auditor is currently performing audit work at the subcontractor's plant or can perform the audit more economically or efficiently,

(4) DCAA audit is necessary for consistent audit treatment and orderly administration, or

(5) the contractor or subcontractor has a substantial financial interest in the other.

f. An assist audit may be requested by the ACO or initiated by the DCAA prime contract auditor. In determining whether the Government should examine a subcontractor's records, the auditor should consider the potential benefits to the Government from the audit, previous audit experience and results at the subcontractor, and the costs of performing the audit.

g. The Government's interest and good auditing practice require that assist audits of incurred costs be accomplished primarily while the contract is physically being performed.

h. Requests for assist audits of incurred costs will be processed through audit channels (see 6-802.5) and documented in the FAO control system to provide visibility of assist audits in process.

i. The auditor should coordinate the assist audit plans with the upper tier contractor to preclude duplicate audits and provide for contractor audits if DCAA does not plan on performing the assist audit.

j. Mandatory annual audit requirements related to auditable subcontracts/assist audits (MAAR 12) are satisfied at the higher-tier location by requesting annual audits of the subcontractor’s incurred costs and incorporating the subcontract assist audit results into the final audit report (Contract Audit Closing Statement) or CACWS. However, each subcontract assist audit is requested only upon initial notification of the subcontract award (see 6-802.5b).

6-802.3 Preparation of Subcontractors' Cost Proposal

a. In most cases, subcontractors also perform as the prime contractor on other flexibly priced Government contracts. Therefore, the subcontractor is already required to provide an incurred cost proposal in accordance with the Allowable Cost and Payment clause (FAR 52.216-7). A subcontractor generally submits its costs on commercial invoices directly to the prime contractor. In cases where DCAA will perform the audit, the auditor cognizant of the subcontractor will arrange with the subcontractor to make available file copies of invoices submitted to the prime contractor. The subcontract auditor should determine that the subcontractor has an adequate billing system that ensures the accurate billing of costs and

timely submission of adjustment vouchers to the prime contractor. The scope of audit and extent of testing of the subcontractor's billing system will be based on risk and auditor judgment.

b. The subcontractor should prepare its invoices and incurred cost proposal in the same detail and manner as required of the prime contractor.

6-802.4 Prime Contractor Audits of Subcontractors' Claims

a. When the DCAA prime contract auditor requests an assist audit of subcontract costs, the prime contractor should be advised of these assist audit plans so that duplicative audits can be avoided. On those low risk subcontracts where the prime contractor performs the audit, the DCAA auditor shall review the prime contractor's audit working papers to ascertain whether the scope and extent of audit was sufficient to establish the validity of the subcontractor's claims, and that appropriate deductions were made in the prime contractor's claims to the Government for unallowable or unallocable subcontract costs. If the DCAA auditor considers the audit to be deficient or inconclusive and believes there is a need for further evaluation of subcontract costs, the prime auditor should discuss the matter with both the contractor and the ACO to determine if it is feasible for the contractor to correct the deficiencies or if a Government audit is necessary.

b. Regardless of whether the prime contractor or DCAA performs the annual incurred cost audit of the subcontractor, it is the responsibility of the prime contractor to ensure that the subcontractor provides the incurred cost proposal and makes annual billing rate adjustments on a timely basis.

6-802.5 DCAA Audit of Subcontractors' Costs

a. The DCAA auditor cognizant of the prime contractor or higher-tier subcontractor will initiate timely requests for assist audits of subcontract incurred costs. Upon notification of a subcontract award, the prime auditor will notify the subcontract auditor of the award and inform them that annual incurred cost audits will be required throughout the life of the subcontract. The DCAA auditor cognizant of the subcontractor or lower-tier subcontractor has a mutual responsibility to assure concurrent and coordinated audit effort. The prime auditor's timely notification of awarded subcontracts or information as to anticipated subcontract volume to the subcontract auditor is essential to sound audit planning and performance of the assist audits. Both prime and subcontract auditors should maintain adequate controls for identifying auditable subcontracts. These responsibilities include satisfying applicable portions of the mandatory annual audit requirement related to auditable subcontracts/assist audits (MAAR 12).

b. The requests for assist audits should be made upon initial notification of the subcontract award. The amount of detail included with assist audit requests will vary according to the respective audit offices involved, but should normally include a copy of the subcontract or agreement that includes the subcontract value and related period of performance, and a contractor identified point of contact for the subcontractor, to include mailing address and phone number. The request should specify that annual incurred cost audits will be required during subcontract performance, and final cumulative allowable subcontract costs should be submitted upon subcontract completion. A pro forma assist audit request is provided as Figure 6-8-1. The prime auditor should

communicate to the subcontractor auditor any special prime contract terms (e.g., ceiling rates, or specific unallowable costs) that should be considered in the audit of the subcontract. The subcontract auditor should promptly acknowledge the request for assist audit. Any potential access to records problem at the subcontractor location should be elevated quickly to the prime auditor and the ACO (see 1-504.)

c. The subcontract auditor should submit the final total cumulative allowable costs to the prime contractor auditor after subcontract completion and settlement of the subcontractor's rates. The final reporting may be in the form of a Contract Audit Closing Statement or Cumulative Allowable Cost Worksheet.

d. Some flexibly priced contracts, such as price redeterminable and incentive types, require the submission of price adjustment proposals after completion of a portion or all of the contract. Process requests for audits of these proposals under the field pricing support procedures of FAR 15.404.2 (i.e., through ACO channels).

e. The prime and subcontract auditor should coordinate planned audit effort. The subcontract auditor should discuss the plans with the subcontract ACO, where applicable, to assure coverage in specific areas of mutual interest. Depending on the materiality of the subcontract and the strengths of the prime contractor's subcontract cost internal control system, the assist audit request can range from a full scope audit to an agreed-upon procedures evaluation encompassing verification of indirect expense rates and direct costs, and the adequacy of the subcontractor's accounting and billing systems. The requesting auditor will also coordinate these matters with the ACO at his/her location.

f. The subcontract auditor will arrange for necessary technical assistance with the subcontract ACO. Guidance on requesting and evaluating technical assistance is in Appendix D.

g. Although subcontractor invoices will not be audited on an individual billing basis, the subcontract auditor will immediately notify the prime auditor of any major cost items which should be suspended or disapproved or of any financial matters adversely affecting subcontract performance.

h. In most circumstances, questioned costs based on the assist audit will be recovered through the annual billing rate adjustment after the subcontractor's settlement of final rates for the year under audit. The subcontract auditor should verify that rate adjustment invoices are submitted to the prime contractor on a timely basis.

i. When agreement on the questioned costs cannot be reached with the subcontractor, the subcontract auditor should advise the prime contract auditor of a suspension or disapproval of a subcontractor cost. Upon receipt of advice of a suspension or a disapproval of a subcontract cost, the prime auditor will immediately discuss the matter with the prime contractor's designated representative. The purpose of this discussion is to alert the prime contractor to the need for reaching an agreement with the subcontractor regarding disapproval or suspension of the questioned costs, or recoupment thereof if already paid. On cost-type prime contracts, the prime auditor will also prepare a DCAA Form 1 to effect the necessary deduction from the prime contractor's reimbursement claims. On flexible fixed price contracts, the prime auditor will notify the ACO by letter of the need to suspend the subcontract costs on progress payment requests, if based on costs incurred (see 14-200).

j. Since the Government has no contractual relationship with subcontractors, it is not bound by any agreement between prime and subcontractors as to payment or disposition of any subcontract costs determined to be unallowable by the DCAA auditor. Therefore,

the cognizant auditor will disapprove any such amounts that may be included in the prime contractor's claims under flexibly priced contracts, regardless of the prime contractor's disposition thereof with the subcontractor.

6-802.6 Special Considerations - Release of Subcontractor Data to the Higher-Tier Contractor

When a DCAA subcontract assist audit is contemplated, the higher-tier contractor normally will have made satisfactory arrangements for its unrestricted access to the subcontract audit results so that it will be able to fulfill its responsibilities for settling any audit exceptions. In rare cases, this may be impracticable. The following procedures are required to protect subcontractor data when special circumstances warrant such protection.

a. Before beginning a subcontract audit, determine whether the subcontractor will have any restrictions or reservations on release of the resulting audit report(s) to the higher-tier contractor. A significant reservation exists if the subcontractor desires to withhold its decision on release of an audit report pending review of the audit results or report contents. If the subcontractor does not assure unrestricted report release at the outset, refer the matter to the requesting higher-tier contract auditor. The latter will reassess the assist audit request, consulting with the higher-tier contractor and/or ACO as appropriate.

b. In most cases, the higher-tier contractor should be able to remove the subcontractor's objections to unrestricted release of the audit results. This may be necessary to avoid Government suspensions or disapprovals of subcontract costs billed by the higher-tier contractor. If the prime contractor's diligent efforts are unsuccessful, request the ACO to advise whether the subcontract costs should be audited by the Government, even though some or all of the audit report information may have to be kept within Government channels.

c. There may be rare cases when the higher-tier contract auditor and ACO decide that an audit should proceed without the subcontractor's advance concurrence on report release of the subcontractor’s data. In such cases, the subcontract auditor should attempt during the exit conference to obtain the subcontractor's concurrence in unrestricted release of the report to the higher-tier contractor. If this fails, the subcontract auditor should modify the Restrictions section of the audit report per 10-212.3. If practicable, obtain the subcontractor's written statement as to what information may be released, and provide this to the report addressee either as a report appendix or by separate correspondence.

d. At subcontractor locations where recurring cost audits are made on subcontracts issued by the same higher-tier contractor, try to expedite the process by developing a working arrangement for unrestricted audit report release. The subcontractor's representative should document the arrangement, with a copy to the auditor.

6-803 Interplant Billings

As used in this section, interplant billings are invoices (or credit memorandums) for work or services performed at a contractor's plant or division and charged to flexibly priced contracts at another plant or division. For purposes of this section, the auditor at the plant or division billed for services is referred to as the prime auditor and the auditor at the location where the work is performed is referred to as the lower-tier auditor.

6-803.1 General

a. A contractor may use more than one of its plants or divisions to perform required work or services. It may issue interplant work orders, purchase orders, or requisitions for the services or work to be performed. Where plants or divisions involved are separate entities for accounting purposes, the contractor generally will use interplant billings or invoices to bill costs or charges applicable to the work or services performed. Except as provided in FAR 31.205-26(e), the allowable costs for such work or services will be the actual costs of the performing organizational unit (6-313).

b. The provisions of this section are not applicable to monthly or periodic billings which cover solely estimated indirect expense allocations, such as distributions of home office expenses to various benefiting plants. Ordinarily, the contractor will adjust these allocations to actual at its fiscal year end. The cognizant auditor will review charges of this nature as part of the normal overhead audit at the benefiting plants through the assist audit procedures (6-804).

6-803.2 Audit Procedures

a. The prime auditor will initiate requests for assist audits of interplant billings pursuant to the criteria stated in 6-306.3b.(2) and 6-313 and should normally include copies of the related work orders, purchase orders, or subcontracts and billing documents to help the lower-tier auditor identify the costs to be audited. However, the lower-tier auditor has a mutual responsibility to assure concurrent and coordinated audit effort similar to that envisioned in subcontract audits (6-802). In addition, these responsibilities include satisfying applicable portions of the mandatory annual audit requirement related to auditable subcontracts/assist audits (MAAR 12). The prime auditor's timely identification of auditable interplant work authorizations and information as to anticipated volume of auditable work is essential to sound audit planning and performance of the assist audits.

b. The lower-tier auditor should coordinate planned audit effort with the prime auditor and the lower-tier Plant Representative/ACO to assure coverage in specific areas of mutual interest. Based on this coordination, the lower-tier auditor will furnish the prime auditor with the anticipated issuance date of the assist audit report. The prime auditor will also coordinate these matters with the Plant Representative/ACO at his or her location.

c. The lower-tier auditor will arrange for necessary technical assistance with the lower-tier Plant Representative/ACO. Guidance on technical assistance is in Appendix D.

d. Requirements in 6-1005b. will govern the scope of the incurred interplant costs audit. The audit will normally be comprehensive and include a reconciliation of the cost records to the total interplant billings for each fiscal year during the contract performance. Do not perform audits of individual interplant billings except in unusual circumstances as required by 6-1003f.

6-803.3 Audit Reports

a. The lower-tier auditor will issue timely audit reports, prepared under the general requirements of Chapter 10, to the prime auditor according to the reporting schedule. The report will cover the acceptability of the total transferred costs, together with specific comments on the indirect expense rates. When circumstances warrant, the lower-tier auditor should

issue a special report to advise the prime auditor on a timely basis of newly noted matters which affect the allowability or allocability of interplant costs.

b. Comments on indirect expense rates should indicate whether or not final rates have been established. If final indirect expense rates have not been established, the lower-tier auditor will provide comments regarding claimed billing rates and the effect of questioned costs on the billing rates. The lower-tier auditor will issue a supplemental audit report when indirect expense rates have been finalized.

c. The lower-tier auditor will also provide comments on any transferred costs not covered by an interplant work order.

d. The lower-tier auditor will explain all suspended or disapproved costs in sufficient detail to enable the prime auditor to prepare necessary DCAA Form 1s.

6-804 Corporate or Home Office Audits

The contractor's home or group office comprises the general corporate or divisional headquarters responsible for the management of business carried out at various plants, branches, divisions, or subsidiaries of the organization.

a. The home office is responsible for the overall administration and management of the operations performed under its general guidance and incurs expenses that are allocable to the operations carried out at the various plants, branches, divisions, or subsidiaries.

b. Some home or group office services may not be of a general nature but are performed for a particular plant or division. Under such conditions, the associated costs may be directly charged to the plant or division. Treat these transactions as intracompany billings covered by the audit procedures outlined for interdivisional transactions (6-313).

6-804.1 Audit Responsibility – Home Office Audits

a. The home office auditor is responsible for the audit of all corporate or home office expenses distributed to the various segments of the corporation irrespective of how such expenses may be charged to the segments.

b. There is, however, a significant corollary responsibility placed on lower-tier auditors. They must develop sufficient information and necessary visibility to permit effective evaluation by the home office auditor. For example, lower-tier auditors, in cooperation with the contract audit coordinator (CAC) and home office auditors, may identify overlapping or duplicative effort between the home office and operating entities. The CAC program (15-200) was established, in part, to improve communication and visibility in this important area. Accordingly, take appropriate measures to assure that effective coordination is accomplished among the home office auditor, the plant auditor, and the CAC.

c. The audit scope will depend to a large extent on the overall value and percentage of Government contracts the contractor is performing and the amount of home office expenses allocated and assigned to Government contracts. When appropriate, the corporate auditor should perform the audit during the contractor's fiscal year.

d. The corporate auditor should resolve audit problems, such as inequitable allocation methods or corporate policies, as soon as possible to prevent undue delays of overhead audits at the various segments. In this connection, refer to 15-200 for the CAC program procedures. Plant level auditors should specify dates by which home office reports are needed in the audit request.

6-804.2 Audit Procedures

a. Guidance in Chapters 4 and 6 are applicable to the audit of home office expenses. In reviewing home office expense pools, pay particular attention to the expense types which may not be applicable to the business as a whole, such as those applicable only to a particular group of products, group of plants, or only to those products sold through certain channels or to certain customers.

b. The corporate auditor should review accounts not included in the expense pool for the possibility that they are applicable to Government contracts. These accounts include other (or miscellaneous) income and expense accounts, reserves for contingencies, surplus, and others. (See 6-500.)

c. The corporate auditor should review tax returns, corporate minutes, reports filed with regulatory bodies (such as SEC filings), and financial statements for their impact on the contractor's organization, operations, and claimed costs. (see 3-1S1.) The results of this review should be coordinated with, and written confirmation provided to, cognizant lower-tier auditors to help comply with mandatory annual audit requirement relating to the review of tax returns and financial statements (MAAR 4).

d. The corporate auditor should furnish copies of consolidated financial statements, including notes thereto, to cognizant lower-tier auditors.

6-804.3 Cost Accounting Standards (CAS) -- Home Office

Cost Accounting Standard 403 (Allocation of Home Office Expenses to Segments) is particularly important in reviewing the allocability of home or group office expenses. The need for assuring compliance imposes special requirements on both the home office auditor and lower-tier auditors, and close coordination and interface between these auditors is essential. All auditors involved in the review and analysis of home or group office expenses will observe the specific guidance contained in Chapter 8.

6-804.4 Audit Reports

a. The higher-tier auditor normally should issue audit reports annually, but also report significant findings when discovered. The narrative section of the report should contain summary comments on unsatisfactory contractor policies and procedures affecting contract costs at the plant level to alert those auditors to conditions that may require special emphasis.

b. Audit reports should provide sufficient detail and information for the plant level auditors to identify and evaluate cost allocations considering the circumstances or specific provisions of their contracts.

c. Reports distributed to plant or division level auditors should not divulge "contractor confidential" information which the contractor itself does not release to the plant or division level. A factor representing the percentage of questioned or disapproved allocated home or group office expenses may be all that is required at the plant or division level.

6-805 Offsite Locations (including overseas locations)

The contractor may maintain books and records at locations different from the site of physical work performance. For purposes of this section, auditors at locations where contrac-

tors' books and records are maintained are referred to as prime auditors and those where the work is physically performed as offsite auditors. Both prime and offsite auditors must establish adequate communication to assure effective interface.

6-805.1 Audit Responsibility – Offsite Locations

a. The prime auditor retains responsibility for the audit of the primary accounting records and approval of costs under Government contracts. In this connection, the prime auditor will coordinate the overall plan or program, including assist audit requests, with the offsite auditor to assure proper integration of audit efforts at the respective locations. The assist audit request should include, as a minimum, a listing of current employees at the offsite location, the name, title, and telephone number of the offsite contractor representative, a listing of contractor project numbers active at the offsite location, a cross-reference to active Government contract numbers and types, a copy of a current payroll distribution, and DMIS contractor DUNS ID for the offsite auditor to use when setting up the assignment. It is especially important that the prime auditor notify the offsite auditor of special provisions or sensitive areas concerning contract performance. The offsite auditor has a corollary responsibility to apprise the prime auditor of any auditable work or additional areas of audit coverage at the offsite location which have not otherwise been identified.

b. The offsite auditor will time-phase general areas of audit coverage at the offsite location to coincide with the prime location's overall plan. The offsite auditor should initiate physical observations and coordination with offsite contract administration officials.

c. Where warranted, the prime auditor(s) should make periodic visits to offsite locations to coordinate audit activity. The prime and offsite auditors should discuss any unresolved problems between them through regional channels. (See 6-807.)

d. These responsibilities also include satisfying the applicable portions of the mandatory annual audit requirement related to auditable subcontract/assist audits (MAAR 12).

6-805.2 Audit Reports

a. The format and content of the assist audit report will conform with the general requirements of Chapter 10.

b. The offsite auditor will address assist audit reports to the prime auditor. All assist audit reports with positive findings shall contain a recommendation for a followup assist audit whenever one is considered necessary. When audit results involve questioned costs or require further action at the prime location, the prime auditor will advise the offsite auditor of the disposition of the audit findings.

c. The offsite auditor will issue reports to local contract administration officials concerning matters of local interest or in response to requests from the local officials. The offsite auditor will furnish copies of reports to the prime auditor.

6-806 Washington Area Offices

a. Many large contractors maintain offsite offices in the Washington, D.C. area. Historically, contractors' Washington, D.C. area offices (hereinafter referred to as Washington Office) have incurred significant expressly unallowable costs; e.g., lobbying and entertainment.

Contractors should identify and exclude these unallowable costs from any billing, claim or proposal applicable to a Government contract.

b. A Washington Office is defined as office space that is leased, rented, or owned in the Washington, D.C. metropolitan area by a Government contractor. The space is used, at least partially, for the purpose of Legislative/Executive Branch lobbying, public relations, and/or marketing the contractor's products.

c. To be successful, Washington Office audits require a coordinated audit approach between the cognizant auditor and the Washington Office auditor. The decision to request a Washington Office audit is usually made by the cognizant field audit office. Corporate or home office auditors should contact divisional auditors to determine the extent of divisional employee involvement at the Washington Office. Many contractors staff their Washington Office with both corporate and divisional employees.

6-806.1 Audit Risk Assessment

a. FAOs should perform a risk assessment of the Washington Office before requesting an assist audit. The risk assessment should focus on: the significance and sensitivity of the proposed Washington Office costs, the amount of Washington Office costs being identified and excluded from the proposal, and the adequacy of the contractor's accounting policies and procedures and internal controls for Washington Office costs. The following are examples of conditions that may require an assist audit:

(1) The proposed Washington Office costs are significant.

(2) The contractor does not eliminate any (or very small amounts of) costs for unallowable activities, such as lobbying, from its proposed Washington Office costs (FAR 31.205-22).

(3) The contractor excludes little or no directly associated unallowable costs from its proposed costs for the Washington Office.

(4) The contractor's accounting policies and procedures for Washington Office costs are not documented, especially the policies and procedures for identifying and segregating unallowable costs.

(5) The contractor has made major changes to the accounting policies and procedures for Washington Office costs.

(6) Major Washington Office management changes have occurred.

(7) A compliance audit of the Washington Office accounting policies and procedures has not been performed in the last three to five years (either by the contractor's internal audit department or DCAA).

b. The results of the risk assessment should be included in the assist audit request. If a contractor is eliminating as unallowable costs the entire Washington Office - both corporate and division - an assist audit is normally not needed.

6-806.2 Assist Audit Request

a. The offsite Washington Office assist audit will be performed by the designated audit office for that geographic area. The designated audit office will treat all Washington Office audits as customer requested assignments. It will also initiate coordination with the cognizant FAO if a Washington Office assist audit has not been requested in a three year period.

b. Washington Office assist audits are most efficient and effective when coordinated with FAO corporate or division audits. The designated audit office will tailor their audit program with the FAO requesting the assist audit before performing any field work.

6-807 Differences of Opinion Between DCAA Offices

In the exchange of information and ideas in the performance of assist audits, it is possible that significant differences of opinion on administrative procedures or technical accounting matters may develop. Auditors encountering such differences in performing audit assignments will forward the information to their respective regional offices. If the directors of the respective regions cannot resolve the differences, or if the differences are resolved, but the matters involved would be of interest to Headquarters, either or both regional directors will forward promptly to Headquarters, Attention PAC, a report containing sufficient details regarding the differences involved including, where appropriate, the conclusions reached. Reporting to Headquarters on problem areas encountered in the administration of the CAC program is covered in 15-210.2.

Figure 6-8-1
Pro Forma Assist Audit Request

[Date]

MEMORANDUM FOR FAO MANAGER, [insert the cognizant FAO name]

SUBJECT: Notification of Subcontract Award [Intracompany Order] and Assist Audit Request

As part of our incurred cost audit of [contractor name], we request that you include the following subcontract(s)/intracompany order(s) in your incurred cost audit of [subcontractor name]. Enclosed are copies of subcontract(s)/intracompany order(s) awarded by [contractor name] to the subcontractor under your audit cognizance. We are also providing the [contractor name] identified point of contact for [subcontractor name], along with their mailing address and phone number to assist you in coordinating with the identified subcontractor.

Contract No.	Type	Subcontract No.	Period of Performance	FY Incurred Cost	Subcontract Value

Annual incurred cost audits are required that cover the period of performance of the subcontract(s). Please acknowledge this request. We request that you furnish our office with a Cumulative Allowable Cost Worksheet (CACWS) on an annual basis, and a final CACWS or Contract Audit Closing Statement when audits of costs incurred covering the entire period of performance are completed.

In addition, we request that you inform our office if either of the following conditions occurs during subcontract performance:

- Annual incurred cost audits disclose significant questioned costs. If so, please provide the amount applicable to the subcontract so we can prevent the prime contractor from over billing the Government.
- The subcontractor no longer has an adequate accounting and/or billing system.

If you have any questions pertaining to this memorandum, please contact Mr./Ms. [insert name], Supervisory Auditor, at [insert the telephone number] at your convenience.

John A. Smith
FAO Manager

Enclosures: a/s

6-900 Section 9 --- Notices of Cost Suspensions and Disapprovals under Cost-Reimbursement Contracts

6-901 Introduction

This section states the audit guidance and procedures to be followed for effecting suspensions and disapprovals of costs under cost reimbursement contracts and the issuance of DCAA Form 1, Notice of Costs Suspended and/or Disapproved under Cost Reimbursement Contracts.

6-902 General Guidance for Suspensions and Disapprovals

a. In general, an item of cost, either direct or indirect, which lacks adequate explanation or documentary support for definitive audit approval or disapproval should be suspended until the required data are received and a determination can be made as to the allowability of the item. Suspensions may also be used to:

(1) Reduce the fixed-fee when the interim amount claimed for payment is in excess of the amount authorized by the contract.

(2) Establish the necessary withholding reserves required by the contract terms when the contractor fails to do so.

(3) Provide for the correct amount of current reimbursements of costs in accordance with contract billing requirements (e.g., suspend costs that are otherwise allowable but which have not met the contract billing requirements (see 6-1005c and 6-1006)).

b. Costs claimed by the contractor for which audit action has been completed, and which are not considered allowable, will be disapproved. Disapproved cost may comprise any of the following:

(1) Items specifically limited or excluded by FAR Part 31 or other terms of the contract.

(2) Items which, although not specifically unallowable under (1) above, are determined, in accordance with FAR Part 31, to be unreasonable in amount, contrary to generally accepted accounting principles, or not properly allocable to the contract in accordance with the relative benefit received or other equitable relationship.

(3) Items disapproved at the direction of the ACO (DFARS 242.803(b)(ii)(B)).

c. Costs which the auditor determines should be suspended or disapproved should be discussed with the contractor to ensure that the auditor's conclusion is based upon a proper understanding of the facts and to inform the contractor of the auditor's determination. If the contractor agrees that the costs in question should be suspended or disapproved, one of the following actions will be taken:

(1) Where the costs have not yet been submitted on a reimbursement voucher, arrangements will be made to ensure exclusion of the costs from any future reimbursement claims. The auditor shall maintain a record of improper contract costs which the contractor has agreed to deduct or exclude from its claims on public vouchers.

(2) Where the costs have already been included in provisionally approved reimbursement vouchers, the auditor may issue a DCAA Form 1, or as an alternative the contractor may deduct the amount on the next voucher submitted. For indirect costs, this may be accomplished by the contractor making the appropriate reduction to the billing rates.

d. The issuance of a DCAA Form 1 should not be delayed until the auditor is prepared to issue an audit report if the cost to be disapproved has been reimbursed through interim

billings. If an audit finding has been presented to the contractor and the contractor does not agree with the questioned costs, the auditor may prepare and issue a DCAA Form 1 even though the audit report will not be issued until other portions of the audit are completed.

e. The auditor is responsible for keeping the ACO advised of issues which have the potential for becoming the subject of a DCAA Form 1. This will permit the auditor to ascertain whether the ACO has any additional data which would either support or modify the audit findings. The auditor may also refer the matter to the regional office for guidance, particularly in those cases where the ACO indicates nonconcurrence with the proposed audit action. The regional office, in turn, may consider it desirable to consult Headquarters before reaching a decision. The consultations and discussions held with the ACO and higher level audit personnel should be expedited so that audit action can be completed on a timely basis. The issuance of a DCAA Form 1 triggers the ACO's involvement in the audit determination process (6-708).

f. If the contractor does not agree that the costs in question should be suspended or disapproved, and the auditor has taken the action prescribed in e. above, the auditor will issue a DCAA Form 1 (6-903) to effect suspensions and disapprovals of costs or fees claimed for payment on contractors' reimbursement vouchers.

g. Occasionally a contractor may underbill and wait until the final indirect rates are settled before billing the Government. Where such an underbilling has occurred and the auditor and the contractor do not agree on the allowability of the amounts contained in the contractor's claim, the auditor should still issue a DCAA Form 1. The amount of questioned costs with which the contractor did not agree will be shown in the designated block on the DCAA Form 1. After the explanatory paragraph(s), a statement shall be provided explaining that no action is necessary to recoup the questioned amount as the contractor has not been reimbursed for it. The following statement is suggested and may be modified and/or expanded to suit particular circumstances:

> The purpose of this DCAA Form 1 is to initiate ACO action in rendering a final decision on the questioned costs associated with the issue described herein with which the contractor does not agree. At the present time, no action is required to recoup the questioned amount as the interim billing rate used by the contractor during FY 20XX was low enough to preclude reimbursement of the questioned costs on an interim basis. However, should the contractor bill these costs before this issue is resolved, this DCAA Form 1 will be attached to the request for payment for the purpose of disapproving the costs.

h. A DCAA Form 1 should be issued even though there will be no future billings under a contract. Auditors should reference the contract and the amount of the disapproved costs in the designated blocks on the DCAA Form 1. Following the explanatory paragraph describing the reason for the DCAA Form 1 (6-904.1a(8)), the auditor should provide a statement explaining that:

(1) ACO action is necessary to recoup the disapproved costs because there are no future billings under the contract to which to apply the DCAA Form 1, and

(2) the ACO should issue the demand for payment as part of the final decision, if a final decision is required (FAR 32.604 and FAR 32.605(a)).

If the ACO issues a demand for payment and the contractor does not make payment within 30 days, the ACO may authorize DCAA to disapprove the costs under another contract with future billings. The courts have ruled that the Government has a common-law right to offset contract debts against payments due the contractor under other contracts. The following statement is suggested and may be modified and/or expanded to suit particular circumstances:

> The purpose of this DCAA Form 1 is to initiate ACO action in rendering a final decision on the disapproved costs associated with the issue described herein with which the contractor does not agree. Currently, there are no future billings under Contract No. [Complete applicable contract number]. The ACO, therefore, should take immediate action to recoup the disapproved cost, i.e., issue a final decision and a demand for payment (see FAR Subpart 32.6). If the contractor does not make payment within 30 days following the issuance of the demand for payment, the ACO should coordinate with DCAA when initiating procedures to recoup the disapproved amount through an intercontractual offset.

i. A DCAA Form 1 can be issued to effect a cost suspension or disallowance on one delivery order in order to recover an overpayment under another delivery order on the same contract if it is funded by the same appropriation.

j. When the auditor cognizant of a home office determines that certain amounts should be suspended or disapproved, he/she is responsible for:

(1) discussing the costs with the appropriate home office representatives;

(2) consulting with the CACO, if appropriate;

(3) preparing computations to show the allocation of the suspended/disapproved costs to each receiving entity; and

(4) advising the auditor cognizant of the receiving entity as to the description of the cost element to be suspended or disapproved, the amount allocable to the entity, and the reasons for the action.

A copy of this advisory notice should also be sent to the cognizant CACO and the contractor's home office representative. The auditor cognizant of the entity receiving the costs to be suspended or disapproved should prepare a regular or blanket DCAA Form 1, as appropriate, listing all affected contracts, and showing the computations to the contract level.

k. For special administrative procedures to be followed in processing suspensions and disapprovals related to non-DoD contracts refer to 15-100.

l. Should it be necessary, a previously issued DCAA Form 1, including those issued at the direction of the ACO, may be rescinded by the auditor.

6-903 Types of DCAA Form 1

Suspensions and disapprovals affecting DoD contracts, and contracts of non-DoD organizations where the auditor has been granted the authority (15-103), will be accomplished by means of one of the following types of DCAA Form 1. Costs suspended or disapproved on NASA contracts are accomplished by means of a NASA Form 456 (15-105).

6-903.1 Regular

Where the cost element to be suspended or disapproved is applicable to only one contract, a regular DCAA Form 1 will be prepared and issued as prescribed in 6-904.1.

6-903.2 Blanket

Where the cost element to be suspended or disapproved is applicable to more than one contract, a blanket DCAA Form 1 will be prepared and issued as prescribed in 6-904.2. The blanket DCAA Form 1 will contain a description of the issue involved and will list all affected contracts, showing the computation to the contract level. Although all affected contracts are listed on the blanket DCAA Form 1, the auditor may elect to process the DCAA Form 1 against interim billings for only those contracts containing the major portion of the costs to be suspended or disapproved when the amounts on the remaining contracts are relatively immaterial. Once the issue is settled, the other contracts should be adjusted as necessary. Contract audit closing statements should reflect reductions for all outstanding DCAA Form 1 suspensions and disapprovals applicable to the contract even though the Form 1 has not been previously processed against interim billings under the contract due to materiality considerations.

6-904 DCAA Form 1 Preparation

The auditor is the authorized representative of the contracting officer for the purpose of issuing a DCAA Form 1. Only the auditor shall prepare the form. The auditor should prepare a separate DCAA Form 1 for each major issue. This procedure facilitates tracking the status of the issue should the contractor appeal the DCAA Form 1. Instructions for the preparation of authorized types of DCAA Forms 1 are presented in the following paragraphs. Regional review is required prior to issuance of all Forms 1, as well as all related rebuttals and response letters.

6-904.1 Regular

a. The information to be shown on DCAA Forms 1 and 1-C should conform with the following instructions. (see Figures 6-9-1 and 6-9-2) DCAA Forms 1 and 1-C can be found in Formflow under DCAA Forms.

(1) Contract Number. Insert the number of the contract, and, if appropriate, the job, task, or project order thereunder.
(2) Notice Number. Insert the sequence number of this DCAA Form 1. A separate series of consecutive numbers of DCAA Forms 1 beginning with number 1 will be used for each contract, job, task, or project order for which a separate voucher series of numbers is used. (See DCAAP 7641.90.)
(3) Disbursing Office. Show the name and address of the applicable disbursing office.
(4) Contract Administration Office. Show the name and address of the applicable office.
(5) Signature and Date of Notice. In accordance with the provisions of DCAAR 5600.1, the FAO manager responsible for issuing the DCAA Form 1 will manually sign the original and insert the date signed.
(6) DCAA Auditor Address. Insert the name and address of the FAO.

(7) Contractor's Acknowledgment of Receipt. Do not fill in these three blocks when the form is prepared. Obtain the contractor's acknowledgment per 6-905b.

(8) Description of Items and Reasons for Action. The auditor shall insert in this space a clear and concise description and identification of each item suspended or disapproved. The reasons for action must clearly and specifically state the grounds for suspension, or disapproval. Since the DCAA Form 1 is, in essence, an audit report, the reporting standards in 2-400 will be complied with in its preparation. If there are numerous items, they should be briefly itemized and totaled before the detailed explanations begin, so that the total amounts of costs suspended and/or disapproved appear no later than the first or second page of the form.

b. The amount suspended and/or disapproved will be deducted on a current public voucher in the manner provided by 6-906.

6-904.2 Blanket

a. Where use of a blanket form is appropriate (see 6-903.2), a DCAA Form 1 will be prepared in accordance with the following instructions.

(1) The contractor's name and address will be shown in the space provided.

(2) Insert “see enclosed contract list” in the Contract Number field.

(3) A description of the cost element to be suspended or disapproved, the amount applicable to each affected contract, and the reasons for the action will be shown in the space provided. If the information cannot be conveniently shown in such space, a brief, introductory statement will be furnished, generally describing the items and reasons for the audit action. Amounts suspended or disapproved applicable to each affected contract and detailed explanations will be stated in exhibits or other attachments, and appropriate reference will be made to such data in the introductory statement. For example, in the case of indirect costs disapproved based on the auditor's determination of final indirect cost rates, the foregoing may be shown on the blanket DCAA Form 1 as follows, modified as appropriate in the circumstance:

> "For the Fiscal Year ended 20XX, Factory, Engineering, and General & Administrative expense reimbursed to the Company under this contract in excess of amounts determined allowable are disapproved. The disapproved amounts allocated to this contract are indicated by check mark on Exhibit A."

(4) Clearly identify on the DCAA Form 1 the amount suspended or disapproved applicable to a specific contract when attaching the DCAA Form 1 to the voucher.

b. The blanket DCAA Form 1 will be distributed in accordance with 6-905. The amount suspended or disapproved applicable to each contract will be deducted from the reimbursement claimed on a public voucher for each contract in the manner provided by 6-906.

6-905 Acknowledgement and Distribution of DCAA Forms 1

a. The auditor should obtain the contractor's acknowledgment of receipt of the DCAA Form 1. Where the auditor personally presents the DCAA Form 1 to the contractor, he/she should obtain the required acknowledgment, provide the contractor an acknowledged copy,

and retain the original in the audit file. Where the DCAA Form 1 is mailed to the contractor, rather than personally presented, it should be sent by certified mail, return receipt requested, and the contractor shall be advised to forward the acknowledged original of the DCAA Form 1 to the auditor. This procedure shall be used in any case where the contractor refuses to acknowledge receipt of the DCAA Form 1.

b. Immediately upon receipt, the auditor should distribute a copy of the acknowledged DCAA Form 1 to the ACO. In the case of issues having corporate-wide impact, the CACO should also be provided a copy.

6-906 Deductions on Public Vouchers for Suspensions and Disapprovals

a. If it appears that the full immediate deduction of a cost suspension or disapproval might seriously impair the contractor's ability to continue contract performance, the auditor should consult with the contracting officer concerning the Government's possible use of FAR 32.607 procedures regarding deferred payments of contract debts.

b. If the contractor is authorized to submit interim public vouchers directly to the disbursing office, it may be necessary to rescind the contractor's direct bill authority in order to process the DCAA Form 1 suspension or disapproval. See CAM 6-1007.7 for guidance on rescinding the contractor's authority to direct bill.

c. When effecting a DCAA Form 1 deduction to a cost voucher, the auditor will need to determine the billing process used by the contractor on the impacted contract(s). The acquisition regulations clearly establish electronic billings as the preferred method. However auditors may encounter traditional hardcopy SF 1034/1035 billings in addition to electronic billings using DoD's Wide Area Workflow (WAWF).

(1) When processing a paper based billing, insert in the differences block of the public voucher, SF 1034, the total amount suspended and/or disapproved as shown on the DCAA Form 1, and the net amount provisionally approved, as follows:

DCAA Form 1
[or NASA Form 456] $ (____)
Net Amount Approved $

(2) When processing an electronic billing through WAWF, complete the following process:

(a) Under the auditor actions section, select the Recommend Cost Suspension or Disallowance action box.

i. If the contract is administered by Defense Contract Management Agency (DCMA), a single input box titled Disallowed will be displayed. Enter the DCAA Form 1 disallowed or suspended cost amount in the Disallowed box. If there are multiple DCAA Forms 1 containing both suspended and disallowed costs, enter the sum of all items in the Disallowed input box.

ii. If the contract is not administered by DCMA, two input boxes will be displayed, one for the Suspended amount and one for the Disallowed amount. Enter the appropriate amount in each individual box.

(b) Include the DCAA Form 1 document(s) as an attachment to the electronic billing within the Miscellaneous Information tab.

(c) Delineate the specific amount suspended and/or disallowed and the sum total of all adjustments in the Approver Information comments section of the electronic voucher within the Miscellaneous Information tab. An example comment may read:

"Suspended cost total $5,000 and Disapproved cost total $5,000. The total reduction to voucher is $10,000. The detailed explanation for each reduction is provided for in the attached DCAA Form(s) 1."

(d) Electronically sign and submit voucher.

d. Ensure that the DCAA Form 1 amount is shown as an offset to cumulative billings in the "Contract Reserves and Adjustments" section of the SF 1035 (or equivalent) attached to the next public voucher (see DCAAP 7641.90).

e. If the amount of the deduction is more than the amount of the public voucher, the auditor shall apply the installment method of deductions to this and subsequent public vouchers against the contract(s) involved until the amount is fully liquidated against the contractor's claims. Public vouchers with zero amounts must be forwarded to the disbursing office for appropriate action.

f. Auditors may disapprove costs submitted for payment no matter what cost elements are currently being billed. FAR 52.216-7(g), Allowable Cost and Payment, allows adjustments to be made against current billings for any prior overpayments.

6-907 Follow-up Action on Suspensions and Disapprovals

a. It is expected that within a reasonable time after issuance of a suspension, the contractor will submit the required explanations, documentation, data, or justification in support of the suspended costs. At that time, the auditor will complete the evaluation and determine the allowability of the items involved. Auditors will make all reasonable efforts to obtain the additional information required for an audit determination as promptly as possible. When such efforts are not successful, the auditor, after the lapse of a reasonable period of time, may process a DCAA Form 1 to effect the disapproval of the suspended item. If the contractor disagrees with this determination, it may elect to assert a claim with the contracting officer pursuant to the "Disputes" clause of the contract(s).

b. If a reimbursement voucher contains a resubmission of items of cost or fee that were previously suspended by DCAA Form 1, the contractor will show each such item as a separate line item on its SF 1035 (or equivalent) in the current period column of the section entitled "Contract Reserves and Adjustments" (see DCAAP 7641.90). A final audit determination on all suspended items will be made by the auditor prior to or at the time the completion voucher under the contract or subcontract is processed and the contract closing statement is issued.

6-908 Contractor's Request for Reconsideration or Claims of Disapproved Costs

a. Following the issuance of a DCAA Form 1, the contractor may:

(1) request the cognizant ACO in writing to consider whether the unreimbursed costs should be paid and to discuss the findings with the contractor; and/or

(2) submit to the ACO a claim for disapproved costs in accordance with FAR 33.2 (Disputes and Appeals).

Arrangements should be made for ACOs to notify the auditor promptly of any claims they may receive. The ACO will normally make a written determination as promptly as practicable on contractor written requests for reconsideration, but when a formal claim is filed, the ACO should make a final decision within 60 days. If a contractor disagrees with the ACO's final decision regarding a claim, the contractor may appeal the decision to the ASBCA or the Court of Federal Claims.

b. Written determinations or final decisions may sometimes involve complex issues and significant dollar amounts. Moreover, they may have an impact far wider than the particular transaction at issue. Generally, the ACO will seek legal counsel and advice from others, including the auditor. In these cases, the auditor shall cooperate with the ACO by furnishing any additional information and audit explanations necessary to permit him or her to reach a conclusion. In the event the ACO does not sustain the contract auditor's cost disapproval, DoD Instruction 7640.02 requires the ACO to comply with the documentation and review procedures prescribed by his/her DoD component prior to final disposition of the disapproved cost (see 15-603). In this connection, DCMA procedures are stated in Chapter 6.6 of DLAD 5000.4.

c. When a claim of disapproved costs is decided, in whole or in part, in the contractor's favor, the ACO may advise the contractor to resubmit on its next public voucher the amount determined acceptable by the ACO. The amount of the resubmission shall be shown as a separate item in the section on the SF 1035 headed "Contract Reserves and Adjustments" (see DCAAP 7641.90). The ACO's decision sustaining the contractor's claim will be retained in the audit file with the auditor's copy of the resubmission voucher as supporting documentation.

Figure 6-9-1
DCAA Form 1

DEFENSE CONTRACT AUDIT AGENCY NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED		PAGE _____ OF _____
TO: (Name and Address of Contractor)	Contract Number	Notice Number
	Disbursing Office	Contract Administrative Office

1. This notice is issued pursuant to the authority of DoD Directive 5105.36, as implemented by the Federal Acquisition Regulation and DoD FAR Supplement. It constitutes notice of costs suspended and/or disapproved incident to the audit of contractor costs incurred under referenced contract(s). Description of items and reasons for the action are stated below.

2. SUSPENDED COSTS, as referred to herein, are costs which, for the reasons stated below, have been determined by the undersigned to be inadequately supported or otherwise questionable, and not appropriate for reimbursement under the contract terms at this time. Such costs may be determined reimbursable after the contractor provides the auditor additional documentation or explanation as specified below.

3. DISAPPROVED COSTS, as referred to herein, are costs which, for the reasons stated below, have been determined by the undersigned to be unallowable, that is, not reimbursable under the contract terms.

4. If the contractor disagrees with this/these determinations, the contractor may (1) request in writing the cognizant contracting officer to consider whether the unreimbursed costs should be paid and to discuss his or her findings with the contractor and/or (2) file a claim under the "Disputes" clause of the contract(s).

5. The auditor will submit copies of the acknowledged notice to the cognizant disbursing officer for appropriate action and to the cognizant contracting officer.

ITEM NO.	Description of Items and Reasons for Action	Amount of Costs	
		Suspended	Disapproved

DCAA AUDITOR	Date of Notice	Address:	Signature:

CONTRACTOR'S ACKNOWLEDGMENT OF RECEIPT - The contractor or its authorized representative shall acknowledge receipt of this notice to the DCAA auditor.

Date of Receipt	Name and Title of Authorized Official	Signature:

DCAA Form 1
April 2009

Figure 6-9-2
DCAA Form 1-C

DEFENSE CONTRACT AUDIT AGENCY NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED	PAGE _____ OF _____
CONTRACTOR:	Notice Number

ITEM NO.	Description of Items and Reasons for Action

DCAA Form 1
April 2009

6-1000 Section 10 --- Responsibilities for Processing and Approval of Interim and Completion Cost-Reimbursement Vouchers

6-1001 Introduction

This section provides information on the audit responsibilities for the processing and approval of the contractor's interim and completion reimbursement vouchers. Additional guidance on terminated cost-type contracts and processing of non-DoD reimbursement vouchers is contained in 12-400 and 15-100, respectively.

6-1002 General

a. Contractors submit reimbursement vouchers or invoices (herein referred to as vouchers) to obtain interim and final payment under cost-reimbursement, time-and-materials and labor-hour contracts and the cost-reimbursement portions of fixed price contracts. A cost-reimbursement type contract provides for payment to the contractor of the allowable costs incurred in performing the work or services prescribed in the contract. This type of contract specifies an estimate of total cost for the purposes of:

(1) obligating funds and

(2) establishing a cost ceiling which the contractor may not exceed, except at its own risk, without the approval of the contracting officer.

b. The contract may also provide for the payment to the contractor of a fixed fee, or a target fee subject to subsequent incentive adjustment dependent upon prescribed contract performance or cost factors. Conversely, a cost-sharing contract may limit reimbursement to the contractor to an agreed portion of the total allowable costs, and provide for the remaining portion to be absorbed by the contractor in consideration of expected compensating benefits. A time-and-materials contract provides for acquiring supplies or services on the basis of:

(1) direct labor hours at specified fixed hourly rates that include wages, indirect expenses, and profit; and

(2) materials at cost, including material handling costs, if appropriate.

A labor-hour contract is a variant of the time-and-materials contract, differing in that materials are not supplied by the contractor. The various types of contracts described above are hereafter referred to as cost-reimbursement type contracts for purposes of this section and are more fully explained in FAR Part 16, Subparts 3, 4, and 6, plus applicable supplements.

c. A fixed price contract obligates the contractor to complete physical performance of the contract at the stipulated price(s). The failure to complete performance subjects the contractor to possible Government termination for default. Under a cost-reimbursement type contract, however, although the contractor is expected to use its best efforts to complete performance, the contractor is not obligated to continue performance under the contract if it involves the incurrence of costs in excess of the estimated total cost stated in the contract.

6-1003 Responsibility for Examination and Approval of Reimbursement Vouchers

a. The authority and responsibility for audit examination and approval for payment of contractors' claims (public vouchers) under cost-reimbursement type contracts are set forth in Department of Defense Directive No. 5105.36, subject: Defense Contract Audit Agency (see 1-1S1) as implemented in FAR 42.803(b), DFARS 242.803(b) and other applicable supplements.

b. Under cost-reimbursement contracts, the cost-reimbursement portion of fixed price contracts, letter contracts that provide for reimbursement of costs, time-materials contracts, and labor-hour contracts, the contract auditor is the authorized representative of the contracting officer to:

(1) receive reimbursement vouchers, interim rate adjustment vouchers, and final rate adjustment vouchers directly from contractors,

(2) approve for payment or adjustment those vouchers found acceptable,

(3) authorize direct submission of vouchers to Government disbursing offices for contractors with adequate billing systems (see 6-1007) and (4) suspend payment of questionable costs (see 6-905).

When required, the auditor will assure that completed vouchers are forwarded to the cognizant disbursing officer for payment.

c. If the evaluation of a voucher raises a question regarding the allowability of a cost under the contract terms, the auditor, after informal discussion as appropriate, will issue a DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved". Guidance on the preparation and submission of DCAA Form 1 is contained in 6-900. The Form 1 will be submitted simultaneously to the contractor and the disbursing officer, with a copy to the cognizant contracting officer, for deduction from current payments with respect to costs claimed but not considered reimbursable. If the contractor disagrees with the deduction, it may (1) submit a written request to the cognizant contracting officer to consider whether the unreimbursed costs should be paid, (2) file a claim under the Disputes clause, or (3) do both. The contracting officer may direct the auditor to issue a Form 1 for any cost that he or she believes should be suspended or disapproved. The preparation of a DCAA Form 1 may also result in the auditor rescinding the contractor’s authority to submit vouchers directly to Government disbursing offices (see 6-1007).

d. The auditor will approve separate fee vouchers and fee portions of vouchers for provisional payment in accordance with the contract schedule and any instructions from the administrative contracting officer (ACO).

e. Completion vouchers will be forwarded to the ACO for approval after audit as prescribed in 6-1009.1b.

f. The primary purpose of the examination and approval of interim public vouchers is to provide reasonable assurance that the amounts claimed are not in excess of that which is properly due the contractor in accordance with the terms of the contract. The extent of audits of individual interim vouchers should be based upon the contractor's integrity, its financial condition and the adequacy of its internal management controls and procedures. It is not intended that interim public vouchers submitted by contractors under cost-reimbursement type contracts be individually audited except in those very unusual instances where the auditor has concluded that he or she cannot place reasonable reliance upon the contractor's cost representations or billing procedure (maximum control risk). Guidance pertaining to the auditor's examination of the internal control structure is provided in Chapter 5 and 6-1006, guidance pertaining to audits of interim public vouchers is provided in 6-1008 and guidance regarding completion vouchers is in 6-1009.

6-1004 Preparation and Submission of Reimbursement Claims by Contractors

a. Cost-reimbursement type contracts provide that the contractor may submit periodic claims for reimbursement of costs and fee on Government public voucher forms SF 1034 and SF 1035 or their equivalent. Detailed information concerning the preparation, submission and processing of these forms is presented in DCAAP 7641.90. This pamphlet is included on the AT&L Knowledge Sharing System (AKSS) web site. For contractors utilizing Wide Area Workflow for the submission of interim payment requests on cost-type, T&M and labor hour contracts, the “Cost Voucher” is the equivalent of the SF 1034. Data equivalent to the SF 1035 must be included in a separate electronic file and attached to the cost voucher in WAWF, unless the contractor has been authorized to submit interim vouchers directly to the payment office under the direct bill program.

b. Audit offices receiving requests from contractors for public voucher forms will advise contractors that they may be obtained from the appropriate ACO or from the Government Printing Office at nominal cost.

c. Contractors' interim reimbursement claims will be forwarded for payment to the disbursing officer after appropriate review and approval by the auditor to insure that such payments are consistent with the terms of the contract. However see 6-1007 for contractor direct submission of interim vouchers to Government paying offices. These interim payments are provisional in nature and are subject to retroactive adjustment upon the determination of the allowability of costs claimed. The allowable cost and payment clause at FAR 52.216-7 contained in each cost-reimbursement type contract states in part: "At any time or times before final payment, the Contracting Officer may have the Contractor's invoices or vouchers and statements of cost audited. Any payment may be:

(1) reduced by amounts found by the Contracting Officer not to constitute allowable costs or

(2) adjusted for prior overpayments or underpayments." A similar clause is contained in time-and-materials and labor-hour contracts (FAR 52.232-7).

Guidance concerning the review and processing of interim vouchers is provided in 6-1007 and 6-1008.

d. Upon completion of the contract, the contractor is required to submit a voucher designated as "completion voucher" together with such other documents as are prescribed by the contract. Approval and payment by the Government of the contractor's completion vouchers constitutes complete and final payment to the contractor, except for any items reserved by qualification of the contractor's Release of Claims. Detailed instructions relative to submission and processing of these documents are included in DCAAP 7641.90 and 6-1009.

6-1005 Determination of Allowable Costs Under Cost-Reimbursement Vouchers

a. Each cost-reimbursement type contract provides that the allowable costs of performing the contract will be determined in accordance with the contract cost principles and procedures stated in that part of FAR Part 31 and applicable supplements which is appropriate for the type of contractor organization and work to be performed. Advance agreements or other provisions relating to the allowability or allocability of special or unusual items or categories of costs may also be incorporated into the contract when determined to

be in the Government's interest. This is to avoid possible subsequent disagreements regarding the reasonableness or allocability of allowable costs. Therefore, it is important that each contract be reviewed to determine its specific requirements and contractual terms and conditions. (See guidance on reviewing contract provisions in 3-200.)

b. Audits of contractors performing substantial Government business will normally be made on a comprehensive basis, as contrasted with a contract by contract approach. The auditor will thus evaluate whether an audit of the contractor's internal control structure would be more efficient or economical than transaction testing to reach an opinion on the accuracy and reliability of the contractor's records and cost representations. This decision should be documented in the permanent file. Accordingly, the guidance throughout CAM, particularly Chapters 5 through 8, will be used to perform the audit of contract costs. The nature and extent of audit effort required when the comprehensive approach is not taken will be influenced by such factors as the contract amount, the cost elements involved, the nature of the work performed, the contractor's financial position, prior audit experience with the contractor, and the extent of any probable cost disapprovals. See 6-1006 for guidance regarding minimum steps required when audit experience with the contractor is limited. The extent of audit effort performed on individual vouchers under the comprehensive approach will depend upon the adequacy of the internal control structure, assessed control risk and the internal control weaknesses as identified in the permanent file. Guidance on internal control system audits, assessing control risk and designing substantive testing is provided in Chapter 5.

c. The requirements for preparing reimbursement claims are included in each cost-reimbursement, T&M or Labor-Hour contract, by the clause(s) FAR 52.216-7, Allowable Cost and Payment and/or 52.232-7, Payments under Time-and-Materials and Labor-Hour Contracts and by other special clauses such as withholding clauses, precontract clauses and overtime premium clauses as explained in 3-200.

d. When the contractor's billing system is not adequate for audit reliance upon reimbursement claims, the auditor will discuss the deficiencies with the contractor. If the contractor does not take corrective action promptly, the auditor will conduct sufficient transaction testing to quantify the Government's exposure to premature or excessive payments and issue a DCAA Form 1 to suspend such costs until the contractor establishes acceptable billing procedures. Guidance pertaining to the preparation and issuance of Form 1s is contained in 6-900. There may be cases when the procedures are adequate except for certain types of cost, such as inadequate procedures for the billing of items or services purchased directly for contracts. If the auditor cannot determine whether all of the billed costs are eligible for reimbursement without the expenditure of undue time and effort, the suspension should be confined to only those costs affected by the inadequate procedures. On contracts awarded by a Government agency outside of the DoD, the auditor will follow the procedures prescribed by that agency (see 15-100).

6-1006 Evaluation of Contractor's Procedures for Preparing Reimbursement Claims

a. Chapter 5 discusses the controls that should be in place in an adequate system. These include management review and approval, controls over reconciliation of recorded and billed costs, adjustment of cost and rates, exclusion of nonbillable costs, timely payments, subcontractor's financing payments (progress payments, performance-based payments and commercial financing payments), preparation of estimates to complete, loss contract pro-

cedures and calculation of fixed fee and time-and-materials withholds. Normally, these controls will be tested, after considering the contractor's monitoring and testing, to the extent necessary to assure the system is adequate, during the audit of the billing system and related internal controls. (See Chapter 5 for guidance on the audit of the internal control structure, assessing control risk and designing substantive testing.) In evaluating the acceptability of a contractor's procedures for preparation of reimbursement claims, as a minimum perform the following audit steps, especially when audit experience with the contractor is limited. Additional effort may be required if the contractor has a preponderance of high-risk contract types.

(1) Determine whether a billing record, cost subledger, or other auditable billing system is maintained for all contracts providing for reimbursement of cost. Ascertain whether the record is reconciled for each accounting period by elements of cost with the applicable contract job order in the work-in-process ledger.

(2) Determine whether the billing procedures provide for the costs of items or services purchased directly for the contracts to be claimed for reimbursement only if the costs will be paid in accordance with the terms and conditions of the subcontract or invoice and ordinarily will be paid within 30 days of the contractor’s payment request to the Government. Evaluate whether the contractor adheres to the requirement that accrued costs of items or services purchased directly for the contract claimed for reimbursement, are ordinarily paid within 30 days of the submission of the contractor’s payment request. For this purpose, canceled checks may be examined on a limited basis for indications of recurring instances where the dates for payment of accrued costs claimed for reimbursement are within 30 days of the payment request. However, this procedure should be performed only when the auditor cannot satisfy himself or herself by a systems audit or by other means that such payments are made ordinarily within 30 days of the payment request to the Government. In the case of claims for progress payments made to subcontractors, verify that the subcontracts require computation of progress payment amounts on the basis of cost standards similar to those stated in 6-1005c.

(3) Determine that overhead and G&A expenses are calculated on the basis of billing rates acceptable to the cognizant auditor or contracting officer. As stated in FAR 42.704, the contracting officer or auditor responsible for determining the final indirect cost rates ordinarily shall also be responsible for determining the billing rates. If there are no current established billing rates, follow the procedures contained in 6-700 to determine billing rates.

(4) Verify that the contractor is not delinquent in the payment of costs incurred in the performance of the contracts.

(5) Verify that the contractor has procedures established for interim vouchers under cost-reimbursement contracts that include fixed-fee withholds as required by the contracts. (See FAR 52.216-8 for typical fee withhold clauses that may be used.)

(6) Verify that the contractor has procedures established to insure that 5 percent of the billable labor costs, not to exceed a total of $50,000 per contract, are withheld from interim vouchers for time-and-materials or labor-hour contracts, if contractually required (FAR 52.232-7).

b. As discussed in 5-1105.b(4), the results of audits of other systems impact the scope of the billing system audit. If the following steps have not been performed in the material and labor system audits, the auditor should perform them, considering the contractor's monitoring efforts, during the billing system audit:

(1) Verify that charges for material issued from the contractor's inventory for use on the contracts are identifiable on the billing record and are supported by journal vouchers recording issuance of contractor-owned material. Determine whether individual items of material can be traced to the issue document and whether item pricing conforms to acceptable practice and the contractor's established policy. Verify that the material is issued for current use on the contract and not merely issued to an intermediate holding area for the purpose of obtaining reimbursement.

(2) Verify that weekly and/or biweekly direct labor entries in the billing record are based on the source documents for the journal vouchers distributing salaries and wages for the accounting period. Verify that any labor adjustments appearing in the billing record are supported by correction or reclassification journal vouchers. Verify, in a similar manner, incurred cost entries for direct travel and other direct in-house cost.

6-1007 Direct Submission of Interim Public Vouchers to Disbursing Offices (Direct Billing)

DFARS 242.803(b)(i)(C) and NASA FAR Supplement 1842.803(b)(1)(D) allow the contract auditor, acting as the representative of the contracting officer, to authorize contractors that maintain adequate billing systems to submit interim public vouchers directly to Government disbursing (paying) offices. Contractors that maintain billing systems which meet the criteria in 6-1007.2 will be eligible to submit interim vouchers directly to Defense Finance and Accounting Service (DFAS), National Aeronautics and Space Administration (NASA), Maryland Procurement Office (MPO) and U.S. Army Corps of Engineers (USACE) paying offices. Contractors will continue to submit final vouchers on each contract to cognizant FAOs to assist in closing out contracts. In WAWF, when a contractor submits a final voucher, the voucher is routed directly to the ACO for action and a copy is placed in the DCAA “History” folder within WAWF. It is Agency policy to obtain the maximum contractor participation in the direct submission (direct billing) of interim vouchers program. FAOs should actively work with contractors to eliminate billing system deficiencies and encourage contractor participation in the direct billing program. The direct billing program will reduce the administrative effort (both Government and contractor) related to interim public vouchers processing for contractors with adequate billing systems.

6-1007.1 Coordination with Contracting Officers and Paying Offices

Close coordination among FAOs, contracting officers and paying offices is necessary to effectively implement and operate the direct billing program. Contracting officers and paying offices should be notified when FAOs authorize contractors to participate in the direct billing program. If the authorization to direct bill is rescinded, immediately notify the cognizant contracting officer and paying office and update the DMIS CAGE Code(s) Table to reflect the current direct billing initiative code. In WAWF, contractor cost vouchers are routed directly to the payment office (under the direct billing program) based on the contractor’s CAGE Code(s) and related direct billing data obtained daily from DMIS. See 6-1007.8 for supplemental requirements regarding MPO contracts.

6-1007.2 Criteria for Adequate Billing Systems – Major Contractors

A contractor may be authorized for direct submission of interim vouchers when an audit of its billing system and related internal controls (see 5-1100) find the system to be adequate and the contractor meets the following criteria. The contractor must:

a. Submit timely indirect incurred cost proposals in compliance with FAR 52.216-7, Allowable Cost and Payment contract clause. The requirement to submit indirect incurred cost proposals in a timely manner also includes all corporate or intermediate level submissions used to allocate costs to divisions for establishment of final indirect rates (see 6-706.3). FAR 52.216-7(d) requires the contractor to submit its incurred cost proposal within the six-month period following the expiration of the contractor's fiscal year. Reasonable extensions may be requested in writing by the contractor and granted in writing by the contracting officer. The auditor does not have the authority to grant an extension even in cases where the indirect rates are audit determined.

b. Submit final vouchers for physically complete cost-type contracts within 120 days (or longer if approved in writing by the Contracting Officer) after settlement of the final annual indirect cost rates for all years of a physically complete contract in compliance with FAR 52.216-7(d)(5).

6-1007.3 Criteria for Adequate Billing Systems – Nonmajor Contractors

When the ICAPS process is not used to evaluate a contractor's billing system internal controls (see 5-111, Auditing Internal Controls at Nonmajor Contractors), the auditor may authorize direct submission of interim vouchers if the contractor meets the following criteria. The contractor must:

a. Maintain an accounting system acceptable for Government contract costing. The suitability of a new contractor's accounting system for Government contract costing is normally evaluated as part of an overall "Preaward Survey" conducted by the contracting officer in accordance with FAR 9.106. For billing purposes, the billed costs must be reconcilable to the cost accounting records.

b. Establish billing rates in accordance with FAR 42.704. FAR 42.704(b) requires the contracting officer or auditor to establish billing rates based on information resulting from recent audits, previous audits or experience, or similar reliable data or experience of other contracting activities.

c. Maintain cumulative allowable costs by contract to support the preparation of interim and final vouchers. Cumulative costs are necessary to assure that the cumulative amount billed does not exceed the total estimated ceiling costs on the contract and/or the current contract maximum funding levels.

d. Adjust billing rates, in accordance with FAR 42.704(c), to reflect actual year-end allowable costs. At the end of the fiscal year, the contractor should compare the recorded allowable rates to the billing rates to determine if the billing rates should be adjusted. If there is a significant difference between billing and actual rates, billings should be adjusted as soon as possible to reflect either:

(1) the additional amount due the contractor (if the billing rates are lower than actuals), or

(2) credit due the Government (if the actual rates are lower).

The adjustment to billings can be submitted on a separate voucher(s) or if appropriate on the next voucher(s) submitted for ongoing contracts.

e. Brief contracts to assure that billings accurately reflect special cost limitations contained in contracts. Each contract brief should contain the specific billing requirements and limitations contained in the contract.

f. Submit final year-end indirect incurred cost proposals in accordance with the Allowable Cost and Payment clause (FAR 52.216-7) contained in cost type contracts. FAR 52.216-7 requires these incurred cost proposals to be submitted within 6 months after the expiration of the contractor's fiscal year. Reasonable extensions may be requested in writing by the contractor and granted in writing by the contracting officer (FAR 52.216-7(d)). The auditor does not have the authority to grant an extension even in cases where the indirect rates are audit determined.

g. Submit final vouchers for physically complete cost-type contracts within 120 days (or longer if approved in writing by the Contracting Officer) after settlement of the final annual indirect cost rates for all years of a physically complete contract in compliance with FAR 52.216-7(d)(5).

6-1007.4 Determining Eligible Contractors.

FAOs generally should not initiate separate audits to determine contractors' eligibility to directly submit vouchers. Information necessary to make this determination should normally be contained in the contractor's permanent files. For major contractors, the ICAPS forms summarize the assessment of contractors' billing system internal controls and are included in the permanent files. Similarly, the permanent files should contain the information necessary for FAOs to identify eligible nonmajor contractors.

6-1007.5 Notification Procedures

a. When an FAO determines that a contractor is eligible to participate in the direct billing program, the FAO will send a letter to the contractor explaining the program and requesting the contractor's participation. A copy of the pro forma letter requesting a contractor's participation is available on the DCAA Intranet and the APPS under Direct Billing Letters – Letter Requesting Contractor Participation. A copy of the letter should be sent to the cognizant ACO to keep him/her advised of the contractor's direct billing status. Upon receipt of a response from the contractor, the FAO will notify the contractor of its acceptance in the program. A pro forma notification letter is available on the DCAA Intranet and the APPS under Direct Billing Letters – Notification Letter to Eligible Contractor. The notification letter will include a signed copy of the DCAA authorization memorandum, which is explained below. Copies of the notification letter, along with the authorization memorandum, will be sent to the cognizant ACO and appropriate Government paying office(s) identified in the contractor's response. However, see 6-1007.8 for supplemental requirements regarding Maryland Procurement Office (MPO) contracts. Also, see 6-1007.9 for supplemental requirements regarding DFAS – Columbus Paying Offices.

b. An eligible contractor will be authorized to submit interim vouchers directly to paying offices based on the DCAA authorization memorandum. The memorandum to the paying office will be signed by the cognizant FAO manager and state that the contractor:

(1) has adequate internal controls over its billing system,

(2) submits its incurred cost proposals in accordance with FAR 52.216-7, and

(3) submits final vouchers in accordance with FAR 52.216-7(d)(5).

Therefore, the contractor is permitted to submit interim public vouchers directly without advance DCAA approval. When submitting interim vouchers, the contractor should forward one copy of the DCAA authorization memorandum with the voucher, and indicate in the signature block on the voucher "Direct Submission Authorized." A pro forma copy of the DCAA authorization memorandum is available on the DCAA Intranet and the APPS under Direct Billing Letters – DCAA Authorization Memorandum.

c. When an eligible contractor does not respond to the FAO letter requesting contractor participation in the direct billing program or chooses not to participate in the direct billing program, the FAO should contact the contractor in writing and reemphasize the benefits of participating in the direct billing program. The FAO should specifically emphasize that direct billing results in faster payment, improved contractor cash flow, and eligibility to submit interim vouchers via Electronic Data Interchange and/or web invoicing. The letter to the contractor should also request that the contractor provide a written response by a definite due date as to whether or not it will participate in the direct billing program. A pro forma notification letter to contractors that choose not to participate in the direct billing program is available on the DCAA Intranet and the APPS under Direct Billing Letters – Letter to Eligible Contractors That Choose Not to Participate In The Direct Billing Program. For those contractors that provide a positive response (i.e., agree to participate in the direct billing program), the FAO should send the contractor a notification letter with the enclosed DCAA authorization memorandum as outlined in 6-1007.5a. Copies of the notification letter, along with the authorization memorandum, will be sent to the cognizant ACO and appropriate Government paying office(s).

d. If the contractor formally states that it does not want to participate in the direct billing program or does not provide a written response by the requested due date, the FAO should discontinue audit procedures to provisionally approve interim vouchers submitted by the contractor. The FAO should begin to forward all vouchers to the appropriate DFAS, NASA, MPO and/or USACE disbursing office(s) without DCAA signature. The FAO administrative voucher clerk should forward with each voucher a DCAA authorization memorandum for nonparticipating contractors instructing the appropriate disbursing office(s) to pay the forwarded vouchers without DCAA signature. A pro forma copy of the DCAA authorization memorandum for a contractor that chooses not to participate in the direct billing program is available on the DCAA Intranet and the APPS under Direct Billing Letters – DCAA Authorization Memorandum For Eligible Contractors That Choose Not To Participate In the Direct Billing Program. Final vouchers will continue to be processed in accordance with 6-1009.

e. When the information in the contractor permanent files is not sufficient to determine a contractor's eligibility for direct submission, e.g., a new Government contractor or the permanent files clearly indicate that the contractor does not meet certain criteria, the FAO will write to the contractor, explain the direct submission program, and provide the contractor with a list of the criteria. The FAO will also explain what information is needed and/or which criteria the contractor did not meet. The contractor will be given the opportunity to provide the FAO with the additional information needed to demonstrate that it meets the criteria, or explain what it plans to do to meet the criteria. An example of a letter to a contractor covering these situations is available on the DCAA Intranet and the APPS under Direct Billing Letters – Notification Letter to Ineligible Contractor. Upon receipt of

additional information from the contractor, the FAO will determine if the contractor is eligible to participate. If additional audit procedures are necessary to verify provided information, the audit procedures should normally require minimal audit effort.

6-1007.6 Contractor Continued Participation in the Direct Billing Program

a. A contractor's continued participation in the direct billing program will be based on the results of our ongoing surveillance of contractors' billing systems. Auditors will continue to audit major contractors' billing system internal controls based on documented risk assessments (see 5-103, General Audit Policy). For those nonmajor contractors' internal controls that are evaluated using the guidance contained in 5-111, Auditing Internal Controls at Nonmajor Contractors, audits to determine whether the contractor's billing system internal controls continues to meet the direct submission criteria should normally be included as part of the annual incurred cost audit.

b. FAOs will perform annual testing of the contractor's eligibility for direct bill program. As part of that audit program the testing of paid vouchers should use the audit procedures outlined in 6-1006, Evaluation of Contractor's Procedures for Preparing Reimbursement Claims, to ascertain whether continued reliance can be placed on contractors' internal controls for the preparation of public vouchers. The sampling plan used to test paid vouchers should be documented and updated annually. The procedures reviewed and number of vouchers selected will be based on the results of internal control audits. An FAO with numerous nonmajor contractors may select and test paid vouchers from several of its contractors. The FAO is not required to annually test the contractor's eligibility for direct bill program for all of its nonmajor contractors.

c. FAOs have the option of performing the annual testing of the contractor's eligibility for direct bill program as part of another audit or as a separate assignment. When the annual testing of the contractor's eligibility for direct bill program is performed as part of another audit, the auditor should prepare a memorandum for record (MFR) specifically identifying the audit assignment number and specific working papers where the required audit procedures were performed, thereby documenting the decision to allow the contractor to continue to direct bill. When the annual testing of the contractor's eligibility for direct bill program is performed as a separate assignment, the auditor should use the standard audit program and establish a separate assignment under DMIS activity code 11015.

6-1007.7 Rescinding the Authority to Direct Bill

a. The FAO may rescind the contractor's authorization to direct bill if:

(1) The contractor fails to submit its indirect incurred cost proposals in compliance with FAR 52.216-7, Allowable Cost and Payment clause;

(2) An audit report is issued to the ACO citing significant internal control deficiencies;

(3) A DCAA Form 1 or NASA Form 456, Notice of Contract Costs Suspended and/or Disapproved, has been prepared for issuance;

(4) The contractor fails to apply approved billing system procedures in preparing invoices or vouchers for direct submission resulting in a flash deficiency report (refer to CAM 10-413 for guidance); or

(5) The contractor fails to submit final vouchers in accordance with FAR 52.216-7(d)(5).

b. Even if one of the foregoing criteria is met, the FAO may not be required to rescind the authority to direct bill depending upon the circumstances. For example, the FAO may prepare a DCAA Form 1 that applies to only one contract (see 6-903.1). In this instance, the FAO may decide to require the contractor to submit only vouchers for the affected contract to DCAA for approval. The contractor may continue to submit vouchers on its remaining contracts directly to the disbursing office. However, the preparation of a Blanket DCAA Form 1 (see 6-903.2) affecting multiple contracts would normally require the rescission of the contractor's authority to direct bill for all of its contracts.

c. The FAO is required to provide the contractor with a written notice of direct submission rescission. An example of a written notice rescinding the contractor's authority to direct bill is available on the DCAA Intranet and the APPS under Direct Billing Letters – Letter Rescinding Authorization to Direct Bill. The FAO will send a copy of the written notice to rescind the direct submission authorization to the ACO and the FLA(s), if applicable. The FAO will also notify the disbursing office(s) by fax or e-mail within 24 hours that the contractor's authority to directly submit interim vouchers is rescinded. An example of the message to be sent to disbursing offices is available on the DCAA Intranet and the APPS under Direct Billing Letters – Letter to Disbursing Office Rescinding Authorization to Direct Bill. The contractor's authorization to direct bill may be reinstated whenever the condition causing rescission is resolved. The FAO can reinstate the contractor's authorization to direct bill by issuing a new DCAA authorization memorandum (see 6-1007.5b).

6-1007.8 Supplemental Requirements for Maryland Procurement Office (MPO) Contracts

a. Because MPO has several contracting officers dealing with the same contractor and only one paying office, MPO has requested that FAOs notify only the MPO point of contact regarding contractors' direct billing status. The MPO point of contact will be responsible for notifying MPO contracting officers and the MPO paying office regarding the direct billing status of contractors. The mailing and e-mail address of the MPO point of contact are shown below:

Maryland Procurement Office
Attn: Direct Billing
Suite 6509
Ft. Meade, MD 20755-6509
E-mail Address:
mpo_direct_billing@nsa.gov

b. The MPO point of contact should be notified when FAOs conclude that contractors are eligible to participate in the direct billing program. If the authorization to directly submit vouchers is rescinded, immediately notify the MPO point of contact. Close coordination between FAOs and the MPO point of contact is necessary to assure the effective implementation and operation of the direct billing program.

c. MPO procedures require the contractor to send the original interim voucher to the MPO paying office with a copy of the voucher to the Contracting Officer's Representative

(COR) for each contract. Thus, the notification letter to contractors submitting vouchers directly to the MPO paying office should instruct the contractor that a copy of the interim voucher should be sent to the paying office with a copy to the COR for each MPO contract.

6-1007.9 Supplemental Requirements for DFAS – Columbus Center

DFAS has requested that copies of all direct billing notification letters for paying offices under the DFAS – Columbus Center be sent to the following address:

Defense Finance and Accounting Service
DFAS Columbus Center
3990 E. Broad Street, Building 21
Columbus, Ohio 43213
Attn: DFAS-CO-JAIQaBb (MAF)
E-mail Address: CCO-APS-MAF@dfas.mil

This procedure applies only to the paying offices located at the DFAS – Columbus Center. Copies of notifications letters to DFAS paying offices not located at the DFAS – Columbus Center should be sent to their respective addresses.

6-1008 Review and Approval of Interim Public Vouchers Submitted to the Auditor

a. When contractors are not authorized to submit interim vouchers directly to Government disbursing offices (see 6-1007), contractors must submit each voucher to the contract auditor for approval. FAOs may receive vouchers from the contractor either in paper format or electronically through Wide Area Workflow (WAWF). The directives and regulations which establish the authority and responsibility of the auditor relative to the processing and approval of public vouchers are discussed in 6-1003. Guidance pertaining to the determination of allowable costs claimed by the contractor in public vouchers is contained in 3-2S1, and guidance regarding the clauses in cost reimbursement type contracts is contained in 3-200. Contractors are generally dependent upon prompt receipt of interim payments under cost-reimbursement type contracts to maintain a satisfactory financial position. Therefore, as an objective, interim vouchers will be reviewed and either:

(1) approved for payment and forwarded to the disbursing officer or

(2) returned to the contractor for correction as quickly as possible, but not later than five working days after receipt.

Payments on interim public vouchers under cost-reimbursement service contracts are subject to the interest payment provisions as implemented in the Office of Management and Budget's regulations (5 CFR Part 1315), if they are paid more than 30 days after receipt of a proper invoice. Therefore, FAOs should process and send approved interim vouchers to disbursing offices for payments as soon as possible. FAOs must also annotate (date-stamp) all vouchers with the date the interim vouchers are received by the FAO. The Government disbursing office will use the FAO annotation date, if necessary, to determine the start of the 30-day period used to compute the interest penalty. FAOs should expedite reviews of interim vouchers to assist Government disbursing offices in minimizing the necessity of paying the interest penalty on interim vouchers submitted under cost-reimbursement service contracts.

b. Sampling techniques should be used to select specific vouchers for review. The sampling plan and techniques to be used should be documented and updated annually. The elements reviewed and number of vouchers sampled will be based on the results of the internal control audits or a decision to transaction test as documented in the permanent file annually. The selective review of vouchers should be considered in cases of financially sound contractors where audit experience indicates their internal controls and procedures for accumulating costs and preparing public vouchers are acceptable (low to moderate control risk). Audit guidance for determining the adequacy of the contractor's procedures for preparing reimbursement claims is in 6-1006 and in Chapter 5. The sampling techniques to be used should be approved by the auditor responsible for approval of the vouchers. The review will be limited to the following steps:

(1) Comparison of the information shown on the voucher with the related information on the FAO-prepared briefing cards or the contractor-prepared briefing cards if reliance can be placed on the contractor's work (see 3-202).

(2) Verification that amounts claimed for reimbursement of indirect costs are computed using the billing rates acceptable to the cognizant auditor or contracting officer. (See 6-1006a(3))

(3) Verification that interim fees claimed are computed by the formula or basis in the contract. When the interim fee claim is related to the percentage of physical completion, a statement from the ACO covering this matter should have been submitted with the voucher.

(4) Verification that billable labor costs on time-and-materials or labor-hour contracts have been reduced by 5 percent until the maximum withheld amount of $50,000 is reached, if contractually required per FAR 52.232-7(a)(7).

(5) Determination that the voucher has been properly prepared and that payment for the items listed on the voucher is not precluded by any contractual provisions. See 6-202 for guidance and special considerations on the reimbursement of selected contract terms.

(6) Test of the mathematical accuracy of extensions and footings. This will normally be done only if past experience with the contractor has revealed weaknesses in its billing procedures or if mathematical errors have been otherwise noted.

(7) Reconciliation of billed costs to the contractor’s accounting records. [For non-major contractors, auditors may perform this step on the auditor’s next visit to the contractor (after provisional approval of interim voucher(s)) and any adjustments will impact subsequent vouchers. For vouchers selected from Time-and-Materials and Labor-Hour contracts, auditors should ensure that labor hours and material cost reconcile to the contractor’s accounting records.]

c. Interim public vouchers shall be provisionally approved by authorized auditors by signing the voucher in the space provided. As illustrated in DCAAP 7641.90, the signature, printed name, mailing address, and telephone number of the approving supervisory auditor should be typed on the voucher by the contractor. For applicable signature authorization policy, see DCAAR 5600.1. For vouchers submitted through WAWF, the supervisory auditor provisionally approves the voucher by electronically signing the document.

d. After provisional approval, interim public vouchers shall be forwarded to the disbursing officer for payment and subsequent distribution, as annotated on the vouchers. In WAWF, vouchers are electronically routed to the disbursing office after provi-

sional approval by the supervisory auditor. Amounts provisionally approved on public vouchers are subject to the audit of the contractor's records prior to the final settlement under the contract.

e. In the event that the contractor's public voucher contains an error, it should be returned to the contractor with a written explanation regarding the error that was found. In WAWF, a voucher is returned to the contractor by (i) selecting “Reject to Initiator” in the approval section of the voucher and (ii) typing the reason for the rejection in the “Comment” field on the “Misc. Info” tab. The auditor can also use the DCAA Form 1 (see 6-905) to correct errors in public vouchers which involve downward adjustments with which the contractor is in disagreement.

f. By arrangements made with disbursing officers, public vouchers to be returned to contractors for correction will be transmitted to the contractor via the cognizant auditor. Returned public vouchers should be reviewed to determine the reason for rejection to assure that any systemic problems are corrected or if not corrected are used to adjust control risk and substantive testing.

g. Special procedures for processing cost-reimbursement vouchers for non-DoD agencies are contained in 15-100.

6-1009 Processing of Completion Vouchers

This paragraph provides guidance for the evaluation and processing of completion vouchers on completed or terminated cost-reimbursement type contracts and subcontracts (see 6-706.1 for additional comments on final rates). When processing completion vouchers on subcontracts the auditor should also review the guidance on assist audits for other contract auditors in 6-802.

6-1009.1 Receipt-Completion Vouchers

a. Upon receipt of a completion voucher and the accompanying closing documents, the auditor will ascertain whether the contract closing data has been forwarded to the ACO in a CACWS. In most instances, the CACWS should be acceptable to the ACO to close contracts provided the auditor has coordinated this arrangement with the ACO (see 6-711.3). If so, the auditor will send the original completion voucher and the accompanying closing documents to the ACO, by transmittal letter, so as to expedite settlement procedures. Generally, a copy of each document should be included in the contract audit closing statement workpackage.

b. If any of the received completion vouchers pertain to contracts that have not been finalized in a CACWS, the auditor should determine if a contract audit closing statement (CACS) is required. DFARS 242.803(b)(i)(D) authorizes the contract auditor to review final vouchers and send them to the contracting officer.

c. In WAWF, when a contractor submits a final voucher, it is routed directly to the ACO for action and a copy is placed in the DCAA “History” folder within WAWF.

d. For terminated contracts, the advance copy of the completion voucher will be submitted to the termination contracting officer (TCO) rather than to the ACO.

6-1009.2 Review-Completion Vouchers

a. The review of a completion voucher generally constitutes the final audit on the contract, since all the costs incurred on the contract should have been audited and cost issues resolved through final overhead and direct cost audits. Therefore, if the contractor's internal controls are adequate, the auditor's review of a completion voucher prior to the issuance of a contract audit closing statement is primarily administrative in nature. See Chapter 5 and 6-1006 above for guidance on the audit of internal controls. The extent and kind of testing required based on the audit of internal controls should be available from the permanent file and should be documented in the working papers. When transaction testing would be more efficient or economical than an audit of the internal control structure, make sure this decision is documented in the permanent file and working papers. The following procedures should be performed prior to the issuance of the contract audit closing statement:

(1) Complete the audit of the contractor's operations and costs related to the contract for final overhead years not completed, including a review of contract provisions for any special cost considerations (see 3-202 for information on contract briefing).

(2) Reach a final audit determination on the allowability of all direct costs claimed under the contract by: reconciling the cumulative allowable cost by year to the final overheads; verifying that exceptions to the direct cost taken during the final overhead audits have been deleted from the claim; verifying that exceptions noted in audits in (1) above have been deleted from the claim; and, making sure that all auditable subcontracts and interdivisional transactions for which assist audits have been requested have been received, and that the amounts billed by the prime contractor do not exceed the costs accepted in the assist audit reports.

(3) Reach a final audit determination on the allowability of all indirect costs claimed by verifying the rates claimed to the audit determined final overhead rates, negotiated final overhead rates or approved quick-closeout rates.

(4) For cost-sharing contracts, ascertain that only the Government percentage of allowable costs is recovered.

(5) Verify the incurred labor hours by category for contracts with level-of-effort clauses. Compare the incurred hours to the estimated hours specified in the contract to determine if the specified level-of-effort was met.

(6) For time-and-materials (T&M) and labor-hour contracts, multiply the total labor hours incurred by the contractual hourly billing rates and compare to the total labor amounts claimed. Compare hours incurred by labor category to those specified in the contract. Reconcile claimed to booked material and/or other direct costs and determine that the appropriate material handling or G&A rate has been applied to the claimed costs.

(7) Review the disposition of ending inventory, if any, keeping in mind that cost-type ending inventory belongs to the Government, whereas ending inventory from fixed price incentive contracts belongs to the contractor. When residual inventory exists, the final costs calculated under fixed price incentive and fixed price redeterminable arrangements should be net of the fair market value of such inventory.

(8) Determine that the total costs and fee billed do not exceed the allowable amounts and/or funding limitations in the contract.

(9) Determine that the amount of fixed, award, or incentive fee payable is calculated in accordance with the terms of the contract. Where the contract provides for an incentive fee

based in part upon performance or quality objectives, the auditor should coordinate with the ACO to obtain the information necessary to determine the contract fee. Prepare recommendations on incentive fee, if applicable.

(10) Determine the basic form---completion or term---of the cost-plus-fixed-fee contract. A term form cost-plus-fixed-fee contract per FAR 16.306(d)(2), requires the contractor to provide a specific level of effort within a definite period of time. The contract audit closing statement will state the level of effort expended by the contractor so the contracting officer may determine whether an adjustment should be made in the fixed fee payable under the contract.

b. The auditor's signature will not be shown on the completion voucher, since the contract audit closing statement expresses the auditor's opinion on the contract as a whole.

c. The contract audit closing statement will be prepared following the guidance contained in 10-900.

6-1009.3 Timeliness of the Receipt and Review-Completion Vouchers

As indicated in FAR 4.804-1(a)(3) and applicable supplements, the standard time for the closeout of physically completed, cost-reimbursement type contracts by contract administration and purchasing offices for contracts requiring settlement of indirect cost rates is 36 months. The auditor should review the completion voucher and issue the contract audit closing statement in sufficient time to permit the ACO and PCO to close out such contracts within this time. While a written request for audit is not required, coordination with the contracting officer is mandatory (6-1009.1b). Where circumstances are encountered which delay timely finalization of the audit, the auditor should try to resolve the condition causing the delay. If the reason for the delay appears to be a systems problem, the auditor should report the deficiency to the contractor and the ACO for corrective action. Some factors causing delay and guidance to resolve them are discussed in the following paragraphs.

a. Where indirect cost rates are to be settled by audit determination, the auditor should assure that issues in contention do not extend over protracted periods of time because of discussions with and/or rebuttals from the contractor. If the contractor does not concur in the auditor's determination of rates, a DCAA Form 1 should be issued, as provided by 6-900.

b. Consideration should be given to those circumstances under which it is permissible to close out a physically completed contract. Even though the indirect cost rates may not have been negotiated or settled by audit determination for the period covering the final stage of contract performance, the contract may be closed using the quick-closeout procedures described in 6-1010.

c. Where the contractor fails to submit the completion voucher timely, its responsibility to do so should be pointed out by referring to FAR 52.216-7(d)(5), which states: "Within 120 days after settlement of the final indirect cost rates covering the year in which this contract is physically complete (or longer, if approved in writing by the Contracting Officer), the Contractor shall submit a completion invoice or voucher to reflect the settled amounts and rates." If the contractor continues to be delinquent in submitting the completion voucher, the auditor should consider recommending to the ACO that the contract be closed out unilaterally.

d. In those cases where final assist audit reports on interplant billings or cost-reimbursement type subcontracts have not been issued, the auditor should formally contact the assist auditor stressing the urgency of final audit action. If the contractor is responsible for the audits, determine the reason for the delay, and if necessary, request the ACO's assistance in seeking timely contractor performance. If the audit issuance cannot be expedited, consider requesting assist audits.

e. Issuance of contract audit closing statements should not be delayed pending receipt of final patent and royalty reports by the contract administration office. It is the responsibility of the ACO, as part of the contract close-out process, to ensure that such reports are received and cleared.

f. Special attention is also needed when:

(1) the contractor does not submit the completion voucher after being reminded to do so and

(2) the ACO requests an audit report in order to unilaterally close out the contract.

Using 6-1009.2 as a guide, the auditor should determine from the information in the audit files the proper amount payable to the contractor for the contract performance and prepare a contract audit closing statement following the guidance in 10-900. The report should not refer to the review of a completion voucher since there was not one, and should include the following qualification:

"Our opinion is based upon cost data accumulated during audits of the contractor's cost accounting records. The Government has not received a completion voucher reflecting the contractor's statement of allowable costs. Therefore, our opinion is qualified to the extent a completion voucher would identify information having material implications regarding the allowability of costs."

6-1009.4 Supplemental Requirements for Maryland Procurement Office Contract Closeouts

a. The Maryland Procurement Office (MPO) has engaged the services of a private firm, Omen Inc., Idaho Falls, ID, to effect the closeout and physical retirement of MPO contracts. Responses to inquiries from this private firm for contractor information needed to support MPO’s closeout effort must be submitted in writing to MPO by e-mail at apwronk@nsa.gov or fax to (310) 688-2185. MPO will make the determination of what material can be released outside of the Government. In order to minimize the risk of disclosure of contractor proprietary data to anyone outside of MPO, no potentially privileged information will be furnished orally. This prohibition includes information such as settled rates, which may appear to be in the public domain.

b. A pro forma transmittal, which may be completed manually if desired, is set forth at Figure 6-10-1.

6-1010 Quick-Closeout Procedures

a. The final period of performance under a contract is generally less than a full fiscal year. The direct and indirect costs incurred on an individual contract in the last fiscal year of its performance may be relatively small in amount, particularly if the contract is physically completed early in the year. In such cases it is generally mutually advantageous to the Govern-

ment and the contractor to close such contracts as soon as possible without waiting until after the end of the fiscal year and the subsequent final determination or negotiation of the indirect expense rates for the entire period.

b. FAR 42.708 provides quick-closeout procedures which allow the contracting officer to negotiate a settlement of indirect costs for a specific contract in advance of the determination of final indirect cost rates under specified circumstances. The provision for quick-closeout procedures can be applied not only to the final fiscal year of a contract but also to all other open fiscal years with unsettled indirect cost rates if the criteria contained in FAR 42.708 are met.

c. To encourage the use of quick-closeout procedures, FAR 42.708 was revised effective August 1996. The revised procedures require that the contracting officer negotiate the settlement of indirect costs for a specific contract in advance of the determination of the final indirect cost rate if the criteria in FAR 42.708 are met. The FAR 42.708 criteria for applying quick-closeout procedures are:

(1) the contract is physically complete;

(2) the total unsettled indirect cost allocable to that contract does not exceed $1 million,

(3) the cumulative unsettled indirect costs allocated to all contracts closed using quick-closeout procedures in a single fiscal year do not exceed 15 percent of the estimated total unsettled indirect costs allocable to cost-type contracts for that year; and

(4) agreement can be reached on a reasonable estimate of allocable dollars.

The contracting officer may waive the restriction on the amount of cumulative unsettled indirect costs based upon a risk assessment that considers the contractor's accounting, estimating, and purchasing systems; other concerns of the auditor; and any other pertinent information.

d. Effective February 1998, FAR 42.703-1(c) was revised to make it clear that quick-closeout procedures could be used to establish the final price of fixed-price incentive, fixed-price redeterminable, and like contracts and awards that:

- require the settlement of indirect costs before final contract prices are established, and
- meet the criteria in FAR 42.708 for use of quick-closeout procedures.

e. Although a written request for audit is not required when the contracting officer exercises quick-closeout procedures, the auditor should provide comments regarding any contract being considered for quick-closeout if the auditor has specific concerns related to the criteria in c. above (e.g. the 15 percent ceiling is being approached). The rates recommended should be representative of conditions during the final fiscal year of contract performance. Some alternative rate sources are:

(1) the final indirect cost rates agreed upon for the immediately preceding fiscal year;

(2) the provisional billing rates for the current fiscal year; or

(3) estimated rates for the final fiscal year of contract performance based on the contractor's actual data adjusted for any historical disallowances found in prior years' certified final incurred cost proposals.

f. Because of the small amount of contract costs involved, the use of the quick-closeout procedures should result in only an insignificant difference in the amount of indirect costs applied to the contract for the closeout period as compared with the amount which would be applied if the contract was closed after the final indirect cost rates were established. In addition, the chargeback of gains or losses to other contracts is not in compliance with generally accepted accounting principles. Consequently, except for terminated contracts

discussed in 12-407, no adjustment to compensate for any such difference should be made in computing the periodic indirect cost rates to be applied to other contracts performed during the period.

6-1011 Distribution of Public Vouchers

After provisional approval, interim public vouchers shall be forwarded to the disbursing officer for payment and subsequent distribution, as annotated on the vouchers. In WAWF, the interim voucher is electronically routed to the disbursing office after provisional approval by the supervisory auditor. See 10-905 for distribution of completion vouchers.

Figure 6-10-1
Pro Forma Transmittal of Contractor Closeout Data to Maryland Procurement Office

MEMORANDUM FOR MARYLAND PROCUREMENT OFFICE, 9800 SAVAGE ROAD, FORT GEORGE G. MEADE, MARYLAND 20755

SUBJECT: Request for Data Concerning Maryland Procurement Office Contract(s)

The enclosed materials were requested in support of the Maryland Procurement Office's ongoing process of closeout and retirement of contract actions issued by MPO. The request was made by *(name and telephone or fax)* on *(date)*, and relates to the following contractors and contracts:

Contractor	**Contract no.**

Inquiries may be directed to *(auditor name and telephone)* .

Name
Title

Enclosures *(# each enclosure)*

6-10S1 Supplement --- Billing System Examination Considerations for Contract Types

1. General Considerations

a. Government contracts may arise from negotiation or from formal advertising. Contracts resulting from formal advertising must be either firm-fixed-price (FFP) or fixed-price contracts with economic adjustment and interim payments to the contractor, if any, are not based on cost. Audits of contractor billing systems ordinarily do not address policies and procedures for billings on commercial and formally advertised Government contracts.

b. Negotiated contracts are grouped into two broad categories: fixed price contracts and cost reimbursement contracts. Fixed price contracts may be firm-fixed-price, fixed-price with economic adjustment or fixed price with incentive provisions. Fixed price contracts may be eligible for progress payments, which are invoiced on SF 1443, "Contractor's Request for Progress Payment." Progress payments under fixed price contracts are limited to a predetermined percentage (the "progress payment percentage" specified in the progress payment clause) of the total contract price and do not include profit. Firm-fixed-price level of effort (FFP/LOE) contracts are classified as fixed price, but the data submitted on billings under such contracts closely resembles that submitted on time-and-materials (T&M) contracts in that profit is included in the direct labor billing rates.

c. Cost-type contracts include cost sharing, cost reimbursement and cost plus fixed fee, award fee or incentive fee contracts. Interim payment requests under cost-type contracts are submitted on SF 1034, "Public Voucher for Purchases and Services Other Than Personal" and SF 1035, the continuation sheet. Fee may be billed with cost or may be separately vouchered according to the contract terms, and includes a percentage of the fee up to a predetermined limit. T&M and labor hours contracts are also invoiced on SF 1034 and 1035, but profit is included in the price of a labor hour. Contract types are discussed in detail in FAR Part 16. Standard forms are illustrated in FAR Part 53. For contractors utilizing Wide Area Workflow for the submission of interim payment requests on cost-type, T&M and labor hour contracts, the “Cost Voucher” is the equivalent of the SF 1034. Data equivalent to the SF 1035 must be included in a separate electronic file and attached to the cost voucher in WAWF.

2. Special Considerations --- Fixed Price Contracts

a. It is important to review the contract clauses affecting the contractor's right to receive interim payments based on cost. A fixed price contract may require first article approval (FAR 52.209-3 or -4) before the contract is eligible for progress payments. Progress payments must be liquidated against deliveries or other billable milestones under the contract before any amounts other than progress payments may be paid (FAR 52.232-16(b)). The progress payment and liquidation rates are specified on the SF 1443 in items 6a and 6b respectively.

b. The following example will illustrate the computation of allowable interim payments under a fixed price contract which is not in an overrun status. Assume that the contract requires the delivery of 5 widgets over a two-year period at a unit price of $10,000; a total contract value of $50,000 (5 x $10,000); that the liquidation rate is 80% and the progress payment rate is 80%. The contractor invoices the widgets as they are delivered. There is no standard form for invoicing deliveries. If at the time the first article is delivered the contractor has incurred $12,000 of eligible progress payment costs and invoiced them on SF 1443s, it will have received $9,600 (80% x $12,000) of unliquidated progress pay-

ments. The Government liquidates $8,000 (80% x $10,000) of this against the first article, leaving an unliquidated balance of $1,600. The contractor will bill the Government and receive a payment of $2,000 ($10,000 - $8,000).

c. The contractor is required to report an estimate to complete on SF 1443, item 12b. The instructions to SF 1443 require that this estimate shall be made not less frequently than every six months. FAR 32.503-6(g) requires that if the estimated costs are likely to exceed the contract price, the contracting officer shall calculate a loss ratio factor and adjust future progress payments to exclude the element of loss. Audit steps for evaluation of the contractor's estimate to complete and a matrix for computation of the loss ratio factor appear in the standard audit program for progress payment audits.

d. In addition to verifying that billed costs include only amounts properly recorded and, where required, paid in accordance with an approved cost accounting system, a billing system survey at a location having significant progress payment billings must include a review of the policies, procedures and controls for:

(1) Identifying requisite billing data (progress payment and liquidation percentages, first article approval, billing frequency, etc.).

(2) Assuring compliance with contractual billing conditions.

(3) Preparing and updating estimates to complete.

(4) Timely computation of loss ratio and progress payment reduction when appropriate.

3. Special Considerations --- Flexible Fixed Price and Fixed Price-Level of Effort Contracts

As with FFP contracts, progress payments under fixed price incentive (FPI) contracts are made in accordance with FAR 52.232-16. From an interim billing standpoint, FPI contracts differ from FFP only in the profit computation. They must be audited prior to final payment because the incentive profit is based on a comparison of the actual to the target cost. In an FFP/LOE contract, the deliverable product is the labor hour. Accordingly, such contracts rarely provide for progress payments based on cost. In reviewing billing systems at contractor locations having a significant volume of FFP/LOE work, treat these contracts as if they were T&M.

4. Special Considerations --- Cost-type Contracts

a. Because the Government assumes a higher percentage of risk under cost reimbursement type contracts and because such contracts may contain any number of special provisions affecting billings (ceiling rates, unallowable or unallocable cost elements, key personnel, fee billing and retention, etc.), the accounting and billing system requirements for such contracts are more stringent than for FFP and FPI contracts. Cost-type contracts permit inclusion in the periodic billing of all allowable and allocable paid costs and certain recorded but unpaid costs which do not exceed the contract ceiling or funding limitation, reduced by the contractor's percentage in the case of a cost-sharing contract; and such costs are provisionally reimbursed in full, subject to subsequent audit. Fee billings may be vouchered with cost or separately, depending on the contract terms which frequently provide for a fee retention pending contract completion and closeout.

b. In addition to verifying that billed costs include only amounts properly recorded and, where required, paid in accordance with an approved cost accounting system, a billing system survey at a location having significant cost-reimbursable work must include a review of the policies, procedures and controls for:

(1) Identifying requisite billing data (type of fee, billing procedures, including required supplemental data, frequency etc.).

(2) Assuring that appropriate controls for briefing contracts and adhering to contract provisions and contract ceilings are in place and functional.

(3) Monitoring progress under the contract to provide the data required by FAR 52.232-20b (the Limitation of Cost clause).

(4) Promptly adjusting indirect billing rates for revised budgetary data.

(5) Where applicable, promptly adjusting prior billings to reflect final rates and direct cost disallowances.

(6) Including Form 1 suspensions on subsequent vouchers as an offset to cumulative billed cost.

5. Special Considerations --- T&M and Labor Hours Contracts

a. T&M and labor hours contract costs are vouchered on an SF 1034 (“Cost Voucher” in WAWF) and 1035 (or equivalent data submitted in WAWF). They are a mixed contract type, since labor is billed at price and other direct costs (ODCs) are billed at cost. T&M and labor hours contracts provide for billing direct labor hours at predetermined category rates which include all applicable burden and profit, and bill ODCs (and direct materials on T&M contracts) at cost plus applicable burden. These contracts permit billings up to a stated percentage of the contract value, and may or may not require that each invoice be adjusted to the limitation percentage.

b. T&M and labor hours contracts contain an inherent risk so high that they may be used only after the contracting officer executes a determination that no other contract type is suitable. Nevertheless, at many locations this least favored contract type constitutes a substantial percentage of the workload. A billing system audit is not the best place to identify and correct control weaknesses which arise under this contract type. Refer to 6-204.

c. It is quite common for the contract to specify labor categories which do not coincide with the contractor's established labor classifications. Ideally, the contract itself will specify the required skills and experience for each billable labor category. When this is not the case, the contractor's proposed classifications determine the propriety of employee classifications to contract categories by operation of the Order of Precedence clause (FAR 52.215-8). The contractor's labor distribution system should input incurred labor hours by contract category to the billing system, and the controls preventing misclassification of employees should be reviewed as a part of the labor controls. If these controls do not exist, or have not been evaluated, they must be evaluated as a part of the billing system audit.

d. In addition to review of the controls affecting cost-reimbursable billings, review of a billing system which processes a significant volume of T&M, labor hour, or FFP/LOE contracts must verify that controls are in place which assure: that billings include only actual labor hours per the labor distribution; that each billed hour is assigned to its proper category; and that categories are billed at the correct contractual rate.

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CHAPTER 7

7-000 Selected Areas Of Cost

7-001 Scope of Chapter

a. This chapter discusses items of cost and accounting methods requiring special attention. The guidance furnished is oriented toward audit methods and techniques and is not intended as a substitute for, or interpretation of, the Federal Acquisition Regulation.

b. Expenses which are questioned based on allowability, allocability and/or reasonableness criteria must reference the applicable FAR/DFARS, Part 31 (see 6-608.3).

c. If the contractor included expressly unallowable costs in the final indirect cost settlement proposal, the auditor should question the costs and recommend to the ACO that the costs be subject to the penalty provisions at FAR 42.709. Expressly unallowable costs are defined in FAR 31.001 (see 6-609.1e.). The term “expressly unallowable costs,” as it is used in the penalty regulation, includes only those costs that are expressly unallowable under FAR 31.205 or applicable agency supplement.

7-100 Section 1 --- Computer Cost Allocation (Algorithm)

7-101 Introduction to subject

This section contains guidance for evaluating the accounting for computer programming and reprogramming costs and computer operating costs.

7-102 Allocation of Computer Operating Costs

7-102.1 General Principles

a. DCAA policy requires that where computer costs are material, the FAO audit staff should develop an understanding of computer cost composition and test the contractor's use of the criteria sufficiently to assure that costs are distributed in an equitable manner. If an algorithm is used, and costs distributed are significant, periodic audit evaluation of the algorithm is essential.

b. This coverage addresses a common situation where a contractor has a computer system designed to be responsive to only the internal needs of the organization. Adjustments will have to be made to the audit program to handle the other types of computer system environments which the auditor may encounter. Adjustments should be made on a case by case basis.

c. This section primarily addresses billing algorithms. However, many of our contractors distribute IT costs through general indirect cost allocations. In those cases auditors must still determine whether methods used to distribute IT costs are equitable. While algorithms based on resource utilization are generally preferable, an algorithm is not required if indirect cost distribution is equitable.

d. Cost Accounting Standard 418 as related to computer costs provides for consistent determination of direct and indirect costs. It provides criteria for the accumulation of indirect costs including service center and overhead costs in indirect cost pools and provides guidance on selection of allocation measures based on the beneficial or causal relationships between an indirect cost pool and cost objectives. Refer to CAS 418 (8-418) for additional details.

e. Billing algorithms used by contractors to allocate computer costs should be included in a contractor's disclosure statement in order for the disclosure statement to be considered adequate (see 8-206).

7-102.2 Algorithm Development

a. A computer billing algorithm is a mathematical formula used to develop the amount to be charged a customer, contract or overhead pool for services. The formula is based on such factors as type of equipment used, storage media utilization and space allocation, type of processing, response or turnaround time, and time of day services are provided. In a complex IT environment, a wide range of IT support is provided to various system users. Developing an algorithm to equitably distribute IT costs may incorporate all major IT resources or only a few. The greater the variation in types of application or services provided, the greater the need for a more complex algorithm. The cost of developing a complex algorithm, including subsequent recording of computer use through internal software, is normally compared with the benefit (exactness) of such an algorithm. If it can be demonstrated that an algorithm using only two or three resources is equitable, a complex algorithm is not necessary.

b. Resources typically measured and collected for construction of a user charge include:

--- Central processor (CPU) time - the amount of CPU time required to accomplish a specific task.

--- Computer memory requirements - many algorithms consider the amount of memory (bytes) used for each job.

--- Input/output transactions - with the wide range of data input/output devices such as magnetic tape, disks, and terminals, algorithms often consider the number of times such equipment is accessed.

--- Direct access storage requirements - tape and disk storage requirements are often considered, including the amount of disk workspace and number of tape devices and/or tape mounts required by each job.

c. Typically, accounting information is collected by operating system software for each user application. In addition, the operating system usually contains provisions for user-supplied routines to collect utilization data. Numerous software vendors have developed specialized software packages to reduce these data and generate a variety of management reports. Such packages often provide time-sequenced resource utilization statistics that can be used to develop billing criteria and make recommendations on improving overall system efficiency.

d. Billing information is usually generated by a billing algorithm. Often the final billing unit is an average resource unit incorporating the various algorithm components. A simple example is shown below:

Resource unit = CPU time X coefficient
+ Memory usage X coefficient
+ Input/output transactions X coefficient
+ Printer time X coefficient

e. The coefficients, which include but are not limited to staff costs, programming costs, and hardware costs, should be evaluated for applicability. Most often, coefficients reflect a ratio between the cost of a specific resource and the total availability of the resource (for example, cost of CPU divided by total available CPU seconds.)

7-102.3 Audit Objectives in Algorithm Evaluation

When evaluating computer billing algorithms, audit objectives include:

a. Developing an overall understanding of allocation methods used.

b. Verifying that algorithm components accurately represent resources used.

c. Validating that there are sufficient controls to assure that billings are processed in an accurate and reliable manner.

d. Determining whether all applicable costs are included in the development of the coefficients.

e. Validating that the individual rates or coefficients are accurate and properly applied.

f. Testing allocation criteria to assure that computer cost allocations are equitable.

7-102.4 Algorithm Review Techniques

For purposes of algorithm evaluation, a structured audit approach is suggested as outlined in the following subparagraphs. A billing algorithm summary checklist, as shown in Figure 7-1-1, is often useful to control necessary audit steps.

a. Determine billing formula risk and materiality. If billing algorithms do not distribute a material amount of contract cost (direct and/or indirect), the need for a detailed algorithm review may be obviated.

b. Request contractor support for the billing formula:

(1) Explanation of the algorithm. Generally the contractor should have documented the algorithm. Consideration should be given to any tests (benchmarks) performed to validate the algorithm.

(2) IT resources used in the algorithm. The contractor should be able to identify which resources have been included in the formula and the rationale, if applicable, for excluding major resources.

(3) Cost distributed during recent periods.

(4) Accounting treatment of variances. This is a critical area as the timing of variance adjustments and accounting treatment can significantly impact costs distributed to contracts.

(5) Current inventory of IT equipment. This will be valuable when determining whether all appropriate resources are included in the algorithm. In addition, it is essential for adequate equipment maintenance and control that the contractor have detailed visibility of IT resources.

c. Compare billed IT costs with actual:

(1) Are procedures established for equitable and timely treatment of identified variances?

(2) If there are significant recent variances, has the algorithm been adjusted for more accurate cost distribution?

(3) Does the contractor compare costs for periodic runs of the same job; for example, payroll? Are significant differences investigated?

(4) Does the contractor make periodic revisions to projected rates as a result of changes in estimated costs or usage of a component?

(5) Are discounted coefficients offered for off-hours usage?

(6) Has an evaluation been made of the contractor's previous projections of computer component rates by comparison of actual rates to projected rates? What are the reasons for significant variances such as unplanned usage or nonusage, or the increase or decrease in costs? If the contractor makes periodic reviews of projected rates, arrange to audit these reviews. If there have been significant variances due to volume differences, perhaps more frequent reviews should be recommended.

d. Verify major IT resources. Critical considerations for an algorithm are whether it is based on verifiable usage data, and whether resources used in the algorithm accurately represent services provided system users. Consider whether:

(1) All major resources are included in the algorithm.

(2) Resource usage is based on verifiable data.

(3) Resources are costed appropriately.

(4) Algorithm components are restricted to IT resources.

(5) Lease agreements for equipment have been considered.

(6) Equipment costs are properly determined for each grouping.

(7) The algorithm includes any unallowable costs, such as excessive rental charges for IT.

e. Evaluate coefficients and other factors:
(1) Are coefficients based on verifiable data?
(2) If there are outside sales of IT services, are the services comparable to in-house applications and are they priced comparably to in-house IT support?
f. Manually compute the billing formula for selected major Government projects:
(1) Can the algorithm be computed using verifiable data?
(2) Is the manual calculation reconcilable to the machine output?
(3) Can coefficients and factor utilization be accurately verified?
(4) Are comparisons of items such as the ratio of cost input to IT billings reasonable?

Figure 7-1-1 (Ref.7-102.4)
Billing Algorithm Summary Checklist

Audit Step	Working Papers Reference	Auditor	Date
1. Risk evaluation			
2. Contractor support			
a. Obtain explanation of algorithm			
b. List IT resources in algorithm			
c. List distributed IT costs by quarter			
d. Identify accounting treatment of variances			
e. Identify IT policies/procedures for cost treatment			
f. Obtain current inventory of all IT equipment			
3. Compare billed IT costs with actual			
a. Variance treatment			
b. Timing of adjustments			
c. Are fixed-price/commercial type variances substantial			
4. Verify IT inventory (consider sampling techniques)			
a. Purchase agreements			
b. Are major resources in algorithm?			
5. Evaluate coefficients and other factors – Are coefficients based on verifiable data?			
6. Manually compute billing formula for major Government projects			
a. Is it based on available/verifiable data?			
b. Is the manual calculation reconcilable to machine form?			
c. Can coefficients/factors be verified?			
d. Are parity checks such as contribution to cost comparable?			

7-102.5 Billing Algorithm Example

a. When internal measurements are used, billing rates are developed to allocate the cost of each major component on the basis of the component's usage. These billing rates are usually computed annually and are developed by dividing the estimated annual cost associated with each component by the estimated annual usage of the component. The billing may be made in one of two ways: (1) separate billing rate for each component or (2) a single overall rate which is applied to equivalent units of usage for each component.

b. Computer costs can be distributed equitably using a wide range of mathematical techniques. As previously discussed, it is important that a contractor clearly document methods used, and base cost allocations on verifiable cost and utilization data.

c. The example in Figure 7-1-2 includes a five-resource cost allocation. For illustration purposes, one resource-magnetic tape drives-is traced through a weighting factor (coefficient) adjustment and the rate calculation. Coefficients are not essential but are included in many algorithms. Accordingly, a typical coefficient is included in the example.

Figure 7-1-2
Billing Algorithm Example

1. Formula resource components are:

Resource Allocated	Unit of Measure	Charge/Prime Shift
CPU	CPU hours	$300/hr
Memory	1024 work block hours	$5/hr
Disk Channel Time	Channel hours	$25/hr
Tape Channel Time	Channel hours	$10/hr
7- and 9-track Tape Drives	Elapsed hours	$5/hr

2. The coefficient is computed using the following algorithm:

$$CFW = \frac{\text{Cost r}}{\text{T Cost}} \text{ X Total r X \% used}$$

CWF = computer weighting factor or coefficient to equalize billings.
Cost r = cost of resources being allocated
T Cost = total IT costs to be allocated
Total r = number of resource units available
% used = percent resources are used

3. If we want to illustrate the weighting factor for tape drive utilization, we can assume the following data was available in contractor records.

Cost r = $12,500
T Cost = $3,000,000
Total r = 16 tape drives

Figure 7-1-2

% used = 70%

4. Substitute into the algorithm:

$$CFW = \frac{12{,}500}{3{,}000{,}000} \text{ X } 16 \text{ X } 70\% = .046$$

5. After developing an application weighting factor (coefficient), a rate is normally developed for the resource. Again for illustration purposes.

$$\text{Rate} = \frac{\text{Cost r}}{\text{Max r hours}} \text{ X } \frac{1}{\text{CWF}}$$

6. If contractor records show:

Cost r = $12,500		
Max r (prime shift) 16 tape drives		
X 40 hrs/wk X 52 wks	=	33,280
(second shift) 16 tape drives		
X 40 X 52 X 50% disc		16,640
		49,920

7. Substituting:

$$\text{Rate} = \frac{\$12{,}500}{49{,}920} \text{ X } \frac{1}{.046} = \$.25 \text{ X } 21.7 = \$5.43$$

8. As shown above, manually calculating the rate for tape drives shows an actual rate of $5.43. If a billing rate of $5.00/hr is used and utilization forecasts are accurate, tape drive cost will be underabsorbed.

d. As billing algorithms vary widely, this example should not be viewed as typical. However, it does demonstrate potential algorithm complexity. Accordingly, the approach suggested in 7-102.4 provides a frame-work for developing an audit opinion without evaluating and testing each component of the algorithm. If each factor or algorithm component cannot be verified by historical or current data, risk that costs are unequitably distributed is greatly increased. In such cases, the audit report should recommend that billing algorithms be based on verifiable data and that they include major IT resources used.

e. In many instances contractors may simplify the billing process. The example below addresses CPU costs only (other resources would be billed similarly), and if estimated CPU utilization is reasonable, billed costs would be equitable.

$$\text{Coefficient} = \frac{\text{Cost of CPU for billing period}}{\text{Available CPU seconds for billing period}}$$

Cost of CPU for billing period = $15,000
Available CPU seconds = 720,000

$$\text{Coefficient} = \frac{\$15{,}000}{720{,}000} = \$0.020833$$

Billed amount = $.020833 X CPU seconds consumer for each job

7-103 Significant Nonrecurring Costs of Computer Programming and Reprogramming

7-103.1 General Principles

Equity in accounting for significant nonrecurring costs of computer programming and reprogramming usually requires that such costs be capitalized/amortized. The initial programming costs are incurred in order to place the computer into operation and as such are normally as much a part of the initial costs of the computer as are the equipment installation costs. A major change in either the equipment or the system usually involves the incurrence of significant reprogramming costs. These costs will normally benefit future periods in much the same manner as major modifications of the equipment. On the other hand, established programs are subject to minor refinements and improvements, the costs of which are chargeable to current operations in much the same manner as minor repairs.

7-103.2 Amount to Be Capitalized

The amount of programming or reprogramming costs to be capitalized should represent the actual costs incurred by the contractor in preparing and testing the program; that is, all applicable direct and indirect costs should be included up to the point the program becomes operational.

7-103.3 Amortization Period

The length of the amortization period should be established on the basis of the estimated number of years that will benefit from the incurrence of the programming or reprogramming costs. As a general rule the period of amortization of those programs for which there appears to be a continuing need should not exceed the anticipated useful life of the computer. A shorter amortization period should be used in those cases where the contractor can demonstrate by historical data or otherwise that the useful life of the program is shorter than that of the computer. At the larger computer centers, where numerous programs may be involved, an averaging of the expected lives of various programs may be acceptable when such procedure results in a reasonable amortization of the related programming costs over the years benefited.

7-103.4 Amortization Method

The method used to amortize the costs over the estimated useful life of the program should be based on the contractor's normal practice applicable to other items of software. Where this is not possible, any reasonable method of amortizing such costs over the estimated useful life of the program should be considered acceptable particularly if the method is the same as that used for depreciating the equipment.

7-103.5 Justification for Immediate Charging to Current Operations

In some circumstances, the contractor may represent that the desired objective of capitalization/amortization as outlined above is substantially and consistently achieved by charging to current operations all programming and reprogramming costs when and as they are incurred. Due consideration should be given to such representation, provided the contractor submits sufficient data in support of the representation.

7-104 Accounting for the Costs of Computer Software for Internal Use (SOP 98-1)

7-104.1 Applicability of SOP 98-1

On 4 March 1998, the Accounting Standards Executive Committee (AcSEC) of the AICPA issued Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. In the absence of coverage in FAR, CAS, or other Government regulations, Generally Accepted Accounting Principles will be used for contract costing purposes. All contractors, except state and local governments, will follow the provisions of SOP 98-1, effective for fiscal years beginning after December 15, 1998.

7-104.2 Major Requirements of SOP 98-1

a. Characteristics of Internal-Use Computer Software. SOP 98-1 defines internal-use software as software having both of the following characteristics:

- the software is acquired, internally-developed, or modified solely to meet the entity's internal needs; and
- during the software's development or modification, no substantive plan exists or is being developed to market the software externally.

b. Capitalize Versus Expense. SOP 98-1 stipulates that capitalization of costs should begin after both of the following have occurred: (1) management, with the relevant authority, authorizes (implicitly or explicitly) and commits to funding a computer software project and believes that it is probable that the project will be completed and the software will be used to perform the function intended; and (2) conceptual formulation, evaluation and selection of possible software project alternatives (referred to as the "preliminary project stage") have been completed. After completion of the preliminary project stage, the project proceeds to the "application development stage." Costs related to this stage are capitalized. The application development stage generally includes:

- Designing the chosen path, including software configuration and software interfaces;
- Coding;
- Installation to hardware; and
- Testing, including parallel processing phase.

The costs of data conversion from old to new systems, such as purging or cleansing of existing data, reconciliation or balancing of the old data and the data in the new system, creation of new/additional data, and conversion of old data to the new system, should be expensed. Costs to develop or obtain software that allows for access to or conversion of old data by new systems should be capitalized.

Capitalization should cease when a computer software project is substantially complete and ready for its intended use. Computer software is ready for its intended use after all substantial testing is completed. Costs incurred during the post-implementation/operation stage, such as maintenance and training costs, should be expensed as incurred. The SOP states that even if training cost is incurred during the application development stage, it should be expensed as incurred.

Costs of significant upgrades and enhancements to internal-use computer software should be capitalized if it is probable that those expenditures will result in significant additional functionality. Additional functionality is defined as changes to the software so that it may perform a task it is not currently able to perform.

c. Capitalizable Costs. The following costs incurred during the application development stage should be capitalized:

- External direct costs of materials and services consumed in developing or obtaining internal-use computer software, such as costs incurred to obtain computer software from third parties;
- Payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project.
- Interest costs incurred while developing internal-use computer software (See 7-104.3a).

d. Component Accounting. SOP 98-1 applies to the individual components or modules of the computer system. For each component or module of a software project, amortization should begin when the component or module is ready for its intended use, even though the entire software system will not be completed until a later accounting period.

e. Amortization Method. SOP 98-1 provides that capitalized costs should be amortized over the useful life of the software on a straight-line basis unless another systemic and rational basis is more representative of the software's use. For example, accelerated methods of amortization may be appropriate when the utilization of the software is significantly greater in the earlier years of the useful life than the later years.

7-104.3 Audit Considerations

a. SOP 98-1 stipulates that interest should be capitalized in accordance with the provisions of FASB Statement No. 34, Capitalization of Interest Cost. FAR 31.205-10(c) disallows actual interest cost in lieu of the calculated imputed cost of money. FAR 31.205-10(b)(1) provides that for capital assets under construction cost of money computed in accordance with CAS 417 is allowable whether or not the contractor has contracts subject to CAS. However, the difference may not be material in most cases. Auditors should not take exception to contractor's capitalization of actual interest costs if the amount does not differ materially from the cost of money calculated in accordance with CAS 417.

b. SOP 98-1 provides that general and administrative (G&A) costs, overhead costs, and training costs should not be capitalized as costs of internal-use software -- those costs relate to the period in which they are incurred. The expensing of G&A and overhead costs allocable to capitalized projects conflicts with the fundamental requirements of CAS 410 and 418 that require such costs to be allocated to cost objectives, including capitalized projects. Auditors should first consider the materiality of G&A and overhead costs allocable to capitalized projects when addressing this issue. If the impact would be significant, the auditors should work with the contracting officer regarding how best to protect the government's interest without unduly burdening the contractor or the Government.

c. At contractor locations where the Government, in the past, has allowed the expensing of the costs of developing internal use software, special care must be taken to ensure the costs are not double recovered by the contractor (i.e., the costs expensed in prior periods are capitalized and amortized in the current and future periods). Further, contractors that previously expensed the costs of software developed or obtained for internal use will be required to change their accounting practices to comply with SOP 98-1. Contractors with CAS-covered contracts may be required to submit a revised disclosure statement in accordance with FAR 52.230-2(a)(2) (full CAS-coverage), 52.230-3(a)(3)(i) (modified CAS-coverage) and 52.230-5(a)(2) (educational institutions). Further, in accordance with FAR 52.230-6(a), the contractor may be required to provide the contracting officer the total potential impact of the change in accounting practice on contracts containing the CAS clause and a general dollar magnitude of the change.

7-105 Accounting for Costs Related to Enterprise Resource Planning (ERP) Systems

7-105.1 Introduction

Many contractors are investing significant resources in implementing Enterprise Resource Planning (ERP) systems to reengineer their business processes and to replace legacy systems that no longer meet their needs. A typical ERP project involves reengineering business processes and selecting and implementing commercially available software packages from the vendors such as SAP, Oracle, Deltek, etc. This section provides guidance on accounting treatment of cost related to ERP systems. (See 5-406.7 for guidance related to audit of ERP systems internal controls.)

7-105.2 Applicability of EITF Issue No. 97-13 and SOP 98-1

Financial Accounting Standards Board (FASB) Emerging Issue Task Force (EITF) Issue No. 97-13, Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project that Combines Business Process Reengineering and Information Technology Transformation, dated November 20, 1997, addresses the issue of business process reengineering activities. EITF Issue No. 97-13 sets forth the typical activities of a business process reengineering project that is part of a broader software implementation project, such as an ERP project. It also incorporates the proposed AICPA Statement of Position (SOP) 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use, which was finalized on March 4, 1998, on internal-use software as guidance on accounting for the software elements of the information technologies transformation projects. The detailed audit guidance on SOP 98-1 is provided in 7-104. In the absence of specific coverage in FAR, CAS, or other Government regulations, Generally Accepted Accounting Principles, including EITF Issue No. 97-13 and SOP 98-1, are the principles contractors must use in accounting for costs related to implementing ERP systems for contract costing purposes.

7-105.3 Business Process Reengineering (EITF Issue No. 97-13)

a. EITF Issue No. 97-13 provides that the cost of business process reengineering activities, whether performed internally or by third parties, is to be expensed as incurred. This also applies when the business reengineering activities are part of a project to acquire, develop, or implement internal-use software. The costs associated with the following business process reengineering activities should be expensed as incurred:

(1) Preparation of request for proposal.

(2) Current state assessment: The process of documenting the entity's current business process, except as it relates to current software structure. This activity is sometimes called mapping, developing an "as-is" baseline, flowcharting, or determining current business process structure.

(3) Process reengineering: The effort to reengineer the entity's business process to increase efficiency and effectiveness. This activity is sometimes called analysis, determining "best-in-class," profit/performance improvement development, or developing "should-be" processes.

(4) Restructuring the work force: The effort to determine what employee makeup is necessary to operate the reengineered business processes.

b. Because ERP projects combine internal-use software (governed by SOP 98-1) and business reengineering activities (governed by EITF 97-13), it is important to properly classify such activities. Some of the reengineering activities could be occurring concurrently with software implementation. For costs to be expensed as reengineering activities, the focus of the activities should be on process rather than software systems. This is true even if contractor employees, outside consultants, or software vendors involved in these activities may have information technology and software application expertise.

c. When an outside consultant or a software vendor is used to complete an ERP project, the total price of the contract may include multiple elements, such as business process reengineering, software costs, training, maintenance support, etc. EITF Issue No. 97-13 provides that the cost should be allocated to each element based on the relative fair values of those separate activities, not necessarily the separate prices stated within the contract for each element. This is important because some of these costs are required to be capitalized as discussed in 7-105.4 below. The information such as vendor price lists, price charged or quoted by similar vendors, or vendor pricing sheets (rates per hour times budgeted hours) can be used to determine the separate activity market prices. Auditors should ensure that the estimate of fair value assigned to each activity is reasonable and that contractors have adequate procedures to allocate the consulting costs between business reengineering activities and internal-use software development activities (i.e., preliminary, application development, and post-implementation).

7-105.4 Computer Software Developed or Obtained for Internal Use (SOP 98-1)

a. The software element of ERP projects should be accounted for in accordance with SOP 98-1. SOP 98-1 requires companies to capitalize and amortize many of the costs associated with developing or obtaining software for internal use. A typical ERP project encompasses a wide range of software related activities, such as software acquisition, configuration, modification, data conversion, maintenance, etc. Accounting treatment of those activities should be determined based on the criteria specified in SOP 98-1 as discussed in 7-104.

b. If a contractor has a software license and software maintenance contract from an ERP vendor, the software license costs are capitalized, while the software maintenance portion of the contract is expensed.

c. ERP systems generally involve several modules or components. SOP 98-1 applies to the individual modules or components of the computer system. For each component or module of a software project, amortization should begin when the component or module is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond the reporting period. Auditors should ensure that contractors separately account for costs by module or component to comply with this requirement. Computer software is ready for its intended use after all substantial testing is complete. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

7-106 Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed (FASB No. 86)

a. FASB Statement No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," specifies the financial accounting treatment for the costs of computer software sold, leased, or otherwise marketed either as a separate product or as a part of another product or process. FASB No. 86 identifies the point in time that research and development costs incurred in the process of creating a software product to be sold, leased, or otherwise marketed become production costs which should be capitalized and amortized over future sales.

b. FASB 86 provides that costs incurred internally in creating a computer software product are to be charged to expense when they are incurred as research and development until "technological feasibility" has been established for the product. Technological feasibility is established when either (1) the detailed program design has been completed or (2) a working model has been developed. After technological feasibility has been established, all software production costs are to be capitalized and reported on the financial statements at the lower of unamortized cost or net realizable value and are to be amortized based on current and future revenue. Capitalization of software costs shall stop when the product is available for general release to customers.

7-200 Section 2 --- Lease Cost

7-201 Introduction

This section provides guidance for evaluating leasing costs.

7-202 Applicable Contract Regulations

7-202.1 Applicability of FASB Statement 13

Guidance for the treatment of lease costs is covered by Financial Accounting Standards Board (FASB) Statement No. 13, Accounting for Leases. The Statement is effective for leasing transactions and revisions entered into on or after January 1, 1977. For leases in effect on January 1, 1977, FASB Statement 13 was optional until fiscal years beginning on or after December 31, 1980. FASB Statement 13 is incorporated in FAR 31.205-36 (Rental Costs), and FAR 31.205-11 (Depreciation).

7-202.2 Applicability of FAR

FAR 31.205-36 applies to the cost of renting or leasing real and personal property, acquired under operating leases (see 7-205) as defined in FASB Statement No. 13. If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) apply (see 7-413).

7-202.3 Applicability of CAS

The concepts of CAS 404, Capitalization of Tangible Assets, are incorporated in FAR 31.205-11(h) relative to capital leases. CAS 404 applies to assets acquired by a capital lease as defined by FASB Statement 13. Compliance with FASB Statement 13 and CAS 404 requires that capital leases be treated as purchased assets. The capitalized value of such assets should be distributed over the useful lives of the leased assets as depreciation charges, or over the leased life as amortization charges, as appropriate.

7-203 Capital Leases

If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) and CAS 404 apply (see 7-413 and 7-202).

7-203.1 Main Requirements of FASB Statement 13

a. **Criteria for Classification as a Capital Lease.** From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used to classify the lease.

(4) The present value, at the beginning of the lease term, of the minimum lease payments (excluding executory costs such as insurance, taxes, etc.) equals or exceeds 90 percent of the excess of the fair value of the leased property over any related investment tax credit retained by the lessor. The 90 percent test should be considered a lower limit rather than a guideline. However, where the lease term begins in the last 25 percent of the estimated economic life, this criterion shall not be used to classify the lease.

b. **Determination and Amortization of Minimum Lease Payments.** (1) Capital leases should be recorded as assets and liabilities at the lower of the present value of the minimum lease payments at the beginning of the lease term or the fair value of the leased property at the inception date. The discount rate used in determining present value is the lower of the lessee's incremental borrowing rate (the rate the lessee would have incurred to borrow the funds necessary to purchase the asset) or the implicit (lessor's) rate in the lease, if the implicit rate can be determined. The minimum lease payments are allocated between a reduction of the liability and interest expense to produce a constant periodic interest rate on the remaining balance.

(2) A lessee may use its secured borrowing rate in calculating the present value of minimum lease payments if the rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

(3) Contingent rentals are the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. See 7-204.2 regarding lease payments dependent on economic escalation factors.

c. **Calculation of Amortization (Depreciation) for a Capital Asset.** The asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets. See 7-400 for a discussion of depreciation costs. The asset shall be amortized over a useful life as follows:

(1) If the leased property reverts to the lessee at the end of the lease or if the lessee is able to purchase the property at a bargain purchase price, then the asset life will be that normally used by the contractor for similar assets.

(2) If the property is leased for a term which is 75 percent or more of the economic life of the asset or the minimum lease payments equal or exceed 90 percent of the fair value of the asset (less applicable credits) then the asset should be amortized over the life of the lease to the value to the lessee, if any, at the end of the lease.

d. **Renewals and Terminations.** (1) If a capital lease is renewed or extended and the renewal is also classified as a capital lease, the carrying value of the asset may require adjustment. When the capitalized value under the revised lease and the present balance of the obligation differ, the asset and liability account is adjusted upward or downward to reflect this difference.

(2) If a capital lease is renewed or extended and the renewal is classified as an operating lease, the existing lease shall continue to be accounted for as a capital lease to the end of the original term, and the renewal or extension period shall be accounted for as an operating lease.

(3) A termination of a capital lease shall be accounted for by removing the asset and obligation with gain or loss recognized for the difference.

(4) The exercise of a lease renewal option contained in a current lease other than those already included in the lease term (as defined by FASB Statement 13) is classified as a new agreement and not a renewal or extension.

7-203.2 Audit Considerations---Capital Lease

a. **Proper Classification of Leases.** (1) Auditors should consider the criteria in 7-203.1a to determine whether a lease should be classified as an operating lease or a capital lease.

(2) Auditors should be alert to instances where, to avoid reporting liabilities on their financial statements, contractors may structure their leases, or include assumptions in testing against the FASB Statement 13 criteria, that result in those leases being classified as operating.

(3) When a capital lease is improperly classified as an operating lease, the excess leasing costs should be determined based on criteria for computing the unallowable leasing costs for

capital leases. The cost of leased capital assets in excess of the prescribed depreciation charges (7-202.3) should be disapproved under FAR 31.205-11(i). FAR 31.205-20 (Interest and Other Financial Costs) should not be cited as a basis for disapproving the costs.

(4) Mitigating circumstances involving materiality determinations may exist. For example, leases reclassified as capital leases may result in depreciation during the early years of the leases at amounts higher than the lease payments due to use of accelerated depreciation methods and applied cost of money (COM). The total depreciation and COM under a capital lease may be greater than the total leasing costs. The practice may be in noncompliance with FAR 31.205-11 or FAR 31.205-36 or CAS 404, 405, 409, or 414. These regulations and standards should be reviewed for applicability. The noncompliance should be reported if it currently has no significant effect on contract costs but could eventually result in a significant adjustment because of changed circumstances.

b. **Unreasonable Lease Costs.** If the lease term is substantially shorter than the asset's useful life, the recovery of a high percentage of the fair market value of the asset over the lease term would be indicative of unreasonable rental costs. In this situation, the auditor should determine if the lessor considered and provided adequate residual value at the end of the lease term in accordance with paragraph 5(k) of FASB Statement 13. Reasonable residual value must be considered in computing minimum lease payments in order to attain reasonable lease costs.

c. **Amortization Period.** The proper classification of a lease according to FASB Statement 13 does not automatically result in acceptable contract cost. For capital leases, consideration should be given to the acceptability of the amortization period in accordance with FASB Statement 13 and CAS 409.

(1) Definition of Lease Term

FASB Statement 13 defines a lease term as the fixed noncancellable term of the lease plus:

(i) all periods covered by bargain renewal options,

(ii) all periods for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured,

(iii) all periods covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt related to the leased property is expected to be in effect,

(iv) all periods covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable, and

(v) all periods representing renewals or extensions of the lease at the lessor's option.

However, in no case shall the lease term extend beyond the date a bargain purchase option becomes exercisable.

(2) Audit Considerations

When a capital lease is to be amortized over the lease term (see 7-203.1c), renewal periods will be included if they meet the criteria specified in the FASB Statement 13 definition of a lease term. This would be an important audit consideration when the renewal is assured through substantial penalties for nonrenewal or a guarantee by the lessee of the lessor's debt. Failure to review the lease term for renewal clauses could significantly distort the amortization charges to current contracts.

7-204 Review of Lease Clauses

7-204.1 Payment of Executory (Occupancy) Cost

Lease clauses regarding payment of executory costs are of particular interest to the auditor. FASB Statement 13 requires executory costs to be excluded when computing minimum lease payments. Executory costs include maintenance, insurance, taxes, and utilities. When the lease clause provides that the lessee pays the executory costs, the lease is referred to as a "net" lease. When the lessor pays these costs, the lease is referred to as a "gross" lease. Since "net" and "gross" are not universally defined, the auditor should review the lease clause to determine exactly what costs are to be paid by the lessee.

7-204.2 Escalation Lease Clauses

Auditors should be particularly interested in escalation lease clauses. Recently, clauses containing a provision for increasing lease payments based on the Consumer Price Index (CPI) or some other economic indicator have become common. The increase could be subject to adjustment on an annual basis or when an option is exercised. The escalation may also apply to the purchase price if the lease contains a purchase option.

a. **Computation of Minimum Lease Payments.** The decision to include or exclude the escalation for purposes of computing minimum lease payments depends on the specific circumstances, and would include:

(1) the factor(s) to which the escalation applies, such as executory costs (which would not be included at all), principal payments, or insurance only;

(2) the factor on which the escalation is computed, such as the CPI or prime interest rate,

(3) the period to which the escalation applies, such as annually, only for an option period, or the incurrence of some period of time, and

(4) the current pronouncements of the Financial Accounting Standards Board.

b. **CPI or Prime Interest Rate.** Lease payments that depend on an existing index or rate, such as the CPI or prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease. Any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and are excluded from the minimum lease payments (see 7-203.1b(2)).

7-205 Operating Leases

7-205.1 Definition of Operating Lease

Under the provisions of FASB Statement 13, an operating lease is any lease that is not a capital lease.

7-205.2 Criteria for Allowability

The provisions of FAR 31.205-36 apply to all operating leases including those that involve information technology equipment. The main criterion for allowability of operating lease costs is reasonableness. The cost principle states several criteria that should be considered when making a determination of reasonableness. The provisions in FAR 31.201-3 should also be used in evaluating reasonableness of operating lease cost.

7-205.3 Audit Procedures

a. **Comparison with Comparable Property – FAR 31.205-36(b)(1)**. Included in these criteria is a comparison with comparable property. The auditor must exercise care when determining what is comparable property. To be comparable, the property must be of the same basic age, size, life expectancy, and location. In addition, the lease provisions must also be comparable. Since there are several clauses which can increase time lease costs (see 7-204), the auditor must ascertain what costs truly are included in the comparable property comparison.

b. **Determination of Reasonableness – FAR 31.205-36(b)(1) and 31.201-3**. An audit step in testing reasonableness is to review the results of applying FASB Statement 13 capitalization criteria. This is especially critical when reviewing the results of the application of the fourth criteria of FASB Statement 13 (7-203.1a(4)). Auditors should determine whether the lease term is substantially less than the asset life, and whether the present value of the minimum lease payments is significant as compared to the fair market

value of the leased property (for example, greater than 50 percent but less than 90 percent). If this condition exists, there is a strong indication that lease costs are unreasonably high and the audit scope should be expanded.

7-206 Related Party Lease Cost

Leases between related parties are governed by FASB Statement 13, FAR 31.205-11(h)(2), Depreciation, and FAR 31.205-36(b)(3), Rental costs.

7-206.1 Related Party Capital Leases

a. **FASB Statement 13 and FAR Requirements**. Capital leases between related parties are discussed in FAR 31.205-11(h)(2) and FASB Statement 13 (FAS-13), paragraph 5a. If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, costs shall not be allowed in excess of those which would have been incurred if the lease contained terms consistent with those found in a lease between unrelated parties.

b. **Audit Procedures**. The auditor should test for reasonableness of rental costs by comparing the present value of lease payments with the fair market value prior to applying the provisions of FASB Statement 13. If the present value substantially exceeds the fair market value, the economic substance of the transaction should be recognized over the "legal form" (see FAR 31.205-11(h)(2) and FASB Statement 13, paragraph 29). Consequently, costs should be questioned to the extent of unreasonableness due to lack of an "arms length bargaining" (FAR 31.201-3(b)). FASB Statement 13 criteria should then be applied in establishing the appropriate treatment for the balance of the costs.

7-206.2 Related Party Operating Lease

a. **General**. Leasing costs between divisions, subsidiaries, or organizations under common control for operating leases are generally allowable to the extent that costs do not exceed the normal costs of ownership (excluding interest or other costs unallowable and including cost of money) (FAR 31.205-36(b)(3)).

b. **Common Control**. FAR does not specifically define common control. ASBCA decisions on common control have emphasized the existence or lack of existence of actual common control. FAS 57 defines control as "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise." The question of whether two entities are under common control is a question of fact. The key question is whether or not one party has the ability to exercise control over the operating and financial policies of the related party. A party may have actual control even if such control is not evidenced by the agreement. Therefore, it is imperative to review the events and transactions that actually occurred in making a determination of whether or not control exists. Two of the most important areas to review are (1) the actual decision making process, and (2) the reasonableness of the lease terms.

(1) A review of the joint venture decision making process is important to determine if control actually exists. For example, if it appears that one company is making practically all the decisions (e.g. the other party is not present at decision making meetings, or if present rarely provides input), this would be an indication that this company is controlling the joint venture. In reviewing supporting documentation, the auditor should remember that percentage of ownership is only one factor to be considered. It is possible that common control will exist even where the controlling individuals own a small percentage of the company's equity. Other factors to consider include, but are not limited to, interlocking management/ownership, identity of interests among family members, shared facilities and equipment, and common use of employees.

(2) The existence of unreasonable lease terms may also provide evidence of control. If the lease terms are unreasonable as compared to those available in the competitive market, it may be because one company has exercised significant influence over the operating and financial policies of the joint venture. Reasonableness may be reviewed by comparing the terms of the lease with

(a) the contractor's other comparable leases that did not involve a related party,

(b) other comparable leases, and

(c) actual advertised prices for the facilities in question or other similar facilities.

Both the rates (cost per square foot for example) and other terms (such as fixed noncancellable leases versus those with options) must be considered in determining the reasonableness of the lease costs.

While showing that the lease costs are unreasonable will not in itself constitute a determination of common control, it is an important factor in making such a determination. In addition, if the Government is unable to prevail in its common control argument, it nevertheless should prevail in proving that the lease costs were unreasonable at the time of the lease decision under the provisions of FAR 31.205-36(b)(1).

7-207 Sale and Leaseback Transactions

a. Sale and leaseback transactions are governed by FAR 31.205-16(b), Gains and losses on disposition or impairment of depreciable property or other capital assets; FAR 31.205-11(i)(1), Depreciation, and FAR 31.205-36(b)(2), Rental costs. Effective July 8, 2005, FAC 2005-004 revised the FAR cost principles governing the treatment of costs resulting from sale and leaseback transactions. The rules collectively ensure that the total allowable costs for the use of the subject asset do not exceed the constructive costs of ownership.

b. Gains and losses on the assets involved in sale and leaseback transactions are recognized on the date the contractor becomes a lessee, in accordance with FAR 31.205-16(b)(1). The gain or loss is the difference between the net amount realized and the net book value (i.e., the undepreciated balance) of the asset on the date of the sale and leaseback transaction. However, gains and losses recognized for Government contract costing purposes are further limited as follows:

(i) Gain transactions – FAR 31.205-16 limits the recognition of any gain associated with the disposition of capital assets to the amount of depreciation costs previously recognized. The Government participates in the cost and credit for the use of the capital asset by the contractor; however, the Government participation in the gain (i.e., credit) does not extend to any appreciation in asset value in excess of its acquisition cost, per FAR 31.205-16(d).

(ii) Loss transactions – Sale and leaseback transactions are usually consummated as a means of raising capital; therefore, recognizing losses based on the net amount realized, instead of the fair market value of the asset, may place the Government at risk for reimbursing the costs of raising capital, as well as losses that may be artificially inflated. FAR 31.205-16(b)(2) provides protection to the Government by limiting the allowable amount of a loss to the amount by which the net book value exceeds the fair market value of the asset. The allowable loss is zero if the fair market value exceeds the net book value of the asset.

c. Under a sale and leaseback transaction, the annual lease costs are limited to the amounts that would have been allowed had the contractor retained title to the asset. FAR 31.205-36(b)(2) and FAR 31.205-11(i)(1) require that the allowable lease costs be computed based on the adjusted net book value after recognition of the gain or loss, calculated in accordance with FAR 31.205-16(b). The annual lease cost limitation should reflect the constructive cost of ownership and, as such, include the amortization of the adjusted net book value and also other costs of ownership, which may include cost of money, taxes, insurance, etc. The application of the rules ensure that the Government reimburses only its equitable share of an asset's original acquisition cost.

d. Prior to July 8, 2005, the application of the rules at FAR 31.205-11 and FAR 31.205-36 meant that assets involved in sale and leaseback transactions were not dispositioned (i.e., not subjected to gain/loss recognition) for Government contract costing purposes until the point at which the contractor ceased use of the subject asset. Under prior rules, the gain or loss recognition would generally occur at the end of the lease term. Accordingly, leased assets that resulted from sale and leaseback transactions that took place prior to July 8, 2005 have not been subjected to the recognition of gains or losses, nor do the lease cost limitations reflect such gains or losses. Therefore, to provide equitable treatment of those pre-existing leases under Government contracts subject to the revised rules, auditors should advise the Administrative Contracting Officer that an advance agreement may be beneficial.

7-300 Section 3 --- Allocation of Special Facilities Operating Costs

7-301 Introduction

a. This paragraph provides guidance on the treatment of the operating costs of certain facilities, which, if not properly accounted for, could fail significantly to measure the benefits accruing to the several cost objectives.

b. The guidance includes (1) definition of applicable facilities, (2) criteria for determining whether the contractor is using an acceptable basis for charging or distributing costs to work benefited, and (3) criteria for determining billing or costing rates. Allocation of computer operating costs is covered in 7-100.

c. In the course of implementing the following guidelines, including the development of any recommendation to change an established and previously acceptable accounting procedure with respect to a particular facility, the principles below are not to be applied so rigidly as to complicate unduly the allocation where substantially the same results are achieved through less precise methods.

7-302 Criteria for "Special Facilities"

Facilities to which this guidance is applicable cannot be specifically designated by name or type but rather must be determined by whether or not they meet certain basic criteria. The first criterion to be met is that the costs involved in the operation of each facility must be significant in amount with respect to the contractor's overall operations. The second criterion is that the facility benefits only a limited portion of the contractor's total workload. Wind tunnels and space chambers are representative of facilities which, if they meet the criteria above, would be subject to the guidance provided in this section.

7-303 Methods for Allocating Costs to Benefiting Work

There are three basic methods for allocating costs related to facilities which meet the criteria in 7-302, although variations may be encountered. If a variation appears to reasonably measure the benefits accruing to the several cost objectives, its use should be satisfactory. The three basic methods are described below.

7-303.1 Method 1 --- Full Costing on Usage Basis

Under the first method, all readily identifiable direct costs are charged to projects, contracts, or other work involved. Additionally, all general operating costs of the facility, such as rentals, depreciation (including obsolescence), amortization, repairs, maintenance, supplies, and general support salaries and wages, are allocated to the using projects, contracts, or other work involved, on a usage or other quantitative basis. Generally, this method yields the most equitable results and should be used if cost and usage data for the facility can be economically accumulated with reasonable accuracy. If it is determined that use of methods 2 or 3 below would yield inequitable cost allocations, cost data which will permit the determination of costs by method 1 should be maintained by the contractor.

7-303.2 Method 2 --- Only Directly Identifiable Costs Allocated on Usage Basis

Under the second method, readily identifiable direct costs are charged to the projects, contracts, or other work involved, as in method 1 above. However, all general operating costs of the facility, such as rentals, depreciation (including obsolescence), amortization, repairs, maintenance, supplies, and general support salaries and wages are included in the distribution through one of the contractor's appropriate categories of indirect expense. Although this method is less precise than method 1, its use is satisfactory if it reasonably measures the benefits accruing to the several cost objectives.

7-303.3 Method 3 --- General Indirect Cost Allocation

Under the third method, all costs associated with the facility, including direct labor and material, are grouped and distributed through one of the contractor's appropriate categories of indirect expense. This method should be used only when the contractor demonstrates that (1) neither method 1 nor 2 above is practical and (2) its use is unlikely to result in any significant failure to measure the benefits accruing to the several cost objectives.

7-304 Treatment of Microelectronic Center (MEC) Costs

a. On January 8, 1990, the Acting Under Secretary of Defense for Acquisition (USD(A)) issued guidance concerning the treatment of MEC costs. This USD(A) guidance provides that "The costs of developing and deploying new or improved systems, processes, methods, equipment, tools and techniques to produce the next-generation microelectronics needed for future weapons systems are allowable in accordance with Federal Acquisition Regulation (FAR) 31.205-25, and should be allocated over an appropriate business base in accordance with FAR 31.201-4(c), until such time as the MEC is being substantially utilized for actual production efforts."

b. The Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS) generally classifies MECs as special facilities, and therefore CAS 418 is not applicable to MECs. The MEC facility at a specific contractor may not qualify as a "special facility." For example, if the activities performed by the MEC facility are functionally identical to current engineering and manufacturing activities, the facility may not be "special" in nature. CAS 418 noncompliance reports must include an explanation as to why the particular MEC in question does not qualify as a "special facility."

c. Usually, the number of actual units produced by an MEC facility during the development phase will be small, but will increase gradually as the contractor approaches normal production levels. As a result, if the costs of facilities or equipment incurred at the smaller production level are allocated in total to the units produced, an inordinate amount of costs would be allocated to these units during the development period. Development efforts, when completed, will provide a broader applicability than the utilization in current production represents. Thus, the portion of these costs that represent development efforts should be allocated over a broader business base until the MEC facility approaches anticipated normal and/or substantial production levels, i.e., until the facility achieves self-sufficiency. Any such allocation of development costs should be done on an objective basis.

d. One of the key factors to consider in reviewing MEC costs is the basis used for distinguishing the production efforts from the development efforts. Whatever basis is used, it should be objective in nature to assure that allocations are based upon benefits received and that a broad business base allocation is applied to the development costs only until such time as the facility becomes self-sufficient. For example, an objective basis could include an allocation of total MEC costs based upon the proportion of production effort to development effort. In other circumstances, it may be possible to identify the specific functions associated with production and those associated with development, with an allocation of costs made accordingly.

7-305 Determination of Costing Rates for Special Facilities

7-305.1 Basic Procedures for Costing Rates

a. General operating costs of those facilities which meet the criteria in 7-302 and for which method 1 above is considered appropriate should generally be charged to users by means of actual or predetermined billing or costing rates as provided below. This will require maintenance of a time log for each facility to record the hours of time spent by each user. The period covered by the billing or costing rates will not normally ex-

ceed 12 months. See 8-406 for CAS-covered contractors and FAR 31.203(g) for non-CAS-covered contractors.

b. When only one rate for the facility is to be applied, it should consist of the actual or estimated applicable costs divided by the actual or estimated number of hours or other units composing the basis.

7-305.2 Treatment of Real and Estimated Cost Differentials

a. When real cost differentials (such as certain services furnished during prime shifts only or by different facilities) exist and can be readily demonstrated, separate rates for such cost differentials may be used.

b. In the case of educational institutions, when rental or lease costs are based upon prime-shift usage, second and third shift usage may, with appropriate approval, be charged at reduced rates.

c. Under certain situations, reasonably estimated differential costs may be used in instances where cost differentials logically exist but cannot be determined precisely by contractor. For example, such differentials would permit priority, interrupt, or short-turnaround time runs at premium rates and/or nonpriority, non-prime-time, or large-volume runs at reduced rates.

d. Whether a single rate or several rates are used, the rates should be so designed as to recover, or closely approximate total recovery of, costs from all users of the facility. Where differing rates are used, they should be applied to all users on a nondiscriminatory basis. The costing of accommodations sales at reduced rates is not considered appropriate.

7-305.3 Treatment of Under- or Overabsorbed Rates

Any immaterial under- or overabsorption of costs resulting from application of predetermined rates may be charged or credited to an appropriate category of indirect expense. If the under- or overabsorption is material, it should be treated in accordance with the CAS-covered contractor's disclosed practices (see 8-418).

7-306 Treatment of Manufacturer Discounts to Educational Institutions

When the manufacturer leases or sells the equipment below commercial prices to an educational institution as an allowance to education, the allowance should be treated as a reduction of the cost of leasing or purchasing.

7-307 Treatment of Grants for Special Facilities

When the contractor (usually a university) has received a grant from the Government to be used in connection with a particular facility, application of the funds provided should be in accordance with the terms of the grant.

7-400 Section 4 --- Depreciation Costs

7-401 Introduction

This section contains guidance on depreciation costs under research and supply contracts with commercial organizations. The guidance in this section covers only the FAR provisions regarding depreciation costs.

7-402 Contract Provisions on Depreciation

7-402.1 General Applicability of FAR and CAS

a. The provisions of FAR 31.205-11 govern the allowability of depreciation costs. Contractors with contracts subject to cost accounting standards (CAS) must comply with the provisions of CAS 409, Depreciation of Tangible Capital Assets, and CAS 404, Capitalization of Tangible Assets. CAS 404 concepts relative to capital leases and CAS 409 are incorporated into FAR Part 31.

(1) CAS-covered contractors may elect to comply with CAS 409 on their contract(s) not subject to CAS 409. Contractors electing to comply with CAS 409 on their non-CAS covered contracts must comply with all provisions of the standard.

(2) In some cases the provisions of FAR 31.205-11 may conflict with the provisions of CAS 409. When CAS 409 is applicable, its provisions supersede any conflicting provisions of FAR 31.205-11.

b. Guidance on the cost accounting standards is in Chapter 8 and will not be repeated here. Auditors should refer to Chapter 8 for guidance on auditing depreciation costs on CAS covered contracts.

c. Guidance in the application of the FAR provisions is presented below.

7-402.2 General Allowability Criteria of FAR

Normal depreciation is generally considered allowable contract costs if reasonable and allocable.

a. Depreciation Same For Both Financial and Income Tax Purposes

(1) For non-CAS covered contracts, costs are reasonable if the contractor follows policies and procedures that are (a) consistent with those followed in the same cost center for business other than Government, and (b) reflected in the contractor's books of accounts and financial statements.

(2) However, due to unusual circumstances affecting defense contracts, the contractor's policies and procedures may result in inequitable charges to the Government. If any inequities are found, Headquarters should be advised.

b. Depreciation For Financial Purposes Differs From Income Tax Purposes

(1) If a contractor subject to FAR 31.205-11 rather than CAS 409 does not use the same policies and procedures for financial/book purposes and Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum-of-the-years’-digits, etc.) acceptable for financial purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-government business (FAR 31.205-11(c).

(2) However, if the amounts used for book and statement purposes are not reasonable or equitable for contract cost purposes, costs should be questioned.

7-402.3 Relationship Between FAR and IRS Regulations on Depreciation

a. Tax Methods versus Financial Statement Methods of Depreciation

(1) In 1986 changes were made in the Internal Revenue Code and implementing regulations to permit the use of accelerated methods of depreciation in determining taxable income. Since that time many companies have adopted these methods for income tax purposes in order to defer payment of taxes and to improve cash flow, while for book and financial statement purposes they continue to use the traditional straight-line method of depreciation. Thus, the amount of depreciation charged to operations under the contractor's established depreciation policies and procedures may often differ from the amount claimed for Federal income tax purposes.

(2) The FAR cost principles applicable to non-CAS covered contracts provide that the auditor will be guided by the provisions of FAR 31.205-11(c), which limit depreciation to the amount used for financial accounting purposes. On the other hand, where the book and tax methods differ, the amount allowable for the fiscal period for contract cost purposes is determined on the basis outlined in FAR 31.205-11(c) and may not exceed the book/statement amount.

b. Contract Audit Responsibility Related to IRS Reviews of Depreciation

(1) The Internal Revenue Service regulations which implement Section 167 of the Internal Revenue Code of 1954, as amended, prescribe detailed criteria for determining depreciation costs. These criteria are intended to be understood and applied not only by IRS personnel but also by businessmen as well as professional accountants and auditors so as to obtain substantially the same results.

(2) DCAA auditors should therefore acquire and maintain a working knowledge of the IRS code and regulations on depreciation. It should also be noted in this regard that the taxpayer (contractor) can enter into a written agreement with the IRS in advance of filing its tax return to determine the tax liability on any unusual situation which it does not consider sufficiently covered in the IRS regulations. The auditor should be aware of any such agreement.

7-403 General Audit Techniques for Depreciation Costs

7-403.1 Review of Contractor Depreciation Records

A proper determination of periodic depreciation costs depends largely on the effectiveness and consistency of the contractor's depreciation policies and procedures and on the sufficiency of the related property/depreciation records. Because an interrelationship exists between the amount of depreciation cost chargeable to any fiscal period as compared with prior and/or future fiscal periods, completeness of such records for the entire retention period of the asset(s) is essential. In auditing these records, the following considerations warrant special attention.

7-403.2 Review of Contractor Depreciation Policies and Procedures

The auditor should review the contractor's depreciation policies and procedures and perform selective tests to determine whether the policies and procedures have been followed to calculate depreciation for the accounting period being audited.

7-403.3 Review of Asset Cost

The auditor should determine if the capitalized asset cost, including any cost of making the asset ready for use, is supported by the contractor's accounting records. This may include verifying the cost of the asset to supporting documents such as purchase order, vendor invoice, and cancelled checks. It may also include reviewing the cost of betterments, as well as determining if asset retirements have been properly accounted for.

7-403.4 Review of Contractor's Schedule M and IRS Audit Reports

The examination should also include a review of Schedule M of the contractor's Federal income tax return and the results of any review of the tax returns made by the Internal Revenue Service. In the event the IRS has made any changes, the auditor should evaluate the amounts and circumstances and make whatever adjustments are appropriate to determine allowable depreciation costs of the current or prior years. The review of Schedule M will indicate whether the contractor's method of computing depreciation for tax purposes differs from that used for book and statement purposes. This is important since the criteria in FAR 31.205-11(c), which applies to contracts that are not covered by CFR 9904.409, states that if the amounts differ, allowable depreciation shall not exceed the amounts used for accounting books and financial statement purposes.

7-403.5 Review of Contractor Financial Statements

The contractor's financial statements should reflect the amount of depreciation charged to operations on the contractor's books. Financial statements are considered to be those statements which are annually certified and distributed to stockholders and others. Since such statements generally cover company-wide operations, the FAO responsible for the audit of the home office should serve as the focal point for assistance to other field audit cognizance.

7-404 Special Considerations—Depreciation Cost Charged to Government Contracts

The fact that the contractor's overall book and statement depreciation is also used for Federal income tax purposes, and is acceptable for such purposes, does not necessarily mean that the depreciation charged to defense contracts is acceptable.

7-404.1 Allocation of Depreciation

Depreciation should usually be allocated to the contract or other work as an indirect cost.

a. Identification to Organizational Units

Depreciation should preferably be determined and recorded for each department, cost center, or similar organizational segment, so that the cost is identified as closely as possible with the benefiting work or activity. Where plant or company-wide rates are being used, the auditor should make sufficient tests to determine that the end results are substantially the same as would be achieved by relating depreciation to Government contracts by more refined methods.

b. Inequities of Company or Plant-wide Basis

Allocation of depreciation on a plant-wide basis may not be equitable, for example, where the Government work is being performed in only part of the facilities, or where the contractor is replacing assets in the plant areas performing primarily commercial work more rapidly than in the segments engaged in defense work.

c. Reporting Requirements

Where the auditor determines that the contractor's use of plant or company-wide rates does not currently result in an inequitable cost allocation, the auditor may consider it necessary to formally notify the contractor that if the cost pattern or nature of the work changes so as to result in inequitable charges against Government contracts, the method will no longer be acceptable.

7-404.2 Depreciation Methods for Commercial Versus Government Work

In any given cost center, various classes of assets may be depreciated under more than one method. If so, the auditor should ascertain that the depreciation methods do not vary between assets used for commercial products and those used for Government work so as to result in discrimination against Government contracts.

7-404.3 Depreciation on Assets Acquired from the Government and Depreciation of Fully Depreciated Assets

a. Determine whether the contractor has claimed depreciation on those types of property described in FAR paragraphs 31.205-11(d) and (f). These paragraphs relate principally to assets acquired from the Government at no cost to the contractor and fully depreciated assets.

b. Usage charges for fully depreciated assets are permitted under certain circumstances. FAR 31.205-11(f) states that "... a reasonable charge for using fully depreciated property may be agreed upon and allowed." A usage charge may be appropriate when the actual useful life of an asset exceeds its estimated useful life and there has been a significant change in Government participation after the asset was fully depreciated. In such cases, the allocation of the cost of the asset usage between Government and commercial contracts may be adjusted by applying a usage charge.

c. In reviewing contractor claims for usage charges, it is imperative that the auditor determine if the actual useful life of the asset exceeds the estimated useful life due to a betterment, an error in estimate, or a patchwork repair.

(1) Betterment. CAS 404-40(d) states that "Costs incurred subsequent to the acquisition of a tangible capital asset which result in extending the life or increasing the productivity of that asset (e.g. betterments and improvements) and which meet the contractor's established criteria for capitalization shall be capitalized..." Accordingly, in those cases where the useful life of the asset extends beyond its estimated life as a result of a betterment, CAS requires that the contractor adjust the estimated life of the asset. If the contractor has failed to make such an adjustment, then the asset is not fully depreciated and the usage charge should be disallowed.

(2) Error in Estimate. On a few occasions, the contractor may have an asset that lasts longer than its estimated useful life as a result of an error in the contractor's original estimate. In these cases, the contractor may be entitled to a usage charge (see 7-404.3(d)). However, when the actual useful lives of the contractor's assets exceed the estimated useful lives on a recurring basis, the auditor should review the contractor's estimating procedures to assure that they comply with the requirements of CAS 409. If the assets are fully depreciated as a result of a noncompliance with CAS 409, the usage charge should be disallowed.

(3) Patchwork Repair. On rare occasions, a contractor may decide to continue to utilize an asset beyond its useful life through continual patchwork repairs. In these cases, the contractor may be entitled to a usage charge (see 7-404.3(d)). However, the auditor should review the contractor's rationale for continually repairing the asset rather than overhauling the asset (a betterment), trading in the asset, or scrapping the asset in favor of a new one. The auditor should consider factors such as the cost of patchwork repairs, the utilization of contractor personnel in performing these repairs, the cost of an overhaul, the trade-in value of the old asset, and the cost of a new asset.

d. Approval and Computation of Usage Charge.

(1) When the continued use of a fully depreciated asset is appropriate under the circumstances, FAR 31.205-11(f) provides that the allowability of a usage charge is subject to the approval of the contracting officer. While usage charges are permitted under the FAR, there is no requirement that the contracting officer allow the charges.

(2) When a usage charge is allowed, the amount of the charge should be determined on a case-by-case basis. In determining a reasonable usage charge, the auditor should make sure that the contractor has properly considered each of the factors listed in FAR 31.205-11(f), including the cost, estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation pre-

viously charged to Government contracts or subcontracts. To demonstrate how a reasonable usage charge may be calculated, an example is shown below:

Cost of asset		$100,000
Original Estimated Useful Life		3 years
Actual Useful Life		5 years
Total estimated decrease in efficiency for Years 4 and 5 ($2,000 per year)		$4000
Total estimated increase in maintenance (patchwork repairs) for Years 4 and 5 ($2,500 per year)		$5,000
Average Government Participation for Years 1 through 3		50%
Average Government Participation for Years 4 and 5		90%
Calculation of Recommended Usage Charge:		
Depreciation expense charged to the Government if the estimated useful life had been 5 years:		
Years 1 thru 3 ($20,000 per year X 3 years X 50%)		$30,000
Years 4 and 5 ($20,000 per year X 2 years X 90%)		$36,000
	(a)	$66,000
Less: Actual Depreciation Expense charged to Government contracts ($100,000 X 50%)	(b)	$50,000
Additional depreciation due to extended useful life	(c) = (a) - (b)	$16,000
Less: Efficiency Reduction ($4,000 X 90%)	(d)	$3,600
Increased Maintenance ($5,000 X 90%)	(e)	$4,500
Allowable Usage Charge	(c) - [(d) + (e)]	$7,900

7-404.4 Depreciation on Intracompany Transfers of Assets

On property acquired from a division, subsidiary, or affiliate of the contractor, the auditor's attention is directed to FAR 31.205-11(e) which provides that the depreciation on any such item which meets the criteria for allowance at a "price" under FAR 31.205-26(e) may be based on such price (rather than cost to the contractor), provided the same depreciation policies and procedures are used for costing purposes for all business of the using division, subsidiary, or organization under common control.

7-404.5 Depreciation on Idle Facilities or Idle Capacity

The auditor should ascertain whether any of the depreciation costs charged to Government contracts are generated by idle facilities or idle capacity as these terms are defined in FAR 31.205-17. If this is determined to be the case, the applicable depreciation cost should be treated as part of the total idle facility or idle capacity cost.

7-404.6 Depreciation Under Novation Agreements

For contracts being performed under novation agreements, depreciation allowed to the successor contractor should not exceed the amount which would have been allowed to the predecessor contractor to which the contract was originally awarded (see 7-1700).

7-405 Estimated Useful Life for Depreciation

7-405.1 The Economic Usefulness Criterion

Where depreciation reflected on the contractor's books/statements differs from that used and acceptable for income tax purposes, the estimated useful life of an asset should represent the prospective period of economic usefulness to the contractor as defined in the “depreciation” definition under FAR 2.101. When either useful life, residual value, or depreciation methods differ for book and tax purposes, then the provisions of FAR 31.205-11(c) should be applied in determining allowable depreciation costs (7-402.2(b)). Under this FAR provision allowable depreciation shall not exceed the amounts used for book and statement purposes. If the auditor concludes, with technical assistance, if necessary, that depreciable lives used by the contractor for book purposes do not represent "economic usefulness", depreciation costs should be questioned.

7-405.2 Useful Lives Under ADR Guidelines

a. Bulletin F-Before 1962

Before 1962, business firms depreciated property in terms of useful lives established for several thousand different classifications of assets by Treasury Department Bulletin F. Taxpayers may still use Bulletin F as a guide if they wish, but generally do not do so since subsequent regulations provide for shorter lives.

b. Revenue Procedure 62-21 - July 1962

In July 1962, Revenue Procedure 62-21 introduced a fundamental change in the concept of depreciation. As a substitute for the classifications of Bulletin F, assets were grouped by approximately 75 general asset and industrial classifications, with a "guideline life" prescribed for each of these classes. The guideline lives were approximately 30 percent to 40 percent shorter than Bulletin F lives. Revenue Procedure 62-21 also contained a "reserve ratio test," which was designed to assure that taxpayers would not continually depreciate their assets over a substantially shorter period than their actual use and replacement.

c. Introduction of ADR - June 1971

Next, the Revenue Act of 1971 authorized the "class life asset depreciation range (ADR) system." The major provisions of this system were initially approved by the Treasury Department in June 1971, and later amplified and incorporated into the 1971 Revenue Act. At the taxpayer's election, it may apply the class life ADR system for assigning asset lives to income-producing real or tangible personal property placed in service after 1970. The asset guideline classes, asset guideline periods, and asset depreciation ranges established under the class life ADR system are stated in Revenue Procedure 72-10.

d. Revised ADR Guidelines - March 21, 1977

For assets acquired after March 21, 1977 and prior to January 1, 1981, Revenue Procedure 83-35 contains the revised ADR guidelines. The specified upper and lower limits of the asset depreciation range are generally 20 percent below and 20 percent above the guideline period established for each class of personal property. The taxpayer may select as the asset depreciation period any period of years, that is a whole number of years, or a whole number of years plus a half year, within these upper and lower limits. Realty, however, does not have asset depreciation ranges. Accordingly for land improvements, buildings, and other real estate, the asset guideline period is also the asset depreciation period.

e. Taxpayer Election of ADR System

The system is optional with the taxpayer, who has an annual election. Each year's election applies only to assets acquired during that year. A taxpayer who elects to use the class life system for a particular year must indicate such election and the class lives used in its tax return for that year. Such election is binding on both the taxpayer and the IRS and may not be modified or revoked by either party. The taxpayer must apply the system to all eligible property acquired during the year, which falls within a class for which a class life has been established, and may not arbitrarily exclude particular items. All information relative to ADR election can be found on Form 4832 which the company is required to submit with an ADR election.

f. Asset Exclusions from ADR System

The regulations provide for exclusion of certain types of property from the ADR system. The principal exclusions permissible are for assets that are:

(1) subject to special rapid amortization or depreciation provisions,

(2) received from related parties in a transfer that does not trigger an investment credit recapture,

(3) without an ADR class, or

(4) excludable property under the 10 percent used property rule (see 7-407.6).

7-405.3 Elimination of Reserve Ratio Test --- 1970

The reserve ratio test requirements are eliminated for assets placed in service after 1970, regardless of the system used for estimating useful lives. Thus, taxpayers may now compute depreciation under either the new class life ADR system or under the general rules using estimated lives, without the need for meeting the reserve ratio test.

7-405.4 The Economic Recovery Tax Act of 1981 --- ACRS

The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS) for property placed in service after 1980 in tax years ending after 1980. All property other than ACRS property remains under the previous system of depreciation. Under ACRS, the costs of most tangible, depreciable property are recovered over predetermined periods generally unrelated to and shorter than useful lives. The recovery deduction for each year is determined by applying a percentage specified in the law to the unadjusted basis of the property. Following are some points meant to clarify the relationship between ACRS and depreciation computed under FAR 31.205-11.

a. Use of ACRS for Financial Accounting Purposes

FAR 31.205-11(c) provides that the use of a method of depreciation for financial accounting purposes is a test of an acceptable depreciation method for contract costing. In many cases, the ACRS recovery period will not be within a reasonable range of the asset's useful life and contractors will be unable to use ACRS for either financial accounting or contract costing purposes.

b. Acceptability of ACRS for Contract Costing

(1) For contracts not subject to CAS 409 but to FAR 31.205-11, under FAR 31.205-11(c), ACRS is acceptable for contract costing if:

(a) ACRS is also used for non-Government work in the same cost center, and

(b) ACRS is used for financial accounting.

7-406 Depreciation Methods Under the General Rules

The methods for computing depreciation described in this subparagraph apply only when the class life ADR system has not been elected. When the ADR system is used, the rules are subject to certain modifications as covered in 7-407.

7-406.1 General Principles for Depreciation Methods

a. Acceptable Methods Under FAR

In general, any rational and systematic method that is consistently applied may be used in computing depreciation. Regardless of the method used, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage, during the remaining life of the property.

b. Acceptable Methods Under Internal Revenue Code

Under Section 167 of the 1986 Internal Revenue Code, the depreciation allowance on new tangible property having a useful life of three years or more is presumed to be reasonable if it is computed by use of the straight-line method, the declining-balance method, the sum of the years digits method, or other consistently applied method, subject to the limitations below.

7-406.2 Straight-Line Method

Under this method the cost or other basis of the property less its salvage value is generally deducted in equal annual amounts over the period of its estimated useful life. The straight-line method can be used for any depreciable property, new or used. Only the straight-line method can be used if the depreciation period is less than three years.

7-406.3 Declining-Balance Method

a. With the enactment of the 1954 Internal Revenue Code, taxpayers were permitted to use accelerated methods of depreciation, including the declining-balance method, at a maximum of double the appropriate straight-line rate. Subsequent amendments to the Internal Revenue Code reduced the maximum permissible rate on real estate to the straight-line rate. To be able to apply the 200 percent declining-balance method (or the sum of the years digits method), the asset being depreciated must now be new, tangible personal property with a useful life of three years or more. The following table summarizes the maximum depreciation rates permitted a taxpayer for personal and real property available at the various dates.

Type of Property	Maximum Depreciation Allowance
All property acquired before 1/1/54	150%
Tangible personal property:	
New	200%
Used	150%
Real Property:	
New - 1/1/54 to 7/24/69	200%
7/25/69 to 12/31/86	150%
1/1/87 to date	straight-line
Used - 1/1/54 to 7/24/69	150%
7/25/69 to date	straight-line

*During a brief “suspension period” from 10/10/66 to 3/9/67 the maximum permissible rate was reduced to 150 percent.

b. Special Considerations --- Salvage Value Under Declining-Balance Method

While salvage value is not deducted from the cost or other basis of the property in determining the annual depreciation allowance, an asset may not be reduced below its reasonable salvage value. (See 7-408.2c. for the 10 percent rule regarding personal property.) Where the salvage value is large, use of the double declining-balance method may require special consideration on the part of the auditor (see 7-408).

7-406.4 Sum of the Years Digits Method

The sum of the years digits method may be used only on property that meets the requirements for "twice the straight-line rate" under the declining-balance method described in 7-406.3a. above.

7-406.5 Other Methods

Any consistent method of computing depreciation may be used provided that during the first two-thirds of the useful life of the property, the depreciation deductions under any such method do not result in accumulated allowances at the end of any tax year that are greater than the total that could have been deducted under the declining-balance method. Under appropriate circumstances, "other consistent methods" include the sinking-fund method, the unit-of-production method, and the machine-hour method. The limitations on the use of the declining-balance and sum of the years digits methods apply to any consistent method used other than the straight-line method.

7-407 Depreciation Under the Class Life ADR System

7-407.1 Special Considerations for Contract Costing Under the Class Life ADR System

a. Asset lives and methods of depreciation established by the contractor in consonance with the class life ADR system are considered to be compatible with FAR 31.205-11(c). This cost principle provides that depreciation costs for contracts not subject to 48 CFR 9904.409 shall not exceed the amounts used for financial reporting purposes.

b. However, due to unusual circumstances affecting defense contracts, use of the class life ADR system may result in inequitable charges to the Government. If any inequities are found, Headquarters should be advised.

7-407.2 Limits on Depreciation Method and Rates

The taxpayer may use only the straight-line, declining-balance, or sum of the years digits methods. To eliminate potential areas of dispute between taxpayers and the Internal Revenue Service, no other method is permitted under the class life ADR system. The various rates allowable under accelerated depreciation for new and used property are the same as set forth in the table in 7-406.3a.

7-407.3 Establishing and Using Vintage Accounts

a. **Definition of Vintage Accounts**

All assets for any tax year, for which the taxpayer elects to use the class life ADR system, must be accounted for in either item or multiple-asset accounts by the year placed in service. These accounts are called "vintage accounts."

b. **Adjustment for Salvage Value**

The annual allowance for depreciation of a vintage account is determined without adjustment for the salvage value of the property in such account. Accordingly, the straight-line and sum of the years digits computations are based upon the unadjusted basis of the vintage account without reduction for salvage value. In general, the original basis of the account changes only if there is an extraordinary retirement.

c. **Change in Depreciation Method**

During the depreciation period for a vintage account the taxpayer may change from a declining-balance method of depreciation to the sum of the years digits method, and from the declining-balance method or the sum of the years digits method to the straight-line method without the approval of the Internal Revenue Service.

7-407.4 Asset Retirements Under the ADR System

a. Retirements in General

An asset is treated as retired when it is permanently withdrawn from use in the business. Class life ADR retirements are separated into two categories: extraordinary retirements and ordinary retirements.

b. Extraordinary Retirements

Extraordinary retirements occur when assets are destroyed by fire, storm, or other casualty, or when assets amounting to more than 20 percent of the unadjusted cost or other basis of the entire account are disposed of because business activities are terminated, curtailed, or disposed of. On an extraordinary retirement, gain or loss is recognized in the year of retirement.

c. Ordinary Retirements

With respect to ordinary retirements (all others), gain or loss is generally not recognized at the time of retirement. The sales proceeds, if any, are added to the depreciation reserve of the vintage account from which the asset is retired, and the depreciation deduction is continued as if all the assets survived for as long as the life assigned to the remaining assets in the group.

7-407.5 Conventions for First-Year Depreciation of Vintage Accounts

a. General

The allowance for first-year depreciation of a vintage account is determined by applying the "modified half-year convention" or the "half-year convention." The same convention must be adopted for all vintage accounts of a tax year, but not necessarily for those of another tax year.

b. Modified Half-Year Convention

The first-year depreciation allowance for a vintage account for which the taxpayer adopts the "modified half-year convention" is determined by treating:

(1) all vintage account property placed in service during the first half of the tax year as placed in service on the first day of the tax year, and

(2) all vintage account property placed in service during the second half of the tax year as placed in service on the first day of the succeeding tax year.

Similarly, all extraordinary retirements from the account during the first half of the tax year are considered to have occurred on the first day of the tax year and all extraordinary retirements from the account during the second half of the tax year are considered to have occurred on the first day of the succeeding tax year.

c. Half-Year Convention

The first year depreciation allowance for a vintage account for which the taxpayer adopts the "half-year convention" is determined by treating all property in the account as placed in service on the first day of the second half of the tax year. All extraordinary retirements from the account are considered to have occurred on the same day.

7-407.6 Special Considerations for Acquisition of Used Assets

The class life ADR system applies to used assets as well as new assets. However, the present ranges are geared to new property. In order to remove possible inequities, the taxpayer may exclude used property from the system if the used property placed in service during any year amounts to more than 10 percent of the total. The 10 percent test must be applied separately to Section 1245 and Section 1250 property. If the 10 percent test is met and the taxpayer elects to use this exclusion, all the used property must be excluded from the system.

7-407.7 Transitional Rules for Lives of Buildings (1971-1974)

For real property there is also a transitional rule. Revenue Procedure 72-10 does not now provide a range of lives for Section 1250 assets. Instead it furnishes a single life for each class of building. In the meantime, the taxpayer is permitted to exclude Section 1250 property from the system on an asset-by-asset basis, provided that the particular circumstances show that a life shorter than the initially prescribed life is justified. This exclusion applies to real property placed in service on or after January 1, 1971, until such time as ranges for buildings are issued or January 1, 1974, whichever is earlier. Since no ranges were issued for buildings, the exclusion expired at the end of calendar year 1973. However, PL 93-625, which addresses Section 1250 property, permits election of ADR. To determine class life of Section 1250 property, a taxpayer may use the depreciation guidelines in effect on December 31, 1970 or on the facts and circumstances of the specific asset.

7-408 Salvage Values

7-408.1 Use and Bases-Salvage Value

a. General

Salvage value is the amount the taxpayer expects to receive in cash or trade-in allowance upon disposing of the asset at the end of its useful life to the taxpayer. There is no fixed basis for determining salvage value. If an asset is customarily used for its full inherent life, salvage value may be no more than junk value.

b. Special Considerations in the Use of Accelerated Methods

(1) If it is the policy to retire assets that are still in good operating condition, the remaining salvage value at that date may represent a significant portion of the original cost basis, and therefore special consideration will have to be given when accelerated methods are used.

(2) While a contractor may use any acceptable method provided salvage values and estimated useful lives are realistic, the depreciation should not result in charging all

allowable depreciation costs to the early years of use if an asset has a useful life to the contractor beyond that point. Where, for example, an asset costing $100,000 has a useful life to the contractor of four years and a remaining salvage value at the end of this period of $50,000, it is evident that use of the double declining-balance method (i.e., a rate of 50 percent), would result in writing off all the depreciation in the first year.

(3) Costing distortions of this type run counter to the basic concept of charging depreciation costs over the estimated useful life of the asset in a systematic and logical manner. They can generally be avoided by the use of a depreciation method which recognizes salvage value.

7-408.2 Under the General Rules-Salvage Values

a. Under Straight-Line and Sum of Years-Digits Methods

The contractor may use either gross salvage or net salvage in determining depreciation, and the treatment of the costs of removal must be consistent with the practice adopted. Under the straight-line and sum of the years digits methods, salvage value is subtracted from the cost or other basis before applying the annual depreciation rate.

b. Under Declining-Balance Method

Salvage value is not deducted in computing depreciation under the declining-balance method. However, see caveats specified in 7-408.1 above.

c. Ten Percent Rule on Salvage Value of Personal Property

For taxable years beginning after December 31, 1961, and ending after October 16, 1962, a taxpayer may reduce the salvage value by any amount up to 10 percent of the cost or other basis of personal property having a useful life of three years or more. This rule applies whether the property acquired is new or used. Thus, if the property has an estimated salvage value of 10 percent or less of the basis, salvage value need not be taken into account for the purpose of computing depreciation. In no event may an asset (or an account) be depreciated below a reasonable salvage value after taking into account the reduction permitted under the foregoing 10 percent rule.

7-408.3 Under Class Life ADR-Salvage Value

Salvage value is not used to reduce the basis for computing depreciation (7-407.3b). However, allowable depreciation for any vintage account may not exceed the cost or other basis of the account less the sum of (1) the reserve for depreciation, and (2) the salvage value. Thus, salvage value functions only as an overall limitation on the total depreciation allowable for property in a vintage account; however, see caveats specified in 7-408.1 above. All information relative to ADR election can be found on Form 4832 which the company is required to submit with an ADR election. Gross salvage value must be estimated for each vintage account at the time of electing to use the class life ADR and may be reduced under the percent rule. If the taxpayer consistently follows a practice of understating salvage values, IRS will increase the salvage value to what it finds is a reasonable amount.

7-409 First-Year Write-Off of Qualifying Business Property (Section 179 of IRC)

7-409.1 General Provision

Section 179 of the Internal Revenue Code provides that under certain conditions, taxpayers may elect to write off the cost of qualifying depreciable business property (subject to the limitations discussed below) in the tax year when the property is placed in service. The taxpayer may select the item(s) and the portions of their costs to be expensed; however, the election to expense an item of Section 179 property is irrevocable. If the taxpayer elects to expense only a portion of the cost, ordinary depreciation is then computed by any of the usual allowable methods on the remaining cost, less salvage value, where applicable.

7-409.2 Limitation on Cost of Property

The cost of property which may be expensed is subject to the following limitations:

a. Dollar Limitation. The aggregate cost which may be expensed in any taxable year is limited to the dollar amounts shown below.

For taxable years beginning:	The dollar limitation is:
1986 - 1992	$10,000
1993 - 1996	$17,500
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001 - 2002	$24,000
2003 - 2005	$100,000

b. In addition to the dollar limitation, there are certain other limitations which may further reduce the allowable amount. These additional limitations relate to business income and total value of assets placed in service during the year. The contractor's tax return may be used to verify the correct amount.

c. As indicated by these limitations, the principal objective of Section 179 is to act as a stimulant to small businesses.

7-409.3 Transactions Between Related Parties

a. The property must have been acquired from an unrelated person. If the taxpayer is a corporation acquiring the property from another corporation, the transferor must not be a member of the same affiliated group. Members of such an affiliated group are not entitled to the write-off in the first year on purchases from each other.

b. Also, the limitations on allowable expense are applied to the entire affiliated group.

7-409.4 Acceptability for Contract Costing Purposes

This first-year write-off of qualifying business property would most likely not meet the requirements of CAS 409 and FAR 31.205.11. For contracts not covered by CAS, the FAR limits the depreciation to the amount used for financial accounting purposes, i.e., depreciation over the expected service life of the asset.

7-410 Investment Tax Credit

The investment tax credit was eliminated on January 1, 1986. The Revenue Act of 1971 had reinstated the investment tax credit as a deduction from the Federal income tax otherwise due. The credit was a direct deduction from Federal income taxes. It is DoD procurement policy not to reduce the cost basis of the assets by the investment tax credit for the purpose of computing depreciation. Further, the credit should not be used to reduce otherwise allowable costs of Government contracts. In addition, since the only value of the investment tax credit is to reduce Federal income taxes, any purchase of the investment tax credit is unallowable per FAR 31.205-41(b)(1).

7-411 Consistency in Depreciation Method

7-411.1 General Rule on Consistency

Any method otherwise permissible may be applied to a particular depreciable property "account" (which may represent an individual item or a group of related items). However, once a method is adopted for any specific "account," it must be applied consistently thereafter. In general, under IRS regulations, any change in the method of computing the depreciation allowances with respect to a particular account is permitted only with the consent of the Commissioner.

7-411.2 Depreciation Method Changes Permitted Without IRS Approval

a. Change from Declining-Balance to Straight-Line Method

A taxpayer may change, without the consent of the Commissioner, from an acceptable declining-balance method of depreciation to the straight-line method. When the change is made, the unrecovered cost or other basis (less salvage value) shall be recovered through annual allowances over the estimated remaining life determined under the circumstances existing at that time. The change to the straight-line method must be adhered to unless, with the consent of the Commissioner, a change to another method is permitted.

b. Special One-time Election for Real Property

A special one-time election is allowed for real property. For the first taxable year beginning after July 24, 1969, the taxpayer may elect to change its method of depreciating Section 1250 property from any declining-balance or sum of the years digits method to the straight-line method.

c. Vintage Accounts Under the ADR System

Where the taxpayer has set up vintage accounts under the class life ADR system it may, without the consent of the Commissioner, make the changes in methods of depreciation cited in preceding 7-407.3c.

7-411.3 Consistency by Asset, Not for All Assets

Although the method used must be applied consistently to an account, it need not necessarily be used for acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. A taxpayer may establish as many accounts for depreciable property as desired. It is apparent from the foregoing that although the taxpayer must be consistent in depreciation methods, this consistency relates only to the application of a particular method to a particular asset account from year to year. It does not mean that the same method must be used for all assets.

7-411.4 Consistency in Accounting and Estimating

It should also be noted that the method used for each asset account in computing incurred costs should be consistent with that used by the contractor in estimating costs for pricing purposes.

7-412 Gain or Loss on Disposition of Assets

a. Except for ordinary retirements under the class life ADR system (see 7-407.4), gain or loss is invariably realized at the time a depreciable asset is disposed of. The gain or loss will represent the difference between the asset's book value and the amount realized upon its disposal. However, that will not necessarily be the amount to be considered for contract cost purposes. CAS 409 and FAR 31.205-16 provide several bases for determining the amount of gain or loss to be recognized, as well as certain elections open to the contractor regarding cost treatment of the gain or loss. Audits of depreciation should include appropriate audit steps to

assure that contract costs are determined in accordance with the requirements of CAS 409 and FAR 31.205-16.

b. Impairment losses recognized under FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" effective for fiscal years beginning after December 15, 2001 (formerly FASB Statement No. 121), are not recognized for Government contract costing. Statement of Financial Accounting Standards No. 144 requires that the carrying amount of long-lived assets, such as land, buildings, and equipment, be reduced to fair value when events or circumstances indicate that their carrying amount may not be fully recoverable. For contract costing purposes, however, contractors are required to follow the provisions of CAS 409, FAR 31.205-11, and FAR 31.205-16 regarding asset valuation and depreciation. Consequently, an impairment loss is recognized only upon disposal of the impaired asset. Until an impaired asset is disposed of, depreciation is calculated based on the asset value before any impairment loss which may have been recognized for financial reporting.

7-413 Depreciation of Leased Property

7-413.1 FAR and FASB 13

This paragraph deals with leased assets which have been capitalized using the provisions of Financial Accounting Standards Board Statement No. 13 (FASB 13), Lease Costs (see 7-200). The provisions of FASB 13 were incorporated in the DAR on September 1, 1978.

a. The auditor must be aware that different cost principles could apply to the same lease, depending on the date individual contracts were signed. Contracts signed before September 1, 1978 are subject to the provisions of the lease cost principles in effect the date the contract was signed. DCAAP 7641.6, Conversion Guide for DAR, provides the text of selected cost items in DAR 15-205 for any given date subsequent to July 1, 1976.

b. FASB 13 is not mandatory until fiscal years beginning on or after January 1, 1981. However, if the contractor elects to follow the provisions of FAS 13 for capitalized leases, regardless of the date of the lease, the provisions of DAR 15-205.9(j), effective September 1, 1978, apply.

7-413.2 FASB 13 Summary

a. Classification of Lease as Capital Lease versus Operating Lease

From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the lease property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

(4) The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the lease property over any related investment tax credit retained by the lessor. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

b. Amortization Period

If the asset is capitalized using either of the first two criteria, the asset is amortized over the estimated economic life of the asset. If the asset is capitalized under either of the last two criteria, it is amortized over the lease term. The lease term defined in FASB 13 includes the basic term plus option periods under certain conditions. The conditions which must be part of the lease for the option period(s) to be included in the lease term are:

(1) lease contains bargain renewal options,

(2) the lessee would have to pay a penalty so large as to assure renewal,

(3) the lessee guarantees lessor's debt for the option period(s),
(4) the lease contains a bargain purchase option, and
(5) the lessor has the option to renew the lessee's lease.

7-414 Depreciation or Amortization of Leasehold Improvements

Improvements by the lessee are ordinarily subject to an allowance for depreciation or amortization as discussed below. The auditor should review the basis for writing off the cost of leasehold improvements.

7-414.1 Amortization versus Depreciation

Whether the lease is with a commercial concern or with the Government, the cost of the improvement may be depreciated over the useful life of the improvement or amortized over the remaining term of the lease, whichever is shorter. The distinction between depreciation and amortization has some significance; the language of the regulations is generally interpreted to mean that when amortizing, the declining-balance or the sum of the years digits may not be used. When depreciating, there is no such limitation.

7-414.2 Term of the Lease

The term of the lease will include any period for which the lease may be renewed, extended, or continued pursuant to either:
(1) an option exercisable by the lessee or
(2) in the absence of an option, reasonable interpretation of past acts of the lessee and lessor such as with respect to renewal, unless the lessee clearly establishes, past acts notwithstanding, that is improbable that the lease will be renewed, extended, or continued.
Internal Revenue Code section 1.167(a)-4 and related section 1.178-1 govern the effect to be given renewal options in determining whether the useful life of the improvement exceeds the remaining term of the lease. In general, these rules establish a test for determining whether a renewal is intended, based on a comparison of the life of the improvements with the life of the lease.

7-500 Section 5 --- Insurance Costs

7-501 Introduction

a. This section provides guidance for the review of contractors' insurance programs. Considerations concerning the allocability of insurance costs are covered in Cost Accounting Standard (CAS) 416 (see 8-416). Basic considerations concerning the allowability of insurance costs are covered in FAR 31.205-19. In accordance with DFARS Subpart 242.73 and the DFARS resource companion guide, Procedures, Guidance and Information (PGI) 242.7302(1), joint reviews of insurance costs are conducted by DCMA and DCAA at contractor locations that have $50 million or more of qualifying sales to the Government during the contractor's preceding year, and the ACO determines such a review is needed based on a risk assessment of the contractor's past experience and current vulnerability (see 5-1303). A special Contractor Insurance/Pension Review (CIPR) will be performed when the contractor meets any circumstance in PGI 242.7302(2) that may result in a material impact on Government contracts. Refer to 5-1300 for additional guidance on CIPRs. Due to the contingent nature of insurance charges (projected average loss) to Government contracts, special emphasis should be placed on this element of cost when evaluating forward pricing proposals and forecasted indirect expense rates.

b. Contractors' insurance costs are generated by:

(1) insurance required to be carried by the terms of Government contracts,
(2) insurance maintained in connection with the general conduct of business,
(3) insurance maintained because of statutory requirements, and
(4) insurance maintained as part of employee benefits.

c. When developing an audit program, consideration should be given to the:

(1) materiality of the premium amounts involved for each type of insurance,
(2) types and amounts of coverage included under self-insurance programs,
(3) effectiveness of contractor's management of the insurance function, and
(4) contractor's program for eliminating potential hazards which will cause loss.

d. Insurance costs are normally included in overhead expense pools for allocation to all benefiting cost objectives. Guidance for accumulating costs into overhead pools and selecting proper bases to allocate costs to final objectives is found in CAS 418 (see 8-418).

7-502 Mandatory Insurance Coverage and ACO Approvals

a. The clause in FAR 52.228-7 "Insurance Liability to Third Persons," is required to be included in all Government contracts. Under the provisions of this clause, the contractor must maintain insurance coverage for third party contingencies such as:

(1) workers' compensation,
(2) employer's liability,
(3) comprehensive general liability (bodily injury),
(4) comprehensive automobile liability (bodily injury and property damage), and
(5) other types of third party liability insurance as required by the Government.

In addition, insurance coverage is mandatory under the provisions of FAR 28.301 when commingling of property, type of operation, circumstances of ownership, or conditions of the contract make it necessary for the protection of the Government.

b. FAR 42.302(a)(2) requires the ACO to review contractors' insurance plans. The ACO must specifically approve, normally in advance, the form, extent, amount and period of insurance coverage in accordance with FAR 28.3. This approval, however, does not relieve the auditor of the responsibility of reviewing premium costs for allowability, reasonableness, and allocability to Government contracts.

7-503 Optional Insurance and the Government's Contractor Insurance and Pension Reviews Program

a. In addition to the foregoing mandatory insurance coverage, contractors usually obtain other types of insurance such as health and welfare benefits for employees and various types of casualty insurance. FAR 52.228-7 does not require the contractor to submit these types of coverage to the contracting officer for specific approval unless requested. b. The Government's general survey and review of a contractor's insurance program, which may be performed under FAR 42.3, may be limited to verifying that the contractor's insurance program provides appropriate protection in consonance with the types of risks involved. Such a review, by itself, does not constitute a sufficient basis for accepting related premium costs. Therefore, where insurance costs and the Government's participation therein are material, the auditor should review the contractor's insurance programs to the extent required to establish whether the costs are necessary, reasonable, and allocable to Government contracts.

7-504 Allowability and Allocability

a. Where such benefits are not an incidental part of a pension plan, insurance programs may be established to provide current or retired employees with fringe benefits such as health, medical services, and death benefits. The criteria for the allowability and allocability of such costs is governed primarily by FAR 31.205-6, Compensation, and CAS 415, Deferred Compensation, rather than by FAR 31.205-19 Insurance and Indemnification. Payments under these programs can constitute either current or deferred compensation. Deferred compensation is allowable only to the extent it, together with all other compensation paid to the employee, is reasonable in amount, paid pursuant to a good faith agreement between the employee and the contractor, and consistently applied in future periods. Costs which are unallowable under other paragraphs of FAR 31.2, shall not be allowable under FAR 31.205-6 or CAS 415 solely on the basis that they constitute personal compensation.

b. CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and the allocation to final cost objectives. Briefly stated, the standard requires that allocation of insurance costs to cost objectives shall be based on the beneficial or causal relationship between insurance costs and the cost objectives. It also specifies that the amount of insurance cost to be assigned to a cost accounting period is the projected average loss for that period plus insurance administration expenses incurred in the same period.

7-505 Purchased Insurance Cost

a. Purchased insurance can usually be obtained from commercial carriers for all types of insurance. Generally, contractors purchase insurance at fixed premiums or advance premiums which are subject to retroactive adjustments on the basis of claim experience. The auditor's review should include an appropriate examination of individual insurance policies for indications of excessive or duplicated coverage or unrealistic premium rates. During periods of high competition within the insurance industry, premium costs diminish. Therefore, the auditor should ascertain whether the contractor solicits competitive quotations periodically to determine that downward price trends are reflected in the premiums paid.

b. The Government's participation in premium costs should be commensurate with the benefits received. Also, contracts should share in dividends and other credits received by the contractor, in proportion to the participation in gross premium costs. Insurance provided by captive insurers (owned by or under the control of the contractor) is considered self-insurance and must comply with the self-insurance provisions of CAS 416. Premiums paid to fronting insurance companies (companies not related to the contractor which rein-

sure with a captive insurer) should not exceed (excluding a reasonable service charge) the amount which the contractor would have been allowed had it contracted with a competitive insurer.

7-506 Self-Insurance Cost

7-506.1 Contractor Elections for Self-Insurance

a. Contractors may elect to provide coverage for certain risks from their own resources under a program of self-insurance. The contractor's decision to self-insure should be based on a determination that the coverage can be provided by self-insurance at a cost not greater than the cost of obtaining equivalent coverage from an insurance company or State fund. If purchased insurance is available, the charge for any self-insurance coverage plus insurance administrative expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administrative expenses (FAR 31.205-19).

b. Generally, the contractor will rely on self-insurance to cover ordinary risks and losses and, at the same time, maintain various forms of purchased insurance to cover major risks and catastrophic losses. For example, under a self-insured employee group health and survivorship plan the contractor usually will limit its self-insurance to providing hospital, surgical, and medical expenses and, at the same time, purchase insurance covering life, accidental death and dismemberment, disability income benefits, and dreaded disease coverage.

7-506.2 Approval for Self-Insurance

In accordance with FAR 28.308, self-insurance programs must be submitted to the contracting officer for approval when 50 percent or more of the self-insurance costs to be incurred at a segment will be allocated to negotiated Government contracts and the self-insurance costs at the segment are expected to be $200,000 or more annually. This same section of FAR provides that programs of self-insurance covering any kind of risk may be approved when examination of such programs indicates that their application is in the best interest of the Government. Self-insurance for risks of catastrophic losses, however, is not allowable in accordance with FAR 31.205-19(c)(4).

7-506.3 Self-Insurance Administration Costs

a. A contractor may administer its self-insurance program either by employing personnel possessing the necessary technical skills, contracting with one or more insurance firms to provide the necessary services, or both. Since self-insurance costs should not exceed the cost charged by a commercial carrier, it is important that all costs be readily identifiable in the accounts.

b. In addition to losses related to claims, the cost of operating a self-insurance program should include the salaries of employees in the company's insurance department, any outside services, and all of the incidental expenses incurred such as use and occupancy, telephone, and supplies. The contractor should make periodic comparisons between the actual cost it has incurred and the cost of premiums it would have paid to an insurance company if the coverage had been purchased.

7-506.4 Periodic Charges for Self-Insurance

a. Under a self-insurance program, the contractor shall make a charge for each period which represents the projected average loss for that period. The self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed the cost of comparable purchased insurance plus the associated insurance administration expenses. The contractor's actual loss experience shall be evaluated regularly and self-insurance charges for subsequent periods shall reflect such experience in a similar manner as would purchased insurance.

The actual loss shall be measured by actual cash value of the property destroyed, amounts paid or accrued to repair damage, amounts paid or accrued to estates and beneficiaries, and amounts paid or accrued to compensate claimants, including subrogation. Actual losses may be used to determine self-insurance costs (1) when probable losses will not differ significantly from the projected average loss for that period and (2) under self-insurance programs for retired persons.

b. CAS 416.50(a)(3)(ii) provides that if a loss has been incurred and the amount of the liability to a claimant is fixed or reasonably certain, but actual payment of the liability will not take place for more than one year after the loss is incurred, the amount of the loss to be recognized currently shall be the present value of the future payments. These future payments are to be computed using a discount rate equal to the interest rate determined by the Secretary of the Treasury pursuant to Public Law 92-41, 85 stat. 97 in effect at the time the loss is recognized.

7-506.5 Broker's Quotes Used to Estimate Self-Insurance Costs

a. The use of broker quotes is an estimating technique in which contractors obtain a quote from an insurance broker and use it to represent their projected average loss. They do not actually purchase the insurance but only use the quote to determine the costs that would have been incurred if the insurance coverage had been purchased. Use of these quotes to estimate self-insurance costs for a period is generally considered an acceptable estimating technique to determine the projected average loss for the period under CAS 416.50(a)(2)(i), which states "If insurance could be purchased against the self-insurance risk, the cost of such insurance may be used as an estimate of the projected average loss; if this method is used, the self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed, the cost of comparable purchased insurance plus the associated insurance administration expenses. However, the contractor's actual loss experience shall be evaluated regularly, and self-insurance charged for subsequent periods shall reflect such experience in the same manner as would purchased insurance." Many times quotes may contain statements that actual loss experience was considered but, in reality, there is no relationship between the quoted amount and the loss experience. It is imperative that an evaluation of self-insurance costs based on broker quotes be reviewed for reasonableness, i.e., that the actual loss experiences of the contractor has been included as one of the factors in the quote used to measure the self-insurance charge, and that the quote is based on all pertinent data regarding the contractor's potential liability for the insurance coverage. Contractors should be required to adequately demonstrate that amounts claimed for self-insurance costs based on broker quotes consider these factors.

b. In addition to requiring that the quoted amounts reflect actual experience and potential liability, contractors who use this method should be required, at a minimum, to obtain competitive quotes and to demonstrate that the use of broker quotes is also in accordance with FAR 31.205-19(e)(2)(i) in that they are based on sound business practices and the rates and premiums quoted are reasonable under the circumstances. The contractor's self-insurance program, including the use of broker quotes, should be approved by the ACO and should be in accordance with the contractor's policies and procedures and insurance manual. The contractor should maintain the difference between the estimated and actual cost in a reserve account. The account should be adjusted annually to reflect changing reserve requirements as determined by an actuary, and any adjustment should be reflected in the next year's estimated projected average loss.

7-506.6 Audit Considerations

When reviewing a contractor's self-insurance program, the auditor should evaluate:
(1) the types of risks covered and the nature of the contractor's risk assumption,
(2) comparative costs of the program, including administrative and corollary costs,
(3) effectiveness of the contractor's claims procedures,

(4) equity of the accounting treatment of self-insurance costs from the standpoint of the plan of funding and allocation of costs, and

(5) maintenance of the reserve in accordance with CAS 416.

In reviewing the administrative and corollary costs, the auditor must assure that all appropriate costs have been taken into account and that self-insurance is economical. It should also be ascertained whether the contractor has a staff that is qualified to process claims and whether the system has internal controls that are adequate to assure accurate payment of claims to employees or third parties

7-507 Workers' Compensation and Employer Liability Insurance Cost

7-507.1 General

a. Workers' compensation insurance protects an employer against the liability imposed by workers' compensation laws to pay benefits and furnish medical care to employees for injuries and occupational diseases attributable to their employment. Employer's liability insurance covers claims for damages relating to special types of work and injuries or occupational diseases not covered under the State laws. These types of liability coverage are not a form of personal compensation to the employee, and their allowability should be considered under FAR 31.205-19. FAR 28.307-2 requires contractors performing under Government contracts to carry employer's liability coverage in the minimum amount of $100,000, except in States with exclusive or monopolistic workers' compensation funds which do not permit the writing of such coverage by private carriers, or except in those States where the Workmen's Compensation Act constitutes the exclusive remedy of employees against employers for all injuries or diseases relating to their work. The cost of workers' compensation is affected by geographical location and the hazards of the particular work task. Therefore, the contractor's method of allocating the expense to burden centers should recognize this relationship in order to allocate the premium cost equitably.

b. Each State has its own workers' compensation laws. Accordingly, auditors should determine that contract charges for workers' compensation are in accordance with laws of the contractor's applicable state of business. Premium rate guidelines are published by the National Council on Compensation Insurance based on accident experience throughout the Nation's businesses and industries. Workers' compensation rates are based on employee occupational classifications and on covered payroll. When evaluating such rates, the auditor should determine that all applicable labor categories are used to estimate the insurance premium. The failure to include all labor categories can result in overstated premiums.

c. Usually, an estimated premium is charged when the workers' compensation policy is written. After the policy expires, a payroll audit is made. The actual premium is then determined and adjustments made. Auditors should be alert to specific policy clauses. Some policies call for interim adjustments, such as adjustments to the estimated premium for the actual amount of labor dollars incurred on a monthly basis.

7-507.2 Retrospectively Rated Plans

a. Many workers' compensation policies are retrospectively rated. The initial premium is adjusted (up or down) at a later date, depending on incurred losses. Although there are many variations of retrospectively rated plans, an insurance company will normally go through the following steps when billing a customer under a retrospectively rated policy:

(1) The policy is written using the State bureau rates. The retrospective endorsement and provisions are attached to the policy.

(2) The premium is billed based on payrolls reported to insurance company.

(3) After the policy expires, the insurance company audits the actual payroll data. The insurance company's audited payroll amount is used to develop the standard premium used in the retrospective adjustment.

(4) Actual claims are valued by the claim department six months after the policy expires. The time lag permits accurate valuation of open cases and allows time for settlement of outstanding claims.

(5) The loss and payroll figures are then used by the insurance company to calculate the first retrospective rating adjustment.

(6) Subsequent retrospective adjustments may be made at 1- year intervals to reflect the developments on open cases.

b. The retrospective rating billing procedures should give the auditor an indication of some of the documentation available to evaluate the allowability and allocability of insurance costs.

c. Where retrospectively rated plans are used, insurance companies may hold reserves. Reserves provide for anticipated payouts after the close of the policy year. The auditor should review the written purpose of the reserve to determine that the reserve is not an unallowable deposit. The auditor should evaluate the support for the reserve and the fluctuations within the reserve. Usually, pending lawsuits, known claims, and legal representations from attorneys are included as part of the supporting reserve package. The same documentation should be available for reserves under both a purchase plan and a self-insurance plan.

7-507.3 National Defense Projects Rating Plan

a. Ordinarily, a retrospective rating plan will result in the lowest net cost for workers' compensation insurance. However, the National Defense Projects Rating Plan described in DFARS 228.304 is intended to provide this insurance to an eligible contractor at even lower costs. The savings result partly from covering not only the employees of the prime contractor, but also those of all of its subcontractors performing work at the same location.

b. The rating plan may be applied to cost-reimbursement type contracts and, in appropriate cases, to fixed-price contracts with price redetermination provisions. A defense project is eligible for application of the plan when:

(1) eligible Government contracts represent, at inception of the plan, at least 90 percent of the payroll for total operations at the specific locations of the project; and

(2) the annual premium for insurance is estimated to be at least $10,000.

7-507.4 Defense Base Act and War Hazard Compensation Act Insurance

a. In accordance with 42 U.S.C. 1651, all U.S. Government contractors and subcontractors working outside the United States must secure workers' compensation insurance for their employees. Coverage is required for all U.S. citizens, as well as third-country and local nationals. The insurance is commonly referred to as "Defense Base Act" (DBA) insurance, named after the 1941 legislation which extends the mandatory coverage requirements of the Longshore and Harbor Workers Compensation Act at 33 U.S.C. 901 through 950 to contractor employees working outside the United States. The intent of these acts is to extend workers compensation coverage to employees who would not otherwise be covered under state workers compensation programs due to the location in which they are working.

b. Typically, contractors will purchase DBA insurance from commercial carriers at market premiums. Consistent with the evaluation of other types of purchased insurance, auditors should ensure that the contractor solicits adequate competitive quotes to ensure that coverage is obtained at reasonable rates. Contractors may also offer additional insurance benefits in excess of the mandatory DBA coverage requirements. These additional benefits provided to the employees must be evaluated for reasonableness in accordance with FAR 31.205-6, Compensation for personal services.

c. Where the Defense Base Act applies, the War Hazard Compensation Act, as amended (42 U.S.C. 1701 et seq.), also applies. The War Hazard Compensation Act affords protection to employees against the hazards of war (injury, death, capture, detention). In general, war hazard benefits are payable when the claim cannot be presented under DBA coverage because the event which caused the claim was attributable to a "War Risk Hazard" as defined in the Act. The Department of Labor (DoL) administers the War Hazard Compensation program and provides direct reimbursement for the costs of war related claims to the insurance carrier or self-insured as long as charges for mandatory War Hazard Compensation coverage are not included within the DBA insurance premium charged to the contractor. Since the DoL provides the mandatory coverage at no cost to the contractor, any amounts included as part of a claim or proposal are unallowable. However, contractors may provide additional or supplemental war hazard insurance in order to induce employees to accept work in hazardous areas. This supplemental insurance coverage must be evaluated for reasonableness in accordance with FAR 31.205-6, Compensation for personal services.

d. Upon recommendation of the officials concerned, the Secretary of Labor may waive the applicability of the Defense Base Act with respect to any contract, subcontract, or classification of employees. DoD officials, when submitting requests for waiver, as prescribed at DFARS 228.305(d), are required to follow the procedures included in the DFARS resource companion guide at PGI 228.305(d). Waivers of the Defense Base Act should be considered where foreign employees are subject to compensation laws or comparable provisions of their country.

7-508 Liability Insurance Cost

7-508.1 General Comprehensive Liability Insurance

FAR 28.307-2(b) requires general comprehensive insurance with minimum limits of $500,000 per accident. Third party property damage liability insurance ordinarily is not required under Government contracts. However, where a commingling of operations permits property damage coverage to be obtained at a nominal cost to the Government under insurance carried by the contractor in connection with the general conduct of its business, the participation in such insurance cost may be deemed in the best interest of the Government.

7-508.2 Automobile Liability Insurance

For automobile liability, FAR 28.307-2(c) requires coverage with minimum limits of $200,000 per person and $500,000 per accident for bodily injury and $20,000 per accident for property damage. This coverage is required in a comprehensive policy covering the operation of all vehicles used in performance of Government contracts.

7-508.3 Aircraft Liability Insurance

When aircraft are used in performance of Government contracts, FAR 28.307-2(d) requires public liability coverage with minimum limits of $200,000 per person and $500,000 per accident for bodily injury and a minimum limit of $200,000 per accident for property damage. Also, passenger liability bodily injury limits of $200,000 per passenger is required, with an aggregate minimum limit equal to total number of seats or total number of passengers, whichever is greater.

7-508.4 PL 97-12 Prohibition of Certain Insurance Costs

Public Law 97-12 prohibits payments for commercial insurance to protect against the contractor's own defects in materials or workmanship incident to the normal course of construction. The type of insurance covered by this public law should not be confused with professional liability insurance, such as that maintained by architects and engineers covering liabilities to third parties arising from errors, omissions or negligent acts. The public law is not intended to cover liability insurance for damages (third party suits) arising as a result of the use of the product. Rather it is intended to make unallowable costs to repair defects in materials or workmanship. Accordingly, the public law cannot be cited as a basis for questioning costs of third party liability insurance. However, this does not mean that professional liability insurance may not be questionable due to lack of allocability to Government contracts in accordance with 7-508.5, Professional Liability Insurance.

7-508.5 Professional Liability Insurance

a. Professional liability insurance (also referred to as architects and engineers or errors and omissions insurance) protects against damages to clients or third parties resulting from professional errors or judgments. The cost of professional liability insurance is allowable, subject to tests of reasonableness and/or allocability. In performing these tests, if the cost of insurance is material, the auditor should review the policy coverage and claims and loss experience.

b. Reviewing policy coverage is the first and most important step in determining allocability and reasonableness. If a contractor's liability insurance policy provides coverage for its general practice, allocation of premiums to all contracts through overhead or general and administrative expense is usually acceptable. However, if this policy is written to provide unique liability coverage for a particular business segment or product, costs should be directly allocated to the benefiting cost objective. Where a plain reading of the policy does not clearly establish the general nature of the coverage or the auditor has reason to believe that unique liability coverage is involved, an examination should be made of the types of services being rendered to both the Government and commercial customers. If the services (service primarily refers to discipline, such as architectural, mechanical, civil engineering work, etc.) are essentially similar, a broad-based allocation is acceptable. On the other hand, where the services are dissimilar, examination should be made of the claims and loss experience as explained below.

c. If the costs are material, and the contractor does not provide the same service to the Government as to the commercial customers, then the auditor should review claims and loss experience. (Claims are always defined in the policy.) This could give the auditor some added insight into the applicability of policy coverage as well as allocability of costs. Items reviewed should include a number of settled and pending claims, whether they apply to Government or commercial contracts, and the dollar amounts. The auditor must exercise judgment in selecting a time frame to review claims history relevant to the costs under audit.(1) The existence of claims on either Government or commercial contracts alone is not conclusive as to how premiums should be allocated. However, a significant number of claims arising because of one particular product, segment, customer, etc., may indicate the need for a more thorough review of the nature of the service or projects causing the claims disparity and consideration of a more appropriate allocation base.

(2) The review of claims and loss experience should only be used to challenge the broad-based allocation of costs where the auditor can determine that the insurance is primarily purchased to protect against liability unique to particular types of services, components, or projects.

d. In determining premiums for a contractor, the insurance carrier usually considers such factors as location of the business, size of the firm (billing/revenue), professional discipline(s) being practiced, and loss experience. The proper allocation of premium costs should be determined primarily by the terms of the coverage where services provided are essentially the

same for all final cost objectives. While claims and loss experience may vary considerably from year to year, and between classes of businesses (i.e., Government vs. commercial), such experience should not be used to challenge the broad based allocation of premium cost unless it can be determined that the services provided are essentially dissimilar and hence the risk of claims is proportionally greater for certain services than others.

7-508.6 Product Liability

a. In the normal course of doing business, a contractor will insure itself against bodily injury to others, and damage to, or loss of, property of others arising from the failure of its products. A common basis for this premium is sales. The cost applicable to military versus commercial products should be easily determinable unless an average composite liability rate is used for both.

b. Such a composite rate may be inequitable. It should be discussed with Government contract management personnel and the contractor for the purposes of obtaining separate rates for military and commercial products. For the most part, major defense contractors have negotiated separate rates, but the rates for military products still may be excessive in relation to the actual losses resulting from failure of military products.

c. Auditors should ascertain that the contractor has conscientiously attempted to negotiate with its insurance carrier a separate military products rate commensurate with the loss experience of such products. Whenever premium rates are not commensurate with loss experience, obtain the views of the Government contract management official relative to rating the coverage. Further, ensure there is no absorption by Government contracts of premiums solely applicable to a contractor's commercial products.

d. Audit evaluations of product liability insurance premium allocations should, as a minimum, include an analysis of the Government and commercial loss experience for a representative period. Government premium breakout allocations in excess of the average Government loss experience may be unreasonable. If an excess exists, additional audit considerations would include:

(1) comparisons of premiums and allocation bases with comparable companies;

(2) requesting detailed explanations from the insurance carriers on the basis of the premium split between commercial and Government and a breakdown of risk exposure; and

(3) if possible, obtaining independent quotes from other insurance carriers on Government exposure only.

Where aircraft product liability insurance is allocated on a sales base to Government contracts, auditors should specifically review for compliance with CAS 403.40(b)(4)and 403.60(b)if a home office, and CAS 410.50(g)(2) if an operating segment. Where a breakout between commercial and Government is not provided, exceptions to proposed costs should be considered as noncompliances with the standards as well as FAR 31.201-4(b). Advance agreements between the Government and contractors on acceptable Government premium costs should clearly state the basis of the agreement and how future costs will be allocated.

7-508.7 Insurance for Government-Owned Property

FAR 31.205-19(e)(2)(iv) provides that the costs of insurance for the risk of loss of or damage to Government property are allowable only to the extent that the contractor is liable for such loss or damage and such insurance does not cover loss or damage which results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers or other equivalent representatives. Accordingly, where the risk of loss is not the responsibility of the contractor, the cost of insurance coverage should be questioned.

7-509 Casualty Insurance Cost

7-509.1 Fire and Comprehensive Casualty Insurance

Fire insurance provides for reimbursement to the insured for losses resulting from the causes enumerated within each policy. Most of these policies will include hazards in addition to fire, such as hail, windstorm and earthquake. When such is the case, the policy is usually referred to as a multiple peril or comprehensive policy. These policies ordinarily cover buildings, capital equipment, inventories, and supplies belonging to the insured. With respect to buildings, rating bureaus established under the various State insurance departments are responsible for setting the rates for each type of building. Self-insurance is most appropriate where a contractor's plants are isolated and scattered over a wide area, thereby dispersing the risk.

7-509.2 Fidelity Bonds

Fidelity bonds provide protection against defalcation and theft by employees, especially those in positions of trust. The auditor should become familiar with the circumstances involved in any claim for loss, inasmuch as it indicates a failure of internal control.

7-509.3 Insurance on Lives of Officers and Owners

Costs of insurance on lives of officers, partners, or proprietors are allowable only to the extent that the insurance represents additional compensation [FAR 31.205-19(e)(2)(v)]. The auditor should review the insurance policy to determine who is the beneficiary on the policy. If the company or its owners are beneficiaries, the costs are unallowable; if the executives family or estate are beneficiaries, the costs are allowable if the total compensation paid to the executive is reasonable.

7-510 Split-Dollar Life Insurance Cost / Deferred Compensation Plans

7-510.1 General

a. Split-dollar life insurance plans provide for a sharing between the employer and the employee of the premium payments, ownership, cash values, and the death benefits (hence the name split-dollar life insurance). These insurance plans are used by some contractors to reward executives and key employees for their performance or to induce them to remain with the company. Typically, the employer pays the insurance premiums on the life insurance policy on the employee’s life and takes a collateral assignment (i.e., interest in the policy) equal to the premiums it pays. The employee owns the policy and designates the beneficiary. If the employment ends or the insurance policy is terminated, the employee is required to reimburse the employer for the aggregate premiums paid by the employer.

b. Some plans include a separate but interrelated deferred compensation agreement that provides the employee with deferred compensation in the same amount as the aggregate premiums the employee (or his/her beneficiaries) must reimburse the employer. The deferred compensation is generally payable to the employee at the same time that the employee or his/her beneficiaries are required to reimburse the employer.

c. There is variability in the terms and conditions of split-dollar life insurance plans. The guidance provided in this section is based on the most common plans. It is important that auditors carefully review the terms and conditions of the individual plans and make appropriate adjustments for the individual situation, or seek additional guidance from their regional office if necessary.

7-510.2 Premiums Paid by the Company

The proper accounting treatment of premium payments for split-dollar life insurance is addressed in Financial Accounting Standards Board Technical Bulletin No. (FAST) 85-4, Accounting for Purchases of Insurance. FAST 85-4 states in part, "The amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset." Under a typical split-dollar life insurance plan where the employee owns the policy and has an unavoidable obligation to reimburse the contractor for the amount of the insurance premiums, the employer would receive from the employee an amount equal to the aggregate premiums paid to the insurance company. Therefore, the employer should recognize the annual premium paid to the insurance company as an asset, not an expense. The annual premiums are essentially an interest free loan from the contractor to the employee, not an element of the total cost of a contract as defined in FAR 31.201-1, Composition of Total Cost, and should be questioned if claimed.

7-510.3 Cost Paid under the Interrelated Deferred Compensation Agreement

a. Deferred compensation costs incurred under the employer/employee agreement which provides the employee with deferred compensation equal to the aggregate premiums the employee must reimburse the employer under the terms of a split-dollar life insurance plan should be evaluated in accordance with FAR 31.205-6(k). Under that provision, deferred compensation is allowable if it is based on current or future services and assigned and measured in accordance with CAS 415, Accounting for the Costs of Deferred Compensation.

(1) Based on Current or Future Services. Although the terms of the interrelated deferred compensation agreements may not explicitly state so, these agreements provide essentially a series of annual awards (each equal to the annual premium) to be paid at some future date, for services provided in the period in which the annual life insurance premium is paid. That is, each year, the employee is awarded deferred compensation equal to the annual insurance premium paid by the employer for that period, to be paid upon retirement, death, or other circumstances as stipulated in the agreement. Therefore, the deferred compensation to be paid under the terms of a typical plan is based on current or future services and meets the allowability criteria at FAR 31.205-6(k)(1).

(2) Assigned in Accordance with CAS 415. CAS 415.40(a) requires that the costs of the deferred compensation be assigned to the cost accounting period in which the contractor incurs an obligation to compensate the employee. CAS 415.50(a) provides six conditions that must be met before a contractor is deemed to have incurred an obligation for the cost of deferred compensation. If the applicable conditions are met in the accounting period in which the contractor pays the annual life insurance premiums, the cost of each annual award is assignable to that period. If these conditions are not met, CAS 415.50(b) requires that the cost be assigned to the period in which the compensation is paid. The auditor should review the terms of the plan to determine if these conditions are met.

(3) Measured in Accordance with CAS 415. The assignable cost for each year is measured as the present value of the annual award (i.e., an amount equal to the annual premium) discounted from the estimated date of payment. Under most plans, the estimated date of payment will be the estimated date of retirement. CAS 415.50(d)(5) provides that the discount rate used to calculate the present value is the Treasury rate used to compute cost of money factors (see 8-414.2). To illustrate, assume that the annual deferred compensation award (which is equal to the annual premium payment) is $30,000; the employee is expected to retire in ten years; and the cost of money rate is 8 percent. The amount assignable to the current year is $13,896 ($30,000 discounted for ten years at 8 percent).

(4) Adjustments for Forfeitures Required by CAS 415. The auditor should also verify that the contractor has complied with CAS 415.50(d)(7), which requires that any forfeiture which reduces the employer's obligation for payment of deferred compensation be a reduction of contract costs in the period in which the forfeiture occurred. The amount of the contract cost reduction for a forfeiture is the amount of the award that was assigned to prior periods, plus interest compounded annually, using the same Treasury rate that was used as the discount rate at the time the cost was previously assigned.

b. Deferred compensation payments made in conjunction with a split-dollar life insurance plan are also subject to the reasonableness criteria of FAR 31.205-6(b), including paragraph (b)(2)(i) which requires that special consideration be given to the evaluation of the reasonableness of the compensation if the company is a closely held corporation, partnership, or sole proprietorship and the individual participating in the plan is the owner or a partner.

7-600 Section 6 --- Pension Costs

7-601 Introduction

This section provides guidance for the audit of pension costs. Basic considerations concerning the allocability of costs of retirement and pension plans are found in Cost Accounting Standards (CAS) 412 and 413 (see 8-412 and 8-413). Basic considerations concerning the allowability of costs of retirement and pension plans are in FAR 31.205-6. In accordance with DFARS PGI 242.7302(1), joint reviews of pension costs are conducted by DCMA and DCAA at contractor locations that have $50 million or more of qualifying sales to the Government during the contractor's preceding fiscal year and the ACO determines such a review is needed based on a risk assessment of the contractor's past experience and current vulnerability. A special Contractor Insurance/Pension Review (CIPR) will be performed when the contractor meets any circumstance in DFARS PGI 242.7302(2) that may result in a material impact on Government contracts. If a CIPR or special CIPR are not performed, the only formal review of pension cost will be a DCAA audit. Therefore, it is essential that the auditor perform a risk assessment to determine the need for a CIPR or special CIPR. Refer to 5-1303 for additional guidance on CIPRs. See 9-703.8 for guidance on evaluation of pension costs in contractor indirect cost estimates.

7-602 Definitions and Terms

Due to the complexity of this audit area and the unique terms used in the laws and regulations regarding pension plans, auditors should have a working knowledge of the terms and definitions found in CAS 412 and 413. The auditor should always exercise due care in selecting terms to describe specific issues when reporting the results of audit of pension plans.

7-603 Approval and Review Requirements

a. Most pension plans are submitted to the Internal Revenue Service (IRS) for approval. Generally, the IRS will issue a "favorable determination letter" if the plan meets required qualifications. A plan that satisfies the requirements of section 401(a) of the Internal Revenue Code (IRC) is considered to be a qualified plan. If a plan is qualified, the sponsor is entitled to claim contributions to the plan as tax deductions, while the plan participants are not required to claim earned benefits until they are received. If a contractor's plan is qualified, a copy of the "favorable determination letter" should be in the permanent files. Some of the more important plan qualification requirements are:

(1) the employer's contributions to the plan must be irrevocably funded,

(2) the plan must be intended to be a permanent plan and must be in writing and communicated to the employees, and

(3) the plan must not discriminate either in contributions or benefits in favor of officers, supervisors or highly compensated employees.

Approval of a pension plan by the IRS does not require audit acceptance of the cost of the plan.

b. The auditor should notify his or her regional office in writing when a contractor has a pension plan in effect that will require assistance of the regional office in evaluating the pension plan costs. In the event of a transfer of audit cognizance to another FAO, the relinquishing FAO should prepare a detailed summary of the current pension issues for the FAO that has assumed responsibility for the pension audits. The summary should include data on the change in accumulated assets and liabilities in employee benefit funds as a result of any mergers, acquisitions, and divestitures. In order to ensure adequate audit coverage of transferred pension fund assets and liabilities, it is important that FAOs cognizant of buyer and seller contractors maintain close coordination

and communication in oversight of contractors' accounting for pension cost charged to Government contracts. See 1-502 for additional comments on transfer of audit cognizance.

c. When assistance or guidance is needed by the regional office on a plan or any of its features, the matter should be referred to the Assistant Director, Policy and Plans.

7-604 Types of Pension Plans

a. There are various types of pension plans. Each type will have a formal written document describing details of the plan. Employers will also usually have explanation and announcement booklets, prepared for employees, that provide additional information about each plan.

b. Plans can be classified as insured or trusteed, defined benefit or defined contribution, contributory or noncontributory. Some plans will be a combination of these classifications.

c. A plan is called an insured type if its funding agency is an insurance company. Here, the plan sponsor makes contributions to an insurance company, and the insurance company issues various types of contracts to provide the designated plan benefits. Some insurance arrangements provide investment services only, without guarantees of benefits, investments or earnings.

d. A plan is called a trusteed type if its funding agency is a trust fund. Contributions go to the trustees who in turn invest and manage the assets and pay the stated benefits. The trustees can be third parties, such as banks, or individuals, including employees of the contractor.

e. A plan is called contributory if the participants are allowed (or required) to make contributions to it, usually in the form of payroll deductions. A non-contributory plan does not permit contributions by plan participants.

7-605 Considerations in Evaluating Acceptability of Claimed Pension Plan Costs

7-605.1 Reasonableness of Costs of Plan and Overall Compensation of Participating Employees

a. A comparison of the ratios of current and past service costs of a given contractor's plan to the total basic payroll of participants (or to the total basic payroll of all employees), with similarly calculated ratios of similar industries in the area, will furnish a yardstick for the measurement of the overall reasonableness of the costs of the plan. While these results may not be conclusive, they may be indicative of plans which warrant a more thorough analysis of the factors affecting costs.

b. Pension Fund Valuation and Rate of Return.

(1) There are two methods used to accumulate pension plan assets. One method is to purchase insurance contracts. A second method is to make contributions to a trust fund. CAS 413.40(b) requires the valuation of all pension fund assets using a valuation method which takes into account unrealized appreciation and depreciation of the assets. A realistic value must be placed on the fund for proper determination of funding requirements. The current value, or a method that takes into account current value, should be used. When plan asset values rise, funding contribution requirements will usually fall. The contractor should compute this impact on the pension expense. In many cases, contractors will make this assessment prior to the issuance of the actuarial report on the plan. In rising financial markets, the auditor needs to insure that the Government receives the full benefit of the reduced costs in the pricing and costing of all contracts (cost type and fixed-price type). Consequently, contractor price proposals, indirect cost rate forecasts, and forward pricing rate agreements need to be evaluated to determine if they contain the reduced forecasts due to lower pension expense.

(2) The interest rate assumption is an extremely important factor in computing current contribution requirements, and should be compared with the actual or approximate rate of

return on the securities in the fund. If it is not reasonably close, then appropriate evaluation of this factor should be performed by the auditor.

(3) It is not intended that auditors should attempt any significant recalculations of pension plan rates, as this can best be done by the actuaries. However, information on the market value of the fund and the rate of return should be available from the contractor.

7-605.2 Other Considerations in Evaluating Acceptability of Claimed Costs

a. Allocation and Assignment of Costs

(1) Allocable pension costs under Government contracts should bear a reasonable relationship to the pension costs generated by eligible employees engaged in work under such contracts. The allocation basis of pension plan costs should recognize differences of employment status, within practical limitations, between employees engaged in Government work and employees engaged in other than Government work. Further discussion of the allocation of costs is included in the paragraphs on past service costs and reversionary credits (see 7-605.2c).

(2) Pension costs should be assigned to cost accounting periods in accordance with sound accrual accounting practices. Pension costs are often computed for a plan year that does not coincide with the contractor's cost accounting period. A potential problem arises if the contractor assigns such costs to a single cost accounting period, rather than prorating the costs between the two contemporaneous periods. This practice would be in noncompliance with CAS 406.50(b), which requires accrual practices to be "appropriate," because it would not be in accordance with generally accepted accounting principles (see 8-406). This practice would also be in noncompliance with CAS 412.40(a)(1) and (c) (see 8-412), which requires pension costs to be computed for a cost accounting period. Contractors' accrual practices for pension cost should be reviewed, and material noncompliances should be reported to the contracting officer. See also 6-608.3b.(1).

b. Allowability of Nonqualified Pension Plan Costs

A nonqualified pension plan is any pension plan other than a qualified pension plan (see 7-603(a)). The pay-as-you-go cost method is used on nonqualified plans and is a method of recognizing pension costs only when benefits are paid to retired employees or their beneficiaries. However, as discussed below, nonqualified plans are not limited to the use of the pay-as-you-go cost method.

Following are key dates and associated rules governing the allowability of nonqualified pension plan costs for contracts negotiated in accordance with procurement regulations:

(1) For contracts entered into prior to March 22, 1983, nonqualified pension costs accrued in accordance with CAS 412 and allocated to Government contracts are allowable. This is in accordance with the decision in U.S. v. The Boeing Co., 802 F. 2nd 1390 (Fed. Cir. 1986).

(2) For contracts entered into after March 21, 1983, but before March 28, 1989, allowable nonqualified pension costs accrued in accordance with CAS 412 and allocated to Government contracts are limited to the amount paid in the year the costs are assigned. This limitation is in accordance with the FAR 31.205-6(j)(5) requirements during this time frame.

(3) For contracts entered into after March 27, 1989, allowable nonqualified pension costs are limited to the amount computed in accordance with CAS 412 and 413. Funding is not required for allowability. This is in accordance with changes to FAR 31.205-6, effective March 28, 1989.

(4) The CAS 412 and 413 revisions that were effective March 30, 1995 apply as follows: The revised provisions shall be followed by each contractor on or after the start of its next cost accounting period beginning after the receipt of a contract or subcontract that is awarded on or after March 30, 1995 and is subject to full CAS coverage. Contractors with prior CAS-covered contracts with full coverage are to continue to follow the prior versions of CAS 412 and 413 until the revised standards become applicable following

receipt of a contract or subcontract awarded on or after March 30, 1995 subject to full CAS coverage.

(5) For contracts subject to the revised CAS 412 and CAS 413, the costs of nonqualified defined benefit pension plans must be measured and assigned in accordance with the requirements specified in the revised standards. The costs of nonqualified pension plans must be accrued in the same manner as qualified plans under certain specific conditions (see CAS 412.50(c)(3)). If these conditions are not met, the nonqualified pension plan must use the pay-as-you-go cost method. For nonqualified pension plans that do not use the pay-as-you-go cost method, funding at the tax rate complement (i.e., 100% - tax rate %) is required by the revised CAS 412 as a condition for allocation of pension accruals to cost objectives (See 8-412.4). For nonqualified plans using the pay-as-you-go cost method, pension costs assigned to a cost accounting period are allocable in the period assigned.

c. Credits Arising From Cancellation of Non-vested Benefits (see also 6-608.2d.(5)).

(1) When an employee withdraws from a pension plan or terminates his or her employment for reasons other than retirement or death, employer contributions made on his or her behalf, plus interest, to which no vested rights attach, serve to reduce the contractor's required future contributions. These are referred to as forfeitures (or in some cases "withdrawal gains"). Forfeitures require particular attention because of the long term nature of pension plans and the possibility that completion or termination of Government work will cause a serious cutback in a contractor's labor force. Since the contractor's annual contribution to a pension plan is net of that portion of any forfeitures used in determining the amount of the contribution, Government contracts ordinarily would share in such credits to the extent that the net contribution for the year is included in the indirect cost pools and allocated to Government contracts.

(2) Where the plan is funded through a contract with an insurance company, there is normally no advance consideration given to forfeitures. The necessary adjustment is normally applied as a reduction of the contractor's contribution to the insurance company for the then current taxable year or the next succeeding taxable year (or years in order of time if the aggregate amount of credit exceeds the premium cost otherwise due for the next succeeding taxable year). Forfeitures are usually quite readily ascertained under the insured type of funding arrangement.

(3) Where the plan is of the self-insured trustee type, the annual forfeitures normally reduce the employer's unfunded liability, and are therefore spread over later years (often the expected future service of members) and are only partially accounted for in any one subsequent year. Under most trustee type plans, isolated determination of the value of forfeitures is difficult to accomplish with any degree of accuracy.

(4) Ordinarily it will not be necessary to adjust for forfeitures arising from normal turnover of employees, except to consider such credits in calculating the contractor's net annual contributions. However, adjustment should be made if failure to do so would result in serious inequities to either the contractor or the Government.

(5) Substantial forfeitures may occur at a time when Government work has decreased to a point where it will not share the credits in the proportion that it absorbed the costs of pension contributions from which they are generated.

(6) One method for protecting the Government's interest in abnormal forfeitures is the use of a "recapture" method whereby the contractor and the Government enter into an agreement to negotiate a refund to the Government, if and when appropriate.

(7) The contracting officer has the responsibility for sponsoring the negotiation of all recapture agreements on pension costs under DoD contracts. Accordingly, where a recapture agreement is required for the protection of the Government's interests in future forfeitures, a copy of the pension plan, together with an advisory report containing comments and recommendations, shall be submitted to the contracting officer.

d. Funding Requirements

(1) When contributions are paid by a contractor to pension, profit sharing, and employee stock ownership (ESOP) plans less frequently than quarterly, FAR 52.232-16 (pro-

gress payment clause) and FAR 52.216-7 (allowable cost and payment clause) provide that the accrued costs shall be excluded from indirect costs for payment purposes until such costs are paid.

(2) For contracts subject to one of the payment clauses cited in (1) above, to satisfy the quarterly funding requirements of those payment clauses, contractors are permitted either to fund pension plans in total or to fund only those pension costs allocable to contracts containing the payment clause. Partial funding and delayed funding result in loss of earnings on trust fund assets, and therefore, result in increased future contributions and increased contract costs. Such increased costs are unallowable per FAR 31.205-6(j)(2)(iii), which states that "Increased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable." It is the contractor's responsibility to separately identify and exclude increased costs resulting from delayed funding. Contractors' actuarial rates and methods used in calculating normal and past service costs should be used to compute such unallowable pension cost contributions. The following method can be used to verify the amount excluded by the contractor or to determine the unallowable cost should the contractor fail to make the proper exclusion. In the example below, assume that pension expense of $12 million is claimed in fiscal year (calendar year) 2003 but is not paid until September 15, 2004. Also assume that the actuarial valuation used a six percent interest rate assumption and that the valuation date is January 1, 2004. Unallowable pension expense could be computed as follows:

Qtr a	Date Pymt Should be Made b	Date Pymt Actually Made c	Delay Period d=b-c	Monthly Interest e=6%/12	Delay Period Interest f=d*e	Quarterly Expense g=$12M/4	Excess Expense h=f*g
1Q	4/30/03	9/15/04	16.5 mos.	.5%	8.25%	$3M	$247.5K
2Q	7/30/03	9/15/04	13.5 mos.	.5%	6.75%	$3M	202.5K
3Q	10/30/03	9/15/04	10.5 mos.	.5%	5.25%	$3M	157.5K
4Q	1/30/04	9/15/04	7.5 mos.	.5%	3.75%	$3M	112.5K
Total Unallowable Expense for FY 2004							$720.0K

(3) Loss of earnings may impact future years' pension costs, and the unallowable cost should, therefore, be assigned to the years affected. Unallowable pension cost assigned to future years should be compounded with interest and actuarially amortized over the appropriate future years. As an alternative, however, if mutually agreeable, the unallowable pension cost can be assigned to the current year at the present value. This latter approach may, in fact, be preferable because there would then be no need for any follow-up action related to future adjustments.

(4) Form 5500, Report of Employee Benefit Plan, is required by the IRS to be submitted annually. This form identifies the actuarial assumptions used to determine pension costs, and may be used to determine whether actual funding complies with FAR requirements. If the form discloses that late funding occurred, questioned cost (lost earnings, including the compounding effect on future years) should be computed using the actuarially assumed interest rate used by the contractor in computing pension costs.

e. Actuarial Assumptions. The funding required for a defined benefit pension plan is a function of the actuarial cost method and assumptions used. These assumptions typically

involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of pension assets and liabilities. In evaluating the validity of the assumptions, the auditor should determine that the assumptions are reasonable individually (revised CAS, effective March 30, 1995) or in the aggregate (pre-March 30, 1995 provision.).

f. Adjustment of Pension Costs.

(1) CAS 413.50(c)(12), FAR 15.408(g), and FAR 52.215-15 provide for an adjustment of pension cost when a segment is closed, a pension plan terminates, or benefits are curtailed. A segment closing occurs when a segment (1) is sold or ownership is otherwise transferred, (2) discontinues operations, or (3) discontinues doing or actively seeking Government business under contracts subject to these provisions. The adjustment is computed as the difference between the actuarial accrued liability and the market value of the assets for the segment. Refer to 8-413.3 for additional guidance.

(2) When an adjustment is required, the contractor should be requested to provide a copy of the segment closing analysis mandated by CAS and FAR. The auditor should request the ACO to initiate a special CIPR to audit the contractor data for compliance with CAS 413 and/or FAR 52.215-15. If the contractor does not provide the analysis, a noncompliance audit report should be issued and the DCMA pension specialist should be requested to estimate the magnitude of the adjustment.

g. Transfers of Pension Fund Assets to Other Post-retirement Benefit Funds.

(1) FAR 31.205-6(j)(2) was revised effective September 23, 1991, to require an advance agreement regarding the withdrawal of pension fund assets which are to be transferred to another post-retirement benefit (PRB) fund. The advance agreement is to ensure that the increased pension costs to the Government, in all future periods are offset by a corresponding reduction or avoidance of future PRB costs to the Government, as a result of the pension fund transfers.

(2) Transfers made without an advance agreement will be treated as a withdrawal of pension funds subject to FAR 31.205-6(j)(3).

7-606 Contract Risk Associated with Potentially Overfunded Pension Plans

a. For Government contracting purposes, a pension plan is overfunded if the value of the plan's assets is greater than the actuarial liability plus normal cost for the current period, measured by the plan's actuarial cost method. This definition is the same as the definition used by the IRS prior to the signing into law on December 22, 1987 of the Omnibus Budget Reconciliation Act of 1987. The law (P.L. 100-203, subsequently replaced by the Economic Growth and Tax Relief Act of 2001 as incorporated into 26 USC 412) made a significant change to the way a contractor measures the full funding limitation for making contributions to its defined benefit pension plans under IRC regulations.

b. A pension plan is fully funded under IRC regulations when the value of plan assets equals or exceeds the lesser of

(1) the applicable percentage of current liability or

(2) the actuarial accrued liability, including the normal costs under the plan.

The applicable percentage of the current liability is 150 percent for plan years beginning after December 31, 1987; 165 percent for plan years beginning after December 31, 2001; and 170 percent for plan years beginning after December 31, 2002. For plan years beginning in 2004 and thereafter, the full funding limit is consistent with the pre-1987 public law provision. Therefore, effective for plan years beginning in 2004, a pension plan is fully funded when the value of the plan assets equals or exceeds the actuarial accrued liability plus normal cost for the current period under the plan for both Government contracting purposes and IRC regulations.

c. Contributions made to a fully funded plan are subject to a 10 percent excise tax, in accordance with the Tax Reform Act of 1986. This 10 percent excise tax is expressly unallowable for Government contracting purposes, in accordance with FAR 31.205-41(b)(6). This section of the FAR specifically disallows all excise taxes found at Subtitle D, Chapter 43 of the Internal Revenue Code of 1986, which includes excise taxes imposed in connec-

tion with pension plans, welfare plans, deferred compensation plans or similar types of plans.

d. The auditor must keep in mind that a pension plan can be overfunded on a termination basis and yet be underfunded on an accrual (ongoing) basis. A pension plan is overfunded on a termination basis when the value of the plan's assets exceed the accrued liability computed in accordance with the plan benefit formula at a specific point in time. A pension plan is overfunded on an accrual basis when the value of the plan's assets exceed the actuarial liability computed using assumptions projected to some future date.

e. The value of a plan's assets, for the purpose of determining a funding status for an on-going plan, is the actuarial value computed in accordance with the requirements of CAS 413.50(b)(2). The actuarial liability can be computed by the entry age normal, unit credit, or projected unit credit funding method. The method used must be applied on a consistent basis. On a termination basis, the actuarial liability is computed as stipulated by the plan's provisions which govern a termination.

f. When a contractor's pension plan becomes fully funded, there is no valid liability to the pension fund and thus no cost is assignable to the accounting period. Full funding, or the potential for full funding, may create the opportunity for a contractor to receive windfall profits. For instance, the pension plan may not be fully funded at the time contracts are priced or negotiated. If it becomes fully funded subsequent to negotiation of a fixed-price contract, the contractor could receive windfall profits. See 9-703.8b(5) for guidance on auditing projected pension costs when the contractor’s pension plan is at or near fully funded status.

7-607 Accounting for Pension Costs in Accordance with Financial Accounting Standards Board (FASB) Statement No. 87

7-607.1 General

Starting in 1987, companies were required to implement the provisions in FASB Statement No. 87 for financial and reporting purposes. The statement was developed using

(1) the concept of conservative accounting for the components of pension cost,

(2) realistic statistics on companies' pension plan current obligations, and

(3) the reporting of company financial pension obligations on the balance sheet.

The mechanics and formula for the calculation of pension cost under the statement are different from those now permitted for contract costing purposes under CAS 412 and 413. Accordingly, just because a plan is in compliance with Statement No. 87 does not mean that it is in compliance with CAS 412 and 413.

7-607.2 Actuarial Cost Methods

a. Statement No. 87 only permits the use of either the unit credit actuarial cost method (used for fixed-benefit plans) or the projected unit credit actuarial cost method (used for percent of final pay plans). The spread gain method is no longer permitted for either financial or Government cost accounting.

b. In addition to the unit credit and the projected unit credit actuarial cost methods, CAS 412.50(b)(1) allows the contractor to use the entry age normal actuarial cost method. This additional actuarial cost method may be used because it identifies separately normal costs, any unfunded actuarial liability, and periodic determinations of actuarial gains and losses.

7-608 Accounting for Early Retirement Incentive Payments

a. Early retirement incentive payments are payments offered to employees to induce them to terminate their employment and receive immediate pension benefits. The payment is usually a lump-sum amount based on a formula which takes into consideration the employee's current salary and years of service.

b. Early retirement incentive plans which are not paid for life or offer payments for life do not represent life income settlements and therefore do not qualify as pension plans. However, FAR 31.205-6(j)(6) requires that in order to be allowable, the cost of early retirement incentives be measured, assigned and allocated in accordance with the contractor's accounting practices for pension costs. These costs should be treated the same as pay-as-you-go supplemental pension plans. CAS 412.50(b)(4) provides that the cost of benefits under a pay-as-you-go pension plan shall be measured in the same manner as are the costs of defined benefit plans whose benefits are provided through a funding agency.

c. Early retirement incentive payments are generally made to participants over a period of time shorter than the amortization period required by FAR. However, for cost assignment, incentive payments must be treated as increases in pension benefits that result from unfunded past service liabilities and be amortized over the amortization period stated in CAS 412.50(a)(1)(iii). The amount of increased past service liability from the incentive award is the net present value of the allowable portion of the incentive at the payment date (see 7-2107.1). Under pension accounting concepts, amounts funded or costed in future periods for prior years' unfunded liabilities contain interest in an amount actuarially determined.

7-609 Costs of Post-retirement Benefits (PRB) Other Than Pensions

7-609.1 Definition and Regulation

Post-retirement benefit (PRB) costs are defined and the criteria for allowability are set forth in FAR 31.205-6(o). In general, the costs are for benefits provided for specified purposes to contractor employees after retirement. The same benefits are the subject of FASB Statement 106.

7-609.2 Allowability Determination

a. The costs must be reasonable and must be incurred according to a plan set by law, employer-employee agreement, or an established policy of the contractor.

b. The costs will be measured and assigned to accounting periods using one of three methods: Cash Basis, Terminal Funding, or Accrual Basis.

c. Cash Basis costs are recognized when actually paid to provide benefits to retirees for the current period. These costs have actually been incurred, have been paid out, and are for only the current period's benefits. The costs may include the amortization of prepaid costs over the applicable amortization period.

d. Terminal Funding occurs when the entire cost of a retiree's post-retirement benefit is accrued and funded upon the termination of the employee. The funding is accomplished by purchase of a paid-up benefit or by deposit of an amount equal to the present value of the projected benefit in a trusteed fund. Both CAS 416.50(a)(1)(v)(C) and the FAR require the amount terminally funded to be amortized over 15 years for Government costing. If a contractor with no CAS coverage proposes this accounting and funding method, it should be evaluated for allowability as a form of the Cash Basis method; i.e., amortization of prepaid costs over an appropriate period.

e. Accrual Basis recognizes costs in accordance with FASB Statement 106. Compliance with FAS 106 and FAR 31.205-6(o) should also be considered as satisfying CAS 416 provisions which require that pre-funded retiree insurance programs "apportion the cost of the insurance coverage fairly over the working lives of active employees in a plan." FAR 31.205-6(o) places the following requirements on accrued PRB costs:

(1) Costs must be funded by the time set for filing the Federal income tax for the period.

(2) Increased costs resulting from funding delays beyond 30 days after the end of each contractor fiscal quarter are unallowable.

(3) The allowable amount of past service cost is limited to the amount calculated using the FAS 106 amortization method provided for "transition liability." The past

service costs of PRB plans are the previously unrecognized costs which would have been recognized during prior years if the contractor had been accruing the PRB as earned over the working lives of the employees. "Transition liability" is a term used in FAS 106 which, for contract costing purposes, is substantially the same as past service costs. (FAS 106 also allows an immediate recognition method for transition liabilities which the FAR does not allow for Government costing purposes.)

f. Funding of PRB costs under either the Terminal Funding or the Accrual Basis methods must be made by payment to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRB.

g. The Government is entitled to an equitable share of any PRB funds which revert or inure to the contractor.

7-700 Section 7 --- Patent Costs and Royalty Costs

7-701 Introduction

This section provides the general audit guidance in auditing patent and royalty costs under FAR, DoD FAR Supplement, and 37 CFR Chapter IV, Part 401.

7-702 Patent Costs

7-702.1 General Considerations

A patent for an invention is the Government's grant to an inventor of the right to exclude others from making, using, or selling the invention for a 20-year period. Activities involved in getting a patent include searching through prior patents to determine whether the invention, or something similar to it, has already been patented; preparation of an application for the patent to the Patent and Trademark Office of the Department of Commerce; and prosecution (follow-up) of the application until the patent is granted or rejected.

a. FAR Part 27 and DoD FAR Supplement Part 227 establish DoD's policy with respect to patents. Contracting officers implement the policy by inserting one of the clauses set forth in FAR 27.303 into research and development contracts. Each of the clauses provides that the Government will obtain title to, or royalty-free use of, "subject inventions."

b. A "subject invention" (which is defined in the clauses) is one that is conceived or first actually reduced to practice under the contract.

c. FAR 31.205-47(f)(6) states that the cost of patent infringement litigation is unallowable unless otherwise provided for in the contract.

d. FAR 31.205-30 governs the allowability of the costs of obtaining patents. Costs incurred on patents to which the Government obtains title or royalty-free license are allowable to the extent that they are incurred as requirements of a Government contract (see FAR 31.205-30(a)). Also allowable are general counseling services relating to patent matters, such as advice on patent laws and regulations (see FAR 31.205-30(b)).

e. Other than those for general counseling services, patent costs not required by the contract are unallowable (see FAR 31.205-30(c)). Under CAS 405.40(a) such costs, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from billings, claims, and proposals.

f. Frequently, unallowable patent costs are not segregated in the contractor's accounting system. In these cases, CAS 405.50(a) and (b) permit the use of less formal cost accounting techniques. These less formal techniques may use backup data and working papers to establish adequate identification of all costs including unallowable cost and should be maintained for audit verification.)

7-702.2 Patent Costs/Income Related to Small Business and Nonprofit Organizations

a. The Department of Commerce Patents, Trademarks, Copyrights, 37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines on inventions made by small business firms and nonprofit organizations, including universities under funding agreements with Federal agencies.

b. After payment of expenses (including payments to inventors) incidental to the administration of subject inventions, any royalties and/or income earned by the contractor (nonprofit organization) from inventions will be used to support scientific research or education in accordance with 37 CFR Chapter IV, Part 401.

7-703 Royalty Costs

7-703.1 Royalty Charges

Contractors are required to submit with their proposals under any negotiated contract in excess of (see FAR 15.403-4(a)(1)) detailed information on all royalty costs of more than $1,500 which are included in the proposal (see FAR 15.408, Table 15-2 II.E.). The contracting officer is responsible for determining that royalties in excess of $1,500 charged directly or indirectly to Government contracts have been reported under the provisions of FAR 27.202-1 to the appropriate Government office. This allows the Government to determine whether or not the royalty charges are excessive, improper, or inconsistent with any license or right to an invention which the Government may have acquired under Government-sponsored research. In accordance with these determinations, the auditor should assure that improper direct or indirect charges for royalties are disapproved when claimed under cost-type contracts or questioned in advisory reports submitted for negotiation purposes.

7-703.2 Unpaid Royalties

a. DCAA has found cases where contractors included royalty charges in the costs used to negotiate contract prices but subsequently did not have to pay them in whole or in part. Such royalty charges are considered recoverable when:

(1) a contractor finds that it has been released from obligations to pay royalties (that is, when such release is the result of Government antitrust actions against the patent holders) or:

(2) the royalty estimates are overstated or are based on items that are not subject to royalties (see FAR 27.202-3).

b. In some instances contracts contain recapture provisions to become effective in the event actual royalty payments are less than those estimated and included in the negotiated prices. Other contracts contain no specific provisions for the recovery of unpaid royalties. FAR 27.202-3 provides guidance for determining when royalty escrow or recapture provisions are appropriate for inclusion in a contract.

c. DCAA auditors will insure that audit programs provide for periodic review of a contractor's accrued royalty accounts to determine the nature and validity of unpaid royalties. DCAA auditors will take the following minimum steps:

(1) Ascertain that contracts are complying with contract provisions that require the submission of reports of royalties paid or payable under the contract.

(2) Examine royalty reports submitted to contracting activities, to confirm the accuracy of the royalties reported as paid, or due to be paid, and the adequacy and timeliness of refunds made under contracts containing either escrow or recapture provisions.

(3) Determine the propriety of retention by the contractor of unpaid royalties if the terms of the contracts or the equities of the situation indicate that the Government is entitled to refunds or credits for any part of such unpaid royalties.

7-703.3 Royalty Income---Small Business and Nonprofit Organizations

37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines with respect to inventions made by small business firms and nonprofit organizations including universities, under funding agreements with Federal agencies. Any royalties and or income earned by the contractor (nonprofit organization) from inventions will be used to support scientific research or education in accordance with 37 CFR Chapter IV, Part 401.

7-800 Section 8 --- Labor Settlement and Strike Period Costs

7-801 Introduction

This section provides audit guidance in determining acceptable labor settlement costs and public policy as to the acceptability of strike period costs.

7-802 Labor Settlement Costs

Labor settlement costs (awards) can arise from judicial orders, negotiated agreements, arbitration, or an order from a Federal agency or board. The awards generally involve a violation in one of three areas:
(1) Equal Employment Opportunity (EEO) laws,
(2) union agreements, and
(3) Federal labor laws.

7-802.1 Types of Awards

a. The award can be for compensatory damages, punitive damages, or underpayment for work performed, or it can involve fines and penalties. A settlement may include one or more of these type costs. FAR 31.205-15, Fines and Penalties, provides that any fine or penalty assessed would be expressly unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

b. FAR 31.205-6(k) defines deferred compensation as an award given by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt of compensation by the employee. Subject to FAR 31.205-6(a), deferred awards are allowable when they are based on current or future services. However, awards made in periods subsequent to the period when the work being remunerated was performed are not allowable.

7-802.2 Case by Case Determination

a. The allowability of settlement costs associated with other areas should be determined on a case-by-case basis after considering the surrounding circumstances; i.e., the auditor should look behind the settlement and consider the causes. If the dispute resulted from actions that would be taken by a prudent businessman (FAR 31.201-3), the costs would be allowable. However, if the dispute was occasioned by actions which appear unreasonable or were found by the agency or board ruling on the dispute to be caused by unlawful, negligent, or other malicious conduct, the costs would be unallowable and, should be questioned.

b. Allocability of these costs must be reviewed (see FAR 31.201-4). For CAS-covered contracts, the provisions of CAS 406.40(b) regarding treatment of prior period adjustments must be considered in determining the treatment of allowable backpay awards. As with other items of cost, if the amount of the award is not material, it can be treated as an indirect cost of the period incurred.

(1) Where the violation which gave rise to the award can be identified to a specific contract(s), the entire award should be charged to that contract(s). The cost would not be allocable to any other contract and should not be included in an indirect cost pool. However, when the contract(s) which gave rise to the award is closed, consideration should be given to including the award in an indirect cost pool provided that the amount charged to Government contracts is no greater than that which would have been charged to the Government if the contract(s) was open.

(2) Other points to be considered are:

(a) when the award is for work performed by direct employees, it may impact not only direct costs, but also indirect costs due to the increase in the allocation base,

(b) when a negotiated union contract calls for a retroactive increase, the additional costs should be charged to the same final cost objectives that the actual work performed was charged.

(3) Very often there is a substantial time between when a suit is filed and payment of the award. An inequitable allocation to Government flexibly priced contracts would result where indirect employees are involved and there has been a substantial change in the flexible contract mix in the interim period. For example, if Government flexibly priced contracts represented 10 percent of a firm's business at the time the suit was filed, the Government should not be expected to pay more than 10 percent of the ultimate award.

7-803 Strike Period Costs

FAR does not provide specific guidance with respect to the allowability of costs during strike periods. Underlying this matter are considerations of public policy, and the difficulties that would be encountered in any attempt to provide adequate coverage for the differing situations frequently precipitated by strikes. As a result, the allowability of costs during strike periods shall be considered on an individual case basis.

a. FAR 22.101-1(b) states that "Agencies shall remain impartial concerning any dispute between labor and contractor management and not undertake the conciliation, mediation, or arbitration of a labor dispute." FAR 22.101-2(b) provides that in the event labor disputes give rise to work stoppage, "Contracting officers shall impress upon contractors that each contractor shall be held accountable for reasonably avoidable delays." "All costs incurred during strikes shall be carefully examined to ensure recognition of only those costs necessary for performing the contract in accordance with the Government's essential interest." (see FAR 22.101-2(c)).

b. Strike period indirect costs included in contractors' cost representations should be identified and segregated into the following categories to facilitate a determination as to allowability, allocability and reasonableness of the costs:

(1) Costs directly attributable to the strike, which would not have been incurred otherwise, such as extra security guards, special legal expense, arbitration costs, etc.

(2) Costs which were abnormally higher during the strike period, such as recruitment, training of new employees, etc.

(3) Audit determination of indirect costs of a continuing nature, such as cost of normal plant maintenance, depreciation, rent, other fixed charges, supervisory and administrative personnel, etc., will depend on reasonableness, within the framework of existing circumstances with respect to the strike; the extent to which subsequent production makeup operations were undertaken to maintain production schedule; the action taken by the contractor to minimize costs during the period; and such other factors as have a bearing on the expeditious settlement of the dispute.

c. Allocating indirect costs during a strike period to a contractor's commercial or defense work may consider the total period covered by the labor agreement signed at the conclusion of the strike as the basis for allocating strike period costs. Where, for example, a 3-year labor agreement is reached, a proration or amortization of strike period costs over production during the next three years may be appropriate.

7-900 Section 9 --- Employee Training and Educational Costs

7-901 Introduction

The allowability of a contractor's training and education costs should be determined based on the provisions of FAR 31.205-44 and the reasonableness provisions of FAR 31.201-3. The six types of expressly unallowable costs are as follows:

a. Overtime premium paid to employees while attending training.

b. Compensation for employees attending under-graduate level courses except where circumstances do not permit the operation of classes or attendance at classes after regular working hours. Where the incidence of these costs is high, the auditor should assure himself or herself that circumstances do not in fact permit holding classes or attending classes after regular working hours.

c. Costs of full-time graduate level education in excess of 2 years or the length of the degree program, whichever is less. Unallowable costs include tuition, fees, training materials, textbooks, subsistence and salary.

d. Grants, donations, scholarships, and fellowships are all considered contributions and are, therefore, unallowable.

e. Training or educational costs for other than bona fide employees except in cases where the employee is working in a foreign country and suitable public education is not available. In these cases, the costs for education of the employee's dependents are limited to primary and secondary level studies and may be included in overseas differential pay.

f. Contributions to college savings plans for employee dependents.

7-902 Audit Considerations

a. Training programs vary from contractor to contractor, depending on the relative need for training, training objectives, the size, stability and composition of the work force and other such factors. Where training is a continuous rather than an occasional activity, involves a substantial number of employees, and results in allocation of significant amounts of costs to Government work, the contractor should be required to maintain a well-defined training program based on formal policies and procedures. The policies and procedures should be compatible with the accounting system used to record and distribute costs to cost objectives.

b. Initial audit effort should be directed towards evaluating the contractor's training policies and practices, as well as the related cost accounting procedures. A training manual may be maintained by contractors that could prove useful to the auditor in reviewing the company's criteria for determining employee eligibility and need for specific training courses or activities.

c. The contractor should monitor the program to assure regular attendance and adequate course performance by the personnel enrolled. The program should include procedures for evaluating the suitability and sufficiency of each course of study or activity (e.g., relates to the field in which the employee is working or may reasonably be expected to work). Systematic post-training observation by the contractor of trainees' progress on the job would assist in achieving this objective.

d. Auditors should insure that contractors who provide full reimbursement of tuition have a policy that prevents recipients from receiving reimbursement from both the contractor and other outside sources. For example, even though college tuition reimbursement for veterans would be allowable under FAR 31.205-44, it is not reasonable for a contractor to provide duplicative reimbursements to veteran employees who are also eligible for reimbursement through the Veterans Administration. Therefore, duplicative employee training and education reimbursements should be questioned based on reasonableness (see FAR 31.201-3).

e. Auditors must ensure that training and education costs incurred by contractors, that are subsequently reimbursed under various initiatives provided by the Job Training Part-

nership Act, or any other similar programs, be credited to government contracts in accordance with FAR 31.201-5 (see 7-2113).

f. The auditor should determine that the training and education function does not discriminate against Government business or result in undue charges to Government contracts. This would occur if, for example, a company regularly hired new employees in its Government-oriented divisions, charged their training costs thereto, and then transferred the trained employees to their commercial-oriented divisions. Training and educational costs should properly be charged or allocated on a benefit basis. Such benefit would ordinarily be considered to accrue to the organizational segment(s) or profit center(s) of the company in which the personnel are expected to function (for a reasonable period of time) as a consequence of the training or education provided to them.

7-1000 Section 10 --- Employee Travel Costs and Relocation Costs

7-1001 Introduction

a. This section covers basic guidance, including the applicable FAR provisions, in reviewing employee travel costs and travel costs related to contractor -owned, -leased, or -chartered aircraft.

b. Also, presented in this section is audit guidance and applicable FAR provisions in reviewing employee relocation costs.

7-1002 Employee Travel Costs

7-1002.1 General Considerations

Audits of travel costs (see FAR 31.205-46) should include appropriate examination of the contractor's travel policies and procedures as well as the selective review of individual trips made by contractor personnel. Coverage of this area should thus include a determination that the contractor's travel authorization procedures provide for documented justification and approval of the official necessity of each trip, its duration, and the number of travelers involved. The contractor's procedures should provide for advance planning of travel to assure that:

(1) wherever feasible and economically practical, required visits to locations in the same geographical area are combined into a single trip,

(2) maximum use is made of the lowest customary standard, coach, or equivalent airfare accommodations available during normal business hours, and

(3) coordination between organizational elements is effected to minimize the number of trips to the same location. Individual trips should be reviewed to determine if

(a) the contractor is complying with its travel policies and procedures,

(b) the trip is for an allowable purpose, and

(c) the incurred travel costs are documented and allowable in accordance with FAR 31.205-46. In addition, the auditor should review the contractor's accounting procedures to determine whether or not they provide adequate controls for segregating unallowable travel costs.

7-1002.2 Documentation Required

FAR 31.205-46(a)(7) states that costs are allowable only if the contractor maintains specific documentation to support claimed travel costs. The documentation requirements are similar to the long-standing requirements imposed by Section 274 of the Internal Revenue Code (IRC). For claimed costs to be allowable, the following information must be documented:

(1) date and place (city, town, or other similar designation) of the expenses,

(2) purpose of the trip; and

(3) name of person on trip and that person’s title or relationship to the contractor.

This information must be maintained in a book, diary, account book, or similar records. Documentation such as cancelled checks, credit card receipts, and hotel bills are to be maintained as corroboration for expenses, but without the diary or similar records, they may not be sufficient support for deductibility.

7-1002.3 Allowability of Per Diem Costs Under FAR 31.205-46

a. FAR 31.205-46(a) states that costs for lodging, meals, and incidental expenses may be based on (i) per diem, (ii) actual expenses, or (iii) a combination of a fixed amount and actual expenses. However, except for special or unusual situations, allow-

able costs are limited on a daily basis to the "maximum per diem" rates in effect at the time of travel set forth in the Government travel regulations as follows:

(1) Federal Travel Regulations, for travel in the conterminous 48 United States. These rates are available on the GSA web site www.gsa.gov under Policy.

(2) Joint Travel Regulations, for travel in Alaska, Hawaii, the Commonwealth of Puerto Rico, and territories and possessions of the United States.

(3) Department of State Standardized Regulations, Section 925, Maximum Travel Per Diem Allowances for Foreign Areas, for travel to foreign countries.

b. The Federal Travel Regulations, Joint Travel Regulations and Department of State Standardized Regulations treat certain costs related to the maximum per diem rates differently. The maximum per diem rate consists of lodging and M&IE (meals and incidental expense) rates. The schedule below shows these costs and how each regulation treats them:

	Federal Travel Regulations	Joint Travel Regulations	Department of State Standardized Regulations
Lodging Taxes	Separate allowable expense	Separate allowable expense	Included in lodging rate
Laundry/Dry Cleaning	Separate allowable expense	Included in M&IE rate	Included in M&IE rate

c. FAR 31.205-46 does not incorporate the Government travel regulations in their entirety. The requirements and provisions of the Government travel regulations are to be applied to contractors only in the following three specific areas:

(1) Definitions of lodging, meals, and incidental expenses. Incidental expenses include fees and tips to waiters and porters; transportation between places of lodging or business and places where meals are taken, if suitable meals cannot be obtained at the TDY site; and mailing costs associated with filing travel vouchers and payment of Government-sponsored charge card billings. For travel outside the Continental United States incidental expenses also include the cost of laundry and cleaning and pressing of clothes.

(2) Maximum per diem rates. Maximum per diem rates are a combination of lodging plus meals and incidental expenses. The Government travel regulations provide for two ceiling amounts: one for lodging and one for meals and incidental expenses. However, contractors are subject to only one ceiling, a total of lodging plus meals and incidental expenses.

(3) Special or unusual situations. The applicable travel regulations provide for special or unusual situations where reimbursement of a higher amount (e.g., up to 300 percent of the applicable maximum per diem rate for domestic travel) is authorized based on actual expenses incurred. Examples of such situations include when: (a) the employee must stay at a prearranged hotel where he or she attends a conference or training session; and (b) the travel is to an area where subsistence costs have escalated for short periods of time during special functions or events such as sports events, world fairs, or conventions. For costs in excess of the maximum per diem rates to be allowable, FAR 31.205-46(a)(3) requires a written justification for use of the higher amounts, signed by an officer (or designee) of the contractor. Additionally, if the higher rate is used repetitively, the contractor must obtain advance approval from the contracting officer.

d. The contractor may adopt policies for reimbursing employees for travel expenses based on actual expenses, fixed amount, or a combination of actual expenses (e.g., for lodging) and a fixed amount (e.g., for meals and incidental expenses). In any event, allowable costs to Government contracts may not exceed the maximum per diem rates specified in the Government travel regulations. If a contractor's policy is to reimburse its employees a fixed amount (per diem) for subsistence within the prescribed maximum

daily per diem rates, there is a presumption that the costs are reasonable and allowable and detailed receipts or other documentation are not required to support claims by employees. On the other hand, if a contractor's policy is to reimburse its employees actual expenses incurred, all unallowable costs (such as, alcoholic beverages and entertainment) must be separately identified and excluded from billings, claims, and proposals to the Government in accordance with FAR 31.201-6 and CAS 405.

e. The maximum Federal per diem rates reflect allowance for lodging, meals, and incidentals for a 24-hour period. Use of those rates when travel does not require a full day or does not require lodging expense would be inconsistent with the rate structure. While the cost principle does not prescribe a specific reduction formula for contractor use to account for partial days, it does state that use of the maximum rates in such situations would generally be unreasonable. Contractors must provide for a reasonable reduction from the maximum rates when lodging, meals, or incidentals are not required.

7-1002.4 Use of Statistical Sampling to Segregate Unallowable Costs

a. When employee reimbursement for travel expense is based on actual costs incurred, FAR 31.201-6 and CAS 405 require contractors to demonstrate that all unallowable costs are separately accounted for and excluded from all billings, claims, and proposals to the Government. The use of a statistical sampling analysis to segregate unallowable costs would not generally meet the requirements of the CAS and the FAR. CAS 405.50(a) and (b) and FAR 31.201-6(c) require contractors to establish and maintain sufficient detail and depth of records of identified unallowable costs so as to permit audit verification of the accounting treatment for the unallowable costs. The use of a projection or estimate of unallowable costs in lieu of specific identification of such costs, even though based on a valid statistical sampling analysis, normally would not be compliant with the requirements of CAS 405.50(a) and (b) and FAR 31.201-6(c).

b. In circumstances where costs involved are not material, CAS 405.50(c) provides that the Government and the contractor may reach an agreement on an alternate method in lieu of specifically identifying unallowable costs. In evaluating the contractor's submission for the use of an alternate method of identifying unallowable costs, consider such factors as materiality of unallowable portions of per diem costs and additional administrative costs required to specifically identify such unallowable cost. Consider, for example, a situation such as a corporate home office of a contractor whose Government work represents only a minimal portion of its total business. The requirement to specifically identify and segregate all unallowable per diem costs could cost significantly more than the cost of the unallowable items. If the contracting officer agrees that an alternate procedure would be advantageous to the Government, the contractor may use statistical sampling or other appropriate methods to estimate the unallowable costs. If a circumstance warrants the use of statistical sampling analysis to estimate the unallowable travel costs, auditors must ensure that proper sampling techniques are used.

7-1002.5 Allowability of Airfare Costs

a. Allowable airfare costs are limited to the lowest customary standard, coach, or equivalent airfare offered during normal business hours, except for special circumstances set forth in FAR 31.205-46(b). Because airlines use many different fare codes to indicate the class of service, determining the lowest fare class regularly offered during normal business hours may be difficult. However, an explanation of the fare codes may generally be obtained from the contractor's travel agency and/or the applicable airline.

b. A "business class" accommodation that is offered at a price slightly lower than the first-class fare does not meet the FAR criteria for reasonableness and allowability. Conversely, use of special discount, excursion, or night rates, as a matter of common practice, should not be required when use of such fares is impractical for business travel purposes,

results in circuitous routing, or causes travel accommodations not reasonably adequate for the physical needs of the traveler.

c. Whenever the contractor is able to obtain special fares (Ultra Savers, Ultimate Super Savers, etc.) in lieu of full economy fares, the resulting cost savings should be reflected in any billing, claim, or proposal submitted by the contractor. Travel agencies often prepare and provide to their customers airline cost savings reports designed to attract and retain customers. In connection with forward pricing, the auditor should review any recent savings reports to make sure that the proposed airfare costs reflect appropriate savings. Alternatively, at contractor locations where travel costs are significant, the auditor should recommend that the contractor develop a decrement factor to be applied when basic cost estimates are based on full economy fares, rather than achievable, lower special fares.

d. Increased competition among airlines has resulted in certain airline companies offering various promotional benefits, including cash, merchandise, gifts, prizes, bonus flights, reduced-fare coupons, upgrade of service, membership in clubs, check-cashing privileges, and free vacations. Contractors are not required to collect airline promotional benefits from their employees. It is up to each contractor to establish its own policy addressing the treatment of these promotional benefits. However, if a contractor has a policy that results in its employees turning in the frequent flyer bonus credits for company use, then the auditor should ensure that the Government receives its applicable share of any credits actually received by the contractor. In those instances where contractors have executed agreements with individual airlines for discounts and bonuses, auditors should determine that appropriate credits or cost reductions are being reflected in forward pricing and actual cost submissions, and that appropriate use of the agreement is being made.

7-1002.6 Fly America Act – International Air Travel

a. FAR 47.4, Air Transportation by U.S.-Flag Carriers, implements the Fly America Act. The Fly America Act requires that U.S. Government-financed international air travel be provided by a U.S.-flag carrier, if available. The requirement applies to all international air travel by Federal employees and their dependents, consultants, contractors, grantees, and others, including their personal effects, when paid for by U.S. Government funds. Guidelines for Implementation of the Fly America Act (Case No. B138942), issued by the Comptroller General of the United States on March 31, 1981, are incorporated at FAR 47.403.

b. FAR 47.403-1, Availability and unavailability of U.S.-flag air carrier service, provides detailed requirements for determining the availability of U.S.-flag carrier service, as well as guidelines that must be followed to ensure that U.S.-flag carriers are used to the greatest extent possible. Contractors are required to use U.S.-flag carriers when they are available, even though a foreign carrier may offer lower fares for the same flight or flight segment. Contractors that frequently travel abroad should have processes and procedures in place to ensure compliance with the Fly America Act.

c. Although FAR 47.403 provides detailed implementation requirements of the Fly America Act, the regulations do not address code share carrier agreements. Code share carrier agreements are commonplace in the air transportation industry and involve arrangements between carriers where one carrier will book and provide air travel transportation services aboard another carrier's aircraft. The Comptroller General's Decision, B-240956, dated September 25, 1991, views code share arrangements between a U.S.-flag carrier and a foreign carrier as simply a lease of the seats and its crew aboard the aircraft, and as such, the U.S. carrier is responsible for the transportation service for passengers in the leased seats. Based on the Comptroller General's decision, contractors are required under the Fly America Act to use U.S.-flag carriers, or foreign carriers under a code share arrangement with the U.S.-flag carrier, whenever available, unless the contractor can provide adequate justification and supporting documentation, as required by FAR 47.403-1.

d. To the extent that a U.S.-flag carrier, including code share flights booked through the U.S.-flag carrier, is not used for international air travel funded by the U.S. Government,

FAR 47.403-3(a) provides that Agencies shall disallow the costs associated with the air transportation on the foreign air carrier unless adequate justification is attached to the voucher, which notes that a U.S.-flag carrier was unavailable. Requirements of the Fly America Act are to be incorporated into all contracts where international travel is anticipated through the contract clause at FAR 52.247-63, Preference for U.S.-Flag Air Carriers. When the travel is by indirect route or the traveler otherwise fails to use available U.S.-flag air carrier service, the amount to be disallowed is based on the loss of revenues suffered by U.S.-flag air carriers, determined by the formula provided in FAR 47.403-1. However, based on the Comptroller General's decision, 56 Comp. Gen. 209, dated January 3, 1977, the disallowed amount shall not exceed the fare of the segment improperly traveled.

7-1003 Travel Costs on Contractor Aircraft - Owned, Leased, or Chartered

7-1003.1 General Audit Considerations

a. FAR 31.205-46(c) sets forth principles and criteria for determining the allowability of costs incurred in the operation and maintenance of contractor-owned, -leased, or -chartered aircraft (collectively referred to as private aircraft).

b. As a general rule, travel costs via private aircraft in excess of the standard commercial airfare are unallowable. Exceptions to this general rule are described in 7-1003.2. The use of private aircraft generally results in higher costs than travel by commercial airlines or other modes of transportation.

7-1003.2 Conditions for Allowability of Contractor-Owned, -Leased, or -Chartered Aircraft

a. As a prerequisite to allowability, the contractor must maintain and make available to the Government full documentation in support of the costs including the manifest/log for all flights (see 7-1003.6). If the contractor fails to maintain required documentation or refuses to provide such documentation, the auditor should disallow costs in excess of otherwise allowable standard commercial airfare.

b. Travel costs via private aircraft in excess of the standard commercial airfare are allowable in two situations:

(1) when travel by such aircraft is specifically required by contract specification, term, or condition; or

(2) when a higher amount is approved by the contracting officer.

c. All or part of excess costs incurred for operating private aircraft may be approved by the contracting officer:

(1) when one or more of the conditions described in FAR 31.205-46(b) are present that would justify costs in excess of the lowest standard commercial airfare, such as requiring circuitous routing, travel during unreasonable hours, or excessively prolonged travel; or

(2) when an advance agreement has been executed.

7-1003.3 Use of Advance Agreements

a. When the contractor proposes an advance agreement with respect to the costs of company aircraft, the auditor should evaluate the contractor's proposal and provide audit findings and recommendations to assist the contracting officer in establishing the negotiation objective. The auditor should request technical assistance in areas such as the size, type, and number of aircraft; safety factors; and other technical requirements of aircraft.

b. In evaluating the contractor's proposal, the auditor should consider major financial and nonfinancial factors. Generally, the contractor must demonstrate that scheduled commercial airline service is not readily available at reasonable times to accommodate

the company's air travel requirements. In addition, proximity of commercial airports to the contractor's location as compared to private air fields that are used, or are intended to be used, is also a factor in conjunction with any time savings of key personnel. Increased flexibility in scheduling flights may result in time savings and more effective use of personnel. However, the auditor should be mindful that a contractor in the normal course of conducting its business seldom needs corporate aircraft and that the convenience of corporate aircraft should not be a substitute for the economy of commercial flights. While there may be critical or emergency situations that cannot be effectively handled by commercial flights, such situations generally occur so infrequently that they do not justify the long-term use of corporate aircraft. It is the contractor's responsibility to justify and demonstrate that the need for corporate aircraft truly outweighs cost savings arising from the use of commercial airlines.

c. The ASBCA ruled (in the General Dynamics case no. 31359, 92-2, BCA 24922) that "time savings, productivity gains, or more effective use of personnel" can be used to demonstrate and justify the higher cost of private aircraft. It is the contractor's responsibility to provide the Government a fully supported submission to demonstrate that these savings exceed the costs of using private aircraft as compared to using commercial airlines. The ASBCA also ruled that it is appropriate for the contractor to consider the value of executive time in the cost-benefit analysis. The ASBCA accepted the concept that the calculation of the value of the executive's time could include an estimate of the executive's value to the corporation in addition to the executive salary and fringe benefits. The ASBCA referred to the estimate of the executive's value to the corporation as a "multiplier." The use of a multiplier by the contractor should not be accepted solely as a result of the ASBCA case. The contractor must provide supporting data to justify any proposed multiplier. If the contractor does not justify the use of a multiplier, the related costs should be questioned.

d. The costs associated with private aircraft flights should be allocated to all passengers. The information listed in 7-1003.6 is required by the cost principle to determine if unallowable trips such as spousal travel have been identified and all allocable costs to the unallowable trips were excluded from reimbursement by the Government. The auditor should recommend that the advance agreement state that unallowable passenger trips be allocated their fair share of costs and these costs should be excluded from requests for reimbursement by the Government.

e. In situations where the contractor's proposal includes acquisition of an aircraft, either through purchase or capital lease, the auditor should carefully review the feasibility studies the contractor has made in advance of acquiring the aircraft, justification presented to the approving authorities within the company, the contractor's decision, and the implementing procedures adopted. Corporate aircraft costs, once the purchase or capital lease is made, are very much like sunk costs and cannot be rapidly altered by management decision. It is particularly important for the auditor to recommend that the contracting officer not approve the proposed acquisition of the aircraft unless the contractor can demonstrate the cost-effectiveness of corporate aircraft.

f. When an advance agreement allows only a portion of the corporate aircraft costs, the auditor should recommend that the advance agreement clearly state that allowable cost of money will also be limited to the proportionate amount. This is consistent with the instructions for the form referred to in CAS 414-50(a). These instructions require that the facilities capital values be the same values as those used to generate the depreciation or amortization that is allowed for Federal Government contract costing purposes.

7-1003.4 Reasonableness of Contractor-Owned, -Leased, or -Chartered Aircraft Costs

a. In situations where all or part of travel costs via private aircraft in excess of the standard commercial airfare are approved by the contracting officer (see 7-1003.3), such costs are subject to the determination of reasonableness and allocability. Costs of private aircraft in-

clude costs of lease, charter, depreciation, cost of money, operation (including personnel), maintenance, repair, insurance, and all other related costs.

b. A corporate aircraft is sometimes used for nonbusiness or otherwise unallowable activities. The contractor is required under CAS 405 and FAR 31.201-6 to identify all unallowable costs. The auditor should review the flight manifest/log to determine whether the contractor has excluded the amount allocable to any travel for nonbusiness or otherwise unallowable activities. If the trip is considered unallowable, the auditor should calculate the related unallowable aircraft costs considering the entire costs of the aircraft, both fixed and variable costs.

c. The size, type, and number of aircraft maintained or chartered are major considerations in evaluating the reasonableness of the costs involved. The auditor should also review the flight manifest/log and other available documentation to determine whether optimum use is made of such aircraft to the extent that they are used for all suitable trips except where the variable costs involved in their use would exceed the trip cost by commercial airline.

d. Depreciation often represents the major item of contractor-owned aircraft costs. In evaluating it, the auditor should ensure that the allowable amount is determined in accordance with the provisions of FAR 31.205-11. Supplemental audit guidance on depreciation is at 7-400. Costs of aircraft overhaul and major component replacement, and their accounting treatment, also merit close audit scrutiny. If such costs are not capitalized and amortized by the contractor but are expensed in the period they are incurred, the auditor should assure that the procedure does not result in distorting the total aircraft costs for the period involved. Any gain or loss on the disposition of contractor-owned aircraft should be accounted for as provided in FAR 31.205-16.

e. Audit of private aircraft costs should include the evaluation of the propriety of the method used for their assignment or allocation to Government contracts. When an aircraft is used exclusively by a particular organizational element, such as by the home office, division, or plant, the costs of the aircraft should be charged to that entity. When use is broader based, the aircraft costs should be distributed equitably to all of the user units. Some contracts may provide for travel costs as direct charges. In these cases, the auditor should assure that similar type costs are not duplicated as part of the allocation of aircraft costs to these contracts through overhead. Aircraft may also be used for non-travel purposes, such as instrument testing. Applicable costs should be charged directly to the benefiting projects.

7-1003.5 Contractor Responsibility

FAR 31.205-46(c)(2) specifically requires that the contractor must maintain documentation of all travel via private aircraft as a prerequisite of consideration for allowability of such costs. The contractor has the responsibility to support and justify the cost of aircraft usage. This responsibility includes:

(1) identification of all costs associated with private aircraft,

(2) submission of a comparative analysis of costs of private aircraft and standard commercial airfares, and

(3) maintenance of a flight manifest/log.

Costs that are unsupported as a result of a contractor's inability or unwillingness to furnish the required documentation should be disallowed.

7-1003.6 Maintenance of a Flight Manifest/Log by Contractor

The flight manifest/log which the contractor is required to maintain, plus other necessary backup data, should be in sufficient detail to serve as a source of support for its proposed costs. At least the following information for each flight should be provided:

(1) Date, time, and point of departure (airport).

(2) Date and time of arrival, and destination (airport).

(3) Names of pilot and crew.

(4) For each passenger aboard:
- Name.
- Name of company or organization represented.
- Position held in company or organization.
- Authorization for trip.
- Purpose of trip.

7-1004 Employee Relocation Costs

7-1004.1 General

a. The cost principle for allowability of relocation costs is FAR 31.205-35. It defines relocation costs as costs incident to the permanent change of duty assignment for a period of 12 months or more of an existing employee or upon recruitment of a new employee. Relocation costs are usually comprised of:

(1) cost of travel and transportation of household goods for the employee and immediate family members,

(2) cost of advance trips to find a permanent residence,

(3) closing costs (including state and local transfer taxes) incidental to sale of prior residence,

(4) expenses such as the costs of cancelling an unexpired lease and rental differential payments,

(5) costs for acquisition of new house,

(6) continuing mortgage interest at the old residence,

(7) interest differential between the old and new mortgage and rental differential payments where the relocated employee retains ownership of a vacated home in the old location and rents at the new location, and

(8) miscellaneous expenses.

Costs of travel for the employee and the employee's family to the new duty station and for house hunting trips include per diem costs which are also subject to FAR 31.205-46. (See 7-1002.3.)

b. The costs of relocating an employee are generally substantial. Evaluation of the contractor's policies and procedures as well as employment agreements as to reasonableness and compliance with FAR requirements is an important step of any audit program when significant costs are charged to Government work. The allocation methods should be reviewed to determine that proper costs are being charged to benefiting contracts. In this regard, relocation costs should generally be charged to the receiving segment. Tests of individual personnel actions should be included to determine if established practices are being followed. When the contractor's policies and procedures are inadequate to control the incurrence of and accounting for unallowable costs, individual voucher testing must determine if the costs are allowable in accordance with FAR 31.205-35.

7-1004.2 Conditions for Allowability of Relocation Under FAR 31.205-35

a. The contractor's relocation costs must be reasonable and allocable, and must meet the criteria listed in FAR 31.205-35(b) to be allowable. FAR 31.205-35(a) lists specifically allowable relocation costs and 31.205-35(c) lists expressly unallowable costs.

b. Allowable relocation costs for an existing or new employee must involve a permanent change of duty assignment. Relocation assignments should normally last at least 12 months. When an undue number of such relocation assignments are terminated or completed in less than 12 months, the auditor should evaluate the reasons and recommend remedial action if appropriate. Relocation costs in excess of constructive temporary duty assignment costs should be questioned if the contractor should have known at the time of the assignment that it would not continue for a period of 12 months or more.

c. Failure to fulfill the 12-month requirement of a permanent change of duty assignment agreement for reasons within the employee's control requires the contractor to refund or credit the relocation costs to the Government (FAR 31.205-35(d)). The auditor should encourage contractors to include recapture provisions in relocation agreements if this is not a practice. The provision should then be monitored by the auditor to assure that an adequate contractor follow-up system is in place to collect refunds when appropriate. The auditor should assure that a proper portion of any such refunds is credited to the Government. However, the contractor is required to make appropriate refunds to the Government whether or not the contractor recovers relocation payments from the employee.

d. Per FAR 31.205-35(f)(4), the recapture rule is not applicable to return relocation costs of a new employee who:

(1) is hired specifically for a long-term (at least 12 months) field project or contract assignment;

(2) is entitled to return relocation under the terms of his or her employment contract; and

(3) is not a permanent employee and is released from employment upon completion of the assignment for which he or she was hired.

This exception is applicable to only those employees who meet all three requirements. Accordingly, it is not applicable to the existing employees who are reassigned to field projects.

7-1004.3 Applicability of Joint Travel Regulations (JTR) to Relocation Per Diem Costs.

The FAR 31.205-46 allowable maximum Government travel regulation per diem rates for lodging, meals and incidental expenses apply to contractor employees while traveling on official company business. House hunting trips and travel to the new duty station are considered official business travel and subject to the FAR 31.205-46 per diem criteria. These criteria do not apply to temporary quarters allowances because the employee is not considered to be on official business travel while in temporary quarters.

7-1004.4 Employee Assignments not Covered by the Relocation Cost Principle

Certain duty assignments, principally overseas locations, are accompanied by "location allowances." These "location allowances" represent compensation in addition to normal wages and salaries that are paid by contractors to induce employees to undertake or continue work at locations which may be isolated or in an unfavorable environment. Such allowances do not constitute relocation costs covered by FAR 31.205-35. They are considered a part of "compensation for personal services" by provision of FAR 31.205-6. They should be evaluated using the procedures described in 5-808. Also costs of travel to an overseas location should be considered travel costs in accordance with FAR 31.205-46 and not relocation costs if dependents are not permitted at that location for any reason and the costs do not include costs of transporting household goods. Under these circumstances the move is considered a temporary rather than a permanent change of duty station.

7-1004.5 Unallowable Relocation Cost

a. The allowability provisions of FAR 31.205-35 are significantly different between contracts awarded prior to July 29, 2002 and contracts awarded after that date. The substantive changes in the cost principle are:

(1) Payments for house hunting trips and temporary lodging are limited to a maximum of 60 days for the employee and 45 days for spouse and dependents for contracts awarded prior to July 29, 2002 (FAR 31.205-35(a)(2)). For contracts awarded after that

date, these payments are limited only through the general reasonableness provisions in FAR 31.201-3.

(2) Payments for increased employee income or FICA taxes related to relocation reimbursements (commonly referred to as tax gross-ups) are expressly unallowable on contracts awarded prior to July 29, 2002 per FAR 31.205-35(c)(4). For contracts awarded after that date, tax gross-ups are specifically allowable per FAR 31.205-35(a)(10). See 7-1004.8 for calculation of tax gross-ups.

(3) Payments for spouse employment assistance are expressly unallowable on contracts awarded prior to July 29, 2002 per FAR 31.205-35(c)(5). For contracts awarded after that date, the costs are specifically allowable per FAR 31.205-35(a)(11).

(4) Lump-sum reimbursement of miscellaneous expenses (FAR 31.205-35 (b)(4)) on contracts awarded prior to July 29, 2002 is limited to $1,000. For contracts awarded after that date, the limit is raised to $5,000.

b. In addition to the allowability of the costs discussed in a. above, FAR 31.205-35(c) lists several other types of costs that are not allowable, regardless of the date of contract award. These unallowable costs include

(1) loss on the sale of a home;

(2) continuing mortgage principal (not interest) payments on the residence being sold;

(3) certain costs incident to the acquisition of a new home as shown in FAR 31.205-35(c)(2); and

(4) costs incident to furnishing or obtaining equity, nonequity, or lower-than-market-rate loans to employees.

In addition, FAR 31.205-35(d) requires the contractor to refund or credit contract costs for amounts previously charged to relocate an employee if the employee resigns for voluntary reasons within 12 months after relocation. Termination of employment for illness, disabling injury, or death is not generally within the employee's control and, therefore, would not serve as a basis for compelling contractors to refund or credit relocation costs to the Government.

7-1004.6 Mass Relocations

a. Large scale or mass relocation of employees may result in abnormal total relocation costs. FAR 31.205-35(e) recognizes that questions may arise as to the reasonableness and allocability of the total amount, even though the items comprising the total are otherwise allowable. Thus FAR 31.109, Advance Agreements, provides the means by which parameters of reasonableness and allocability of special or mass relocation may be agreed upon in advance between the Government and the contractor. In absence of an advance agreement, the provisions of FAR 31.2, should be used by the auditor for determination of reasonableness and allocability.

b. If the auditor learns that large scale employee relocations are to be made which may result in significant costs to prospective or existing Government contracts, the auditor should report the matter to the cognizant ACO with a recommendation for an advance agreement regarding the allowability of such costs. The recommendation should cite important areas for agreement such as:

(1) the segments of the company among which the costs are to be equitably distributed,

(2) the length of time over which the costs are to be amortized, and

(3) the employees eligible for reimbursement of relocation costs.

After coordination with the local ACO, the auditor should provide any needed information to other contracting officers who are concerned.

c. Depending on the circumstances, as covered in FAR 31.109, an advance agreement may be negotiated by the local ACO, the CACO, or a PCO. Be responsive to any request from the designated Government negotiator for audit assistance in establishing the negotiation objective.

7-1004.7 State and Local Transfer Tax

Some state or local governments may impose taxes on sales of homes. If the tax is imposed on the seller (employee) by law, it is considered a form of transfer tax which must be satisfied before the sale can be consummated and would qualify as closing costs described in FAR 31.205-35(a)(3). However, agreement to pay the tax not imposed on the seller by law, in the interest of making a sale or for other reasons, would not qualify as an item of closing costs and would be unallowable.

7-1004.8 Calculation of Tax Gross-up

a. A common method for calculating the tax gross-up is:

Tax Gross-		x
Up Factor	=	1.0 – x

(where x = employee's marginal tax rate)

b. For example, assume that the employee's marginal tax rate is 28 percent and the non-deductible moving expenses are $50,000. A company would commonly compute the tax gross-up amount as follows:

Tax gross-up factor = 0.28/(1.0-0.28) = 0.3888888

Tax gross-up amount = $50,000 x 0.3888888 = $19,444.44

Simply increasing the employee's $50,000 payment by the 28 percent marginal tax rate (i.e., $14,000) will not make the employee whole. This is because the employee must also pay taxes on the additional $14,000. The tax gross-up amount must be sufficient to pay not only the additional tax on the taxable relocation expenses, but the taxes on all amounts paid to the employee to reimburse the additional employee taxes. The formula shown above reaches that result. In essence, the formula summarizes the following computations:

Taxable Amount	**Tax Paid (@28%)**
$50,000.00	$14,000.00
$14,000.00	$3,920.00
$3,920.00	$1,097.60
$1,097.60	$307.33
$307.33	$86.05
$86.05	$24.09
$24.09	$6.75
$6.75	$1.89
$1.89	$0.53
$0.53	$0.15
$0.15	$0.04
$0.04	$0.01
Total Tax	$19,444.44

7-1100 Section 11 --- Dues, Membership Fees and Professional Activity Costs

7-1101 Introduction

a. This section provides basic guidance in reviewing dues, memberships, and professional activity costs (FAR 31.205-43).

b. Additional guidance is provided on costs of memberships in industrial liaison programs of universities, the Army, Navy, and Air Force associations, and organizations engaged in lobbying or charitable activities.

7-1102 Dues, Memberships, and Subscription Costs

7-1102.1 General

a. Generally, costs of memberships in trade, business, technical, and professional organizations are allowable per FAR 31.205-43(a) but see 7-1102.2, 7-1102.3, 7-1102.4, and 7-1102.6 below for special considerations.

b. Subscription costs include trade, business, professional, or technical periodicals. Such costs are generally allowable per FAR 31.205-43(b).

7-1102.2 Army, Navy, and Air Force Associations

The Association of the United States Army, Army Aviation Association of America, Navy League of the United States, Air Force Association, and other nonprofit associations with similar objectives have for many years offered memberships to contractors. These associations are primarily concerned with fostering and preserving the images and efficiencies of the Army, Navy, and Air Force. They operate outside Government channels in an endeavor to preserve a spirit of fellowship among former and present Service members and to inform and arouse the interests of the public in activities and achievements of their respective military services. Generally, memberships are offered to contractors that wish to support the objectives of these associations. The membership dues often include a subscription to publications issued periodically. For example, the Association of the United States Army monthly publishes a magazine entitled ARMY. It includes numerous articles primarily designed to enhance Army personnel programs and to promote manpower and combat readiness. In addition, conventions and meetings are periodically held by these associations, at which contractors frequently exhibit their products. Occasionally, these conventions or meetings will be sponsored by a contractor or group of contractors. These conventions or meetings are usually held to focus the attention of the public on the activities of a particular military service that contribute to national defense programs. In determining the allowability of costs incurred by contractors with these associations, the auditor will be guided by the following:

a. Costs related to these associations such as membership fees, exhibit or display costs, and sponsorship expenses do not qualify as allowable under the trade, business, technical, or professional activity principle in FAR 31.205-43.

b. The costs of travel, registration, hotel, and other expenses incurred in connection with these associations' conventions, meetings, and conferences are considered unallowable in accordance with FAR 31.205-43(c), unless the contractor can show that the primary purpose of the meeting is for "the dissemination of technical information or the stimulation of production." The inference here is that the technical information will benefit performance, or stimulate production, under a particular Government contract, or series of contracts.

7-1102.3 Costs of Memberships in Industrial Liaison Programs of Universities

Industrial liaison programs are offered to contractors by various universities throughout the country. Under such programs, contractors are usually entitled to the use of university facilities, consultations with faculty members, copies of research reports,

attendance at symposiums, and possibly other benefits. To become eligible for such benefits, the universities require that contractors pay membership fees. Some universities enter into formal agreements with contractors describing the types of benefits that will be provided.

a. The membership fee in each industrial liaison program, as further discussed in b. below, should be considered a retainer fee under FAR 31.205-33 and an allowable cost if supported by evidence that:

(1) the services are necessary and customary;

(2) the level of past services justifies the amount; and

(3) the retainer fee is reasonable compared to the cost and level of expertise required to maintain an in-house capability to perform the covered services.

b. Normally, benefits available from membership in an industrial liaison program are the same for all members, regardless of fee paid by each member. Universities usually set a schedule of fees based on company size which is often based on voluntary compliance or negotiation above the minimum fee. Generally, amounts paid in excess of the minimum fee are voluntary and should be disapproved as contributions under FAR 31.205-8, in the absence of evidence to the contrary. However, a larger company or one with a special need may derive more benefits than other industrial liaison program members. In such cases, all or a portion of the amount above the minimum fee may be allowable.

7-1102.4 Costs of Membership Fees in Organizations Engaged in Lobbying or Charitable Activities

The allowability of membership fees, association dues, or the costs of donated time or materials to any organization can normally be determined from the primary mission of the organization receiving the payments or benefits. We believe that all organizations fit three basic categories and that the allowability of associated costs is predicated on the nature and materiality of expenses.

a. Bona Fide Trade or Professional Organizations

If an organization is formed for the basic purpose of providing technical services to member contractors and the contractors can demonstrate that such services were actually received, the membership and associated costs are normally allowable, even though the organization may occasionally engage in an immaterial amount of lobbying activities or charitable endeavors.

b. Trade or Nonprofit Organizations Partially Engaged in Lobbying or Charitable Activities

The costs of membership or other support activities donated or supplied to organizations which are partially engaged in lobbying or charitable endeavors should be examined in light of their nature, purpose, and materiality. There is no hard and fast rule to apply to these conditions in order to objectively determine the extent of unallowable costs attributed to association with certain organizations. Therefore the following steps should be taken in order to provide reasonable assurances that unallowable contributions or lobbying costs are not billed or claimed by contractors when they are commingled with other allowable costs:

(1) Question any special assessment or separately identified portion of the costs of membership fees or other type costs applicable to lobbying or charitable activities as unallowable.

(2) Notify the contractor that it is responsible for the identification and removal from its claims and proposals of any unallowable activity costs and that it is required to maintain adequate records to demonstrate compliance with applicable cost principles.

(3) In the absence of documentation as to the amount of unallowable lobbying or charitable activities performed by such organizations, it may be difficult to question estimated unallowable activities. The auditor should request the contractor to obtain from the organization in question a confirmation letter identifying or estimating the amounts or percentages of lobbying or charitable effort expended by the organization in the accounting year being audited.

c. Organizations Dedicated to Lobbying or Charitable Activities

When it can be determined that the fees or other type costs associated with membership in these organizations are ultimately expended on lobbying or charitable activities, the costs are to be evaluated for allowability under FAR 31.205-8, or 31.205-22.

7-1102.5 Costs of Political Campaign Activities at Contractor Facilities

Costs associated with political campaign activities, such as candidates' appearances and speeches at contractor facilities, are unallowable in accordance with FAR 31.205-22(a)(1), Legislative Lobbying Costs, when such activities are clearly an attempt by the contractor to influence the outcome of an election by soliciting votes. The key considerations in this determination are how the candidate is portrayed by the contractor and the subject matter of the candidate's speech. When questioning such an event all costs associated with these activities including applicable burdens should be questioned.

7-1102.6 Contributions Claimed as Dues or Subscriptions

When auditing dues and subscription accounts auditors should be alert for any contributions paid separately or included as part of the billing. Professional organizations often include a suggested voluntary contribution as part of the membership dues. If the contractor receives something in return for the contribution (e.g., professional publications) it is the contractor’s responsibility to establish the value of the product or service received. The value of goods or services received is not a contribution; it is a purchase. The amount in excess of the value established is an expressly unallowable contribution under FAR 31.205-8.

7-1103 Professional Activity Costs

7-1103.1 General

a. Paragraph (c) of FAR 31.205-43, Trade, Business, Technical and Professional Activity Costs states that the cost of technical or professional meetings and conferences are allowable when the primary purpose of the meeting is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity, provided the costs meet the other requirements controlling allowability (FAR 31.201-2).

b. The cost principle makes the following type of professional and technical activity costs expressly allowable:

(1) Organizing, setting up, and sponsoring the technical and professional meetings, symposia, seminars, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs.

(2) Attending the meetings by contractor employees, including travel costs. (See FAR 31.205-46)

(3) Attending the meetings by individuals who are not contractor employees, provided the costs are not reimbursed to them by their own employer and their attendance is essential to achieve the purpose of the meetings.

7-1103.2 Conference Costs versus Entertainment Costs

a. Determinations as to whether or not expenses associated with a particular meeting or conference represent allowable business expense under FAR 31.205-43(c) provisions or unallowable social activity under FAR 31.205-14 (Entertainment Costs) should be made on a case-by-case basis, based on all pertinent facts.

b. Under the provision of FAR 31.205-43(c)(3), costs associated with the spouse of an attendee are not allowable because the spouse's attendance is not essential to achieve the purpose of the meeting.

7-1103.3 Business Meals

a. For individuals on official travel, assure the meal expense is not included in both the claimed travel costs and subsistence costs included as part of organizing the meeting.

b. For individuals not on official travel, assure that any meal expense is an integral part of the meeting as described in FAR 31.205-43(c), necessary for the continuation of official business during the meal period, and not a social function.

7-1103.4 Documentation

a. Determination of allowability requires knowledge concerning the purpose and nature of activity at the meeting or conference. The contractor should maintain adequate records supplying the following information on properly prepared travel vouchers or expense records supported by copies of paid invoices, receipts, charge slips, etc.

(1) Date and location of meeting including the name of the establishment.

(2) Names of employees and guests in attendance.

(3) Purpose of meeting.

(4) Cost of the meeting, by item.

b. The above guidelines closely parallel the current record-keeping requirements in Section 274 of the Internal Revenue code for entertainment costs as a tax deductible expense. Where satisfactory support assuring the claimed costs are allowable conference expenses is not furnished, the claimed conference/meal costs and directly associated costs (see 8-405.1d. for description) should be questioned.

7-1103.5 Standards of Conduct --- Federal Employees

Guest expenses for meals or other incidentals applicable to Federal employees should normally be questioned as unnecessary, and hence unreasonable costs, except under limited circumstances, since they are prohibited from accepting gratuities by Executive Order 11222 of 1965, Title 5 CFR 2635, and various departmental implementing directives (e.g., DoDD 5500.7, "Standards of Conduct").

7-1200 Section 12 --- Public Relations and Advertising Costs

7-1201 Introduction

This section provides supplemental guidance on audits of public relations and advertising costs including publications. The guidance in Chapters 2 through 6, 8, and 9 also applies to these areas.

7-1202 Applicability of FAR

FAR 31.205-1 defines and addresses the allowability of public relations and advertising costs.

7-1202.1 Definition of Public Relations and Advertising

Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities identified in the FAR definitions of public relations and advertising.

a. Public Relations

Public relations as defined in FAR 31.205-1(a) means all functions and activities dedicated to:

(1) Maintaining, protecting, and enhancing the image of a concern or its products; or

(2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising and customer relations.

b. Advertising

(1) Advertising as defined in FAR 31.205-1(b) means the use of media to promote the sale of products or services and to accomplish the activities referred to in FAR 31.205-1(d) (see 7-1202.2a) regardless of the medium employed, when the advertiser has control over the form and content of what will appear, the media in which it will appear, and when it will appear.

(2) Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, direct mail, dealer cards, window displays, outdoor advertising, radio, television, and internet/web-based.

7-1202.2 Allowability of Public Relations and Advertising Cost

FAR provisions 31.205-1(d), (e), and (f) address the allowability of public relations and advertising costs. These provisions and supplemental audit guidance are provided in the following paragraphs:

a. Advertising Costs

All advertising costs other than those specified in FAR 31.205-1(d) are unallowable. Allowable advertising costs include:

(1) Costs that arise from requirements of Government contracts and that are exclusively for:

(a) Acquiring scarce items for contract performance; or

(b) Disposing of scrap or surplus materials acquired for contract performance. If incurred for more than one Government contract or both Government and other work of the contractor, costs of this nature are allowable to the extent that the principles in FAR 31.201-3 (reasonableness), FAR 31.201-4 (allocability), and FAR 31.203 (allocation of indirect costs) are observed.

(2) Costs to promote sales of products normally sold to the U.S. Government that contain a significant effort to promote exports from the United States. See 7-1202.2g.

(3) Costs that are allowable in accordance with FAR 31.205-34, Recruitment Costs. See 7-2104.

b. Contract Requirements

Advertising and public relations costs specifically required by contract are allowable.

c. Liaison Cost

(1) Allowability of Liaison Costs

Allowable public relations costs include cost incurred for

(a) responding to inquiries on company policies and activities;

(b) communicating with the public, press, stockholders, creditors, and customers; and

(c) conducting general liaison with news media and Government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, and financial information.

(2) Audit Evaluation

(a) Public relations costs may encompass

(i) services performed in-house, possibly in a public relations or similarly designated department, by the contractor's own employees; and

(ii) services performed by the contractor's own employees at any offsite liaison office.

Public relations costs incurred in-house and offsite include the salaries and related travel and fringe benefits of the employees involved and an allocable share of supervision, space, utilities, and administration costs. Audit evaluation of public relations costs should encompass all of the foregoing aspects.

(b) The costs of offsite liaison/public relations offices are often substantial and the contractor's in-house records may not be sufficient to permit the necessary scope of audit of such costs. This condition would call for additional audit effort at the offsite facility to the extent required to determine the allowability, allocability, and reasonableness of the costs incurred by that facility.

d. Community Service Activities

(1) Costs of participation in community service activities such as blood bank drives, charity drives, savings bond drives, and disaster assistance are allowable.

(2) Under FAR 31.205-8, contributions and donations, whether in the form of money, goods, or services, are unallowable. However, the costs of services of executive and other personnel in support of charitable and community funds or other similar campaigns or drives are allowable under FAR 31.205-1(e)(3) and should not be questioned. When such services affect the concurrent full discharge of their other regular duties and responsibilities to the contractor by the personnel involved, the auditor should consider whether the costs are reasonable.

(3) Employee Leave Donation Programs

On February 11, 2002, the Director, Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS) issued a memorandum regarding the allowability of contractor payments to charitable organizations, such as those helping victims of the September 11, 2001 attacks, for the value of leave donated by employees. DPAPSS concluded that such payments for vacation and personal leave, but not sick leave, represent an allowable compensation cost under FAR 31.205-6, Compensation for personal services, rather than an unallowable contribution under FAR 31.205-8, Contributions or donations. Such costs are considered compensation costs for Government contract costing purposes regardless of the contractor’s classification of the costs for tax or financial accounting purposes. Such treatment will be considered appropriate for payments made prior to January 1, 2003. The DPAPSS conclusion was based on the Internal Revenue Service (IRS) ruling that employee donations of leave made before January 1, 2003 do not constitute taxable income to the employee and that employers may treat these employee donations as either ordinary and necessary business expenses or charitable contributions. On December 12, 2002, DPAPSS issued a memorandum stating that this treatment will not be extended to payments made after December 31, 2002. Therefore, contractors must record employee donations of vacation and personal leave made after December 31, 2002 as compensation costs.

e. Plant Tours and Open Houses

Costs of plant tours and open houses are allowable; however, costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities are unallowable under FAR 31.205-1(f)(5) (see 7-1202.2i).

f. Ceremonial Costs

Costs of ceremonies such as corporate celebrations and new product announcements are unallowable. Costs of keel laying, ship launching, commissioning, and roll-out ceremonies, to the extent specifically provided for by contract, are allowable.

(1) Ship Launching Ceremonies

Items of cost which are normally acceptable for ship launching ceremonies include (a) the construction of a minimum-size launching platform large enough to accommodate the launching party and speakers; (b) modest decorations of the launching platform and a sponsor's shelter, if needed; and (c) a bottle of champagne, decorative ribbon and suspension, and a simple decorative packing case without metal container.

(2) Sponsor's Costs

Costs related to personal expenses of the sponsor and its party, luncheons or dinners, and gifts for the sponsor are unallowable and should be questioned.

g. Air Shows, Special Events, and Trade Shows

Generally, air shows and trade shows are classified as broadly targeted selling efforts and are covered under FAR 31.205-1. However, the allowability of these costs has been complicated by numerous changes effected through the public laws to the regulations. These costs are classified as allowable or unallowable on contracts depending on when the costs were incurred.

In determining the allowability of air shows, special events, and trade shows, auditors must pay specific attention to the contract award date, when the costs were incurred, and the Governmental agency purchasing the goods and services. The chart below assists in identifying the applicable allowability criteria. The numbers are keyed to the following six paragraphs in this subsection. Advertising costs of air shows, special sales events, and trade shows with no foreign sales (export) value have been and still are unallowable costs. Likewise, entertainment costs and other costs not necessary to a sales presentation have always been and still are unallowable. For additional information on the allowability of foreign selling costs, see the chronology presented in 7-1306.2.

5/16/97 - Current	(1)	(1)
5/15/91 - 5/15/97	(2)	(2)
4/12/88 - 5/15/91		
Costs incurred on or after the start of the contractor’s 1st fiscal year beginning on or after 12/15/88	(3)	(4)
Costs incurred prior to the start of the contractor’s 1st fiscal year beginning on or after 12/15/88	(4)	(4)
Prior to 4/12/88	(5)	(6)

(1) Costs of “significant effort” to promote export sale of product normally sold to the U.S. Government are allowable. This includes air shows, trade shows, and special events.

(2) Costs of "significant effort" to promote export sale of products normally sold to the U.S. Government are allowable subject to a ceiling. This includes air shows, trade shows, and special events.

(3) (a) For DoD contracts open as of 5/15/91, (2) is retroactively applied to fiscal years beginning on or after 12/15/88.

(b) For DoD contracts open as of 12/15/88 but closed prior to 5/15/91, costs of "significant effort" to promote export sales of U.S. defense industry products were allowable subject to a ceiling. DoD contracts have specific coverage in the DFARS that is applied in place of the FAR coverage. The FAR coverage remained applicable to non-DoD contracts

as discussed in (4) below. For these DoD contracts, DFARS 231.205-1 and 231.205-38 provided that the costs of activities which contain "significant efforts" to promote exports of U.S. defense industry products are allowable. Such promotional activities primarily targeted at foreign selling are allowable even if they include domestic marketing efforts. Additional information regarding ceiling limitations and the effective dates are in 7-1306.2(d).

(4) The following costs to promote American aerospace exports at domestic and international exhibits, such as air shows, trade shows, and conventions, were allowable provided they were reasonable:
Transportation of the aircraft;
Aerospace parts and equipment;
Other associated support cost.

(a) These allowable costs did not include other exhibit costs (such as cost of entertainment, hospitality suites or chalets, advertising media other than exhibits, and other costs not necessary to establish, operate, or maintain an exhibit, display, or demonstration).

(b) In addition, the allowability coverage was limited to promoting a specific category of products (i.e., American aerospace products) to a specific class of customers (i.e., foreign customers). Accordingly, costs incurred for promoting a contractor's non-aerospace products at an international trade show, and that portion of costs incurred for promoting a contractor's aerospace products to American customers, were unallowable (Section 8062 of the 1988 Appropriations Act).

(5) For DoD contracts awarded prior to April 12, 1988 and completed before the start of the contractor's first fiscal year beginning on or after December 15, 1988, air shows, trade shows, and conventions were generally unallowable. However, for DoD contracts awarded prior to April 12, 1988 and still in progress on or after the start of the contractor's first fiscal year beginning on or after December 15, 1988, air shows, trade shows, and convention costs are generally allowable as described in (2) and (3). On such in-progress contracts awarded prior to April 12, 1988, the costs of air shows, trade shows, and conventions incurred in prior fiscal years remain generally unallowable. This type of change in the applicability of the cost principles based on the timing of cost incurrence is unusual. It was mandated by Public Law 100-456. These costs are allowable subject to a ceiling, which is described in 7-1306.2.

(6) For contracts with the U.S. Government other than with DoD awarded prior to April 12, 1988 and completed prior to May 15, 1991, air shows, trade shows, and conventions were generally unallowable. However, for non-DoD contracts awarded prior to April 12, 1988 and still in progress on or after May 15, 1991, air shows, trade shows, and convention costs are generally allowable as described in (2) if incurred on or after May 15, 1991. These costs are allowable subject to a ceiling, which is described in 7-1306.2.

(7) Audit Guidance

(a) Contracts awarded in the period discussed in 7-1202.2g(1), (2), and (3) do not require the segregation of promotional costs based on targeted customers. The provisions make allowable significant effort primarily targeting the promotion of exports even though domestic marketing efforts are included.

(b) For all contracts awarded in the period discussed in 7-1202.2g(4) the contractor must be able to document that the products are American aerospace products and that the targeted customers are foreign. Certain trade shows or exhibits target a mixed customer audience (both foreign and American customers). When an event targets both types of customers, only a portion of the costs (those targeting foreign customers) is considered allowable. FAR 31.204, Application of principles and procedures, requires the contractor to assign costs targeting domestic customers as unallowable and costs targeting foreign customers as allowable. The auditor should review the contractor's documentation and assumptions.

h. Meetings, Symposia, Seminars, and Other Special Events

Costs of sponsoring meetings, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information or stimulation of production are unallowable.

i. Promotional Material

Costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities are unallowable.

j. Souvenirs, Models, and Mementos

Costs of souvenirs, models, imprinted clothing, buttons, and other mementos provided to customers or the public are unallowable.

k. Costs of Memberships

(1) FAR Provision

Costs of memberships in civic and community organizations are unallowable.

(2) Audit Guidance

Allowable costs of memberships in trade, business, technical, and professional organizations (FAR 31.205-43) include dues paid to Chambers of Commerce. Dues paid to Army, Navy, and Air Force Associations are unallowable (7-1100). The minimum fee for membership in any university's industrial liaison program is allowable if reasonable, provided it is supported by evidence of bona fide services available or rendered (7-1100). Expenditures for influencing legislation are unallowable by Federal statute. Any identifiable portion of the costs of memberships in bona fide trade, business, technical, and professional organizations, intended for use in connection with influencing legislation is likewise unallowable (FAR 31.205-22).

l. Other Public Relations Costs to Promote Sales

Under FAR 31.205-1(f)(1), unallowable public relations costs include costs of efforts whose primary purpose is to promote the sale of products or services by stimulating interest in a product or product line, or disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services. Exceptions to this unallowability rule include

(1) a limited list of allowable public relations costs in FAR 31.205-1(e) and

(2) direct selling efforts discussed in FAR 31.205-38(b)(5).

7-1203 Public Relations Costs

7-1203.1 Contractor's Accounting Systems

Public relations consists of different types of materials and services which by themselves may be separately treated in FAR 31.205. Moreover, many contractors do not establish public relations as a separate category of cost in their accounting systems. Although they may be recorded in other accounts, public relations costs are most likely to be found as part of:

a. Advertising Costs (FAR 31.205-1).

b. Compensation for Personal Services (FAR 31.205-6).

c. Contributions and Donations (FAR 31.205-8).

d. Employee Morale, Health, Welfare and Food Service and Dormitory Costs and Credits (FAR 31.205-13).

e. Entertainment Costs (FAR 31.205-14).

f. Labor Relations Costs (FAR 31.205-21).

g. Other Business Expenses (FAR 31.205-28).

h. Professional and Consultant Service Costs-Legal, Accounting, Engineering and Other (FAR 31.205-33).

i. Selling Costs (FAR 31.205-38).

j. Trade, Business, Technical and Professional Activity Costs (FAR 31.205-43).

7-1203.2 Review of Public Relations Costs

Contractor expenditures for public relations and advertising activities identified in FAR 31.205-1(f) (see 7-1202.2) and those which meet the criteria for contributions and donations, or entertainment costs are unallowable under the cited FAR provisions. The extent of and criteria for allowability of the other above listed cost categories are expressed in the identified FAR paragraphs. Appropriate audit steps should be designed to identify public relations items in each category and to evaluate their allowability.

a. Factors to be Considered

When reviewing the different categories of costs, the most important major factors to be considered are the nature of the service rendered, the function performed, the propriety of the base of allocation, and the basic consideration of reasonableness as defined in FAR 31.201-3. Nomenclature or similar less-than-in-depth audits are apt to result in an incorrect determination.

(1) Nature of Services Rendered and Functions Performed

The nature of the service rendered and the function performed are important in determining the proper classification of costs. FAR 31.204(d) provides that the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with the cost at issue. This FAR provision prevents contractors from successfully claiming unallowable public relations costs under more favorable and broader cost principle coverage; e.g., unallowable costs of ceremonies (FAR 31.205-1(f)(4)) claimed as employee morale and welfare under FAR 31.205-13 (but see 7-2117.3).

(2) Reasonableness and Allocability of Costs

(a) The auditor should be primarily concerned with the positive criteria of allowability, reasonableness and allocability. Costs will generally be considered reasonable if they are of a type normally recognized as ordinary and necessary for the contractor's business, or are the actions of a prudent businessman in the conduct of competitive business. On the other hand, costs which represent a significant deviation from established business practices, increasing contract costs, are likely to be unreasonable.

(b) The reasonableness of costs should also be viewed from the standpoint of magnitude. Careful scrutiny should be given to large amounts of public relations expenditures especially when there have been significant increases relative to the base from prior years. This is particularly true when most of the contractor's costs are allocated to Government contracts. Accordingly, where amounts appear to be disproportionately large or otherwise out of line, the auditor should consider questioning costs as appropriate, even though they fall within allowable classifications.

b. Special Audit Considerations

Special audit considerations for certain other items of public relations cost are summarized below.

(1) Government Requested Public Relations and/or Advertising Activities

The types of public relations and advertising costs which are unallowable, and the limited ones that are allowable, are set forth in FAR 31.205-1. Even in instances where a contractor is satisfying a contract related suggestion or request by Government contracting personnel, a public relation or advertising cost that is classified as unallowable by this section remains unallowable. However, FAR 31.205-1(d) provides the contracting officer with the latitude to request public relation or advertising effort when needed to meet contract requirements. To be allowable, the public relations and/or advertising activity must be specifically required by contract or modification. Unallowability would also extend to the costs of exhibits in which the contractor is invited to participate by any agency of the Government, and at which the company or its products are publicized for the purpose of delivering a sales message.

(2) Public Relations Account

The auditor may occasionally find a contractor that maintains an account entitled public relations. Such accounts should not be questioned/disapproved on a nomenclature basis; rather an adequate analysis of their contents should be made since they may contain both allowable and unallowable costs. FAR 31.201-6 incorporates Cost Accounting Stan-

dard (CAS) 405 which requires contractors to identify unallowable costs (see 8-405). The auditor should coordinate with the administrative contracting officer in obtaining necessary refinements in the contractor's accounting procedures to identify unallowable public relations costs.

c. Reporting

Public relations types of costs are particularly sensitive because of their controversial nature. Audit coverage should therefore be of commensurate scope and depth. Reasons given in audit reports for audit questioned or disapproved costs should be clear, precise, and complete.

7-1204 Publication Costs

Publication costs claimed by a contractor may include costs related to the preparation and dissemination of such items as plant newspapers and magazines, recruitment pamphlets, technical brochures, and contractor and product capability promotional items. These items may be disseminated in hardcopy or electronic format (e.g., web pages, web sites, CDs, etc.), or both. While the amounts individually may not be significant, collectively on DoD procurements they amount to significant dollars.

7-1204.1 Audit Guidelines

a. Audits of claimed publications costs should be based on an appropriate examination of the contractor's policies and procedures (6-600), as well as on a selective review of individual publications. FAR specifically allows (within limitations) help wanted, scarce and scrap material advertising (31.205-1(d)); house publications (31.205-13), and corporate stockholders reports (31.205-28).

b. The allowability of the cost of any publication which is construed as public relations and/or advertising must be determined in accordance with FAR 31.205-1. Unfortunately, the contents of the publications do not always lend themselves to a ready determination as to the FAR category into which they fall. To assist in these determinations the following guidance sets forth five broad categories into which most publications may be grouped.

7-1204.2 Broad Categories Covering Publications

Examples of the types of publications to be included under each category and factors which indicate the appropriate section of FAR under which the allowability of the related costs should be determined are discussed below.

a. Employee Welfare and Industrial Relations

(1) The most common publications of this type are regularly issued newspapers or magazines. These publications generally provide information as to events of interest within the organization or of the employees' outside activities. Although there are frequently articles on company achievements, the intent here is to instill a feeling of accomplishment rather than to advertise. Other industrial relations publications incorporate information on available employee benefits, safety, and education. Dissemination of the above types of publications is usually limited to immediate employees and/or their families. The related costs of the foregoing publications are considered allowable under FAR 31.205-13.

(2) Recruitment pamphlets and materials which are used primarily to explain the available fringe benefits to prospective employees should be considered in conjunction with the review of help wanted advertisements and as such are allowable under FAR 31.205-1 subject to the limitations of FAR 31.205-34 (see 7-2104).

b. Professional and Technical Articles

(1) These publications are disseminated to a professional or technical type audience and generally take the form of dissertations on technical subjects that are related to the

contractor's products or activities. This type of publication has generated much of DoD's interest in contractors' house publications. In most instances the costs of publishing such material can better be related to professional activity costs since they are the result of, or are copies of, papers delivered at professional meetings. Others are dissemination of articles of scientific interest from other sources.

(2) In evaluating individual publications of this nature, difficulty may be experienced in determining whether they should be classified as capability advertising or as technical treatises. Some difficulties will normally arise where there are subtle, even though infrequent, references to the contractor. Where such references are the only questionable aspect of the publication, it would be extremely difficult to support a position that these references necessitate consideration of the publication as an advertisement. Therefore, to the extent that the publication costs incidental to technical presentations at meetings and conferences and dissemination of such technical papers for use in contractors' house publications are reasonable and allocable, and can be construed as providing technical information rather than advertising, such publications are considered allowable within the intent of FAR 31.205-43.

c. Selling, Marketing, and Advertising

In those instances where the material provides little or no technical assistance to the recipient and is distributed to all customers and/or potential customers, the cost should be treated as advertising (FAR 31.205-1) or selling costs (FAR 31.205-38). More specific guidance in determining the allowability of selling costs is in 7-1300. Advertising costs of this nature are unallowable (see 7-1202.2a).

d. Contractor and Product Capability Promotional Items

(1) These differ from normal selling, marketing, and advertising publications in that they stress the superior capabilities of the contractor's facilities and/or personnel in research and/or development of new products. They may also advertise achievements of the contractor, but generally do not supply detailed technical data. Advertising costs of this nature are unallowable under FAR 31.205-1(f) (see 7-1202.2a). Accordingly, such costs should not be accepted under cost-type contracts and should be questioned in advisory audit reports for price negotiation purposes.

(2) Certain publications can be clearly identified as capability advertising; however, in some cases publications that provide technical data necessary for equipment operation may include some descriptive data that could be construed as capability advertising if taken out of context. The primary purpose of the publication and type of distribution, such as, operating manuals delivered with the equipment, would be the significant factor in determining allowability.

e. Public Relations

This category includes pictures, images, decals, and promotional material that emphasize the contractor's accomplishments in producing equipment or providing services. They do not contribute to the performance of the Government contracts, even if they are related to items produced under such contracts, but merely serve to enhance the contractor's reputation. The costs of such items are unallowable (see 7-1202.2).

7-1205 Contractor Logos and Emblems

7-1205.1 Contracting Officers' Position

A common practice for a company is to identify its products using logos and emblems. Some contracting officers are concerned over the costs being incurred for contractors' logos and emblems being placed on Government systems. These contracting officers are treating the direct and indirect costs for logos and emblems produced by means of a special mold or casting (not simple stick-on adhesive decals) as unallowable advertising costs under FAR 31.205-1.

7-1205.2 Audit Procedures

a. Applicable FAR Provisions

The contracting officers' position reflects an internal negotiating/contracting policy. This policy is enforceable to the extent that contracting officers obtain contractor concurrence and include a specific clause in contracts making such costs expressly unallowable or issue a notice of intent to disallow. Unless contracts contain such a clause, contractors need only comply with FAR 31.205-1 and FAR 31.201-3, Reasonableness.

b. The use of the terminology “logos and emblems” may be misleading. Logo is an abbreviation for the word logotype, which actually means the standard ways in which to letter or set in type the company trade name, while emblem represents the mark of a nonprofit organization. However, "contractor logos and emblems" as used in Government contracting represent the actual design and typesetting of all company marks. Company marks can be trademarks (companies who manufacture products) or service marks (companies who provide services to their customers). Regardless of the type of mark, the key factor is the purpose for which the marks are designed. Marks are initially designed to meet three main purposes,

(1) to indicate the origin of the product or service provided,

(2) to guarantee quality consistency (the mark tells the buyer that the product or service is the same as that provided previously), and

(3) to serve as an advertisement (simple enough to catch attention, complete enough to tell a story, and persuasive enough to move the viewer to action).

When a company initially designs a mark, each of these three purposes are relevant. Therefore, disallowance of these costs under FAR 31.205-1 is generally not practicable. However, the initial design of logos and emblems may be challenged as unreasonable if costs are determined to be excessive.

c. While the initial design of a company mark cannot generally be questioned under FAR 31.205-1, the redesign can be. When a company redesigns its mark, the public is usually already familiar enough with the original mark to know the origin of the product; thus, this purpose is usually not relevant to a redesign. In addition, redesigning the mark does not serve to guarantee quality consistency, since the original mark already told the prospective buyer that the product or service is the same as that previously provided. However, redesigning the mark does serve as an advertisement, since it is intended to catch the attention of those who were previously unaware of the company, tell a story (a new one or the rephrasing of an old one), and be persuasive enough to move a viewer to take a form of action that the old mark could not. Thus, the major purpose of redesigning a company mark will usually be advertising; if this is the case, then these costs are unallowable under FAR 31.205-1.

d. A company mark may be redesigned for other reasons, such as a corporate merger, reorganization, etc. The auditor must carefully consider the purpose of redesigning the company mark in determining the allowability of such costs. For example, if the redesign results from a reorganization, then FAR 31.205-27, Organization Costs, should be considered in evaluating the allowability of these costs. Furthermore, as was the case with the initial design, the redesign of logos and emblems may also be challenged as unreasonable if costs are determined to be excessive.

e. Audit Evaluation

(1) Auditors should continue to evaluate proposed advertising costs, including the redesign of logos and emblems, in accordance with the FAR. Excessive costs of logos and emblems, even those falling within allowable categories under the FAR provisions, should be questioned based on reasonableness.

(2) Comments may be included, as part of the applicable report exhibit note, on the effect of the contracting officer's position on proposed costs.

(3) FAOs should assure that the auditor's review of contract provisions (see 3-202) clearly identify special contract clauses disallowing the costs of logos and emblems. Audit programs for evaluation of direct and indirect costs should include steps to verify compliance with this and other contractual cost limitations.

7-1300 Section 13 --- Selling Costs

7-1301 Introduction

This section contains general audit guidance in determining the allowability, allocability, and reasonableness of selling costs under Government contracts including:

a. Selling costs as discussed in FAR 31.205-38,

b. Selling costs under Foreign Military Sales contracts as discussed in DoD FAR Supplement (DFARS) 225.7303-2 and 225.7303-4, and

c. Contingent fees as discussed in FAR 3.400.

7-1302 General Audit Considerations

Selling expenses are subject to the same basic audit procedures and tests for allocability and reasonableness as manufacturing and administrative expenses. However, there are certain factors for special consideration. Where a significant amount of selling expense is involved there should be adequate tests of the individual items and accounts classified under this expense category to enable the auditor to fully understand:

(1) the type and size of the contractor's sales organization,

(2) the basis of employee compensation,

(3) the nature of the selling and distribution activities involved,

(4) their relationship to the contractor's different operations, products or product lines, and

(5) their applicability to Government and commercial business.

A nomenclature review of account titles is not sufficient for this purpose.

7-1303 Proper Classification of Selling Expenses

7-1303.1 Nature of Selling Effort

a. The nature of costs classified and charged as selling expense should be compatible with the provisions of FAR 31.205-38. The costs of such effort are considered allowable if reasonable in amount. Although the generic term "selling" encompasses all efforts to market a contractor's products, the acceptability of the costs of this effort are governed by several subsections of FAR 31.205. Costs that fall into the following categories should be classified accordingly. These costs should be evaluated using the appropriate subsection of FAR 31.205:

(1) Advertising costs (FAR 31.205-1). Also see 7-1200.

(2) Corporate image enhancement and public relations costs (FAR 31.205-1). Also see 7-1200.

(3) Bid and proposal/independent research and development costs (FAR 31.205-18). Also see 7-1500.

(4) Entertainment costs (FAR 31.205-14).

(5) Long-range market planning costs (FAR 31.205-12).

b. Costs of activities which are correctly classified and disallowed under the above cost principles should not be considered as allowable costs under FAR 31.205-38 or any other subsection of FAR 31.205.

7-1303.2 Illustrations of Improper Classification

The following illustrations represent the use of other FAR 31.205 subsections in reviewing a contractor's claimed selling costs for proper classification:

a. A contractor incurred engineering costs incident to adapting a system currently being produced for the Government on one program for possible use on another major weapon

system. The engineering effort was related to reducing the weight of the current system so it would be suitable for use on the other program. The effort performed included

(1) development of a new cooling concept;

(2) development of a new mechanical configuration and installation concept;

(3) installation analysis of electrical power requirements; and

(4) evaluation of reliability predictions and maintainability considerations.

The contractor classified and claimed these costs as selling expense. Since the nature of the effort was "development," the costs should have been classified as independent research and development expenses and the criteria contained in FAR 31.205-18 applied. The effort of technical personnel can properly be classified as selling costs only when they are functioning in a marketing role. Selling does not include generating the technology which the contractor is trying to market. Due to the Government's exposure to risk in this area, technical effort charged to selling expense should be closely monitored and reviewed for proper classification.

b. A contractor incurred costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines and other media that were designed to call favorable attention to the contractor and its activities. FAR 31.205-38(b) prohibits the contractor from claiming these costs as selling expenses, since FAR 31.205-1(f)(5) specifically disallows such costs as unallowable advertising or public relations costs.

7-1303.3 Audit Techniques to Identify Improperly Classified Selling Cost

The audit techniques and procedures necessary to determine whether a contractor has properly classified selling effort may include:

a. Floor checks and interviews of contractor personnel.

b. A review of documentary evidence establishing the purpose of the effort. This may include work order authorizations, expenditure authorizations, management reports, and board of directors' minutes.

c. An examination of correspondence with selling agents to ascertain the true nature of the activities and evidence of disputes over amounts of fees and commissions due.

d. Technical assistance which may be useful in determining the proper classification of selling effort.

7-1304 Allocability of Selling Costs

7-1304.1 General Allocability Considerations

a. FAR 31.201-4 and 31.203 contain criteria regarding the allocability of costs to cost objectives. These sections also apply to the determination of the allocability of selling costs. Proper allocability is accomplished by

(1) the direct charge or

(2) apportionment to particular cost objectives such as products, product lines or individual contracts, by means of a basis that will apportion the expenses in accordance with the benefits derived by the particular cost objectives, or the purposes for which the expenses were incurred.

Also see 6-606 regarding allocability.

b. FAR 31.202(a) and 31.203(b) require, for costs incurred for the same purpose in like circumstances, consistency in the allocation of these costs as direct or indirect costs. Where a specific type or category of selling expense is allocated as a direct charge to Government contracts or other cost objectives, care must be exercised to assure that all items or transactions in the same type or category applicable to other cost objectives are likewise allocated as a direct charge.

c. FAR 31.203(c) addresses selection of appropriate bases for allocation of indirect costs. The selection of an appropriate base for the apportionment of selling expenses as an indirect charge involves certain considerations different from those applicable to manufac-

turing expenses. Manufacturing expenses are usually apportioned without regard to the specific end item being manufactured or the customer to whom the item may ultimately be sold. These latter factors, however, are important considerations in apportioning selling expenses which may indicate that an over-all allocation of selling expenses on the basis of cost of sales or cost of goods manufactured may not be equitable. The auditor should perform a careful analysis of the time, effort, and expense incurred for selling activities in relation to the company's products, product lines or other objectives to determine the most suitable base for apportioning selling expenses.

d. When a contractor, with contracts subject to the Cost Accounting Standards, includes selling costs in its G&A pool, those costs are subject to the provisions of CAS 410.40(d) and 410.50(b)(1). CAS 410 does not provide guidelines on how foreign selling cost should be allocated, but instead takes a permissive position. These sections require that marketing costs, whose beneficial or causal relationship to business unit cost objectives can best be measured by a base other than a cost input base representing the total activity of a period, be removed from the G&A expense pool and allocated on a representative base. If a total cost input or value-added base is used to distribute G&A expenses, selling costs would then become part of the G&A allocation base. See also 8-410.

7-1304.2 Special Considerations for Allocability of Selling Costs

a. Selling agents' fees and commissions will usually be charged direct to contracts since, in most cases, independent agents are used and paid for individual sales transactions. However, where an agent is paid a retainer, fees may be charged indirectly. Where fixed retainer fees are paid to agents representing the contractor in specific geographical areas, they should normally be allocated to all applicable sales in these areas.

b. A review of past activities of the sales agents or selling agencies as they relate to the contractor's products or services may be useful in identifying causal or beneficial relationships of the agents' or agencies' services to the final cost objectives. A review of any agreements between sales agents and the contractor may also prove useful in verifying allocability.

7-1305 Reasonableness of Selling Cost

Reasonableness involves consideration of

(1) the nature and amount of these costs in light of the expenses which a prudent individual would incur in the conduct of competitive business,

(2) the proportionate amounts expended by Government and commercial business,

(3) the trend and comparability of the company's current period costs in relation to prior periods,

(4) the general level of such costs within the industry, and

(5) the nature and extent of the sales effort in relation to the selling costs and to the contract value.

The foregoing considerations may result in a determination that a particular item or category of selling expense is not reasonable either in total due to its nature or in part due to the excessiveness of the amount involved (see FAR 31.201-3). In determining reasonableness, the following factors should receive special consideration:

a. Some companies engaged in defense production expend substantial amounts to establish and maintain large staffs of salesmen and engineers whose primary function is obtaining new or additional Government business on a prime or subcontract basis for existing company products and to seek out other products required by the Government which the company can manufacture with its existing facilities. The submission of unsolicited bids and proposals and the preparation of brochures setting forth the company's capabilities and past accomplishments with respect to defense work usually represent an important aspect of this function. In periods of low volume, companies may divert normal production

engineering personnel to augment their sales staff on a temporary basis or hire additional sales personnel to increase volume.

b. If appropriate safeguards are not maintained with respect to selling expenses, companies engaged wholly or substantially in Government production under flexibly priced contracts may conceivably be encouraged to increase their selling activities without restraint since they would expect to be compensated therefore as a necessary cost of doing business. Other companies in the same industry with little or no existing flexibly priced Government business (cost-type or price-redeterminable contracts) would thus be placed in an unfavorable competitive position for new Government business as compared with those companies who in effect have been subsidized by the Government for their selling activities.

c. Each audit should also include an appraisal of the extent to which the sales promotion, consultation, technical, liaison and other related activities engaged in by the contractor's personnel produced a recognizable benefit to the Government in consonance with the amounts included in the contractor's claims or cost representations. "Benefit to the Government" should be considered, in a broad sense, as the acceptability of selling expense is not necessarily contingent upon a showing of proof that the performance of a specific item would not have been possible without the incurrence of such expenses. If it can be established that useful and desirable information was exchanged or that technical matters concerning existing contracts were discussed during visits by the contractor’s personnel to Government procurement offices, the resulting costs may be considered to result in "benefit to the Government." This situation is contrasted with visits made for purely promotional purposes where a contractor's sales representative seeks Government contracts or related information and his or her visits do not result in any commensurate benefit to the Government.

7-1306 Allowability of Selling Cost

7-1306.1 Introduction

Several types of selling costs are expressly unallowable per FAR 31.205-38 and other subsections of the FAR and DFARS. FAR 31.201-6 and CAS 405 (see 8-405) require contractors to identify and exclude any expressly unallowable costs, including directly associated costs, from any billing, claim, or proposal applicable to a Government contract. Costs that have been made expressly unallowable by other subsections of FAR 31.205 should not be considered as allowable selling costs under 31.205-38 (see 7-1303). Auditors should screen selling costs to ensure that contractors have properly identified and segregated the expressly unallowable costs discussed in the sections that follow.

7-1306.2 Foreign Selling Costs

a. Direct selling costs incurred in connection with potential and actual Foreign Military Sales, as defined by the Arms Export Control Act, or foreign sales of military products or services have been specifically allowable or unallowable on U.S. Government contracts for U.S. Government requirements depending on the date of the contract or when the costs were incurred and the issuing agency.

b. The following chronology shows the regulatory history of foreign selling costs (see 7-1202.2g):

(1) 1/20/86 - 5/15/91

Foreign selling costs were unallowable on U.S. Government contracts for its own requirements. (FAR 31.205-38(f))

(2) 4/12/88 - 12/15/88

Costs of "significant effort" to export American aerospace products were made allowable in the FAR as an exception to the normal rule on foreign selling costs. (FAR 31.205-1(g)) Other foreign selling costs remained unallowable. (FAR 31.205-38(f))

(3) 12/15/88 - 5/15/91

Effective December 15, 1988, the DAR Council issued new DFARS cost principle coverage for foreign selling costs to implement the requirements of Section 826 of the Defense Authorization Act for FY 1989 (P.L. 100-456). Costs of "significant effort" to export U.S. defense industry products were made allowable (as an exception to the FAR rule) for DoD contracts, subject to a ceiling of 110% of the prior year's costs for those business segments allocating $2,500,000 or more of such costs to DoD contracts. (DFARS 231.205-1 & 231.205-38) The allowability of costs for all other business segments was subject to the usual reasonableness criteria. The FAR rules were unchanged.

(4) 5/15/91 - 5/15/97

Effective May 15, 1991, the DFARS coverage was moved to the FAR, thereby applying the rule to all U.S. Government contracts. Costs of "significant effort" to export products normally sold to the U.S. Government were allowable for all U.S. Government contracts, subject to a ceiling of 110% of the prior year's costs (for those business segments allocating $2,500,000 or more of such costs to U.S. Government contracts) and the allocability, reasonableness, and allowability tests otherwise applicable to such costs. (FAR 31.205-1(d)(2) & 31.205-38(c)(2)).

(5) 5/16/97 – 8/25/03

Effective May 16, 1997, FAR 31.205-38(c)(2) was revised to remove the $2.5 million threshold and the 110% ceiling on allowable foreign selling costs. Costs of “significant effort” to export products normally sold to the U.S. Government are allowable for all U.S. Government contracts subject to the allocability, reasonableness, and allocability tests otherwise applicable to such costs. (FAR 31.205-1(d)(2)). See guidance in 7-1304, 1305, and 1306.1 for discussions on allocability, reasonableness, and allowability of selling costs.

(6) 8/25/03 – Current

Effective August 25, 2003, FAR 31.205-38 was revised to remove the distinction between the allowability of foreign and domestic selling costs involving direct selling and market planning efforts other than long range planning. This eliminates the requirement that foreign selling costs must be related to products normally sold to the U.S. Government to be allowable. However, distinguishing between foreign and domestic broadly targeted sales efforts remain unchanged. The allowability of these costs are covered in FAR 31.205-1 (see 7-1202.2).

Effective May 16, 1997, FAR 31.205-38(c)(2) was revised to remove the $2.5 million threshold and the 110% ceiling on allowable foreign selling costs. Costs of “significant effort” to export products normally sold to the U.S. Government are allowable for all U.S. Government contracts subject to the allocability, reasonableness, and allowability tests otherwise applicable to such costs. (FAR 31.205-1(d)(2)). See guidance in 7-1304, 1305, and 1306.1 for discussions on allocability, reasonableness, and allowability of selling costs.

7-1306.3 Sellers' or Agents' Compensation, Fees, Commissions, etc.

a. FAR 31.205-38(c) makes unallowable sellers' or agents' compensation, fees, commissions, percentages, retainer, or brokerage fees, whether or not contingent upon the award of contracts, except when paid to bona fide employees or established commercial or selling agencies maintained by the contractor. DFARS 225.7303-4 extends this guidance to FMS contracts (see 7-1307). The following guidance is applicable to the review of sales agents' fees and commissions:

(1) Business firms sometimes hire an independent organization or individual to conduct business on their behalf. Often this is done for foreign locations where it would be too difficult and/or expensive to open and maintain a regular place of business. An organization or individual hired for this purpose is known as an "agent" of the employing firm. If hired specifically to make sales for the firm, the person or organization is known as a sales agent and is usually paid a fee or commission calculated on some percentage of his sales.

(2) Agents' fees are normally not encountered in domestic DoD contracts. They are usually included in foreign military contracts and may be paid under either of two forms of foreign procurements:

(a) the foreign government may buy direct from a U.S. contractor or

(b) it may use DoD's procurement resources to buy items commonly referred to as foreign military sales (FMS).

In either case, if agents are involved in arranging the sales, their fees should be identified in contractors' proposals. See 7-1307 regarding FMS contracts.

(3) FAR 3.402 states that contingent fees for soliciting or obtaining Government contracts are considered contrary to public policy because such arrangements may lead to attempted or actual exercise of improper influence. However, an exception is provided for contingent compensation arrangements with bona fide employees or bona fide agencies (FAR 3.402(b) & FAR 31.205-38 (c)). As defined in FAR 3.401, a bona fide employee or bona fide agency neither exerts nor proposes to exert improper influence to solicit or obtain Government contracts, nor holds out as being able to obtain any Government contract or contracts through improper influence.

b. Payments of commissions, fees, or compensation of any kind by, or on behalf of, a subcontractor to any officer, partner, employee, or agent of a prime contractor or upper-tier subcontractor as an inducement for, or acknowledgment of, a subcontract award under any negotiated contract with the Government are prohibited by the Anti-Kickback Statute. When the auditor discovers that such fees or commissions have been paid, the procedures in 4-704 should be followed.

7-1307 Selling Costs Under Foreign Military Sales (FMS) Contracts

7-1307.1 General Requirements

The basic procurement policy for pricing FMS contracts is in DFARS 225.7303. These regulations supplement those policies contained in FAR Part 31 and FAR Subpart 3.4.

7-1307.2 Definition of Foreign Military Sales (FMS)

The Arms Export Control Act (formerly known as the Foreign Military Sales Act of 1968) defines FMS as sales of defense articles and services to foreign governments. Although it is DoD policy to encourage the purchase of defense articles and services directly from U.S. sources, most of them are purchased through established DoD procurement and contract administration channels because many kinds of defense transactions are not conducive to direct sales. These include transactions that require Government-to-Government arrangements, such as sales of classified equipment, items produced in U.S. arsenals, major weapon systems, and sales in situations where the U.S. Government wants to exercise special control. Additionally, foreign governments usually want the advantages of DoD's procurement expertise, including contract administration and audit. Thus, FMS only encompasses Government-to-Government transactions as defined by the DoD Security Assistance Management Manual (DoD 5105.38-M).

7-1307.3 Audit Considerations

a. DFARS 225.7301(b) requires that acquisitions for FMS contracts be conducted under the same acquisition and contract management procedures as other defense contracts. DFARS 225.7303(a) states that foreign military sale contracts are to be priced using the same principles as are used in pricing other defense contracts. However, application of the principles contained in FAR Part 15 and FAR Part 31 may result in prices that differ from other defense contract prices for the same item. Therefore, DFARS 225.7301(c) requires known FMS requirements to be separately identified in solicitations.

b. DFARS 225.7303-2(a) provides for the recognition of, under FMS contracts, the costs of doing business with a foreign government or international organization.

c. According to DFARS 225.7303-2(c), the cost limitations for major contractors on bid and proposal (B&P) costs and on independent research and development (IR&D) costs for projects that are of potential interest to DoD, in DFARS Part 231.205-18(c)(iii), do not apply to FMS contracts, except as provided in DFARS 225.7303-5; i.e., for acquisitions wholly paid for from nonrepayable funds. IR&D and B&P costs allowed on FMS contracts, not wholly paid for from funds made available on a nonrepayable basis, shall be limited to the contract's allocable share of the contractor's total IR&D/B&P expenditures. In pricing FMS contracts, use the best estimate of reasonable costs in forward pricing. Use actual expenditures to the extent that they are reasonable, in determining final cost.

d. Costs of sales agents' commissions or fees under FMS contracts are subject to the allowability criteria as specified in FAR 31.205-38(c) (see 7-1306.3). However, DFARS 225.7303-4 provides additional guidelines on the allowability of contingent fees under FMS purchases. The following guidance is relevant when reviewing the acceptability of contingent fees under FMS contracts:

(1) As specified in FAR 31.205-38 (c), the commissions and fees are allowable only if paid to a bona fide employee or a bona fide established commercial or selling agency. DFARS 225.7303-4(a) also requires that the contracting office determine that contingent fees are fair and reasonable.

(2) The auditor should request from the contractor documents or other information bearing on the allowability and reasonableness of the agent's commissions or fees.

(3) Commissions and other items of cost such as taxes and miscellaneous fees, unique to each country, must be handled on an individual basis in evaluating the overall reasonableness of the agent's fees. These costs should be brought to the contracting officer's attention through coordination and reporting.

(4) DFARS 225.7303-4(b)(1) provides a listing of countries that have prohibited the payment of sales commissions or fees, unless such payments have been identified and approved in writing by the Government involved prior to contract award. For FMS to countries not included in the listing, DFARS 225.7303-4(b)(2) specifies that contingent fees exceeding $50,000 per FMS case are unallowable under DoD contracts, unless payment has been identified and approved in writing by the foreign customer before contract award.

e. DFARS 225.7303-5 states that sales to foreign governments wholly paid for from funds made available on a nonrepayable basis shall be priced like domestic DoD acquisitions in regard to profit, overhead, IR&D/B&P and other costing elements. The determination of whether the funds are nonrepayable can be made from the Letter of Offer and Acceptance (LOA) between the U.S. Government and the Government of the foreign country, which the contracting officer can provide. Nonrepayable funds, made available through Congressional appropriations under Foreign Military Financing programs, are similar to grant aid, which the foreign government must spend on defense products of U.S. contractors.

7-1307.4 Foreign Military Sales (FMS) Offset Arrangements

a. The purpose of an FMS offset arrangement is to fulfill commitments negotiated pursuant to an FMS agreement. The general policy in fulfilling these commitments is to exempt the FMS country's products from the requirements of the Buy American Act on a case-by-case basis. DFARS 225.7307 contains additional information on the implementation of offset arrangements.

b. DFARS 225.7303-2(a)(3) permits defense contractors to recover costs incurred to implement their offset agreements with a foreign government or international organization if the LOA is financed wholly with customer cash or repayable foreign military finance credits. Since the U.S. Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs, auditors should be sure that these costs are charged direct to the contract and not charged to indirect expense pools and allocated to domestic Government business. Charges to domestic Government contracts

should be questioned if claimed by the contractor. In addition, a U.S. defense contractor may not recover costs incurred to implement its offset agreement with a foreign government or international organization if the foreign military sale is financed with funds made available on a nonrepayable basis. Auditors should be sure these costs are not recovered directly on the contract or charged to indirect expense pools (DFARS 225.7303-5(c)).

7-1400 Section 14 --- Taxes

7-1401 Introduction

This section provides general guidance in reviewing the allocability and allowability of taxes, including Federal, state, and local taxes; employment taxes; employment taxes of successor contractors following mergers or consolidations; Federal excise taxes; foreign taxes; and environmental taxes.

7-1402 Unallowable Taxes

a. FAR 31.205-41(b) states that the following types of taxes are expressly unallowable as costs under Government contracts:

1. Federal income and excess profits taxes.
2. Taxes in connection with financing, refinancing, or refunding of operations, or reorganizations (see also FAR 31.205-20 and 31.205-27).
3. Taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government, except when the contracting officer determines that the administrative burden of obtaining the exemption outweighs the benefits accruing to the Government (see FAR Part 29).
4. Special assessments on land that represent capital improvements.
5. Taxes (including excises) on real or personal property or on the value, use, possession or sale thereof, which is used solely in connection with work other than on Government contracts (see also 7-1403.1a below).
6. Taxes on accumulated funding deficiencies of, or prohibited transactions involving, employee deferred compensation plans pursuant to Section 4971 or Section 4975 of the Internal Revenue Code of 1986, as amended.
7. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements (see also 7-1403.4a below).

b. Contractors that elect Subchapter S Corporation tax status are not taxed at the corporation level and thus are not normally required to pay state or local income taxes or to accrue such tax liability. Instead, the corporate income passes through to the shareholders and is taxed on the shareholders' personal income tax returns. Accordingly, state and local taxes that are passed through to the individual shareholders are not an expense of the corporation and as a result, are not allowable costs under Government contracts. Auditors should ensure that contractors who have elected Subchapter S tax status, or any other tax status (e.g., Limited Liability Corporation) in which taxes on the pass-through income of the corporation are required to be paid by the individual shareholders, are claiming only those taxes which are required to be paid or accrued by the contractor. Individual shareholder state and local income taxes claimed by the contractor on their pass-through income to the shareholders are unallowable in accordance with FAR 31.205-41, Taxes, and should be questioned.

7-1403 State and Local Taxes

State and local taxes, including property, franchise, and income taxes, are allowable contract costs in accordance with FAR 31.205-41. However, if the taxes are paid late or in error, any penalty, or interest on borrowings (see 7-1403.1(e)), assessed by the state or local government is an unallowable cost except in the limited circumstances described in FAR 31.205-41(a)(3).

7-1403.1 General Audit Considerations

a. Care must be exercised regarding the propriety of allocation of certain taxes to Government work. For example, the allocation to all work of the contractor of personal property taxes levied against the contractor's commercial inventories may not be proper where similar taxes are not levied against Government contract inventories.

b. FAR 31.205-41(b)(5) states that taxes (including excises) on real or personal property, or on the value, use, possession, or sale thereof, which is used solely in connection with work other than on Government contracts are not allowable. FAR 31.205-41(c) states that these taxes should be allocated to the respective category of work unless the amounts involved are insignificant or comparable results would otherwise be obtained. The costs of taxes incurred on property used in both Government and non-government work shall be apportioned to all such work based upon the use of such property on the respective final cost objectives.

c. If the contractor claims taxes for which there exists a question of illegal or erroneous assessment, the amount of such taxes should be identified and described in advisory audit reports and contract audit closing statements. If it is subsequently determined that the taxes have been improperly assessed, a credit or refund may be pursued by the Government (See FAR 31.205-41(a)(2)).

(1) The auditor should follow up as appropriate to assure that a proper share of credits or refunds received by the contractor is passed on to the Government (See FAR 31.205-41(d)).

(2) If the contractor has failed to take actions as specified in FAR 31.205-41(a)(2), the costs should be questioned or disapproved.

d. Penalties assessed by state or local tax authorities are unallowable in accordance with FAR 31.205-15 even if they are unavoidable or incurred inadvertently. However, FAR 31.205-41(a)(3) provides a specific exception to the disallowance of penalties when incurred as a result of following the contracting officer's direction or permission not to pay taxes assessed by a state or local government.

e. Generally, interest associated with an intentional underpayment of state or local taxes is unallowable per FAR 31.205-20 because the interest can be considered to be “interest on borrowings.” “Intentional,” as used here, means intentionally paying less than the contractor reasonably believes is due. However, interest associated with an underpayment of taxes, where the contractor’s intent to borrow cannot be shown, is allowable. If the contractor’s underpayment was directed or agreed-to by the contracting officer, FAR 31.205-41(a)(3) allows any resulting interest.

f. Interest incurred as a result of late payments (e.g., not paying financial obligations by the due date) represents “interest on borrowings” and is therefore unallowable per FAR 31.205-20.

7-1403.2 Allocation Problems and Methods

a. State income or franchise taxes sometimes present unique allocation problems. From a taxing standpoint, when a corporation is engaged in activities in several states it becomes necessary to determine the share of a corporation's income to be attributed to each state. The states have developed three primary methods of dividing the income of a multi-state taxpayer: separate accounting, specific allocation, and formula apportionment. Each method is discussed below.

(1) Separate Accounting. The separate accounting method is based on the premise that a multi-state taxpayer can be divided into separate entities so that its activities within the taxing state can be segregated from its activities elsewhere and accounted for separately. This method is seldom acceptable to the states.

(2) Specific Allocation. The specific allocation method provides for the designation of specified items of income in their entirety as either within or outside the state. This method is infrequently used by itself, but is often combined with the formula apportionment method discussed below.

(3) Formula Apportionment. This is the most frequently used method. The percentage of income to be assigned to a particular state is determined by averaging a number of ratios. For example, one ratio frequently used is the ratio of in-state sales to out-of-state sales. Similar ratios are commonly based on property and on payroll. The average of the ratios used is then multiplied by the net income subject to apportionment (defined by the state) to arrive at the taxable income for the state.

b. Through the use of the method described in a.(3) above, it is possible that a multistate taxpayer may be assessed a large corporate state income or franchise tax by a particular state and in actuality have very little income recorded on the books of its operations within that state. Apportionment of unitary income in excess of local book income within the state is justified by courts on the assumption that all component activities, wherever located, contribute proportionately to all corporate income.

c. Contractors often include the above discussed taxes, along with other indirect expenses, in an established burden center for allocation to operating divisions located in various states. In reviewing these allocations, the general rule for the auditor to fol-low is to determine that the amount allocated to operations within a particular state approximates the amount of tax paid to such state. The further allocation of this amount to cost centers or contracts within the state should be made through divisional G&A. However, in those cases where a division is doing business in several states, the auditor may find that more equitable results are obtained by applying the method used by the state in assessing the tax, or through an established burden center of the contractor other than G&A. The following guidance relates to the allocation of state franchise taxes to a company's segments:

(1) CAS 403.40(b)(4) requires that central payments or accruals (which may include state and local income taxes and franchise taxes) made by a home office on behalf of its segments shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments. Any such types of payments or accruals which cannot be identified specifically with individual segments shall be allocated to benefited segments using an allocation base representative of the factors on which the total payment is based. (Also see 8-403.)

(2) Lockheed Corp. and Lockheed Missiles & Space Co., ASBCA Case No. 27921, 86-1 BCA ¶ 18,614, aff'd, 817 F.2d 1565 (Fed. Cir. 1987) and U.S. Court of Appeals for the Federal Circuit Case No. 86-1177 contain extensive and detailed discussions of the allocation of state franchise taxes to segments. In the ASBCA case, the Board ruled that Interpretation No. 1 to CAS 403 is not binding as to the meaning of CAS 403 because the promulgation of the Interpretation did not follow the statutory requirements for issuance of a standard and that a segment's income (or loss) was an appropriate factor to consider in the allocation of state franchise taxes to segments. The ASBCA decision was upheld by the Court. However, in rendering its decision, the Court's rationale departed somewhat from that of the ASBCA. It did not believe the validity of Interpretation No. 1 was relevant to its decision. The decision effectively relegated Interpretation No. 1 to the status of elaborating upon the CAS 403.60(b) illustration concerning taxes. The Court ruled that the one example in CAS 403.60(b) did not defeat the plain meaning of "factors" as used at CAS 403.40(b)(4). Since segment net income is a causal factor, the Court ruled that CAS 403.40(b)(4) permitted it in an allocation formula. In the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992), the Court re-emphasized that net income is permitted, but not required, as an allocation factor.

(3) The Court's ruling does not mean that all allocation methods that use segment book income are automatically compliant. In fact, the Court only held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4), because the parties had stipulated that if CAS 403 permitted net income as an allocation factor, then the Lockheed method complied with CAS 403. In the ASBCA case that was the subject of the appeal, two other allocation methods that used income as an allocation factor were con-

sidered and rejected. The Lockheed method which the Court ruled is compliant and the two methods using income (the Factor Analysis, and Proration Percentage) that the ASBCA held were noncompliant are described and illustrated at 7-1403.3.

d. Allowing income as an allocation factor broadens the choices of possible allocation methods and makes the evaluation of tax allocations more difficult. Each situation must be carefully evaluated to determine if the particular methodology makes appropriate use of segment book income. The following two key areas deserve special attention when evaluating any methodology which uses segment book income:

(1) The first is evaluating the contractor's methodology for determining the propriety of segment book income. For tax purposes, most states do not use segment book income as a unitary income apportionment factor because of concerns that companies could easily manipulate segments' books to show income only at segments that are in low-tax or no-tax jurisdictions. This risk of income manipulation is why most states choose not to accept the taxpayer's identification of segment income. Because proper identification of income is a high-risk area, the auditor should carefully assess a contractor's determination of segment book income to ensure the methodology is sound and consistently applied.

(2) The second is ensuring that taxes are confined to segments doing business in the taxing jurisdiction. This issue was dealt with in the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992). The Court ruled that a contractor is not in full compliance with CAS 403 if the taxes of a jurisdiction are not allocated to only those segments that do business in the taxing jurisdiction.

7-1403.3 Illustrations of Allocation Methods That Use Income as an Allocation Factor

The illustrations below supplement the guidance in 7-1403.2 and are intended to be used as a guide when evaluating allocation methods that use segment book income. The following facts will be used for all three illustrations:

a. A company has a California Franchise Tax expense of $11,000,000 and five segments --- A, B, C, D, and E with property, payroll, and sales of:

			SEGMENTS			
	A	B	C	D	E	TOTAL
			(in millions)			
PROPERTY:						
Total	$1,500	$ 800	$ 600	$ 400	$ 200	$3,500
Calif.	750	720	600	100	20	2,190
Calif. %	50%	90%	100%	25%	10%	62.6%
PAYROLL:						
Total	$ 700	$ 300	$ 250	$ 100	$ 80	$1,430
Calif.	280	240	250	30	8	808
Calif. %	40%	80%	100%	30%	10%	56.5%
SALES:						
Total	$2,000	$1,000	$ 800	$ 600	$ 300	$4,700
Calif.	600	800	760	240	45	2,445
Calif. %	30%	80%	95%	40%	15%	52%
AVG CALIF. %	40%	83.3%	98.3%	31.7%	11.7%	57%

The five segments had the following net income (loss):

	(in millions)
Segment A	$(200)
Segment B	125
Segment C	180
Segment D	90
Segment E	20
Total Net Income	$ 215

b. Lockheed Two-Step, Four-Factor Method: The ASBCA and the Federal Circuit Court held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4). The first step entails calculating each segment's net income derived from or attributable to a particular state's sources (e.g., California sources) using the ratio of in-state property, payroll, and sales, to total property, payroll, and sales for the segment. In the second step, Lockheed totals individual segment net income derived from or attributable to profitable in-state sources and then assigns taxes only to each profitable segment in the proportion that the segment's profits bear to total profits. Segments with no net income get no allocation and segments that do get allocations get them based upon relative profitability.

STEP 1:

	(in millions)				
	Segment net income (loss)		Segment apportionment %		Segment net income from Calif. sources
Segment A	$(200)	X	40%	=	$0*
Segment B	125		83.3%		104
Segment C	180		98.3%		177
Segment D	90		31.7%		29
Segment E	20		11.7%		2
					$312
*Note: Credits are not permitted, therefore segments with losses always are assigned $0 income.					

STEP 2:

	(in millions)				
	Total Tax		Segment Contribution		Allocation
Segment A	$11	X	0	=	$0
Segment B	11		104/312		3.67
Segment C	11		177/312		6.24
Segment D	11		29/312		1.02
Segment E	11		2/312		.07
					$11.00

c. Factor Analysis Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA considered and rejected an allocation method that used income entitled the "Factor Analysis

Method." Under this method a segment's share of total California Franchise Tax liability is calculated by first determining the percentage that the segment's net income is of the total net income (segment net losses result in negative percentage). A second percentage is calculated by averaging the ratio of the segment's California property, payroll, and sales to the total California property, payroll, and sales. Next the two percentages are averaged by adding them together and dividing by two. The resulting percentage is then multiplied by the total California Franchise Tax expense to obtain the amount of tax or credit allocated to the segment.

The ASBCA concluded that the Factor Analysis Method did not comply with CAS 403 because it allows credits for loss segments. Including credits for losses yielded allocations in excess of the actual amount actually paid. Following is an illustration of this method:

STEP 1:

	(in millions)	
Segment net income as % of total income (loss)	Segment Calif. property, payroll, and sales as % of total Calif. property, payroll, and sales	
	Property Payroll Sales	
A (200/215 or (93%)	750/2190 = 34% + 280/808 = 35% + 600/2445 = 25% / 3	or 31%
B 125/215 or 58%	720/2190 = 33% + 240/808 = 30% + 800/2445 = 33% / 3	or 32%
C 180/215 or 84%	600/2190 = 27% + 250/808 = 31% + 760/2445 = 31% / 3	or 30%
D 90/215 or 42%	100/2190 = 5% + 30/808 = 4% + 240/2445 = 10% / 3	or 6%
E 20/215 or 9%	20/2190 = 1% + 8/808 = 1% + 45/2445 = 2% / 3	or 1%

STEP 2:

	Sum of two% divided by 2		Total Tax		Allocation (Credit)
Segment A	[(93%) + 31%]/2 = (31%)	X	$11	=	$(3.41)
Segment B	[58% + 32%]/2 = 45%		11		4.95
Segment C	[84% + 30%]/2 = 57%		11		6.27
Segment D	[42% + 6%]/2 = 24%		11		2.64
Segment E	[9% + 1%]/2 = 5%		11		.55
					$11.00

Note: Together, segments B, C, D, and E are allocated $3,410,000 more in tax expense than the total California Franchise Tax liability.

d. Proration Percentage Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA also considered and rejected a second allocation method that used income. This one was called the Proration Percentage Method. Under this method a segment's share of the state tax liability is calculated by multiplying the segment's net income or net loss by the ratio of in-state property, payroll, and sales, to total property, payroll, and sales. The product is then multiplied by the state tax rate to yield the amount of tax or credit allocated to the segment.

The ASBCA rejected the Proration Percentage Method because it in effect allocates only on the basis of profit and loss. In other words, there is no consideration of each segment's apportionment factors. Moreover, this method also included credits for losses and would result in allocations to profitable segments in excess of actual taxes paid. Following is an illustration of this method:

	(in millions)							
	Segment net income (loss)		Calif. Apportionment %		Calif. Franchise Tax Rate			Allocation (credit)
Segment A	[$ (200)	X	57%]	X	9%		=	$(10.2)
Segment B	[125		57%]		9%			6.4
Segment C	[180		57%]		9%			9.2
Segment D	[90		57%]		9%			4.6
Segment E	[20		57%]		9%			1.0
								$11.0

7-1403.4 Guidance in Determining Allowable State and Local Taxes

a. Tax Accruals

(1) Contractors sometimes make provisions to account for estimated state income or franchise taxes when there are significant differences between taxable income, as determined in accordance with state regulations, and income for the period, as determined in accordance with generally accepted accounting principles. These differences may result from items such as (a) recognizing in the income statement possible losses that may not be deductible for tax purposes until they occur, (b) computing depreciation for income statement purposes by use of a method different from that used for tax purposes, or (c) by recognizing revenue for tax purposes before it would be recognized in the income statement in accordance with generally accepted accounting principles. Provisions are made for taxes related to such items based on an assumption that a tax liability exists, and will ultimately materialize, as a direct result of such transactions. For example, in the case of a straight line method of depreciation being used for income statement purposes and an accelerated method for tax purposes, the tax savings in the early years of the asset's life will ultimately be offset by higher taxes in the later years of the asset's life. Therefore, the provisioning of an additional amount for taxes in the early years of the asset's life to offset the higher taxes in the later years in effect tends to relate the state income tax expense for the period to the income as shown in the financial statements. The opposing view contends that if a contractor follows a consistent program of asset replacement, which would be necessary to a continuing concern, tax savings on new assets should offset higher taxes on expiring assets.

(2) The auditor should obtain the best evidence available that supports the amount of costs incurred. In determining allowable costs under Government contracts, the best evidence available to support the amount of state income or franchise tax incurred is the amount paid. The auditor should not attempt to estimate the amount of tax currently being paid that is applicable to future or prior periods, for purposes of determining allowable costs under Government contracts. Similarly, amounts estimated by contractors as tax liabilities in excess of the amounts actually paid should not be considered in de-

termining allowable contract costs. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income, as reflected by the books of account and financial statements are unallowable (See FAR 31.205-41(b)(7)).

(3) Income tax accruals designed to estimate additional taxes to be paid resulting from tax audits by the state or local tax authorities are considered contingencies that are unallowable under FAR 31.205-7(b). However, tax accruals designed to relate the amount paid on the basis of a taxing authority's fiscal year to the contractor's accounting period are allowable in accordance with FAR 31.205-41(a). (See also 7-1402.g.)

b. Tax Credits and Refunds

(1) Many states follow the same or basically similar procedures as provided in the Internal Revenue Code for net operating loss carry-backs. In most states, a net operating loss can be carried back for 3 years or forward for 5 years. We are primarily concerned with carry-backs for state income or franchise taxes. Operating loss carry-backs will result in a refund of prior years' taxes which have been paid by the contractor and reimbursed by the Government.

(2) The Government's right to share in these refunds is covered by FAR 31.205-41(d), which provides that "Any taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the Government in the manner it directs." This requirement is also addressed in FAR 31.201-5 and the "Allowable Cost and Payment" clause at FAR 52.216-7. In Hercules Inc. v. United States, 292 F.3d 1378 (Fed. Cir. 2002) issued June 5, 2002, the United States Court of Appeals for the Federal Circuit concluded that the principal requirement of FAR 52.216-7, Allowable cost and payment, and FAR 31.201-5, Credits, is to provide the Government with a refund when a cost that has been reimbursed to a contractor is later reduced. The Court found that these clauses require the refund be passed to the Government in the same ratio as the tax payment was originally reimbursed by the Government. Accordingly, if the contractor receives a refund of previously reimbursed tax, the auditor should determine the Government’s share of the refund based on the Government reimbursement of that expense in the year in which the cost was originally incurred.

Example: ABC Company claims $1,000,000 in state income tax expense in the G&A pool in 2000. The Company receives a $500,000 refund of its 2000 income tax in 2002. The Government participation in the G&A allocation bases are:

Fiscal Year	2000	2001	2002
Percentage	65%	70%	55%

The percentages represent cost reimbursable contracts containing the FAR 52.216-7 contract clause. The Government’s share of the refund is determined as follows:

Amount of Refund		Government Participation for 2000		Government Share of Refund
$500,000	x	65%	=	$325,000

If the Company accounts for the refund in the fiscal year received (2002), the Government would receive $275,000 ($500,000 x 55%). The auditor must assure the remaining Government share of $50,000 ($325,000 – 275,000) is credited to the Government in accordance with FAR 31.201-5, Credits.

7-1403.5 Changes in Method of Measuring Taxable Income

a. State tax regulations have usually permitted a taxpayer to initially select one of several acceptable methods of stating the elements that determine taxable income and later, under specified conditions, to change from the initial selection to another acceptable method. Some elements for which alternate acceptable methods have been allowed are

(1) income from long-term contracts,

(2) inventory pricing, and

(3) depreciation methods.

b. The Tax Reform Act of 1986 (TRA) repealed the acceptability of the completed contract method for measuring annual taxable income for long term contracts awarded after February 26, 1986. Since the TRA, the IRS has implemented additional restrictions on methods that can be used to measure annual taxable income. Although the changes in method are intended primarily to apply to Federal income taxes which are not allowable on Government contracts under FAR 31.205-41(b)(1), State income taxes, which are allowable on Government contracts, will in many cases also be affected since a number of States have adopted Federal tax regulations to determine State taxes.

c. Under the provisions of the change, contractors must recognize income from long term contracts using either the percentage of completion method or the percentage of completion-capitalized cost method. Both methods must be based on a cost-to-cost relationship rather than an estimate of physical completion (engineering cost method or other modified methods not based on cost) which was previously permitted. The percentage of completion method based on a cost-to-cost relationship recognizes income from long term contracts based on the proportion of the estimated contract price that costs incurred through a period bears to the total expected costs reduced by the amounts of contract price that were included in income in previous years. Under the percentage of completion-capitalized cost method, only a certain percent of the items of each contract need to be recognized under the percentage of completion method and the remaining percent of the items are to be accounted for under the taxpayer's normal method (e.g., the completed contract method). Costs to be used in determining the percentage of completion are:

(1) direct material and direct labor costs, and

(2) depreciation, amortization and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the contract.

It should be noted that the prescribed cost-to-cost relationship is an example of circumstances where the tax law is at variance with appropriate cost accounting.

d. Any changes made in the method of measuring income for long term contracts as a result of changes in tax regulations (e.g., a change from the completed contract method to the percentage of completion method or the percentage of completion-capitalized method) should be considered to be a change in cost accounting practice because it alters the measurement of State tax costs for a cost accounting period by assigning taxable income or loss to other periods. Because measurement and assignment of cost are involved, the change in determining contract income is a change in cost accounting practice as described in CAS. Since the change is not being required by any change in CASB rules, regulations and standards, it should be considered a unilateral change unless and until the cognizant Federal agency official (CFAO) determines that the change is desirable. (See CAS Working Group Paper 81-25.)

e. When a contractor is required by the tax laws to change its accounting practices, changing from a no longer acceptable method to an acceptable method may be considered a desirable change. However, a final determination on this matter is the responsibility of the CFAO. Unless the CFAO makes the determination that the change meets the requirement to be considered a desirable change (i.e., not detrimental to the interests of the Government), the change would be considered a unilateral change covered by paragraph (a)(4)(iii) of the CAS clause (FAR 52.230-2) and no increased costs as a result of the change would be permitted (see also 8-303).

f. Auditors should also be aware that the TRA includes a look-back provision. This provides that, to the extent that the percentage of completion applies to a long term contract, a

taxpayer who does not accurately predict the eventual contract price must recompute its tax liability for the years that such method was used on the basis of the actual contract price and costs. If the recomputed tax liability exceeds the previously reported tax liability, the taxpayer must pay interest; if the recomputed tax liability is less, the taxpayer is entitled to interest. This provision may affect State tax costs to the extent that this look-back provision is incorporated into State laws. Accordingly, auditors should review the look-back computations to determine if any unallowable penalties and interest are included in costs charged to Government contracts or if the Government is due a credit.

7-1403.6 Special Considerations---Revenue Based State Taxes

a. Some state taxes (e.g., New Mexico and Washington) are imposed on the seller, and are computed by multiplying the total revenues (with limited exceptions) received from doing business in the state by the applicable tax rate. There is no legal obligation for the seller to collect the tax from the buyer. For the purpose of Federal immunity, this makes these state taxes different from conventional sales taxes.. If the tax is imposed on the seller and there is no legal obligation to collect the tax from the buyer, then the seller is not exempt from paying state sales taxes on sales to the Government unless there is an express Government sales exemption in the applicable tax code. However, normally the seller has a legal obligation to collect the tax from the buyer. When there is a legal obligation to collect the tax from the buyer, and the buyer is the Government, the sales are exempt from state sales tax as a matter of federal supremacy. State law dictates whether the Government is the buyer or not in transactions involving Government contracts. For example, the Connecticut Supreme Court, applying Connecticut statutes, found that the United States is the actual buyer of personal property sold by third parties to a cost-reimbursement Government contractor because the one who takes title to the property is the United States. It held such sales exempt from Connecticut sales tax. In contrast, services sold by third parties to Government contractors were not exempt since a different statutory test applied and it identified the contractor as the buyer, not the Government. Determinations of whether state and local taxes are allowable contract costs under FAR 31.205-41 must be made on a case-by-case basis based on each state’s tax laws. Questions regarding state-law exemptions and federal sovereign immunity should be addressed to the contracting officer’s designated legal counsel because they require interpretations of statutes, regulations, and case law (FAR 29.101).

b. Revenue based state taxes are levied on the contractor's revenue from doing business in the state, which generally comprises many contracts. Therefore, the costs incurred by the contractor are not identifiable to specific contracts. Accordingly, the state tax should be distributed to contracts using the contract revenue that is subject to the state tax as the allocation base.

c. Revenue based state taxes are overall costs of doing business in the nature of G&A expenses. However, these taxes, if material, should not be accounted for in the G&A pool. Any method of distributing material amounts of revenue based state taxes through overhead, G&A, or any other cost based allocation would be inappropriate, since the taxes are based on revenue rather than cost.

d. Revenue based state taxes should be included in the total cost input base for G&A allocation. Exclusion of these taxes through the use of a special allocation under CAS 410.50(j) is inappropriate, since such special allocations apply to final cost objectives, not specific cost elements.

7-1404 Employment Taxes

a. The Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) each impose a tax upon employers for each calendar year, the amount of which is based upon a specified percent of the wages paid by the employer to his

individual employees. The taxes are limited to the annual maximum wages established by statute for each individual employee. These rates and wage limits vary periodically. The taxes imposed by the FUTA are levied and collectible in part by the state and in part by the Federal Government. The guidance in this paragraph is concerned with the phase of these taxes levied on employers and not on employees.

b. Generally, if during a calendar year an employee receives remuneration from more than one employer, the annual wage limitation does not apply to the aggregate remuneration received from all employers, but instead applies to each individual employer. Exceptions to this rule are discussed below in 7-1405 and 7-1406.

c. The auditor should familiarize himself or herself with the rates and wage limitations in effect for each calendar year and ascertain that the contractor is not paying taxes in excess of the statutory requirements. He or she should also obtain supporting documentation for the various state unemployment rates being used by the contractor in those states in which it is paying the tax. Attention should also be given to tax credits or reductions granted the employer in state unemployment tax rates because of favorable employment experience. In such cases, the auditor should accept as allowable costs only the actual (net) amounts which the contractor is required to pay.

d. Where historical data are the basis for cost projections or estimates, consideration should be given to the effect that prospective changes in the tax rates and annual wage limitations will have on such forecasts. The auditor should assure that where expense accruals are made for these taxes they are adjusted periodically so that costs charged to contracts do not exceed the actual cost.

7-1405 Employment Taxes of Successor Contractors

a. Successor contractor situations generally relate to yearly service or maintenance contracts at Government installations where, under recompetition, a new contractor receives a cost-reimbursement type contract award, usually cost-reimbursement type, and takes over performance as of the beginning of the fiscal year, 1 July, and retains many of the same employees. In this regard, Revenue Ruling 68-105 (C.B. 1968-1, 418) holds that a new contractor may qualify as a successor contractor, where the property used in the performance of the contracts is the same Government-owned property. It is immaterial that no interest in the property used was acquired directly from the predecessor employer.

b. Section 3121(a)(1) of the Federal Insurance Contributions Act (FICA) and 3306(b)(1) of the Federal Unemployment Tax Act (FUTA), respectively, and the applicable regulations provide that the wages paid by a predecessor to an employee shall, for purposes of the annual wage limitation, be treated as having been paid to the employee by a successor, if

(1) the successor during a calendar year acquired substantially all the property used in a trade or business, or used in a separate unit of a trade or business, of the predecessor;

(2) the employee was employed in the trade or business of the predecessor immediately prior to the acquisition and is employed by the successor in his or her trade or business immediately after the acquisition; and

(3) the wages were paid during the calendar year in which the acquisition occurred and prior to the acquisition.

The method of acquisition by an employer of the property of another employer is immaterial. The acquisition may occur as the result of purchase or any other transaction where substantially all the property is acquired by the new employer.

c. If the new employer (contractor) meets these criteria, he or she may qualify as a successor employing unit so that for the purpose of establishing the wage limitations, remuneration paid to continuing employees by the predecessor during the calendar year and prior to the acquisition shall be considered as having been paid by the successor. The statutory minimums then apply to the combined earnings under both contractors. Additionally, the successor may be eligible to file with state authorities and obtain a lower merit unemployment tax rate based on the predecessor's experience at the location.

d. Where a contract changes hands under the foregoing circumstances, or the auditor has knowledge that such a change is to occur shortly, it is a matter of some urgency that the auditor takes the following steps on a timely basis.

(1) Ascertain whether the new contractor has determined that it qualified as a successor. If there is any doubt or question as to its status, the contractor should obtain a ruling from IRS.

(2) Determine that the successor obtains the predecessor's earnings record and tax payments records for the current year on the continuing employees.

(3) Determine that the successor, if qualified, ceases from incurring further costs for FICA and FUTA as soon as an employee's total combined earnings under both the predecessor and successor reach the statutory wage limitations.

(4) Where a lower merit rating is available under FUTA, based on the predecessor's experience at the location, determine that the successor has filed with state authorities and has obtained and is using the more favorable unemployment tax rate. However, there are some states which do not recognize predecessor experience as being eligible in obtaining a lower merit tax rate.

(5) In the event that taxes have been paid in excess of the proper amounts, determine that the successor obtains refunds and properly credits the Government.

(6) Advise the contracting officer of any failure of the successor to take full advantage of its status as a successor employing unit under both FICA and FUTA.

7-1406 Employment Taxes in Mergers and Consolidations

a. The Internal Revenue Service has ruled (Revenue Ruling 62-60, C.B. 1962-1, 186) that, in the absorption of one corporation by another in a statutory merger or consolidation, the resultant entity is regarded as the same taxpayer and same employer as the absorbed corporation for FICA and FUTA purposes. Thus, there is no interruption in the employment status of the continuing employees and they are considered to have been in one employment throughout the year.

b. Where contractors have undergone statutory mergers or consolidation, the auditor should determine that FICA and FUTA taxes on the continuing employees are paid on the basis of a single employment for the year. Additionally, the auditor should ascertain whether credits for contributions to state unemployment funds and merit rating credits available to the absorbed corporation have been utilized by the surviving corporation.

7-1407 Federal Excise Taxes

Such taxes are allowable unless exemptions are available to the contractor (FAR 31.205-41(b)(3)). When there are substantial amounts involved (in either incurred or projected costs) and where there is a reasonable probability that the benefits of an exemption will outweigh the administrative burdens involved, the auditor should investigate the possibility that an exemption exists. If an exemption does not exist, appropriate inquiry or recommendation should be made to the contracting officer regarding the desirability of obtaining one.

7-1408 Foreign Taxes

a. When a contractor performs Government contracts in foreign countries, whether under a Foreign Military Sales (FMS) contract or for domestic requirements, certain host countries impose taxes on the contractor. FAR 31.205-41(a)(1) specifically addresses the allowability of Federal, state, and local taxes without addressing the allowability of foreign taxes. Because foreign taxes are analogous to state or local taxes, they are considered to be allowable contract costs.

b. When a contractor has paid an income tax to a host country, it can subsequently claim a foreign tax credit against its Federal income tax under Internal Revenue Code Section 901. If

a contractor claim for a foreign tax credit is accepted by the Internal Revenue Service, it will result in a reduction in Federal income tax liability by the full amount of the credit. In that situation, the contractor would be duplicating the recovery of foreign income tax expenditures---first as a contract cost and second as a reduction in its Federal income tax liability.

c. This situation is addressed in contract clauses at FAR 52.229-6, 52.229-8, and 52.229-9 as well as in FAR 31.205-41(d).

(1) For fixed-price contracts, FAR 52.229-6(h) requires that if a contractor obtains a reduction in its U.S. tax liability because of the payment of any tax or duty which was included in the contract price, the amount of the reduction shall be paid or credited to the U.S. Government as directed by the contracting officer.

(2) For cost-reimbursable contracts awarded on or after March 7, 1990, FAR 31.205-41(d), 52.229-8 and 52.229-9 require that contractors and subcontractors pay or credit to the U.S. Government the amount of such reductions as directed by the contracting office unless the contract costs are being reimbursed by a foreign government. In the case of a foreign government reimbursing the contract costs, the contractor or subcontractor must repay the U.S. Treasury for any reduction in U.S. tax liability. FAR 52.229-9 specifically requires the payment to the Treasury and prohibits credit to a contract in such a case.

(3) For cost-reimbursable contracts awarded prior to March 7, 1990, FAR 31.201-5, "Credits," should be cited to assert the Government's right to recover such reductions in U.S. tax liability.

d. Generally, foreign income taxes on the employee's salaries and wages are unallowable because they are a liability of the employee, not the contractor. However, contractors may be able to reimburse the employee and claim, as part of foreign differential pay, the difference between the employee's total income tax payment and the amount the employee would have incurred had the employee remained on domestic assignment. Refer to 7-2121 for guidance on the evaluation of employee foreign tax differential allowances.

e. Foreign taxes may include taxes levied for social insurance contributions in addition to income taxes. Social insurance contributions generally include payments for such items as retirement pay insurance, health insurance, unemployment insurance, nursing care insurance, and accident insurance. The employee's share of the social insurance contribution is generally not allowable because it is the employee's responsibility, not the contractor's. The contractor's share of the social insurance contribution is generally allowable in accordance with FAR 31.205-41(a)(1).

7-1409 Environmental Taxes

a. The Superfund Amendments and Reauthorization Act of 1986, Public Law 99-499, designated funding sources for the Hazardous Substance Response Trust Fund ("Superfund"). Among the sources is the Environmental ("Superfund") Tax enacted by Section 516 and codified at Section 59A of the Internal Revenue Code. The tax is placed in the subtitle devoted to income tax provisions. The positioning of the statute in this subtitle and the direct relationship of the tax rate to income denotes this as a tax on income. The tax is equal to 0.12 percent of that portion of the corporation's modified alternative minimum taxable income which exceeds $2,000,000.

b. For contracts awarded prior to January 22, 1991, the Superfund Tax is considered to be an expressly unallowable Federal income tax in accordance with FAR 31.205-41(b)(1). (Rockwell International Corporation v. Widnall, No. 96-1265 (April 1, 1997), aff"g ASBCA No. 46544, 96-1 BCA para 28,057.) Effective January 22, 1991, FAR 31.205-41(a) was revised to make the Superfund Tax a specifically allowable cost for contracts entered into on or after that date.

7-1500 Section 15 --- Independent Research and Development and Bid and Proposal Costs (IR&D and B&P)

7-1501 Introduction

a. A contractor's independent research and development effort (IR&D) is that technical effort that is not sponsored by a grant or required in the performance of a contract and consists of projects falling within the following four areas:

(1) basic research,
(2) applied research,
(3) development, and
(4) systems and other concept formulation studies.

b. Bid and Proposal (B&P) costs, as defined at FAR 31.205-18(a) and CAS 420.30(a)(2), are the expenses incurred in preparing, submitting, and supporting bids and proposals on potential Government and non-government contracts, provided that the effort is neither sponsored by a grant, nor required in the performance of a contract.

c. Coverage for both IR&D and B&P is contained in FAR 31.205-18 and in the DoD FAR Supplement 231.205-18. FAR 31.205-18(b) provides that all contracts (whether CAS covered or not) are subject to the cost identification and accumulation provisions of CAS 420.

7-1502 General Audit Considerations

a. CAS 420 requires that contactors identify and accumulate IR&D and B&P costs by individual project. The CAS also requires that costs for IR&D and B&P projects be accounted for in the same manner as contracts, and include costs that would be treated as direct costs of that contract, if incurred in like circumstances, and all allocable indirect costs, with the exception of general and administrative expenses. For example, if a contractor charges clerical and technical support cost directly to final cost objectives, then it must also charge them directly to IR&D and B&P projects. If, however, the contractor charges these costs to indirect cost pools, such costs incurred in support of IR&D and B&P efforts should also be charged to indirect cost pools.

The auditor should perform audit procedures to test for consistent cost accounting in similar circumstances.

b. As a general rule, IR&D and B&P costs shall be allocated to contracts on the same basis as the general and administrative expenses. Where specific projects clearly benefit other profit centers or the entire company, such costs shall be allocated through the G&A of such other profit centers or through the corporate G&A, as appropriate. The contracting officer may approve the use of a different base of allocation in those instances where allocation through G&A does not provide an equitable cost allocation.

c. Advance agreements may include a provision stating how the costs are to be allocated. In these cases, the auditor should determine if the costs are properly classified and allocated in accordance with the advance agreement.

d. In accordance with the IR&D definition at FAR 31.205-18(a), any efforts that are “sponsored by a grant or required in the performance of a contract” are not IR&D. Auditors must ensure that contractors do not include costs in the IR&D and B&P cost pools for developmental effort that are specifically required in the performance of a

contract or those efforts that are not explicitly stated in the contract, but are necessary to perform the contract.

7-1503 DFARS IR&D and B&P Requirements

a. Allowable IR&D and B&P costs that major contractors can allocate to DoD contracts are limited to those projects which have "potential interest to DoD." DFARS 231.205-18(a)(iii) defines a major contractor as any contractor whose covered segments allocated a total of more than $11 million in IR&D/B&P costs to covered contracts during the preceding fiscal year. In determining if the $11 million threshold is met, any contractor segments allocating less than $1.1 million of IR&D/B&P costs to covered contracts should be excluded. Covered contracts include both DoD prime and subcontracts exceeding the simplified acquisition threshold (FAR 2.101), except for fixed-price contracts and subcontracts without cost incentives.

b. DFARS 231.205-18(c)(iii)(B) provides seven broad categories of IR&D and B&P projects that are specifically defined to be of potential interest to DoD. The broad definition of "potential interest to DoD," reduces the probability that certain IR&D/B&P projects are unallowable due to a lack of potential DoD interest. However, there is a continuing audit risk that research and development performed directly for a contract may be inappropriately charged to IR&D accounts. This audit risk is more prevalent when research and development effort is required under fixed price contracts, flexibly priced contracts with a potential for cost overruns, or commercial contracts.

7-1504 Impact of CAS 402 Interpretation on B&P Allocation

Contractually required proposal efforts (e.g., a contract requirement to submit a proposal for a follow-on contract) should generally be charged direct to the contract. However, the interpretation of CAS 402, under certain circumstances, permits these contractually required proposal costs to be accumulated and allocated to final cost objectives as an indirect cost. The interpretation explains that proposal preparation costs may be treated as direct or indirect depending on the circumstances under which the costs are incurred. Proposal preparation costs which arise as a result of a specific contract requirement may be treated as direct costs, while ordinary B&P effort (i.e., effort that is not required by a contract) is treated as indirect. CAS 402.61, Interpretation, notes that contractors may elect to charge all proposal costs (including B&P costs and those required by contract) indirect, provided that the practice is applied consistently and the practice results in an equitable distribution of the costs to final cost objectives.

7-1505 Deferred IR&D

Deferred IR&D costs that were incurred in previous accounting periods are unallowable in the current period except when contract provisions specifically allow such costs. The detailed requirements for allowability are provided at FAR 31.205-18(d).

7-1506 Cooperative Arrangements/Agreements

a. FAR 31.205-18(e) provides that costs incurred by a contractor working jointly with one or more non-Federal entities pursuant to cooperative arrangements (e.g., joint ventures, limited partnerships, teaming arrangements, and collaboration and consortium arrangements) should be considered as allowable IR&D costs if the work performed would have been allowed as IR&D had there been no cooperative arrangement. The auditor should also consult

CAM 7-2115 when evaluating costs incurred under consortium arrangements. FAR 31.205-18(e)(1) provides that costs contributed by a contractor in performing cooperative research and development agreements entered into under any of the authorities listed below should also be considered as allowable IR&D costs if the work performed would have been allowed as IR&D had there been no cooperative agreement:

(1) Section 12 of the Stevenson-Wydler Technology Transfer Act;

(2) Section 203(c)(5) and (6) of the National Aeronautics and Space Act of 1958, as amended;

(3) 10 U.S.C. 2371 for the Defense Advanced Research Projects Agency; or

(4) Other equivalent authority.

"Other equivalent authority," as referred to in FAR 31.205-18(e)(1)(iv), applies to any cooperative research and development agreement or similar arrangement entered into under a statutory authority. When contractors classify costs incurred under such agreements as IR&D, the auditor should coordinate with the agency that awarded the agreement to determine if the agreement is entered into under a statutory authority, otherwise the effort and associated cost may not be classified as IR&D.

b. Costs incurred in preparing, submitting, and supporting offers on potential cooperative arrangements are allowable to the extent they are allocable, reasonable, and not otherwise unallowable. Contractors may use various forms of teaming arrangements when seeking business from third parties. These team arrangements may vary. Two or more teaming contractors may simply agree to combine expertise and resources to bid on a potential future work without altering their respective business structure. Other contractor teaming arrangements may create a separate legal entity to pursue the marketplace. CAS 420 requires, and auditors must ensure, that B&P costs of a business unit be allocated to the final cost objectives of that business unit. When contractors form a teaming arrangement where a new business segment is established (whether a separate legal entity or not), B&P efforts of that new business segment are allocable only to the contracts of that entity.

7-1600 Section 16 --- Warranty Costs and/or Correction of Defect Costs

7-1601 Introduction

a. This section covers the various warranty clauses that may be used in contracts awarded by the Federal Government.

b. This section also presents general guidance in reviewing estimated and/or actual warranty costs and the various methods in accounting for warranty costs.

7-1602 FAR Warranty Clauses Affecting Warranty Cost

Warranty clauses or correction of defects clauses are included in some contracts to give the Government certain rights and remedies if supplies or service furnished under the contract are found to be defective or deficient within a prescribed period. Generally, a warranty should provide that, for a stated period of time or use, or until the occurrence of a specified event, the Government has a contractual right for the correction of defects (see FAR 46.702). The FAR contains the following warranty clause requirements:

a. Except for clauses governing cost-reimbursement supply contracts (FAR 52.246-3), and cost-reimbursement research and development contracts (FAR 52.246-8), warranties are not included in cost-reimbursement type contracts (FAR 46.705).

b. FAR 46.703 provides criteria for determining whether a warranty is appropriate for a specific acquisition, other than in those situations discussed in paragraph a. above.

c. When a warranty is to be included in a contract, the terms and conditions may vary with the circumstances of the procurement. FAR 46.706(a) requires that the following items be clearly stated in the warranty clause:

(1) The exact nature of the item and its components and characteristics that the contractor warrants;

(2) The extent of the contractor's warranty including all of the contractor's obligations to the Government for breach of warranty;

(3) The specific remedies available to the Government, such as payment of the costs incurred by the Government in procuring the items from another source, the right to an equitable reduction of the contract price, or that the contractor repair or replace the defective items at no additional cost to the Government, and;

(4) The scope and duration of the warranty.

7-1603 Definition of Warranty Costs and Accounting for Such Cost

a. For purposes of the following guidance, the term "warranty costs" encompasses costs related to

(1) the warranty aspects of the Inspection of Supplies clause at FAR 52.246-3 and

(2) warranty clauses. FAR 46.703(b) states that "Warranty costs arise from the contractor's charge for accepting the deferred liability created by the warranty. . ."

The acquisition cost of a warranty may be included as part of an item's price or may be set forth as a separate contract line item (see DFARS 246.703(b)). The warranty clauses specify that a contractor's cost of compliance with the provisions of the warranty will be at the contractor's expense with no increase in contract price.

b. A warranty may cover all costs of repairs regardless of the actual reimbursement for repair costs. For example, the contract may provide for reimbursing the contractor $50,000 to cover all repairs done during a specified time period. Thus, regardless of how much the actual repairs are (e.g., $20,000, $60,000, $100,000, etc.), the contractor will be reimbursed $50,000.

c. Alternatively, warranty may cover the cost of repairs up to a ceiling amount. For example, the contract may provide reimbursement of $75,000 to cover repairs, with a warranty ceiling of $175,000 (with any actual costs incurred in excess of the warranty ceiling reimbursed on a dollar-for-dollar basis). Under such an arrangement, if the actual repair

costs were $30,000, the contractor would receive $75,000. If the actual repair costs were $125,000, the contractor would still receive only $75,000. However, if the actual repair costs were $200,000, the contractor would receive $100,000 ($75,000 covered by the warranty agreement, plus an additional $25,000 of actual repair costs in excess of the ceiling amount ($200,000 less $175,000)).

d. The audit of estimated or incurred warranty costs is dependent upon the terms of the contracts and the contractor's accounting policies and procedures. The contractor should maintain written accounting practices and procedures describing how the warranty costs are accounted for. For CAS-covered contractors, these accounting practices should be part of the disclosure statement. Warranty costs may be accounted for:

(1) as a direct contract cost,

(2) as an indirect cost on the basis of actual expenditures in the period of incurrence, or

(3) as an indirect cost on the basis of a reserve.

The use of this last method is similar to that generally used in accounting for bad debt losses.

7-1604 General Audit Considerations

The following points should be considered when evaluating warranty costs included in contractors' cost submissions or pricing proposals:

a. When briefing contracts and/or auditing specific contract costs, the auditor should be alert to whether or not there is a warranty clause, and whether the clause includes a warranty ceiling. If the contract includes warranty coverage, the clause should be examined to determine the period covered by the warranty, the warranty terms, and that the warranty costs reviewed are allowable under the contract. The auditor should communicate with the Contracting Officer to assure a proper interpretation of the warranty provisions.

b. When express warranties are included in contracts (except contracts for commercial items) all implied warranties of merchantability and fitness are negated by use of the language in the warranty clause (see FAR 46.706(b)(1)(iii)). Under cost-reimbursement type contracts, the Inspection of Supplies clause provides that corrections or replacements are to be made without cost to the Government if the defects are the result of fraud or other causes of the types listed in FAR 52.246-3(h). In the absence of such causes, costs of correcting defects may be allowable if incurred within the period covered by the clause.

c. Verify actual costs to ensure that contractors have properly segregated warranty costs for the correction of defects from the costs of ongoing performance (such as redesign, rework, test and quality control). In many cases, the department or group tasked with correcting a defect under the warranty requirements will be the same department or group performing the ongoing portion of the contract. The auditor should ascertain whether the contractor has established procedures for reviewing items processed for correction of defects and for determining the reason(s) for the defects and the extent of its responsibility. In some cases, where costs are relatively large, the auditor may obtain technical advice from Government technical personnel prior to accepting such costs.

d. Determine whether the contractor's policies and procedures for allocating warranty costs are equitable and give effect to any existing significant differences in warranty conditions or costs among the various items or product lines produced by the contractor. For example, if a contractor produces several items or product lines which have significant differences in types of warranties offered, or in the warranty costs incurred, the auditor should ascertain that the basis of allocation to the particular items or product lines appropriately reflects these differences. When warranty costs are included in overhead, the auditor should determine that the base for allocating this expense is made up only of contracts containing warranty provisions. When evaluating direct charges to a contract for warranty costs, the auditor should ascertain that the same type of costs incurred on other Government or commercial products are excluded from allocable overhead unless it is clearly established that a cost duplication does not exist.

e. Determine whether the contractor's policies and procedures are being followed and properly implemented. To ascertain this, a representative number of transactions should be reviewed. When warranty costs are accounted for under the reserve method, the auditor should ascertain that the periodic charges to overhead and additions to the reserve account are not excessive in relation to actual warranty costs experienced over an appropriate number of years.

f. When there is a warranty ceiling, the auditor should assure that any claimed repair costs are limited to those in excess of the warranty ceiling.

g. Some warranty clauses permit the Government to perform the repair work themselves, with the contractor required to reimburse the Government (either through payment or credit) for the work performed. When the contract contains this type of clause, the auditor should coordinate with the PCO/ACO to determine if any amounts owed by the contractor have been recovered. If it is determined that significant monies owed have not been recovered, the auditor should formally notify the PCO/ACO of the amount owed so that the PCO/ACO can take the appropriate collection action.

h. In estimating costs to provide a warranty, contractors must consider many factors, including the specific warranty terms, the types of defects which may occur, the probability and number of occurrences, and the nature, extent, and cost of the corrective action which will be required. In the evaluation of proposed warranty costs, the following steps should be performed:

(1) Review the warranty provisions in the request for proposal to ascertain that a warranty is required and to determine the nature and extent of the warranty requirements.

(2) Evaluate the contractor's accounting policies and procedures for the treatment and segregation of warranty costs. Review the practices to determine if any inequity exists in allocating costs between and among commercial and Government work loads.

(3) Determine the basis of the proposed warranty costs. The estimates should be based on auditable data such as actual experience, industry-wide experience, actuarial estimates or parametric estimates (see 9-1000). If estimated costs are predicated on incurred costs related to isolated events which are nonrecurring, a contingency exists; therefore, attention should be given to FAR 31.205-7, "Contingencies."

(4) Evaluate the contractor's past experience in the actual incurrence of warranty cost.

(5) Determine if there are any discernible trends or changes in accounting or operating practices which are likely to affect warranty costs in future periods.

(6) Determine that warranty costs charged direct on prior contracts are excluded from the base amounts used to project future product costs on follow-on contracts.

(7) When the examination relates to a proposal for a contract where a warranty may be appropriate (see 7-1602), the audit report should include any comments which would assist the contracting officer in determining:

(a) whether the best interest of the Government would be served by including a warranty clause in the contract,

(b) the approximate cost to the Government for the protection afforded by such clause (the amount not questioned), and

(c) whether major subcontracts include warranty provisions.

If so, the report should also include comments on vendor warranty costs, particularly in cases where the express or implied contractor or vendor policy is that vendor warranties will not be passed to the Government. This may require an assessment of (i) the dollar impact of warranty costs included in vendor prices, and (ii) the need for the contractor to have warranty protection when material is purchased for inventory or for other prudent reasons. Where determinable, the report should include a statement to the effect that the contractor's proposal costs include amounts for either vendor or contractor warranty, even though the dollar impact may not be quantifiable.

(8) When the examination relates to a proposal for a contract not including a warranty clause (see 7-1602), comments similar to those provided in (7) above would not

be appropriate. However, those contractor proposals may contain an "inspection clause," and should include a reasonable estimate for costs of complying with the requirements of the related contract clause (see FAR 52.246). The omission or understatement of such costs may result in the negotiation of a contract with a built-in overrun factor. If the auditor encounters an apparently inappropriate omission, this should be brought to the attention of the contractor and the appropriate contracting officers. The auditor should not prepare the proposed estimate for the contractor. However, the auditor should disclose any deficiency in the narrative report comments with attention to the appropriate contractor responsibilities addressed at FAR 46.105, 46.202, and 46.3.

i. Other Audit Considerations

Other areas that may require special consideration in the audit of warranty costs include CAS compliance and the use of offsite indirect expense pools.

(1) DFARS 246.703(b) provides that warranty costs may be included as a separate contract line item. If the contractor proposes warranty costs as a separate line item, the auditor should verify that this is in compliance with the contractor's disclosed practice. In addition, consideration must be given to the requirements of CAS 402 which requires consistency in the allocation of costs incurred for the same purpose in like circumstances (see 8-402).

(2) Another audit concern resulting from the inclusion of warranty clauses in contracts relates to the use or establishment of offsite overhead pools to accumulate and allocate expenses related to effort of correcting defects at offsite locations (for example, correction of a defect at a Government installation). The audit of costs associated with offsite activities would include a determination of whether the effort is of such magnitude as to justify establishment of a separate cost pool, and whether the allocation method used satisfies the requirements of FAR 31.203 and, if applicable, CAS 418 (see 6-606 and 8-418).

7-1605 Coordination with the PCO/ACO and Technical Staff on Warranty Costs

The technical nature of the subject matter and the relevancy of interpretation of contract provisions on warranty costs make it especially important that the auditor coordinate with the PCO/ACO and their technical staff.

7-1606 Audit Considerations of Warranty Costs in Negotiating Final Price under Fixed-Price Incentive Contracts

The final total price negotiated under a fixed-price incentive contract containing a warranty clause may consider all costs incurred or to be incurred by the contractor in complying with the warranty clause (see FAR 46.707). When it is the contractor's practice to account for warranty cost as a direct charge or by establishing a reserve (see 7-1603 b), its repricing proposal for the above purpose may include an estimate of warranty costs remaining to be incurred. In such cases the auditor should examine closely the basis for the estimates and their reasonableness.

7-1700 Section 17 --- Business Combination Costs

7-1701 Introduction

This section provides guidance for audit evaluation of business combination costs proposed or claimed by contractors.

7-1702 Business Combinations

a. A business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over the entity or entities. The new entity carries on the activities of the previously separate, independent enterprises (see FASB Statement No. 141).

b. Once an auditor becomes aware of a business combination whether it be through a merger, consolidation, acquisition, divestiture, etc., he/she should take the following steps:

(1) Contact the contractor immediately to obtain information on the situation.

(2) Request that the contractor keep DCAA advised of all related transactions and activities as they occur.

(3) Remind the contractor of the FAR and CAS requirements concerning affected costs, including the requirement that unallowable costs together with directly associated costs be identified and excluded from any claim applicable to the Government.

(4) Maintain contact between and among the affected FAOs to assure a complete exchange of information, and to ensure that consistent audit action is being taken. Where there is a Contract Audit Coordinator (CAC) or a Corporate Home Office Auditor (CHOA) (see 15-200), overall coordination responsibility should reside therein.

(5) Contact the ACO and the major buying commands to ensure that they are aware of the circumstances. There should be a complete exchange of information with emphasis on items such as advance agreements and novation agreements.

(6) Evaluate the benefits of having a CAC or CHOA conference or a meeting of the auditors cognizant of the specific organizational units involved in the change.

7-1703 Basic Approaches to Obtaining Control Over Assets Owned and Used by Other Firms (Business Acquisition)

There are two basic approaches to obtaining control over assets owned and used by other firms. The acquiring firm may buy the desired assets and thereby obtain title to their use directly, or it may obtain an ownership interest in the common stock of another company enabling it to exercise indirect control over the other firm's assets. These two basic approaches can be adopted in various forms, as follows:

- Acquisition of assets.
- Acquisition of stock.
- Statutory merger.
- Statutory consolidation.

7-1703.1 Acquisition of Assets

a. The acquisition of assets under a business combination is more than a casual sale and purchase of an asset. It is the purchase and sale of a major amount of operating assets, requiring approval by each company's board of directors and, generally, its stockholders. Payment for the assets may be made by cash, debt securities, the acquiring firm's stock, or a combination thereof.

b. The acquiring corporation may:
(1) create a new corporation for the assets,
(2) assign the assets to a new division or branch, or
(3) assimilate the assets into its present organization.
An important point to bear in mind is that purchasing the assets does not give the acquiring firm any ownership rights in the selling organization. The acquiring firm is buying title to specific assets and is in no way acquiring any stockholders' rights in the selling firm.

7-1703.2 Acquisition of Stock

Instead of buying assets directly, an acquiring firm may gain control of assets by buying the voting common stock of the investee. Voting stock may be acquired by :
(1) purchase of outstanding stock on the open market,
(2) negotiation with major stockholders to purchase all or part of their interests,
(3) purchase of authorized but unissued shares (including treasury stock) from the investee company, and
(4) a tender offer.
In a tender offer, the investor makes a public announcement to the stockholders of the corporation whose stock the investor wishes to purchase. The announcement stipulates the price offered for the shares and the number of shares the potential investors want to purchase, what will happen if more or less than that number are tendered, and the time period for tendering the stock. Information regarding the tender offer must be filed with the Securities and Exchange Commission prior to making the offer.

7-1703.3 Statutory Merger

A statutory merger occurs when one or more corporations give up their separate legal identities to another constituent corporation which maintains its identity. Stockholders of the liquidated corporation usually receive common stock of the surviving corporation, but they may also receive cash, debt securities, or preferred stock. Normally, a statutory merger must be approved by the boards of directors of the constituent corporations and then by the stockholders of each company.

7-1703.4 Statutory Consolidation

A statutory consolidation is similar to a statutory merger in that the consolidation must be approved by the boards of directors and stockholders of the constituent corporations. Unlike a merger, however, a consolidation results in the formation of a new corporation and the liquidation of the constituent corporations. The shareholders of the constituent corporations are issued stock in the new corporation, which then controls the assets and liabilities of the former constituent corporations.

7-1704 Accounting for Business Combinations

7-1704.1 Introduction and Use

FASB Statement No. 141 requires that all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Prior to this date the pooling of interest method was acceptable under certain circumstances. (See editions of CAM prior to July 2003 for discussion of the pooling of interest method.)

7-1704.2 Purchase Method

a. The purchase method reflects the acquisition of one company by another. The excess, if any, of the fair value of the identifiable assets purchased over the fair value of the

liabilities assumed and the amount paid is recorded as goodwill. Goodwill is an expressly unallowable cost. Also, goodwill is an unallowable element of the facilities capital employed base used to compute cost of money.

b. The effect of using the purchase method on the valuation of acquired assets is stated in paragraph 7 of FASB Statement No. 141. It requires that the cost of each individual asset be determined based on its estimated fair value at the date of acquisition. Any excess of the price paid for the acquired business over the sum of the amounts assigned to all recognized assets acquired less liabilities assumed is assigned to unidentified assets, including goodwill.

c. In a business combination, a write-up (or write-down) of the asset values can occur when the fair value of the assets acquired is more (or less) than the book value of the assets (7-1705.1). Costs assigned to intangible assets should reasonably reflect their fair market value (7-1705.2).

d. For more specific guidance relating to the valuation or write-up of assets under the purchase accounting method, see 7-1705 below.

7-1705 Asset Valuation and Revaluation Resulting from Business Combinations

7-1705.1 GAAP for Write-ups (or Write-downs)

a. The GAAP for determining the value of an acquired company's assets and liabilities are principally provided in Statement of Financial Accounting Standards No. 141. Five paragraphs are restated below.

(1) Paragraph 7 - Allocating cost.

Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group. The cost of such a group is determined using the concepts described in paragraphs 5 and 6. A portion of the cost of the group is then assigned to each individual asset (or individual assets and liabilities) acquired on the basis of its fair value. In a business combination, an excess of the cost of the group over the sum of the amounts assigned to the tangible assets, financial assets, and separately recognized intangible assets acquired less liabilities assumed is evidence of an unidentified intangible asset or assets.

(2) Paragraphs 35 and 36 - Allocating the Cost of an Acquired Entity to Assets Acquired and Liabilities Assumed.

Following the process described in paragraphs 36-46 (commonly referred to as the purchase price allocation), an acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition (refer to paragraph 48). Prior to that allocation, the acquiring entity shall:

(a) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20-23 and

(b) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39, regardless of whether they had been recorded in the financial statements of the acquired entity.

Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed. The tax basis of an asset or liability shall not be a factor in determining its estimated fair value.

(3) Paragraphs 37 and 38 - Assets acquired and liabilities assumed, except goodwill.

The following is general guidance for assigning amounts to assets acquired and liabilities assumed, except goodwill:

(a) Marketable securities at fair values.

(b) Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

(c) Inventories.

- Finished goods and merchandise at estimated selling prices less the sum of

(i) costs of disposal and
(ii) a reasonable profit allowance for the selling effort of the acquiring entity.
- Work in process at estimated selling prices of finished goods less the sum of :
(i) costs to complete,
(ii) costs of disposal, and
(iii) a reasonable profit allowance for the completing and selling effort of the acquiring entity based on profit for similar finished goods.
- Raw materials at current replacement costs.
(d) Plant and equipment.
- To be used, at the current replacement cost for similar capacity unless the expected future use of the assets indicates a lower value to the acquiring entity (Note - Replacement cost may be determined directly if a used-asset market exists for the assets acquired. Otherwise, the replacement cost should be estimated from the replacement cost new less estimated accumulated depreciation.)
- To be sold, at fair value less cost to sell.
(e) Intangible assets that meet the criteria in paragraph 39 at estimated fair values.
(f) Other assets, including land, natural resources, and nonmarketable securities, at appraised values.
(g) Accounts and notes payable, long-term debt, and other claims payable, at present values of amounts to be paid determined at appropriate current interest rates.
An acquiring entity shall not recognize the goodwill previously recorded by an acquired entity, nor shall it recognize the deferred income taxes recorded by an acquired entity before its acquisition. A deferred tax liability or asset shall be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with paragraph 30 of FASB Statement No. 109, Accounting for Income Taxes.
b. Further guidance on the proper procedures for writing up assets is contained in Section 7610 of the "AICPA Technical Practice Aids."

7-1705.2 Intangible Assets

a. Intangible assets such as patents, trademarks, and franchises are referred to as “identifiable.” Other intangible assets lack specific identity. The excess amount paid for an acquired company over the sum of identifiable net assets, usually termed goodwill, is the most common unidentifiable intangible asset. The most significant distinction between “identifiable” and “unidentifiable” intangible assets is separability. Identifiable intangible assets may be acquired singly, as part of a group of assets, or as part of an entire company. Unidentifiable intangible assets are inseparable from the entity.
b. Costs should be assigned to all identifiable assets, normally based on the fair values of the individual assets; costs of identifiable assets should not be included in goodwill or any other type of unidentifiable assets (see FASB Statement No. 141 Paragraph 39). The cost of unidentifiable intangible assets is measured by the difference between the cost of the group of assets or enterprise acquired and the sum of the assigned costs of individual tangible and identifiable intangible assets acquired, less liabilities assumed.
c. The assets of the acquired company are appraised and fair values established. Usually, outside appraisers perform the appraisal. They may take several different approaches in arriving at their estimated fair values. While:
(1) the accounting processes prescribed by FASB Statement No. 141 require the assignment of costs to identifiable assets, and
(2) GAAP prescribes recognition of the assigned cost, the auditor should not automatically conclude that the resulting costs are reasonable and reimbursable.
d. The auditor needs to evaluate the contractor's categorization of each identifiable intangible asset to determine whether or not the fair value assigned to such asset is reasonable and commensurate with economic reality or substance of the asset in review. The

allowability of identified assets should be limited to fair market values subject to allocability and reasonableness tests.

7-1705.3 Allowability of Asset Valuation Write-ups

a. Contracts subject to TINA awarded after February 27, 1995 incorporate a contract clause (FAR 52-215.19) which specifically requires the contractor to notify the Government of any changes in contractor ownership which would impact asset valuations. The clause also expressly requires maintenance of the records and calculation of the expense amounts which are required in order to comply with the cost principle at 31.205-52. For business combinations that use the purchase method of accounting, FAR 31.205-52 (Asset Valuation Resulting from Business Combinations) limits the amount of allowable amortization, depreciation, and cost of money to the total amount that would have been allowable had the combination never taken place. This provision became effective July 23, 1990. Simply stated, the Government will not recognize for cost allowability purposes any costs resulting from the increase in the value of acquired assets (or the creation of new assets) as a result of business combinations. FAR 31.205-52 applies to contracts awarded on or after July 23, 1990. For purposes of pricing and costing contracts entered into after July 22, 1990, this FAR provision also applies to preexisting business combinations that predate the effective date of the cost principle. However, the contracting officer may need to separately address the costs of past asset write-ups on a case-by-case basis to achieve equity or to protect the Government's interest in special situations (see 7-1705.3.c.).

b. An exception exists in those cases when the assigned values of noncurrent assets are adjusted downward (purchase price is less than net fair value). For contracts not subject to the April 15, 1996 revision to CAS 404, the allowability of costs will be based on the written-down amount. This is in accordance with the pre-April 15, 1996 version of CAS 404. More specifically, the pre-April 15, 1996 version of CAS 404.50(d) provides that when the fair value of assets less liabilities exceeds the purchase price of the acquired company under the purchase method of accounting, the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess. The Government cannot allow costs that are not assignable to a cost accounting period under the CAS requirements. Therefore, prior book values in excess of the price paid by the contractor are unallowable. The April 15, 1996 revision to CAS 404 goes beyond the FAR concept of “no step-up” and provides “no step-up, no step-down” of asset values. Consequently, under the provisions of the revised CAS 404, the net book value of the tangible capital asset in the seller’s accounting records will be used as the capitalized value of the asset for the buyer (see 8-404.2b). The contractor is responsible for maintaining the proper documentation to demonstrate that the proposed or claimed costs do not exceed the amounts calculated based on the book values of the acquired assets (but see 8-404.2b). This becomes particularly important in those business combinations when one company purchases another company and the acquired company is dissolved.

c. Auditors who encounter the following situations should advise the contracting officer that an advance agreement, while not required, may be beneficial to provide equitable treatment to both the Government and the contractor and to minimize future disputes:

(1) when the Government, prior to July 23, 1990, had agreed to a settlement covering a business combination which implied acceptance of such costs in the future. For example, when the Government had agreed to accept an immediate credit for excess depreciation and amortization costs recognized prior to the business combination;

(2) when the acquired company had no or little Government business before being acquired so that no material credit exists for excess depreciation and amortization previously recognized, and the acquiring company subsequently entered Government business with the asset valuations established by the combination.

(3) when an extensive period of time has elapsed between a prior business combination and the effective date of the cost principle. A reasonable period of time may need to be considered in applying the limits of FAR 31.205-52 when the acquired company’s asset

values prior to the business combination are no longer available and it is not practical or cost beneficial to reconstruct these costs.

d. Gains and losses on the disposition of assets resulting from a business combination are not allowable as specified at FAR 31.205-16(a) (but see 8-409.1g.(5) and (6) for the measurement of gains and losses under the April 15, 1996 revision to CAS 409).

e. For contracts awarded on or after April 24, 1998, whether or not the contract is subject to CAS, FAR 31.205-52 allows costs calculated based on the seller's net book value (no step-up, no step-down) if the assets generated depreciation expense or cost of money charged to Government contracts in the most recent accounting period prior to a business combination. If tangible capital assets did not generate depreciation expense or cost of money charged to Government contracts in the most recent year, such costs calculated based on the purchase method (step-up or step-down) of accounting would be allowable.

f. The asset values determined in accordance with CAS (or GAAP) are used in the three-factor formula for distributing home office costs. Likewise, depreciation and amortization costs assigned in accordance with CAS will be included in any allocation base which normally includes such costs (e.g., the total cost input base). FAR 31.203(d) requires that the full amount of such costs be included in allocation bases so as to cause the unallowable portion of the costs to absorb a portion of overhead cost or G&A expense (see 8-410.1a(2) and 8-405.1g(1)). However, on September 29, 1999, a class deviation from this requirement was issued for DoD contracts and subcontracts, effective through September 30, 2002. This deviation was extended on September 9, 2002, effective through September 30, 2005, also on September 26, 2005, effective through September 30, 2008 and on February 18, 2009, effective through September 30, 2011. Under this DoD deviation, the indirect costs allocable to the step-up asset value under the prior CAS 404 requirements will not be disallowed.

7-1705.4 Unallowable Costs

a. Goodwill. FAR 31.205-49 defines goodwill as an unidentifiable intangible asset. It originates from use of the purchase method of accounting for a business combination. Goodwill arises when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. Goodwill may arise from the acquisition of a company as a whole or in part. Any costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable.

b. Cost of Money. The cost of money resulting from including goodwill (however represented) in the facilities capital employed base is unallowable (see FAR 31.205-10(b)(2)).

7-1705.5 Summary of Audit Guidelines for Write-ups

a. For contracts awarded after July 22, 1990, the auditor should verify that contracts do not receive increased costs flowing from asset revaluation resulting from business combinations. This would also apply to preexisting business combinations that predate the contracts being entered into. The auditor may have to advise the contracting officer of the need to separately address the costs of past asset write-ups on a case-by-case basis to achieve equity or to protect the Government's interest in special situations.

b. For contracts awarded on or after April 15, 1996, the auditor should verify whether the contracts are subject to the revised CAS 404 and 409, effective April 15, 1996 (8-404.b and 8-409.b). If the revised CAS 404 and 409 apply, the auditor should verify whether the acquired tangible capital assets generated depreciation or cost of money charges on Federal Government contracts or subcontracts negotiated on the basis of cost during the most recent cost accounting period. For tangible capital assets that generated such depreciation expense or cost of money charges, no write-up and no write-down of asset values is permitted and no gain or loss is recognized on asset disposition. For tangible capital assets that did not generate such depreciation or cost of money charges, asset

values are written-up or written-down in accordance with CAS 404.50(d)(2). However, tangible capital assets meeting the requirements of CAS 404.50(d)(2) must still comply with the requirements of FAR 31.205-10, 31.205-11, 31-205-16, and 31.205-52 (i.e., costs resulting from asset write-ups are unallowable).

c. For contracts awarded on or after April 24, 1998, whether or not the contract is subject to CAS, the allowable depreciation and cost of money would be based on capitalized asset values measured in accordance with CAS 404.50(d). (See 8-404.2 and 8-409.2)

7-1706 Novation Agreements

a. A successor in interest to a Government contract usually evolves from a change in the ownership of a contractor organization. The successor in interest is recognized by a novation agreement executed by:

(1) the contractor (transferor),
(2) the successor in interest (transferee), and
(3) the Government.

By the novation agreement, among other things, the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the Government recognizes the transfer of the contract and related assets (FAR 42.1201). Novation agreements are entered into for all executory contracts transferred to a successor in interest.

b. The transfer of a Government contract is prohibited by law (41 U.S.C. 15). However, FAR 42.1204(a) states: "The Government may, when in its interest, recognize a third party as the successor in interest to a Government contract when the third party's interest in the contract arises out of the transfer of

(1) all the contractor's assets or
(2) the entire portion of the assets involved in performing the contract." Examples include, but are not limited to:

(a) Sale of the assets with a provision for assuming liabilities.
(b) Transfer of the assets pursuant to merger or consolidation of a corporation.
(c) Incorporation of a proprietorship or partnership or formation of a partnership.

c. When it is in the Government's interest not to concur in the transfer of a contract from one company to another company, the original contractor remains under contractual obligation to the Government, and the contract may be terminated if the original contractor does not perform (see FAR 42.1204(c)).

d. When a contractor requests the Government to recognize a successor in interest, the contractor is required to submit a signed novation agreement. The form of the novation agreement and the conditions for its use are prescribed in FAR Subpart 42.12.

e. The standard novation agreement provides in part that "The Transferor and the Transferee agree that the Government is not obligated to pay or reimburse either of them for, or otherwise give effect to, any costs, taxes, or other expenses, or any related increases, directly or indirectly arising out of or resulting from the transfer or this Agreement, other than the Government in the absence of this transfer or Agreement would have been obligated to pay or reimburse under the terms of the contracts" (see paragraph (b)(7) of the standard novation agreement at FAR 42.1204(i)). Auditors should be aware that the cited provision is not limited to professional services, taxes, and corporate expenses directly related with the change in ownership. For novated contracts, the Government is not obligated to pay any increase in contract costs that would otherwise not have occurred. This applies not only to total cost of performance but to any element of cost. The Armed Services Board of Contract Appeals barred an increase in depreciation resulting from a revaluation of assets by the new owners (LTV Aerospace Corporation, ASBCA No. 11161, 67-2 BCA para. 6406). In that case, the Board also rejected a contention that the claim was proper as an offset for "savings" resulting from decreases in other cost categories such as reduced state income taxes resulting from increased depreciation. The "savings" were not costs under the contract because they were never incurred by the contractor.

f. Auditors need to review each novation agreement to determine its accounting impact on the applicable contracts, the concurrently running contracts, and those contracts entered into subsequent to the agreement.

g. Pending the execution of a novation agreement, auditors should consult with the ACO on matters such as the appropriate recognition of the transferee and transferor for contract costing and payment purposes.

7-1707 Organization and Reorganization Costs

a. Expenditures made in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, are unallowable under FAR 31.205-27, Organization Costs (see Dynalectron Corporation, ASBCA 20240, 77-2 BCA 12835). Such expenditures include, but are not limited to, incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants, and investment counselors, whether or not they are employees of the company. This would also include costs related to changes in the financial structure which may result from divestitures or the establishment of joint ventures or wholly-owned subsidiaries. In establishing the coverage at FAR 31.205-27, the Cost Principles Committee relied on the following definition of an organization and reorganization and the costs thereof:

(1) A major change in the financial structure of a corporation or a group of associated corporations resulting in alterations in the rights and interest of security holders; a recapitalization, merger, or consolidation.

(2) Any costs incurred in establishing a corporation or other form of organization; as, incorporation, legal and accounting fees, promotional costs incident to the sale of securities, security-qualification expense, and printing of stock certificates.

b. In the event a contractor creates or acquires a new segment or business unit through an acquisition or reorganization, the auditor should review the activity associated with the transaction to determine if any unallowable or unallocable costs are assigned to Government contracts. These activities are often performed by an in-house business planning group, an acquisition and divestiture committee, and by the corporate legal and accounting departments. The auditor should review any available documentation to identify activities and associated costs which are directly incident to establishing or altering the contractor's financial structure. Many times the employees involved in these activities do not maintain adequate time records to identify and support their effort expended on reorganizations and related work. The auditor should ensure that the contractor implements the necessary policy and procedures to properly identify and account for these activities.

c. Normal recurring expenditures associated with internal reorganizations of contractor segments and divisions are generally allowable costs to the extent they are reasonable and allocable. Such expenditures may be incurred for business planning and forecasting, developing policies and procedures, preparing a CAS disclosure statement, establishing an accounting system, etc.

7-1708 Costs Associated With Resisting Change in Ownership (Golden Parachutes and Golden Handcuffs)

7-1708.1 General Allowability

a. For contracts awarded prior to April 4, 1988, contractor expenditures to resist a takeover should be disapproved in accordance with the provisions of both FAR 31.205-27, "Organization Costs," and FAR 31.205-28, "Other Business Expenses." In addition, the auditor should:

(1) Be aware that such costs do not meet the criteria for allocability stated in FAR 31.201-4 (i.e., the costs are not incurred specifically for a Government contract nor do they benefit Government work).

(2) Make every effort to have the contractor segregate its expenditures to effect or resist a business combination as they are being incurred.

b. For contracts awarded on or after April 4, 1988, the costs incurred by a contractor in connection with successfully or unsuccessfully resisting a merger or takeover are expressly unallowable per FAR 31.205-27(a), and must be segregated as unallowable costs per FAR 31.201-6.

7-1708.2 Abnormal Executive Severance Pay (Golden Parachutes)

In order to discourage a hostile takeover attempt, some companies have instituted extraordinary arrangements with key employees to provide very large termination benefits to be paid only in the event of a merger or loss of control and the subsequent dismissal, termination, or departure of the executive. These arrangements have been referred to as "Golden Parachutes" because they provide extremely lucrative financial arrangements for the executives in those circumstances. See 7-2107.8 for a discussion of the allowability of these costs.

7-1708.3 Special Compensation for Retaining an Employee (Golden Handcuffs)

Special compensation which is contingent upon the employee remaining with the contractor for a specified period of time is commonly called "golden handcuffs," and is expressly unallowable per FAR 31.205-6(l), "Compensation incidental to business acquisitions." With respect to the FAR provision, it is important to note that the disallowance of costs is linked with the requirement for the employee to remain with the company. For example, assume an individual was performing a job normally paid and objectively worth $50,000 per year, but for good reason, (e.g., to help the company through a rough financial period) accepted and was paid only $40,000 per year. If the new owners immediately raise the individual's salary to $50,000, this would not be considered a "golden handcuff" unless the pay raise is granted on a condition that the individual would remain with the company for a specified period of time.

7-1709 Adjustment of Pension Costs

a. In the event of a business combination, the DCAA auditor cognizant of the selling contractor, in consultation with the DCMA insurance/pension specialist, will determine whether an adjustment of pension costs is required in accordance with CAS 413.50(c)(12). In making this determination, the asset purchase/sales agreement should be reviewed immediately following the business combination. If an adjustment of pension cost is warranted, the auditor should request the ACO to initiate a special CIPR. Refer to audit guidance contained in 7-605.2 (f) and 8-413.3 for additional guidance.

b. The FAO cognizant of the selling contractor should also verify the amount of pension assets and liabilities transferred to the acquiring contractor. Actuarial reports, bank wire transfers and trust statements for the pension plan document the amount of assets and liabilities transferred. The FAO should confirm in writing the amounts transferred with the DCAA office cognizant of the acquiring contractor.

7-1710 Organization and Reorganization References

a. Access to Records 1-504
b. Advance Agreements FAR 31.109
c. Asset Valuation Resulting from Business Combinations FAR 31.205-52
d. Business Combinations FASB Statement No. 141
e. Capital Investment 14-602
f. Capital Tangible Assets CAS 404
g. CAS Disclosure Statement 48 CFR 9903.2
h. Cash Disbursements 14-305.2f

i. CAS Impact Statement 48 CFR 9903.3
j. Compensation FAR 31.205-6
k. Consultants FAR 31.205-33 & 37.203
l. Cost of money FAR 31.205-10; CAS 414
m. Depreciation FAR 31.205-11; CAS 409
n. Economic planning FAR 31.205-12
o. Gains and losses on assets FAR 31.205-16
p. Goodwill FAR 31.205-49
q. Insurance FAR 31.205-19; CAS 416
r. Intangible assets FASB Statement No. 142
s. Labor relations costs FAR 31.205-21
t. Pensions FAR 31.205-6(j); CAS 412 & 413
u. Plant Rearrangement 9-703.9
v. Records Destroyed 1-506
w. Sale and Leaseback 9-703.11
x. SEC Current Report 3-1S1 (Form 8k)
y. Taxes FAR 31.205-41

7-1800 Section 18 --- Joint Ventures, Teaming Arrangements, and Special Business Units (SBUs)

7-1801 Introduction

a. This section provides guidance for audit evaluation of joint ventures, teaming arrangements, and special business units (SBUs).

b. The form of business organization chosen by the contractor to carry on its business or to bid on Government contracts significantly affects contractor costs and income taxes. Eligibility for award of a Government contract may be directly linked to the form of business organization under which a contractor elects to bid. Concurrently, the form of business organization will have a significant bearing on determining the allowability and allocability of costs incurred under Government contracts. Therefore, in reviewing a contractor's business organization, the auditor must consider the related business circumstances and the contractor's compliance with generally accepted accounting principles, FAR, and CAS. An understanding of the applicable Internal Revenue Service Regulations and provisions of both Federal law and state law would also be beneficial in many instances.

7-1802 General Terms and Definitions

a. Corporation. A business organization of one or more persons, partnerships, associations, or corporations chartered by the state for the purpose of conducting profit making endeavors with the objective of dividing the gains. A corporation is a separate legal entity with the following usual characteristics: continuity of existence, centralized management, liability limited to corporate assets, and free transferability of interest. A corporation may perform any business action that can be performed by a natural person.

b. Joint Venture.

(1) An enterprise owned and operated by two or more businesses or individuals as a separate entity (not a subsidiary) for the mutual benefit of the members of the group. Joint ventures possess the characteristics of joint control; e.g., joint property, joint liability for losses and expenses, and joint participation in profits. Joint ventures can be either incorporated or unincorporated. The incorporated joint venture involves the issuance of stock and is most common on large construction type contracts. These joint ventures possess the typical characteristics of a corporation. The unincorporated joint venture can be a partnership or teaming arrangement between two or more corporations usually involved in large research and development and/or major weapons systems contracts. Usually in this type of joint venture, the joint venture is the contracting entity and is designated to act as the prime contractor.

(2) Joint venture ownership seldom changes, and the stock of an incorporated joint venture is normally not traded publicly. Furthermore, under the usual arrangement:

(a) each investor participates, directly or indirectly, in the overall management of the joint venture (i.e., joint venturers usually have an interest or relationship in the venture other than as passive investors);

(b) significant influence of each of the investors is presumed to be present; and

(c) one investor does not have control by direct or indirect ownership of a majority voting interest (otherwise the venture is likely to be a subsidiary of the controlling investor).

c. Teaming Arrangement. An arrangement between two or more companies, either as a partnership or joint venture, to perform on a specific contract. The team itself may be designated to act as the prime contractor; or one of the team members may be designated to act as the prime contractor, and the other member(s) designated to act as subcontractors. (See FAR Subpart 9.6.) When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the

teaming arrangement is a joint venture. When these characteristics are not present then the arrangement may more closely resemble that of a prime contractor/subcontractor.

d. Partnership. An ordinary partnership occurs when two or more entities (persons) combine capital and/or services to carry on a business for profit. From a legal standpoint, it is a group of separate persons.

e. Cooperative Research Consortiums. A cooperative research consortium is a partnership, joint venture, or corporation organized pursuant to the 1984 National Cooperative Research Act. Research consortiums involve collaborations among competitors and are usually formed to explore specific research areas. Unlike other business entities discussed in this section, cooperative research consortiums are not formed to bid on Government contracts. See 7-2115 for additional guidance on cooperative research consortiums.

f. Special Business Unit (SBU). SBU is the term used within CAM and other Agency guidance to describe business organizations established by a single contractor to:

(a) support a single contract, program, or product line,
(b) limit financial, tax, or legal liability, and/or
(c) gain a technical or cost advantage.

For purposes of this guidance, an SBU may be a wholly-owned subsidiary, a corporate division, or a joint venture/partnership composed of segments of the contractor.

g. Subsidiary. An entity controlled, directly or indirectly, by another entity. Control is usually conditioned upon ownership of a majority of the outstanding voting stock. It may also exist, however, with less than a majority of the outstanding voting stock under certain conditions (e.g., there is a contract, lease, agreement with other stockholders, or court decree).

7-1803 Characteristics of a Joint Venture

a. An incorporated joint venture normally has characteristics common to a corporation (see 7-1802a.). It is a separate legal entity and acts as a contracting party.

b. An unincorporated joint venture usually is either a partnership or a teaming arrangement and most often has:

(1) few or no employees hired and paid by the joint venture,
(2) little or no assets or separate facilities,
(3) no separate financial statements, and
(4) little or no G&A, B&P, or material handling expenses.

All contract work is performed by the venturing organizations or other subcontractors. Employees are paid by their respective companies. The terms of the formation, operation, and dissolution of the venture are usually specified in a written agreement between the venturing organizations (see 7-1807a.).

7-1804 Characteristics of SBUs

a. An SBU is a segment of the establishing contractor since the SBU is either a subdivision of that contractor or is controlled by that contractor.

(1) Some SBUs have employees hired and paid by the SBU who actually perform the required contract effort. These SBUs may also have their own assets and liabilities and have profit and loss responsibility. They are usually reportable segments for financial and tax purposes. These SBUs are often engaged in foreign military sales or direct commercial sales to foreign governments. These SBUs are usually formed to limit tax and /or legal liability.

(2) Other SBUs are more like joint ventures and teaming arrangements. These business organizations have no employees and subcontract virtually all (over 90 percent) contract effort to other contractor division s and/or outside subcontractor(s). Often these SBUs have little or no assets. This type of SBU may have been formed to gain competitive, cost, and/or technical advantages.

b. The audit concern is that any cost advantage be based on valid cost allocation practices. Basically, there are two types of cost advantages that SBUs can attain. The first type results from the fact that an SBU is a specialized contracting entity supported by one or more established contractor entities. The second type results from cost allocation practices that enable an SBU contract to significantly reduce, or altogether avoid, the amount of material overhead and G&A that the contractor would normally have to allocate to its subcontracts and/or interdivisional work. If the cost allocation practices cause a significantly different allocation to a SBU contract than would have been allocated to the same contract if issued directly to the contractor's operating segment, the cost allocation practices may be inequitable and/or CAS noncompliant.

7-1805 Audit Considerations

a. The joint venture and teaming arrangement guidance in this section has been written to specifically cover unincorporated joint ventures, and may not apply to incorporated joint ventures.

b. There are a number of audit issues and concerns related to the formation, organization, and operation of joint ventures, teaming arrangements, and SBUs. These types of business organizations can have a material impact on the contractor's existing organizations and Government business. The creation of an SBU may change our prior assessment of internal controls and may cause increased costs on contracts at existing contractor segments.

c. The impact, however, is not always adverse, and the creation of joint ventures and SBUs may be proper and acceptable. A number of contractors have established joint ventures in response to an RFP requirement for contractor teaming arrangements. In these procurements it is the Government's acquisition strategy to have two or more contractors team together to jointly design, develop, and test some type of new technology with the intent to qualify multiple contractor sources for future production. This type of acquisition strategy is most popular on major weapon system procurements. Normally, these teaming arrangements have the characteristics of joint and equal control where neither contractor possesses a majority ownership nor exercises management control. Similarly, some contractors have established wholly-owned subsidiaries or divisions for FMS contracting purposes. Many of these SBUs have been created to limit tax or legal liability.

d. There are also a number of joint ventures and SBUs that may present problems which the auditor and CAC/CHOA should fully disclose to the contracting officer, DACO, CACO, and DCE to aid in making their decisions in relation to contracting with the joint venture or SBU. This is particularly important when the performance of a joint venture or SBU contract would cause increased costs on other Government contracts or when the changes in accounting practices associated with the contract have not been fully disclosed. After award of a contract to such a joint venture or SBU, the auditor should monitor the costs allocated to the SBU to assure that it absorbs an equitable share of costs.

e. In developing audit steps to disclose and report on these situations, consider both the form and substance of the business unit. In reviewing the form and substance of the business unit, consider the following:

(1) Is the joint venture or SBU a business segment? (see 7-1806.)

(2) What is the actual relationship between the venturing organizations? (see 7-1807.)

(3) Is the joint venture/SBU cost accounting and tax treatment consistent with the form and substance of the business organization? (see 7-1808 and 7-1809.)

(4) Does the joint venture/SBU accounting result in equitable cost allocations between and among the business organizations/segments? (see 7-1810.)

(5) Does the joint venture/SBU have a cost impact on the existing contracts of the venturing/parent organizations, and if so, has a change in cost accounting practice occurred? (see 7-1811.)

7-1806 Characteristics of a Legitimate Business Unit/ Segment

a. When reviewing the accounting aspects of a contractor's business organization, the identification of the organization as a segment or business unit is important for the following reasons:

(1) CAS consistently uses the terms "segment" and "business unit" to present its accounting guidance on business organizations.

(2) Various financial accounting pronouncements, such as those dealing with consolidated reporting, also use the term "business segment" to present GAAP that applies to business organizations in general. (Note that the CAS and FASB definitions for "segment" are not the same.) The CAS/FAR definition is the relevant definition for Government cost accounting purposes.

(3) Entities that do not satisfy the basic criteria for a segment or business unit are actually an undivided part of a contractor business unit. Therefore, separate allocations to such an SBU would often be in noncompliance with those provisions of CAS (e.g., 402, 403, 410, 418, and 420) which deal with the consistency and fragmentation of allocation bases. (See 7-1810.)

b. The terms "segment" and "business unit" are defined for CAS purposes in FAR 2.101. A CAS segment is "one of two or more divisions, product departments, plants, or other subdivisions reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service." A CAS segment may include a GOCO facility, or a joint venture or subsidiary in which the organization exercises control. CAS does not define control nor provide criteria for determining whether an organization exercises control. A business unit, in turn, is any segment of an organization which is not further divided into segments.

7-1807 Relationship Between Business Organizations

The form and substance of a contractor's business organization can significantly influence the allowability and allocability of costs incurred under Government contracts. Determine not only the form of the business organization but the actual relationship (substance) between the venturing contractors. Several criteria and appropriate review procedures are presented below. Normally no one factor should be the sole determinant of whether the relationship is a joint venture or more closely resembles a prime contractor/subcontractor relationship. The allocation of costs should reflect the causal/beneficial relationships between and among the venture partners and other segments/home offices of the contractor.

a. Review of Joint Venture Agreements

(1) FAR 9.603 requires contractor joint ventures and teaming arrangements to identify and disclose the arrangements in an offer or, for arrangements entered into after submission of an offer, before the arrangement becomes effective. This is normally done in a written agreement between the participating contractors. An agreement will normally contain and/or explain:

(a) the name of the venture;
(b) the customer and solicitation number;
(c) the names of the participants;
(d) any limitations on the powers and rights of the participants;
(e) the contributions that each participant is required to make with regard to the venture's capital, personnel, proposal preparation, etc.;
(f) anticipated subcontracts;
(g) funding requirements;
(h) responsibilities for record keeping and for the preparation of reports and invoices;
(i) the designated management;
(j) limitation of liabilities;
(k) term of venture and dissolution agreements;

(l) responsibilities for and restrictions on royalties, patents, copyrights, and property rights arising from venture operations;

(m) the resolution of disputes among the venturers;

(n) covenants on how litigation costs will be borne by the participants;

(o) which state's laws will govern the venture;

(p) the filings or disclosures required by the state, FAR, etc.;

(q) any technology transfer agreements; and

(r) any cost/profit sharing agreements.

(2) Review the written agreement to help determine the management, financial, and technical responsibilities of each contractor. In addition, review the joint venture/teaming arrangement organization chart(s) and policies and procedures. This information can be useful in determining if the characteristics of joint control and management are present or if one contractor seems to possess the control and management characteristics of a prime contractor.

b. Ascertain each venturers responsibility for the financial and technical management of the joint venture. Determine the composition of the joint venture management team, the location of the joint venture program office, the procedures for preparing the joint venture financial statements, tax returns, and Government billings and technical reports. Also review each venturer's responsibility and role in the preparation of the joint venture proposal. Ascertain each venturer's responsibilities for outside subcontractor selection and material purchasing. The composition of the key personnel to the joint venture should also be analyzed. When considered together this information will help determine the actual relationship between the venturers. It will also help determine if one venturer exercises control over the joint venture.

c. Review the composition of the joint venture or teaming arrangement capital and equity to help determine if one of the venturers exercises ownership control. Analyze any cost and revenue sharing agreements and asset contributions.

d. Review the technical relationship between the venturers by reviewing the written agreement, any technical exchange agreements, the cost and technical proposals, the contract and/or subcontract statements of work, and other relevant documentation. Determine the assignment of technical responsibilities to each venturer, the integration of work products between the venturers, and the technical areas of expertise of each venturer. The responsibilities of each organization for technical interface with the Government can also help determine the technical relationship between the venturers.

e. Discuss the joint venture/teaming arrangement with the cognizant DCAA offices for the other venturing contractors to help ensure consistent audit treatment. Coordinate with the other cognizant DCAA offices to establish responsibilities for audits of forward pricing proposals, public vouchers, progress payments, etc., to request appropriate assist audits, and to ensure adequate audit coverage of joint venture costs. See 6-800 and 9-100 for additional guidance on audit coordination between DCAA offices and for requesting assist audits.

7-1808 Accounting Considerations

7-1808.1 Accounting Considerations for Joint Ventures

a. General. A joint venture, proposed and established as a separate business entity, should have its own set of books and supporting documentation sufficient for an audit trail. Transactions should be recorded consistent with the joint venture agreement (7-1807a.), and care must be taken to ensure that the joint venture bears its equitable share of the costs. For audit guidance on the general implications of FAR and CAS in the review of joint ventures and SBUs, see 7-1810.

b. Incorporated Joint Ventures. Investors, in most circumstances, should use the equity method to account for incorporated joint ventures. The generally accepted accounting principles (GAAP) relating to this method of accounting for investments in joint

ventures are contained in APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," and, to a lesser extent, in APB Opinion No. 23, "Accounting for Income Taxes-Special Areas." Paragraph 16 of APB 18 concludes that investments in common stock of incorporated joint ventures should be accounted for by the equity method, regardless of the percentage of stock held, to reflect the underlying nature of their investment in such ventures. The uncommon circumstances under which the cost method of accounting for incorporated joint ventures should be used in lieu of the equity method are noted in paragraph 16 of APB Opinion No. 18.

c. Unincorporated Joint Ventures. The provisions of APB Opinion No. 18 have generally been interpreted as being applicable to unincorporated joint ventures as well as incorporated joint ventures. Therefore, in most circumstances when the investment in an unincorporated joint venture is material, the equity method should also be used to account for the investment.

d. Joint Venture Accounting as a Partnership. If a joint venture elects to be treated as a partnership, or is required by either the Federal tax code or any state's partnership laws to be treated as a partnership, then the joint venture should

(1) adopt accounting practices that are consistent with the single entity concept, and

(2) maintain a complete set of books and records.

e. See 7-1807 for criteria to help determine the actual relationship between the venturing contractors.

7-1808.2 Accounting Considerations for Teaming Arrangements

a. The accounting for teaming arrangements should be consistent with the form of business organization that the teaming contractors have agreed to and disclosed in their proposal(s). For example, if the agreed-to arrangement is in the form of a joint venture, then this should be disclosed in the proposal(s) and the accounting principles applicable to a joint venture should be followed. FAR 9.603 requires contractors to fully disclose all teaming arrangements in their offers. If an arrangement is entered into after submitting an offer, then disclosure is required before the arrangement becomes effective.

b. When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the business arrangement is a joint venture. If the characteristics of joint control are not evident, then the terms of the business arrangement should be reviewed to see if a prime contractor/subcontractor relationship exists between the parties. Note, however, that a disclaimer of a joint venture arrangement in itself does not preclude an arrangement from being classified as a joint venture if it possesses the characteristics of a joint venture. See 7-1807 for criteria to determine the actual relationship between the contractor organizations.

7-1808.3 Accounting Considerations for SBUs

A Special Business Unit or SBU, as explained in 7-1802f., is DCAA's term to describe a contractor subsidiary, division, or other form of business organization established to accomplish certain specific tasks or to gain a competitive advantage. It is not a distinct entity form; therefore, the accounting for an SBU should follow the principles established for the actual entity involved and be consistent with the contractor's disclosed accounting practices.

7-1809 Joint Venture, Teaming Arrangement, and SBU Federal Taxes

7-1809.1 Tax Classification and Definitions of Organizations

a. General. The classification and definitions of organizations for Federal tax purposes are contained in the regulations of the Internal Revenue Service (26 CFR 301.7701-1 et seq.). Except for organizations of professional persons, local law will have little bearing in the determination of an entity's classification for tax purposes. The tax and common busi-

ness law definitions for the various types of business organizations are usually different. Some examples of these differences are noted below.

b. Corporation. The term "corporation" as defined in the CFR is not limited to the entity commonly known as a corporation (see 7-1802a.); it includes an association, a trust classified as an association due to the nature of its activities, a joint-stock company, an insurance company, and certain kinds of partnerships.

c. Partnership.

(1) The term "partnership" is also broadly defined in the CFR to encompass just about all types of unincorporated organizations including most forms of syndicates, groups, pools, and joint ventures. In other words, if a legal business entity does not constitute a trust, estate, or corporation for tax purposes, then it is likely to be considered a partnership. Further note that the tax status of a partnership is not affected by the fact that a corporation may be one of the partners, or that local law does not permit a corporation to be a partner.

(2) Notwithstanding the above, DoD contractors have established several forms of unincorporated joint ventures and joint venture teaming arrangements that they do not consider to be partnerships for tax purposes.

d. Limited Partnership. A limited partnership, depending upon its specific characteristics, is classified in the CFR as either an ordinary partnership or as an association taxable as a corporation.

e. Association. Section 301.7701-2 of the CFR defines an association as a corporation if it has certain characteristics, including:

(1) associates,
(2) free transferability of interest,
(3) an objective of carrying on a business and distributing profits,
(4) liability for debt limited to corporate property,
(5) continuity of life (i.e., a going concern), and
(6) central management.

7-1809.2 Review of Tax Returns

a. Review the joint venture, teaming arrangement, or SBU tax returns and supporting records to determine, confirm, or gain additional insight into the type and nature of the contracting entity. Tax information can answer questions on ownership and control and on whether a given organization exists as a separate legal business entity or as a component of a contractor's existing business entity. When reviewing a joint venture or teaming arrangement that may or should be treated as a partnership for tax purposes, request Schedules K and K-1, supporting Partnership Return Form 1065. These schedules address the apportionment of income, credits, deductions, etc. to the individual partners (i.e., joint venturers/team members). They also identify the individual partners and contain other information relating to the assessment of costs, degree of control, ownership of capital, percentages of profit and loss sharing, and credits.

b. General guidance on the review of contractor tax returns is provided in 3-1S2, and brief descriptions of some of the applicable tax forms are also presented in 3-1S2.

7-1810 FAR and CAS Cost Allocation Considerations

7-1810.1 FAR Compliance

a. General. The FAR does not specifically address a joint venture as a party in the procurement of supplies and services under Government contracts. It is therefore necessary to understand the purpose for and characteristics of a joint venture when reviewing the venture in terms of the FAR, specifically the FAR cost principles on allowable costs.

b. Material/Service Costs and Venture Control. When one of the venture participants exercises majority control over the joint venture, FAR 31.205-26(e) specifically provides that

the transfer of material costs or service costs from any of that company's segments to the joint venture should be on the basis of cost incurred, unless competitive or catalog prices are involved. In the event that the venture members appear to be equal participants, the provisions of FAR 31.205-26(e) still apply, if the auditor can determine that one of the members actually exercises predominant control over the venture. To help make this determination the auditor should look at the venture agreements to ascertain if any member has significant risk or underwriting responsibility in disproportion to the others.

7-1810.2 CAS Disclosure Statements.

a. General. Any contractor which, together with its segments, receives net awards of CAS-covered negotiated Government contracts totaling $50 million or more in its most recent cost accounting period must submit a CAS Disclosure Statement (48 CFR 9903.202-1(b)). Any business unit that is selected to receive a CAS-covered negotiated Government contract or subcontract of $50 million or more is also required to submit a Disclosure Statement. (see 8-103.8)

b. Joint ventures are composed of two or more contractors each of which may have already filed a Disclosure Statement as a result of having obtained other Government contracts. Review the characteristics of the joint venture to determine if the joint venture meets the definition of a CAS segment.

c. The need for a joint venture CAS Disclosure Statement depends upon the characteristics of the venture itself. The determination must be made on a case-by-case basis. Where the joint venture is the entity actually performing the contract, has the responsibility for profit and/or producing a product or service, and has certain characteristics of ownership or control, a Disclosure Statement should be required. Where the venture merely unites the efforts of two contractors performing separate and distinct portions of the contract with little or no technical interface, separate joint venture disclosure may not be required. Where doubt exists, discuss the circumstances with the contracting officer.

7-1810.3 Cost Allocation

a. There is no one cost allocation model which covers contracts issued to all joint ventures, teaming arrangements, and SBUs. The range includes everything from models where all costs are incurred at the contracting entity to models where no costs are incurred at the contracting entity. The former model is a normal prime contracting scenario and the later is descriptive of SBUs which have no employees or assets of their own.

b. Many contractors either have their SBUs "borrow" employees from other segments of the contractor or have the other segments perform the tasks normally performed by the prime contractor in place of the SBU. In either case, the arrangement may create a home office at the segment providing the services to the SBU. A home office provides management services or supervision to two or more segments. For CAS-covered contractors, the home office costs must be disclosed and be compliant with CAS 410.50(h) and CAS 403. The tasks performed by the home office for the SBU may include a wide range of functions; e.g., general management, bid and proposal, independent research and development, selling, contract administration, material handling, procurement, computer services, personnel services, etc. When a segment begins to perform indirect functions for another segment it may present new labor charging and timekeeping problems requiring new training and internal controls.

c. In extreme cases, SBUs have no employees or assets. All the deliverable services and products are designed, manufactured, assembled, and provided by operating segments of the contractor. These operating segments only transfer the costs to the SBU for billing purposes. All G&A/B&P/IR&D, any specifically identifiable contract management functions, and any other indirect costs are performed by one or more of the contractor's other segments, making those segments home offices which must allocate the costs to the SBU.

d. When residual home office expenses are allocated using the three factor formula, CAS 403 requires that inter-segment sales be claimed at the segment which produced the contract deliverable product or service. When determining the sales factor to be used in the three factor allocation for residual expenses at a home office or a group home office, CAS 403.50(c)(1)(ii) requires that each segment in the allocation grouping include inter-segment sales in its sales total and then reduce its sales total by the amount of purchases from other segments in the allocation grouping.

e. Allocation of Home Office Expenses to Joint Ventures and Teaming Arrangements.

(1) General. Most of the joint ventures or teaming arrangements encountered to date have been established as CAS 403 segments with the venturing companies acting as intermediate home offices for their share of the venture costs. Such arrangements usually involve the adoption of a "special" method of allocating residual home office expenses wherein each venturer allocates a portion of its residual expenses to their portion of the joint venture costs. Notwithstanding this background on the typical arrangement, follow the guidance below in the review of home office expenses relative to joint ventures.

(2) If the joint venture or teaming arrangement is considered a segment in accordance with the definition of CAS 403 (see a & b above), the auditor needs to ensure that each of the venturing companies:

(a) identifies and directly allocates those home office expenses that were specifically incurred in support of the joint venture,

(b) separately allocates to the joint venture its share of home office support expenses from any homogeneous pools, and

(c) adopts one of the following practices for the allocation of residual expenses:

(i) The venturer’s can request a special allocation of the residual expenses in accordance with the criteria in CAS 403.50(d)(1).

(ii) The majority or controlling contractor can treat the joint venture as a segment of its company, and include the entire operations of the venture in its formula for allocating residual expenses.

(iii) The minority contractor may also allocate its company's residual expenses to joint venture, but is not required to.

(3) The joint ventures and teaming arrangements that have not been formed as separate CAS 403 segments (see a & b above) generally do not have, and would not be expected to have, significant assets or payrolls (elements of the three factor formula for allocating residual expenses). Home office expenses are allocated to the contracts of these joint ventures in the same manner that the venturing companies allocate these expenses to their other contract work.

f. CAS 410.50(d) requires that the cost input base used to allocate the G&A expense pool include all significant elements of that cost input which represent the total activity of the business unit. Only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from G&A expense can the contractor deviate from this requirement. All special allocations of this nature must be handled in accordance with CAS 410.50(j). Such special allocations may be appropriate in unusual circumstances that are not expected to recur. To the extent that subcontracts or any other significant element of cost input, representative of the total activity of the unit, are excluded from the base, a noncompliance occurs.

g. CAS 420.50(f)(2) requires that the cost input base used to allocate IR&D/B&P costs to all final cost objectives be the same as the G&A allocation base. As with G&A above:

(a) only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from IR&D/B&P costs can the contractor deviate from this requirement, and

(b) to the extent that a significant element of cost input is excluded from the base, a noncompliance occurs.

h. CAS 418.50(d)(2) states that a material cost base is appropriate if the activity being managed or supervised is a material-related activity. Upon selection of a material cost base, all significant elements shall be included in that allocation base.

i. When reviewing joint ventures or teaming arrangements that have been established as a separate business entity and which have a CAS-covered contract the auditor should:

(1) Treat the venture as a separate contractor segment, even if the venture has few, if any, assets or employees, and no up-front investment. See 7-1806 for further guidance relating to the determination of separate business units/segments.

(2) Ensure that all of the costs that should be allocated to the venture are appropriately allocated to the venture in accordance with the provisions of CAS. (G&A and IR&D/B&P, for example, should be allocated to the venture according to the provisions of CAS 403, 410, and 420.)

j. When reviewing joint ventures and teaming arrangements that have not been established as a separate business entity, the auditor should:

(1) Determine the reasons why the venture is not being treated as a separate entity or CAS business unit/segment. For example, do the venturer's claim that a separate segment does not exist because

(a) the venture has no assets, employees, or up-front investment, and/or

(b) the cost impact of establishing the venture as a separate entity is not significant enough considering the extra administrative costs involved?

(2) Determine how the venture and venturing companies are being treated and accounted for. For example, are the venturing companies being treated as independent contractors (vs. subcontractors to the joint venture)?

(3) Develop a position based on appropriate consideration of

(a) the CAS requirements,

(b) the principle of "substance over form,"

(c) materiality of the cost impact associated with establishing a separate entity, and

(d) the intent of the contracting officer.

If a preliminary position is developed which substantially differs from, or conflicts with, the intent of the contracting officer, elevate this matter through normal channels to the attention of the Headquarters Accounting and Cost Principles Division.

(4) Meet with the contracting officer and/or administrative contracting officer to:

(a) discuss your findings and the contracting officer's position with respect to the arrangement, and

(b) work toward changing any unsuitably proposed or established joint ventures.

(5) Communicate any adverse impact associated with the joint venture arrangement (i.e., CAS noncompliance or accounting inconsistency) to the ACO, cognizant PCO, and other PCOs affected by the arrangement, and continue to closely monitor the arrangement for such an impact.

7-1811 Changes in Cost Accounting Practices

a. Basic Audit Requirement. Once a CAS-covered joint venture or SBU is established, and there are no apparent CAS noncompliances associated with the allocation of costs, the auditor must next determine whether the SBU organization itself has impacted the costs on any existing company contracts, and if so, whether a change in cost accounting practice occurred. Each organizational change must be evaluated separately to determine whether a change in cost accounting practice has occurred. Specific criteria for making these determinations are provided in 48 CFR 9903.302 and 8-303.3, and are restated in part below.

b. Basis for Audit Determination. The CAS definition for a change in cost accounting practice is presented in 48 CFR 9903.302-2. The CAS Board's discussion on when an organizational change may be considered a change in cost accounting practice is presented in Part II, Preamble J, of the Appendix to FAR loose-leaf edition. As part of this discussion, the Board stated that while organizational changes by themselves are not changes in cost accounting practices, such changes may cause a change in a contractor's cost accounting practices. The Board further stated that the decision as to whether there is a change in cost accounting practice should be made through an analy-

sis of the circumstances of each individual situation based on the criteria being promulgated in the CAS regulations.

c. References For Pursuing Cost Accounting Changes. The CAS rules, regulations, and administrative requirements for changes in cost accounting practices are contained in 48 CFR 9903.3, FAR 30.603, and CAS contract clause FAR 52.230-6, "Administration of Cost Accounting Standards." (See 8-303.3 and 8-500.)

d. Evaluating Cost Impact. When reviewing a joint venture or SBU to determine the cost impact on existing company(s) contracts, care must be taken to distinguish between:

(1) the cost impact due to the change in the measurement, allocation, and assignment of costs and

(2) the impact due to the initial adoption of a cost accounting practice, or the partial or total elimination of a cost or the cost of a function, which are not considered changes in cost accounting practices under CASB rules and regulations.

7-1900 Section 19 --- Restructuring Costs

7-1901 Introduction

Contractors frequently consolidate and restructure to reduce operating costs and thereby reduce contract costs. Unique requirements have been established governing the evaluation and approval of costs related to restructuring activities resulting from business combinations. This section contains guidance for evaluating the contractor's restructuring proposal and incurred costs.

7-1902 Legislation and Regulations

a. Beginning August 15, 1994, various legislation has been enacted to restrict the reimbursement of restructuring costs associated with a business combination. For business combinations that occur after September 30, 1996, legislation requires that for external restructuring costs to be allowable, the projected savings must either (1) exceed allowable costs by a factor of two to one, or (2) exceed allowable costs and the business combination will result in the preservation of a critical capability that might otherwise be lost to the Department.

b. DFARS 231.205-70 prescribes policies and procedures regarding a contractor's external restructuring costs. Several steps are required before external restructuring costs may be reimbursed. The procedural steps relating to the Government's responsibilities are provided in the DFARS resource companion guide, Procedures, Guidance and Information (PGI), at PGI 231.205-70.

(1) The first step for the cognizant ACO is to promptly novate contracts when required. The novation agreement must include the provision at DFARS 242.1204(i) which allows increased costs on flexibly-priced novated contracts for restructuring, provided that the transferee demonstrates that the restructuring will reduce overall costs for DoD (and the National Aeronautics and Space Administration (NASA) when there is a mix of DoD and NASA contracts). DoD will not treat a shifting of costs from DoD contracts to NASA contracts as an overall cost reduction for DoD. Restructuring costs are not allowed until execution of the advance agreement required by DFARS 231.205-70(c)(3).

(2) The cognizant ACO must take other steps before restructuring costs may be either reimbursed on the flexibly-priced contracts that were awarded after the business combination or included in the price of future fixed-price contracts. These steps are outlined at PGI 231.205-70(d) and include requirements for the ACO to obtain an adequate restructuring proposal, which must be audited.

(3) The advance agreement will not be executed until the USD(AT&L) or for external restructuring costs less than $25 million over a 5 year period, the Director DCMA, determines in writing that projections of future cost savings from the business combination are based on audited cost data and should either (a) exceed allowable restructuring costs by a factor of two to one on a present value basis, or (b) exceed allowable costs on a present value basis and the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD. Until the determination is obtained, the contractor must segregate restructuring costs and suspend them from billings, final contract price settlements, and overhead settlements, as noted at PGI 231.205-70(d)(ii).

(4) The audit, ACO review, and USD(AT&L) or Director DCMA determination requirements of DFARS 231.205-70 apply only to restructuring activities that:

(a) occur after a business combination,

(b) affect the operations of companies not previously under common ownership or control,

(c) are initiated within three years of the business combination, and

(d) result in costs allocated to DoD contracts of $2.5 million or more.

The phrase "initiated within three years" means that a restructuring decision was made within three years of the business combination. Each of these four conditions must be met in order for DFARS 231.205-70 to apply.

(5) Testing for the $2.5 million materiality threshold should be based on the best information currently available. A decision that the threshold is not met should not be reversed in the future if conditions change (e.g., actual business mix differs from projected business mix) and actual DoD reimbursement exceeds $2.5 million. The materiality threshold applies to all restructuring activities associated with a business combination. It is not to be applied project by project or segment by segment. A general dollar magnitude estimate should be sufficient to determine if the $2.5 million threshold is met.

7-1903 Contents of External Restructuring Proposals

a. The proposals for external restructuring costs, as noted at DFARS PGI 231.205-70(d)(iii), must show projected restructuring costs and savings by year and by cost element. Data supporting the projections and the methods by which restructuring costs will be allocated must also be included.

b. The following basic elements should be part of any restructuring proposal and its supporting data:

- An outline of proposed restructuring actions, anticipated time span for accomplishing proposed actions, and the affected locations.
- A summary of proposed restructuring costs and savings, by year and by cost element, that includes the present value of the DoD share of projected costs and savings.
- Points of contact for obtaining clarification or additional information.
- A description of how restructuring costs will be accumulated and amortized (if restructuring costs will be accounted for as a deferred charge), and the methods by which restructuring costs will be allocated. External restructuring costs should be identified separately from internal restructuring costs, if any.
- A plan for updating forward pricing rates to reflect the impact of projected restructuring savings. Restructuring costs may also be reflected in the forward pricing rates provided the contracts priced with the rates include a downward price adjustment clause to remove restructuring costs should the written determination required by DFARS 231.205-70(c)(4)(i) not be obtained.
- Supporting data sufficient to establish the reasonableness of the cost and savings projections.

7-1904 Coordinated Audit Approach

To accomplish effective and timely audits of contractor restructuring proposals at multi-segment contractors, it is important that the DCAA Contract Audit Coordinator maintain effective communications with all affected DCAA offices throughout the review process.

7-1905 Purpose and Scope of Audit

a. The purpose of the audit of the contractor's external restructuring proposal is to verify that savings projected from the restructuring for DoD contracts will exceed the allowable restructuring costs by a factor of two to one on a present value basis. Specifically, the audit should determine that:

- The contractor's classification of costs as restructuring costs is proper.
- The projected restructuring costs are allowable, reasonable, and allocable to Government contracts.
- The projected restructuring savings represent reasonable estimates of future cost reductions that will accrue to the Government as a result of the contractor's restructuring activities.
- The restructuring savings will exceed restructuring costs on a present value basis.

- Savings resulting from the restructuring will exceed costs allowed by a factor of at least two to one.

b. While the nature and extent of audit effort required to accomplish these audit objectives will vary depending on individual circumstances, the scope of audit should be influenced by the following items:

- Risk that projected savings will not exceed projected costs by a wide margin.
- Types of Government contracts.
- Existence of sensitive audit issues.
- Results of other audits (e.g., adequacy of estimating system and past reliability of estimates).
- Input from the contracting officer.
- Contract provisions.

c. These and other areas which may impact the scope of audit are discussed in detail in 3-104. The audit working papers should clearly document the impact of these considerations on the scope of audit.

7-1906 Evaluation of Projected Costs

7-1906.1 Definition of Restructuring Costs

a. Restructuring that is a direct outgrowth of a business combination is termed "external restructuring." External restructuring costs are defined in DFARS 231.205-70(b)(4) as the costs, both direct and indirect, of restructuring activities. A restructuring activity is defined as:

- A nonroutine, nonrecurring, or extraordinary activity to combine facilities, operations, or workforce in order to eliminate redundant capabilities, improve future operations, and to reduce overall costs.
- It is not a routine or ongoing repositioning and redeployment of a contractor's productive facilities or workforce.
- It is not a routine or ordinary activity charged as an indirect cost that would otherwise have been incurred (e.g., planning and analysis, contract administration and oversight, recurring financial and administrative support.)

b. Planning for restructuring would not be a restructuring activity when performed by employees whose costs would otherwise have been incurred (e.g., G&A employees). However, planning for restructuring performed by outside consultants, attorneys, or other professionals whose charges would not otherwise have been incurred is a restructuring activity.

c. Direct contract costs might increase as a consequence of restructuring (e.g., recalibration of special test equipment that was moved to another plant, increased labor time per unit of production due to relocation of production). In these situations, direct costs may not be reclassified as indirect restructuring costs or allocated to other contracts. This is prohibited by Cost Accounting Standard 402 and applicable cost principles, including: FAR 31.202, Direct costs; FAR 31.203, Indirect costs; FAR 31.205-23, Losses on other contracts; and FAR 31.205-40, Special tooling and special test equipment costs.

7-1906.2 Evaluation Of Employee Related Costs

a. Employee Termination Costs. Employee termination costs such as early retirement incentive or severance payments may be incurred to effect reductions in the contractor's workforce as part of restructuring efforts. The auditor should review any proposed employee termination costs to determine if allowable under FAR 31.205-6, Compensation for personal services (see 7-1907).

b. Retention Pay. The cost of a plan introduced in connection with a change in ownership through which employees receive special compensation that is contingent upon the employee remaining with the contractor for a specified period of time is unallowable under FAR 31.205-6(l), Compensation incidental to business acquisitions.

This cost principle is typically applicable to “golden handcuff” arrangements with key executives upon a business combination. It should not be applied to plans that provide additional dismissal wages to employees who remain with the contractor until their employment is involuntarily terminated (e.g., until a plant is closed). The allowability of such dismissal wages should be determined under FAR 31.205-6(g), Severance pay.

c. Employee Relocation Costs. Employee relocation costs may be incurred when a contractor's restructuring activities involve the consolidation of facilities or functions from different geographic locations. The auditor should review any proposed relocation costs to determine if allowable under FAR 31.205-35 and FAR 31.205-46 (see 7-1004).

d. Recruitment Costs. Recruitment costs may be incurred to hire employees at new or expanded contractor locations as a result of a contractor's restructuring activities. The auditor should review any proposed recruitment costs to determine if allowable under FAR 31.205-34 (see 6-408).

e. Employee Training. Employee training costs may be incurred to train employees on new or modified practices as a result of a contractor's restructuring activities. The auditor should review any proposed training costs to determine if allowable under FAR 31.205-44 (see 7-900).

f. Bonuses. See 6-414.7 for limitations applicable to DoD contracts.

g. Pension and Post Retirement Health Benefit Costs**.** After a business combination, a contractor may have employees who are covered by multiple pension and post retirement health benefit plans. As a result, the contractor may decide to modify the existing plans to provide for comparable benefits or to merge the plans together into a single plan covering all employees. The cost of implementing these changes and any associated increases in pension and post retirement health benefit costs do not meet the DFARS definition of restructuring costs. Depending upon their nature and extent, other changes and their associated cost increases may not meet the definition of restructuring costs (see DFARS 231.205-70). For example, increased pension costs resulting from changes in actuarial assumptions (e.g., changes in interest rates) would not meet the DFARS definition of restructuring costs. On the other hand, increases in actuarial liabilities of the pension plan resulting from contractor implementation of an early retirement incentive plan would meet the DFARS definition of restructuring costs if done in connection with a restructuring activity. In either case, the auditor may need to establish a separate review to determine if the changes are in compliance with the requirements of FAR 31.205-6, CAS 412, and 413 (see 7-600, 8-412 and 8-413).

7-1906.3 Evaluation of Facilities Related Costs

a. Idle Facilities. FAR 31.205-17, Idle facilities and idle capacity costs, provides that costs of idle facilities are allowable for a reasonable period of time, usually not to exceed one year, depending upon the initiative taken to use, lease, or dispose of the idle facilities. The regulation provides the contracting officer with the flexibility to accept idle facilities costs for a period greater than one year. When the contractor has identified facilities that are expected to be idle in excess of one year, the auditor should recommend that the contracting officer obtain justification from the contractor for the time in excess of one year. The contractor should address, at a minimum, the following areas:

- Whether the facility will be needed in the future, and if so, why.
- If not needed for future operations, the actions that are being taken to lease or dispose of the facility.
- An estimate of the time it should take to lease or dispose of the facility based on an analysis of existing market conditions; such as surveys of real estate prices, public records of real estate sales for similar facilities, etc.

The auditor should assist the contracting officer in determining a reasonable period of time for accepting idle facilities costs. The contractor and Government should enter into an advance agreement specifying the maximum period for which costs of idle facilities will be reimbursed. If there is no advance agreement between the contractor and the contract-

ing officer to accept idle facilities costs for a period greater than one year, any proposed idle facilities costs beyond one year should be questioned.

b. Extraordinary Maintenance and Repairs. The costs of extraordinary maintenance and repairs are allowable provided those costs are reasonable and assigned to the accounting periods in accordance with applicable provisions of CAS and GAAP. However, such costs incurred to prepare a facility for sale are generally factored into the calculation of the gain or loss on the sale. The costs of restoring or rehabilitating the contractor's facilities to approximately the same condition existing immediately before the start of a Government contract, fair wear and tear excepted, are limited in allowability by FAR 31.205-31, Plant reconversion costs. Ideally, such costs would be covered by an advance agreement on idle facilities or restructuring.

c. Asset Relocation. Asset relocation costs include the cost of removing the asset from its current location, transportation to the new location, and reinstalling the asset at the new location. Merely moving an asset from one location to another generally does not extend its expected service life or production capacity. Therefore, relocation costs are generally assigned to the cost accounting period in which they are incurred. When incurred in connection with restructuring, Cost Accounting Standard 406.61 provides that asset relocation costs may be included as restructuring costs. When reviewing asset relocation costs, auditors should be alert for the possibility that assets might be improved or bettered in connection with their relocation. If the useful life of a tangible capital asset will be extended or its productivity increased, then the cost of the improvement or betterment should be capitalized and depreciated over the remaining useful life of the asset in accordance with CAS 404.40(d) [see 8-404]. The capitalized costs of betterments or improvements are eligible for facilities capital cost of money under CAS 414. The reasonableness of proposed relocation costs should be determined under FAR 31.201-3, Determining reasonableness.

d. Gain/Loss on Sale of Assets. Restructuring is an extraordinary activity that may involve mass or extraordinary dispositions of assets. Dispositions may range from equipment, such as surplus furniture or computer hardware, to an entire plant. The actual gains or losses realized upon disposition of depreciable assets should be reviewed to determine if they are allowable under FAR 31.205-16 (see 7-412). Proposed gains or losses, which have not been realized and are not based on a firm sales agreement should be treated in accordance with FAR 31.205-7, Contingencies. The gain or loss expected from the sale of items for which there is a ready market may be foreseeable within reasonable limits of accuracy. Such projected gains or losses should be included in cost estimates as stated in FAR 31.205-7(c)(1). When a gain or loss cannot be measured or timed within reasonable limits of accuracy, the contractor should exclude it from cost estimates and propose it as a contingency in accordance with FAR 31.205-7(c)(2). When reviewing the contractor's proposed gains or losses, the auditor should be alert for any asset write-ups or write-downs that may have occurred as a result of the business combination (see 7-1705).

e. Environmental Remediation**.** Environmental cleanup efforts may arise in connection with a contractor's restructuring activities. In general, environmental remediation costs (e.g., cleanup of soil or ground water contamination, removal of asbestos from buildings) do not meet the DFARS definition of restructuring costs. Therefore, these costs should be excluded from the contractor's restructuring cost and savings proposal and negotiated under a separate advance agreement. The cleaning of a building in preparation for its sale (e.g., cleaning air ducts, removing chemical stains from floors) should normally be treated as extraordinary maintenance and repairs, not environmental remediation (see 7-2120).

7-1906.4 Evaluation of Other Categories of Costs

a. Discontinued Operations. During the restructuring process, a contractor may have continuing costs associated with discontinued operations (i.e., a segment that is merged, sold, or abandoned). Generally, costs associated with segments that are merged into one or more new or existing segments should be allocated to the new or existing segment where the work effort or contracts are transferred. However, some costs may be addressed by a

specific procurement regulation. Pension costs, for example, associated with closed segments should be measured, assigned and allocated in accordance with CAS 413.50(c)(12)). For other costs, special allocations may be required under CAS 403 or CAS 418. To ensure the appropriate regulation is properly applied, the FAO should coordinate with Headquarters (Accounting and Cost Principles Division), through the regional office, when significant costs associated with discontinued operations are encountered.

b. Organization and Reorganization Costs. The auditor should be alert for organization or reorganization costs, unallowable under FAR 31.205-27, that may have been included in the contractor's restructuring cost and savings proposal. In addition, when a contractor's restructuring activities result in the formation or dissolution of separate entities, the auditor should ensure that any organization or reorganization costs are properly excluded from the contractor's restructuring cost and savings proposals and forward pricing rates. Depending upon the nature and extent of contractor organization or reorganization activities, the auditor may need to establish a separate review to ensure that all associated costs have been properly segregated and excluded from Government contracts (see 7-1707)

c. Facilities Capital Cost of Money. Deferred restructuring costs should not be included in the computation to determine facilities capital cost of money (see CAS 406.61(i)). Deferred charges are not tangible or intangible capital assets as defined in CAS 414.30.

d. Credits. Reductions in workforce and facilities should reduce the cost of various employee benefit plans (e.g., health insurance, life insurance) and property and casualty insurance plans. This may lead to credits from insurance companies as reserves are reduced or policies canceled. Auditors should be alert for such credits and the requirement in FAR 31.201-5 for the applicable portion to be credited to the Government either as a cost reduction or by cash refund, as appropriate (see 6-203).

7-1907 Evaluation Of Projected Savings

a. Contractor restructuring efforts are intended to result in combinations of facilities, operations, or workforce that eliminate redundant capabilities, improve future operations, and reduce overall costs. Benefits which accrue to the Government from a contractor's restructuring efforts are the overall reduced costs on future contracts and existing flexibly-priced contracts. Cost reductions on already negotiated firm-fixed-priced contracts are not savings to the Government.

b. Auditors should carefully evaluate proposed restructuring savings to ensure that the contractor's estimates of future cost reductions are reasonable and can be expected to benefit Government contracts. To accomplish this, the auditor must first establish that the contractor's baseline for measuring restructuring savings represents a reasonable expectation of future contract costs had the restructuring not occurred. Contractor budgets, contract estimates to complete, and existing forward pricing rate proposals/agreements can be used to establish a baseline for pre-restructuring costs. It is the contractor's responsibility to establish and support the reasonableness of the baseline used in developing savings estimates.

c. Once a reasonable baseline has been established, the auditor should review the proposed restructuring savings to ensure that estimated cost reductions are the result of the contractor's restructuring efforts and not due to other factors (e.g., reduced inflation rates, changes in interest rate assumptions) impacting on future contract costs. Materiality should be considered in planning the review. The use of statistical sampling should also be considered (see 3-104.17 and 4-605a.).

7-1908 Determination of Present Value and Overall Reduced Costs

a. DFARS 231.205-70(c)(4)(i) requires a determination that restructuring savings will exceed restructuring costs on a present value basis. The auditor should review the contractor's methodology for discounting projected restructuring costs and savings to determine if it is reasonable under the circumstances. Overall reduced costs should be

computed based on restructuring costs and savings that will be realized over the next five years. Those costs and savings that are not stated in current year dollars should be discounted to current year dollars using the most recently published cost of money rate.

b. PGI 231.205-70(d)(viii) requires the cognizant ACO to negotiate an advance agreement with the contractor that includes a cumulative cost ceiling. Projected savings must exceed allowable external restructuring costs, on a present value basis by a factor of at least two to one. Auditors should provide any assistance requested by the ACO in making present value calculations during negotiation of the advance agreement.

7-1909 CAS Considerations

7-1909.1 Assignment of Costs to Accounting Periods

a. The Cost Accounting Standards (CAS) Board issued the interpretation at CAS 406.61 on June 6, 1997. It is based on Interim Interpretation 95-01, "Allocation of Contractor Restructuring Costs Under Defense Contracts," which was issued by the CAS Board on March 8, 1995. The interpretation clarifies whether restructuring costs are to be treated as an expense of the current period or as a deferred charge that is subsequently amortized over future periods. It is applicable to contractor restructuring costs (both external and internal) that are paid or approved on or after August 15, 1994.

b. Paragraph (e) of CAS 406.61 (and preceding Interim Interpretation 95-01) require that the costs of all restructuring activities comprising a specific restructuring event be accounted for as a deferred charge unless the contractor proposes, and the contracting officer agrees, to expense the costs in the current accounting period. A contractor may defer the costs of one restructuring event (e.g., restructuring in connection with acquisition of Company A) and propose to expense the costs of a subsequent restructuring event (e.g., restructuring in connection with Company B years later), subject to the CAS Board rules governing accounting practice changes. However, a contractor may not defer the costs of some activities and expense the cost of others that comprise a specific restructuring event. According to 48 CFR 9904.406-61(e), "Contractor restructuring costs defined pursuant to this section may be accumulated as deferred cost, and subsequently amortized, over a period during which the benefits of restructuring are expected to accrue. However, a contractor proposal to expense restructuring costs for a specific event in a current period is also acceptable when the Contracting Officer agrees that such treatment will result in a more equitable assignment of costs in the circumstances."

c. The Director, Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS), issued guidance on May 20, 1997 which stated that it would be appropriate to accept a contractor's proposal to expense restructuring costs in the current period when expensing should result in overall lower costs for DoD. In making this assessment, the business base (Government versus commercial contracts) and the contract mix (fixed price versus cost reimbursement) for current and future years should be considered.

d. Deferred restructuring costs should be amortized over the same period of time during which the benefits of restructuring are expected to accrue. However, the amortization period is limited by 48 CFR 9904.406-61(h) which states: "The amortization period for deferred restructuring costs shall not exceed five years. The straight line method of amortization should normally be used, unless another method results in a more appropriate matching of cost to expected benefits."

7-1909.2 Allocation to Cost Objectives

a. Direct Restructuring Costs. Restructuring costs which benefit a single cost objective should be charged directly to that cost objective. For example, if a contractor's restructuring activities result in a need to recalibrate special test equipment which is related to a single contract, the recalibration costs should be assigned directly to that contract.

b. Indirect Restructuring Costs. 48 CFR 9904.406-61(j) states: "Restructuring costs incurred at a home office level shall be treated in accordance with the provisions of 48 CFR 9904.403. Restructuring costs incurred at the segment level that benefit more than one segment should be allocated to the home office and treated as home office expense pursuant to 48 CFR 9904.403. Restructuring costs incurred at the segment level that benefit only that segment shall be treated in accordance with the provisions of 48 CFR 9904.418. If one or more indirect cost pools do not comply with the homogeneity requirements of 48 CFR 9904.418 due to the inclusion of the costs of restructuring activities, then the restructuring costs shall be accumulated in indirect cost pools that are distinct from the contractor's ongoing indirect cost pools."

7-1909.3 Disclosure of Accounting Practices and Changes in Accounting Practices

a. Accurate disclosure statements are required by 48 CFR 9903.202-3. If the deferral of restructuring costs results in a new or changed cost accounting practice, the contractor is required to file a revised disclosure statement describing the accounting practices associated with the assignment and allocation of deferred restructuring costs. The contractor is also required to revise its disclosure statement for any other changes in cost accounting practice that result from the restructuring. Audits of the revised disclosure statement should be conducted in accordance with Chapter 8.

b. 48 CFR 9904.406-61(f) states: "If a contractor incurs restructuring costs but does not have an established or disclosed cost accounting practice covering such costs, the deferral of such restructuring costs may be treated as the initial adoption of a cost accounting practice (see 48 CFR 9903.302-2(a)). If a contractor incurs restructuring costs but does have an existing established or disclosed cost accounting practice that does not provide for deferring such costs, any resulting change in cost accounting practice to defer such costs may be presumed to be desirable and not detrimental to the interests of the Government (see 48 CFR 9903.201-6). Changes in cost accounting practices for restructuring costs shall be subject to disclosure statement revision requirements (see 48 CFR 9903.202-3), if applicable."

c. Contractor restructuring activities may also result in changes to cost accounting practices other than deferral of restructuring costs. For example, as a direct result of restructuring activities, the contractor may decide to change from a value-added base to a total cost input base for allocation of its G&A pool. Effective June 14, 2000, the cost impact process does not apply to cost accounting practice changes directly associated with external restructuring activities that are subject to, and meet the requirements of, 10 U.S.C. 2325. This statute established the allowability requirements and two-to-one savings requirements for external restructuring implemented by DFARS 231.205-70. Cost accounting practice changes associated with restructuring activities that (1) took place prior to June 14, 2000 or (2) do not meet the requirements of 10 U.S.C. 2325 are subject to the administrative procedures outlined in the CAS contract clause at 48 CFR 9903.201-4(a)(4). See further guidance in 8-502.4.

7-1910 Reporting Results Of Audit

Audit reports should follow the format contained in 10-300, Audit Reports on Price Proposals, modified as appropriate. To promote consistency, external restructuring cost and savings proposal audit reports should be reviewed prior to issuance by the Regional Office, and when applicable, the Contract Audit Coordinator (CAC). The audit report on the first restructuring proposal following a business combination should also be reviewed by Headquarters prior to issuance. Auditors should take appropriate actions to ensure that sufficient time is available to facilitate these reviews within the required due dates.

7-1911 Forward Pricing Consideration

7-1911.1 Adjustment of Forward Pricing Rates

a. A plan for updating forward pricing rates to reflect the impact of projected restructuring costs and savings should be developed with the contractor and cognizant ACO at an early stage. Upon receipt of the contractor's restructuring cost and savings proposal, the auditor should be prepared to advise the cognizant ACO on the contractor's adjustments to forward pricing rates to reflect the impact of projected restructuring costs and savings.

b. PGI 231.205-70(d)(v) requires that the cognizant Administrative Contracting Officer adjust forward pricing rates to reflect the impact of projected restructuring savings as soon as practicable.

7-1911.2 Reopener or Savings Clauses in Forward Pricing Reports

a. PGI 231.205-70(d)(v) provides that if restructuring costs are included in forward pricing rates prior to execution of the required advance agreement, the contracting officer shall include a repricing clause in each fixed price action that is priced based on the rates. The repricing clause must provide for a downward price adjustment to remove restructuring costs if the written determination required by DFARS 231.205-70(c)(4)(i) is not obtained.

b. In addition to the repricing clause required by PGI 231.205-70(d)(v), the auditor should recommend a contract reopener or savings clause in the audit report on a contract price proposal when a major contractor acquisition, merger, or associated restructuring is significant and the effect on the price proposal cannot be reasonably determined (see 10-304.4k).

7-1911.3 TINA Considerations

A management decision to restructure is cost or pricing data that must be disclosed for compliance with the Truth in Negotiations Act (TINA). An adequate disclosure requires current, accurate, and complete information on the nature and magnitude of the restructuring decision. Typically, judgments on the effects of a restructuring decision (i.e., estimated cost reductions) are so intertwined with facts that they cannot be segregated. In this case, complete data must be disclosed to place the Government on an essentially equal footing with the contractor when making pricing decisions. Thus compliance with TINA will usually require disclosure of the impact of restructuring decisions on forward pricing rates and contract price proposals. As indicated in 9-1211, whenever the auditor has an indication that forecasted rates should have been revised for significant changes to reflect more accurate, complete, or current cost or pricing data, pricing actions using the rates should be subject to a postaward audit when cost or pricing data was required.

7-1912 Reimbursement Of External Restructuring Cost

a. PGI 231.205-70(d)(ii) requires the cognizant ACO to direct the contractor to segregate restructuring costs and to suspend these amounts from any billings, final contract price settlements, and overhead settlements until a written determination is obtained from the designated official. When contractors incur restructuring costs prior to obtaining the determination, the auditor may need to evaluate the contractor's internal controls to determine if they are adequate to reasonably ensure that restructuring costs are properly accounted for and excluded from contract billings, final contract price settlements, and overhead settlements. This evaluation should include limited transaction testing to determine if the controls have been implemented and are working effectively. Floor checks (see 6-405) or other time sensitive audit procedures may be performed, when appropriate, for the risks identified.

b. Costs of activities such as restructuring planning and analysis, contract administration and oversight, and recurring financial and administrative support, when

performed by employees whose costs would otherwise have been incurred, are not restructuring costs as defined by DFARS 231.205-70(b)(2). Therefore such costs should not be excluded from contract billings, final contract price settlements, and overhead settlements merely because the written determination required by DFARS 231.205-70(c)(4)(i) has not been obtained.

7-1913 Audit Consideration - Internal Restructuring Cost

a. The term "internal restructuring activities" means all restructuring activities that are not subject to DFARS 231.205-70. While DFARS 231.205-70 does not apply to internal restructuring activities, an advance agreement on internal restructuring costs should be recommended since the costs are unusual and can be substantial. This is particularly true if the cost is to be accounted for as a deferred charge. FAR 31.109(a) advises contracting officers and contractors to seek advance agreement on the treatment of special or unusual costs to avoid possible subsequent disallowance or dispute based on reasonableness, nonallocability, or unallowability.

b. Auditors may encounter internal restructuring costs in audits of proposals for advance agreements on restructuring, forward pricing rate proposals, contract price proposals, or incurred cost claims. As with any other cost, the policies and procedures within the Federal Acquisition Regulation (FAR) and DoD supplement (DFARS) should be followed in determining the allowability of internal restructuring costs.

c. The criteria in FAR 31.201-3 should be applied in determining the reasonableness of internal restructuring costs. Evidence of reasonableness might include an analysis of costs and benefits (e.g., reduced costs, more efficient use of resources, improved financial capability). The criteria in FAR 31.201-4 should be applied in determining the allocability of internal restructuring costs. Allocations of restructuring costs should comply with applicable Cost Accounting Standards. The interpretation at CAS 406.61 is applicable to internal restructuring costs. Costs properly classifiable as internal restructuring costs may be deferred and subsequently amortized over a period during which the benefits of restructuring are expected to accrue (not to exceed 5 years).

d. Auditors should be alert for contracts with provisions for costs associated with restructuring. For example, a contract may contain an allowance for the costs of relocating special equipment and tooling to a vendor from a contractor's discontinued operation or closed facility. Such costs would be charged directly to the contract and, as direct contract costs, would not be allocable to other cost objectives as restructuring costs. Auditors should also be alert for existing advance agreements covering costs that may arise in connection with restructuring. Significant environmental remediation costs may coincide with restructuring but are not restructuring costs and should be covered by a separate advance agreement.

e. The contractor should include the reduction in overall cost levels expected from internal restructuring into its forward pricing rates and contract price proposals. If this does not occur, auditors should follow procedures in 9-1208c and 9-1209b in advising the cognizant ACO to request a revised forward pricing rate proposal from the contractor.

7-1914 Auditing Incurred Restructuring Costs

a. The final determination of allowability of incurred restructuring costs can only be made after the contractor provides the annual certified incurred cost proposal. FAR 52.216-7, Allowable Cost and Payment, and FAR 42.705-1, Contracting Officer Determination Procedure, require the contractor to support its proposal with adequate data. The auditor should obtain from the contractor whatever data is deemed necessary to support the amortized restructuring costs claimed (e.g., amortization schedules for deferred restructuring costs and detailed schedules of the incurred restructuring costs by fiscal year, project and cost element).

The support should be at a level of detail sufficient to allow the auditor to determine the allowability of incurred restructuring costs.

b. As actual restructuring expenditures near the negotiated restructuring cost ceiling, there is an increased risk that restructuring costs may be misclassified as other costs. Procedures should be performed to identify costs that should properly be reclassified as restructuring costs, especially when incurred restructuring costs are near or in excess of the negotiated ceiling.

7-2000 Section 20 --- Reserved

7-2100 Section 21 --- Other Areas of Cost

7-2101 Introduction

This section covers other areas of cost not requiring a full section coverage at this time.

7-2102 Purchased Labor -- Personnel Procured From Outside Sources

Some contractors have adopted the practice of obtaining engineers, technical writers, technicians, craftsmen, and other personnel by subcontract (commonly called "Purchased Labor") rather than by direct hire. Such practice, if for any reason other than to meet temporary or emergency requirements, should be carefully studied to determine whether any additional costs resulting therefrom are reasonable, necessary, and properly allocable to Government contracts.

7-2102.1 Audit Considerations

a. Contractors' accounting treatment of purchased labor varies depending on the circumstances under which purchased labor costs are incurred. For example, some contractors classify purchased labor as direct labor costs when the work is performed in the contractor's facilities and under their supervision and otherwise meets the FAR definition of direct costs. These contractors cost such effort using the average labor rate incurred by their own employees for comparable work. Differences between the amounts derived and purchased labor prices are treated as overhead costs and are allocated accordingly. Other contractors classify purchased labor as subcontract costs. The accounting treatment used should be evaluated on a case-by-case basis as discussed in 7-2102.2.

b. Purchased labor most likely causes no fringe benefits and other employee-related costs to be incurred by the contractor. Such costs are generally paid by the entity providing personnel performing the effort.

c. A fundamental requirement of CAS 418 is that pooled costs shall be allocated to cost objectives in a reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor must share in an allocation of indirect expenses where there is a causal or beneficial relationship, and the allocation method must be consistent with the contractor's disclosed accounting practices. In accordance with CAS 418, a separate allocation base for purchased labor may be necessary to allocate significant overhead costs to purchased labor such as supervision and occupancy costs, or to eliminate other costs not benefiting purchased labor such as fringe benefits costs.

d. Where the effort of purchased labor is performed in-house using the contractor's supervision and facilities, overhead exclusive of fringe benefits and other employee related costs, if material in amount, should be allocated to purchased labor. Conversely, where the effort of purchased labor is performed offsite under the supervision and control of an entity other than the contractor, none of the contractor's labor overhead costs may be allocable to purchased labor.

7-2102.2 Audit Procedures

The accounting treatment for purchased labor must be evaluated on a case-by-case basis with consideration given to the materiality of costs involved and the overall effect of the accounting treatment on final cost objectives. Acceptance or rejection of the contractor's treatment of purchased labor must be based upon:

(1) the causal and beneficial relationship of indirect expenses and purchased labor, and

(2) the nature of the employer/consultant relationship using the Internal Revenue Services arms-length tests. In making this assessment, the auditor should:

a. Review the contractor's policy, with emphasis on the criteria used in determining whether personnel should be obtained from outside sources instead of by direct hire.

b. Analyze the purchased labor during the current or most recently completed fiscal year, whichever provides sufficient information, to:

(1) Determine the number of purchased labor personnel and the duration of their engagement.

(2) Compare the number of employees on the contractor's payroll (in each classification of purchased labor involved) with the number of equivalent personnel obtained from outside sources.

(3) Compare the cost per staff-year with the contractor's comparable personnel.

(4) Evaluate the contractor's reasons for resorting to the practice. This is particularly important where the engagement extends beyond one year.

(5) Determine whether the contractor's practices are equitable with respect to the utilization of purchased labor on Government contracts as compared to commercial work, and on fixed-price contracts as compared to cost-type contracts; and whether the accounting treatments of the costs of such personnel and contractor personnel performing the same kind of work, including allocation of related overhead expenses, are equitable.

c. Coordinate with Government production specialists, project engineers, purchase methods analysts, and others on matters such as the effectiveness of performance, staffing requirements, equivalent job classifications, and the award and pricing of the agreements.

d. Examine prior years' records to determine if the practice shows an increasing or decreasing trend.

7-2103 Employee Welfare and Morale Expense

Employee welfare and morale expenses are costs incurred on activities to improve working conditions, employer-employee relations, employee morale, and employee performance. Expenses and income generated by employee welfare and morale activities should be reviewed for compliance with FAR 31.205-13. Note that employee morale type expenses are often covered by the entertainment cost principle, 31.205-14. FAC 90-31, effective October 1, 1995, clarified that entertainment costs are not allowable under any other cost principle. By statute, entertainment costs are expressly unallowable, without exception. Consequently, the entertainment cost principle at FAR 31.205-14 takes precedence over any other cost principle.

7-2103.1 Audit Considerations

a. General

(1) Aggregate costs incurred for employee welfare and morale, less credits for income generated by these activities, are allowable except as noted in paragraphs b. through e. below, to the extent that the net amount is reasonable. In applying the provisions of FAR 31.201-3, Reasonableness, the auditor should consider whether the expenditure is reasonable in nature and amount both for the contractor as a whole and for the employee(s) benefited by the expenditure.

(2) Costs relating to welfare and morale activities, if significant, should be subjected to the test of reasonableness as to purpose and amount (also see 7-1203.2a.). When reasonableness as to purpose has been established, reasonableness of amount should ordinarily be applied to overall amounts and not to individual items of cost, provided the items are not made specifically unallowable by FAR Part 31.

b. Employee Associations

(1) If a contractor has an arrangement permitting an employee association to retain the income from vending machines, such income should be considered in evaluating the total

cost of the employee welfare and morale program as if the contractor received the income (FAR 31.205-13(e) and (f)). The auditor should examine the records of the employee association to ascertain that the income was reasonably expended for the purposes intended and that there is no undue accumulation of unspent funds. Any such accumulation should accrue to the Government by treating it as a deduction from otherwise allowable overhead.

(2) In some instances, employee associations may use the vending machine income for the purchase of recreational and other employee welfare tangible personal or real property, or the employee association may purchase assets by means of a loan or mortgage. Allowable costs on capital assets thus purchased are limited to the equivalent amount of costs that would be allowable if the contractor had acquired the property and incurred the costs directly (FAR 31.205-13(f)). Accordingly, allowable costs will normally be restricted to ownership costs such as depreciation, insurance, taxes, etc. The total expenditure for property should not be allowed as a cost in the year of purchase, except where the property involved is of the type that would be expensed under the contractor's normal accounting practices.

c. Major Property Acquisitions for Employee Welfare Purposes

The reasonableness of major property acquisitions for employee welfare purposes is necessarily a matter of some significance. The auditor should review such purchases to determine whether:

(1) they are reasonable under the criteria set forth in FAR 31.201-3 and

(2) costs resulting therefrom are properly allocable to Government contracts.

If the assets acquired are not of a type generally recognized as ordinary and necessary for purposes of employee welfare and morale, the related costs may be considered unreasonable and, therefore, not acceptable. A situation fitting this category would be when the acquisition benefits only a limited number, or certain classes, of employees. As a further consideration, real property donated or acquired from contributions made by the contractor should be carefully scrutinized, as it would seldom be reasonable for the contractor to give the property to its employee organization. Doing so would not as a rule give the employee association any benefit from the use of the property that it would not enjoy had the contractor retained title. By retaining title the contractor would keep a valuable asset which could be converted to other use or sold when it is no longer needed for its original purpose.

d. Cafeteria Losses

(1) The costs of cafeteria operations should include all indirect expenses pertaining to these services, as required by the full absorption cost methods prescribed by CAS 418. Auditors will verify that an allocable share of occupancy costs is included in the calculation of the total costs of cafeteria operations.

(2) Losses from operating cafeterias may be included as costs only if the contractor's objective is to operate such services on a break-even basis. One factor to consider is whether the prices charged are comparable to those available in commercial establishments. Losses sustained because these services are furnished without charge or at unreasonably low prices obviously would not be conducive to the accomplishment of the above objective and are not allowable. However, a loss may be allowable, provided the contractor can demonstrate that unusual circumstances exist such that even with efficient management, operating the service on a break-even basis would require charging inordinately high prices, or prices higher than those charged by commercial establishments. Examples of unusual circumstances are:

(a) adequate commercial facilities are not available, or

(b) reasonable prices are a necessary incentive to keep employees onsite to avoid the more significant costs of lost productive time due to longer lunch periods if the services were not provided.

(3) When cafeteria losses are claimed by the contractor, it is the contractor's responsibility to demonstrate that unusual circumstances exist and to provide supporting documentation such as price comparisons with similar commercial establishments, or the distance of restaurants. The auditor should determine the validity of the contractor's

justifications on a case-by-case basis. If the contractor fails to provide adequate documentation justifying the allowability of such losses, the auditor should question the costs.

e. Gifts, Recreation, and Entertainment

For contracts issued on or after January 13, 1995, costs of gifts, recreation, and entertainment incurred subsequent to September 30, 1995 were made specifically unallowable, with a few exceptions (see FAC 90-31).

(1) Although gifts are an expressly unallowable expense, the cost principle specifically excludes two categories of awards from the unallowable gift definition:

(a) Awards covered by the compensation cost principle at 31.205-6; and

(b) Awards made pursuant to an established plan or policy for recognition of employee achievements.

(2) Recreation expenses are an expressly unallowable expense with the following exception: Costs of employees' participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work, or physical fitness. The exception does not allow general recreation activities and does not allow any costs disallowed by FAR 31.205-14, Entertainment. If the Government challenges the allowability of claimed recreation costs, it is the contractor's responsibility to establish that the cost claimed meets the following criteria:

(a) The cost is for employee participation in a sports team or employee organization.

(b) The team or organization is company sponsored.

(c) The team's or organization's activity is designed to improve company loyalty, team work, or physical fitness.

(3) Entertainment costs are expressly unallowable, without exception. Therefore, even if the principal purpose for incurring an entertainment cost is other than for entertainment, the entertainment cost is unallowable. For example, while the cost of a contractor open house for employee families is generally allowable, the cost of entertainment provided as part of the open house is unallowable.

(4) Taken together, the statute and the cost principles at 31.205-13, Employee morale, and 31.205-14, Entertainment, expressly disallow costs which some contractors may have considered reasonable and allowable prior to the effective date of the current rule, October 1, 1995. Examples of such costs include, but are not limited to:

(a) Entertainment provided as part of public relations, employee relations, or corporate celebrations;

(b) Gifts to anyone who is not an employee;

(c) Gifts to employees which are not for performance or achievement or are not made according to an established plan or policy;

(d) Compensation awards of entertainment, including tickets to shows or sports events, or travel; and

(e) Recreational trips, shows, picnics, or parties.

7-2104 Help-Wanted Advertising Costs

Help-wanted advertising costs are generally allowable per FAR 31.205-1 if the advertisement complies with the requirements of FAR 31.205-34. Also see 6-407.

7-2104.1 Audit Considerations

a. Paragraph (b) of FAR 31.205-34 (Recruitment costs) lists conditions that cause the costs of the help-wanted advertisement to be unallowable. These conditions and related audit considerations follow:

(1) Prior to May 3, 1999, FAR 31.205-34(b)(1) stated that help-wanted advertising costs for personnel other than those required to perform obligations under a Government contract are unallowable. This provision should not be interpreted as disallowing help-wanted advertising costs applicable to indirect employees, such as accountants, internal audi-

tors, lawyers, etc. This provision did, however, prohibit help-wanted advertising costs that are for personnel peculiar to the performance of obligations under commercial contracts. Effective May 3, 1999, this provision was removed from FAR 31.205-34 because it duplicates the allocability provisions already discussed in FAR 31.201-4.

(2) Help-wanted advertising which does not describe specific positions or classes of positions is unallowable. For example, advertising aimed at building a backlog of resumes, rather than filling specific job openings would fall under the unallowable category. Review of the contractor's help-wanted advertisement and replies to applicants should help to determine whether or not the advertisement is one for filling specific job openings. When the contractor is observed to be expanding its current work force, an audit lead should be developed and pursued in a subsequent audit to determine whether the contractor's projected base used for estimating overhead rates considers such expansion.

(3) Advertising which is excessive in relation to the number and importance of the positions, or in relation to the practices of the industry, is unreasonable and therefore unallowable. Inherent in any such determination is not only the size of a particular advertisement in a publication, but also the length and frequency of recruitment advertising in all media (including radio and television). Consideration must also be given to the effectiveness of the advertising program in terms of responses by qualified personnel and the number of hires. This is an area in which technical assistance from the administrative contracting officer can be most useful.

(4) Help-wanted advertising which includes material that is not relevant for recruitment purposes, such as extensive illustrations or descriptions of the company's products or capabilities, is unallowable. Conversely, allowable recruitment advertising should be limited to information such as:

(a) Description of the position(s) being offered.

(b) Description of the compensation and fringe benefits.

(c) Qualifications of the applicant(s).

(d) Opportunities for advancement.

(e) Brief description of the company and its work.

(f) Pertinent illustrations, conservative in size, that do not evidence promotion of the sale of the contractor's products or fostering of its image.

(g) Name of the company, conservatively presented in relation to the other information in the advertisement.

(h) Prior to May 3, 1999, help-wanted advertising (in publications) which includes color (other than black and white) is unallowable. Effective May 3, 1999, the prohibition of color in help-wanted advertisements has been removed.

(i) Prior to May 3, 1999, recruitment advertising designed to "pirate" personnel from another Government contractor is unallowable. Falling into this category is advertising that specifically offers excessive fringe benefits or salaries significantly in excess of those generally paid in the industry for the skills involved. Usually, advertising of this nature would also contain features which would render it unallowable within one or more of the other limitations noted above. Effective May 3, 1999, the costs are no longer unallowable merely because the contractor’s intent was to “pirate” the employee from another Government contractor.

b. By reason of the several restrictions placed on their allowability, help-wanted advertising costs become a sensitive audit area. Accordingly, the auditor should review any corollary help-wanted advertising costs as well as the costs of the advertising media themselves. The costs of photographs, art and design work, radio and television tapes, whether purchased or incurred in-house, are examples of corollary advertising costs.

7-2105 Professional and Consultant Service Costs

Professional and consultant service fees represent costs of services rendered by persons who are members of a particular profession or possess a special skill and who are not offi-

cers or employees of the contractor. Such costs include those of outside accountants, lawyers, actuaries, and marketing consultants. Contractors should be requested to obtain billings from outside professionals and consultants that itemize amounts applicable to retainer agreements, fees for services not covered by a retainer, expenditures for investigative and other services, travel, and miscellaneous expenses.

7-2105.1 General Considerations on Outside Professional and Consultant Services

a. The cost principle covering outside professional and consultant services is contained primarily in FAR 31.205-33, Professional and consultant service costs. However, consider other cost principles (e.g., FAR 31.205-27 Organization costs; 31.205-30 Patent costs; and 31.205-47 Costs associated with a legal or administrative proceeding) in determining allowability since efforts covered by these cost principles are often performed by consultants.

b. Properly supported professional and consultant service costs (see 7-2105.2) are generally allowable per FAR 31.205-33 when reasonable in relation to the services rendered, unless they are for activity made unallowable by other cost principles (see 7-2105.3).

c. The auditor should carefully consider the factors listed in FAR 31.205-33(d) in determining the allowability of professional and consultant service costs. Some of the factors to be considered include:

(1) the nature and scope of the services rendered in relation to the service required,

(2) the impact of Government contracts on the contractor's business, and

(3) whether the service can be performed more economically by employment rather than by contracting.

d. Contractors may engage outside professionals and consultants on a retainer-fee basis. FAR 31.205-33(e) requires that allowable retainer fees be supported by evidence that:

(1) the services covered are necessary and customary,

(2) the fee is reasonable in comparison with maintaining an in-house capability, and

(3) the level of past services justifies the amount of the retainer fees.

The supporting evidential matter requirements discussed in 7-2105.2 also apply to retainer agreements, except retainer agreements are not required to (and generally do not) have specific statements of work.

e. The auditor should assess the risk that there are irregularities associated with consultant costs, for example, attempts to conceal unallowable political donations or bribes by classifying them as consultant fees.

7-2105.2 Adequacy of Supporting Evidential Matter

a. FAR 31.205-33(f) contains three specific documentation requirements that must be met for professional and consultant service costs to be allowable. These requirements are:

(1) Details of all agreements (e.g., work requirements, rate of compensation, and nature and amount of other expenses if any) and details of actual services performed.

(2) Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided.

(3) Consultant work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

b. Although auditors may not substitute their judgment for the explicit documentation requirements in a. above, auditor judgment remains important for determining if the evidence provided in each of the three categories is adequate. In order to reach a well reasoned audit conclusion on professional and consultant service costs, auditors must have sufficient and relevant evidence to determine the nature and scope of the work actually performed.

c. The third category of required evidence (7-2105.2a.(3)) is intended to provide support for the work actually performed by the consultant (in contrast to the first category of

evidence regarding the work planned to be performed). Although a work product usually satisfies this requirement, other evidence may also suffice. If the contractor provides sufficient evidence demonstrating the nature and scope of the actual work performed, the FAR 31.205-33(f)(3) requirements are met even if the actual work product (for example, an attorney's written advice to the contractor) is not provided. The auditor should not insist on a work product if other evidence provided is sufficient to determine the nature and scope of the actual work performed. If the contractor refuses to provide the work product and the auditor cannot determine the nature and scope of actual work performed by reviewing other supporting documents provided by the contractor, the auditor should question the costs as unallowable under FAR 31.205-33(f). The auditor should note in the report that the evidence provided was insufficient to conclude that the work performed was for an allowable purpose.

d. The contractor is responsible for producing adequate evidential matter to support the claimed costs. If the auditor determines that the claimed costs require additional support, then he or she should notify the contractor as to the additional data required. The auditor should provide the contractor with a reasonable period of time to respond. If the contractor fails to respond within this period, the costs should be questioned as expressly unallowable per FAR 31.205-33(f). The auditor should not attempt to obtain the additional data by requesting attorneys, consultants, or Government personnel to prepare statements of work.

7-2105.3 Allowability of Costs and Audit Considerations

Auditors should consider expressly unallowable activities specified in FAR 31.205-33 as well as the provisions in other cost principles in determining the allowability of professional and consultant service costs.

a. FAR 31.205-33(c) lists four expressly unallowable activities.

(1) Services to improperly obtain, distribute, or use information or data protected by law or regulation (FAR 31.205-33(c)(1)).

(2) Services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, or the selection of sources for contract award (FAR 31.205-33(c)(2)).

(3) Any services performed or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest (FAR 31.205-33(c)(3)).

(4) Services performed which are not consistent with the purpose and scope of the services contracted for or agreed to (FAR 31.205-33(c)(4)).

b. Professional and consultant service costs may be unallowable under the provisions of other cost principles, including:

(1) Costs contingent upon recovery from the Government (FAR 31.205-33(b)).

(2) Costs of planning or executing organization and reorganization (FAR 31.205-27(a)(1)).

(3) Costs of resisting or planning to resist a reorganization (FAR 31.205-27(a)(2)).

(4) Costs of raising capital (FAR 31.205-27(a)(3)).

(5) Costs of financing and refinancing operations, preparation of prospectuses, and preparation and issuance of stock rights (FAR 31.205-20).

(6) Costs related to bad debts (FAR 31.205-3).

(7) Costs related to legal and other proceedings (FAR 31.205-47).

(8) Reasonableness (FAR 31.201-3).

(9) Allocability (FAR 31.201-4).

c. Costs incurred by employees or officers of the contractor for purposes which are similar to those classified as unallowable by FAR 31.205-33 are also unallowable even though that cost principle specifically applies to outside professionals and consultants. FAR 31.204(d) provides that the failure to include any item of cost does not imply that it is either allowable or unallowable. This determination is to be based on the overall principles and standards set forth in the FAR and the treatment of similar or related selected items. Under that rule, a cost is unallowable if incurred by the performance of

an outside service, then the cost of similar work performed in-house is also unallowable.

7-2106 Capital Items as Contract Costs

a. Contractors sometime include the unamortized value of capital equipment in contract cost presentations. For items other than approved special tooling, machinery, or equipment, and in the absence of specific contractual coverage, the auditor will question costs of capital items.

b. Special Tooling and Special Test Equipment. The cost of special tooling and special test equipment (as defined in FAR 2.101b) used in performing one or more Government contracts is allowable and shall be allocated to the specific Government contract or contracts for which acquired (FAR 31.205-40). In auditing costs for special tooling or test equipment, determine if such items are properly classified and authorized under the contract. Unauthorized or otherwise inappropriate charges for this type of item may be misclassified in detailed cost accumulations such as for material, supplies, or miscellaneous in-house work orders for fabrication, production support, or maintenance (see 9-602). The auditor will use the Government property administrator's review data and evaluation reports, and should request technical assistance to review any observed or suspected deficiencies (See 14-400).

7-2107 Employee Termination Payments

7-2107.1 Termination Plans, Early Retirement Incentives, and Severance Payments

a. A termination plan sets out the criteria used by a contractor to terminate its employees and determines the termination compensation to be paid to those employees.

b. A special termination plan uses different criteria than the contractor's normal established criteria or provides different benefits than its normal established benefits. Special termination plans are used for unusual circumstances such as the requirement to make mass terminations or a goal to make significant reductions in the company's work force. In such situations, employers have found it advantageous to provide incentives for employees who "volunteer" to be terminated. The employer can design these plans to limit the employees eligible for termination as well as steer employees who would be the best choices from the employer's viewpoint toward "volunteering."

c. Early retirement incentive payments are payments made pursuant to a plan offered exclusively to employees eligible to retire under a pension plan. The purpose of such plans is to induce eligible employees to make an election to retire early and receive immediate pension benefits. Early retirement incentives are sometimes included within a termination plan. If included in a termination plan, the early retirement incentive policy and procedures must meet the same requirements as if it were a separate plan. (For further discussion of early retirement incentive payments, see 7-608.) Under FAR 31.205-6(j)(6) the present value of the total early retirement incentives given to an employee in excess of the employee's annual salary for the last contractor fiscal year completed prior to the employee's retirement is unallowable.

d. Severance pay, also commonly referred to as dismissal wages, is defined in FAR 31.205-6(g) as a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. If a contractor makes a severance pay plan available to its employees regardless of their retirement eligibility, the payments from that severance plan are allowable if they are reasonable and in accordance with FAR 31.205-6(g). The payments made under a severance pay plan to employees who, coincidentally, are also eligible for pension benefits should not be reclassified and treated as early retirement incentive payments subject to FAR 31.205-6(j)(6).

e. The auditor should closely review the reasonableness of special termination plans that offer both severance-type benefits and early-retirement-incentive-type benefits to the

same employee. A well designed special termination plan usually does not need to offer both of these benefits to the same employee to achieve its goals to reduce levels of employment. Usually, if both types of benefits are included in the plan, the employee can choose one of them, but not both. However, the actual determination of allowability must be made considering the reasonableness of the entire termination plan (see 7-2107.7).

7-2107.2 Severance Pay Benefits

Contractors usually have a severance pay policy that pays employees a set number of weeks' pay based upon years of service. However, some contractors may provide additional termination benefits, such as medical care, education, and relocation expenses in order to reduce hardship to employees terminated as the result of a mass work force reduction process. These additional benefits also represent severance pay. The allowability of the total severance pay is subject to the reasonableness criteria contained in paragraph (b) of FAR 31.205-6, Compensation for personal services. Note that FAR 31.205-6(b) requires the contractor to demonstrate reasonableness of compensation items. It specifies factors to be considered in determining reasonableness, including the compensation practices of other firms in the same industry as well as the practices of firms engaged in non-Government work.

7-2107.3 Payments for Involuntary versus Voluntary Terminations

FAR 31.205-6(g) provides that severance pay is a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. This provision can be applied to both of the following situations. First, "involuntarily terminated" can refer to situations where the employee has no option of staying with the company. Secondly, "involuntarily terminated" can refer to situations where the contractor has an established goal for a reduction in work force. Whether or not any specific employee is given an option to stay is irrelevant, provided that the contractor has an established goal. The contractor's commitment to a work force reduction may be evidenced by providing assurance to the Government that the terminated employees will not be replaced; i.e., their jobs have been abolished in order to reach the established goal. Reductions in the work force made under this second situation are often accomplished under special termination plans and may produce higher termination costs than would the contractor's previously established termination benefits. The higher costs are allowable if reasonable (see 7-2107.7). Payments made for involuntary terminations are allowable subject to the provisions contained in FAR 31.205-6, while payments made for voluntary terminations are unallowable.

7-2107.4 Normal and Abnormal Severance Pay

a. FAR 31.205-6(g)(2) classifies severance pay as either normal or abnormal. Either is allowable only to the extent that in each case it is required by:

(1) law;

(2) employer-employee agreement;

(3) an established policy that constitutes, in effect, an implied agreement on the contractor's part; or

(4) the circumstances of the particular employment.

b. Normal severance pay should be allocated to all work performed in the contractor's plant. When the contractor provides for accrual of pay for normal severances, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period and if the amounts accrued are allocated to all work performed in the contractor's plant.

c. Abnormal or mass severance pay is considered by FAR 31.205-6(g)(2)(iii) to be of such a conjectural nature that measurement of costs by means of an accrual will not

achieve equity to both parties. Accruals for abnormal or mass severance pay are not allowable. However, when specific payments occur, allowability will be considered on a case-by-case basis. Severance paid under the terms of a special termination plan is generally abnormal severance.

7-2107.5 Severance Pay When There Is a Replacement Contractor

Severance payments made to employees who are to be employed by a replacement contractor are not allowable. For this purpose, employment by a replacement contractor occurs when continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment, or continued employment by the contractor at another facility, subsidiary, affiliate, or parent company of the contractor.

7-2107.6 Severance Paid in Addition to Early or Normal Retirement Benefits

a. Prior to October 3, 1988, FAR 31.205-6(g)(2)(i) provided that severance payments, or amounts paid in lieu of, are not allowable when paid to employees in addition to early or normal pension payments.

b. The prohibition of payment of both severance and pension benefits was deleted by Federal Acquisition Circular 84-39 effective October 3, 1988. The FAR now permits the payment of otherwise allowable severance and pension benefits concurrently, as well as sequentially, i.e., in the latter case, the contractor may delay payment of pension benefits until after the period for which severance pay is provided. In the circumstances where the contractor provides payment of both severance and pension benefits to the same employee, the auditor needs to closely review the plan to determine if the total plan costs are reasonable.

7-2107.7 Reasonableness of Special Termination Plan Costs

a. Contractors may offer special termination plans, which provide enhanced benefits, to achieve a work force reduction goal by inducing voluntary employee terminations. The rationale behind offering an enhanced severance payment, or an early retirement incentive, should be that the contractor will achieve lower overall costs which will offset the higher termination costs of the special plans. The costs of such plans could include loss of key personnel, higher severance costs (e.g., increased severance benefits for each employee class when compared to the normal plan and higher severance costs resulting from senior workers volunteering to terminate), and higher pension costs resulting from primarily the early retirement incentives. The primary cost reductions of such plans generally are lower overall compensation of the remaining employees, as well as reductions in recruiting and training needs in the near-term. For example, by inducing older employees to retire, the contractor retains younger, fully trained employees who will not need to be replaced for a longer period of time and who are likely to be paid less than the terminated workers.

b. The contractor should be able to support a special termination plan with sufficient information to make a determination that the additional costs incurred by the special plan are offset by associated additional reductions in other costs. Both FAR 31.205-6(b)(1) and 31.201-3 require a contractor to demonstrate that its plan is reasonable.

c. In assessing the reasonableness of a plan, the auditor should consider the value of intangible benefits associated with employee morale and the contractor's reputation as an employer. However, there is no presumption that the Government will allow the costs of such intangible benefits. If justification for a special plan is based on the value of intangibles, it would be an appropriate subject for an advance agreement with the Government before the cost is incurred. (See FAR 31.109 for further discussion of advance agreements.) If the cost/benefit analysis includes intangible benefits and no advance agreement was executed, the auditor should discuss this matter with the contracting officer. If it is

decided that the intangible items should be included in the cost/benefit analysis, the auditor should evaluate the reasonableness of the values assigned to those items. The auditor should question any unreasonable costs associated with the plan.

7-2107.8 Golden Parachute Plans

a. A "golden parachute" is a termination agreement which provides for the payment of extremely lucrative financial benefits, usually to a limited number of key executives. The termination or severance payments granted under the "golden parachute" arrangement are normally well in excess of normal severance payments. Such payments are paid only in the event the employee leaves the company following an actual or anticipated corporate merger or a transfer of control over the company. A common motivation for instituting a "golden parachute" plan is to discourage a hostile takeover by making the costs of a takeover prohibitively expensive.

b. The costs of "golden parachutes" were made expressly unallowable in FAR 31.205-6(l)(1) effective April 4, 1988. Costs of "golden parachutes" are not reasonable, do not benefit the Government, and constitute costs incidental to reorganization because such agreements become operative only with the actual or anticipated corporate takeover. Accordingly, the auditor should also question costs of "golden parachutes" claimed by the contractor for contracts awarded prior to April 4, 1988 based on the cost principle provisions for reasonableness (FAR 31.201-3 and 31.205-6), allocability (the benefits received requirement at FAR 31.201-4), and organization costs (FAR 31.205-27). For costs of "golden parachutes" included in any billing, claim, or proposal submitted by the contractor for contracts awarded on or after April 4, 1988, the auditor should cite FAR 31.205-6(l)(1) as a basis for disallowing such costs. See also 7-1708.

7-2107.9 Severance Pay to Foreign Nationals

a. Effective March 29, 1989, service contracts to be performed outside the United States included the clause at FAR 52.237-8. The clause limits severance paid to foreign nationals performing services outside the United States to the amount typically paid to employees providing similar services within the United States. Effective February 19, 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective October 30, 1992, for DoD contracts.

b. Effective December 21, 1990, the clause at FAR 52.237-8 was revised to make such severance payments totally unallowable for terminations of employment resulting from requests of the host foreign government to close or curtail the employing activity. This prohibition of severance payments only applies to terminations of agreements between the United States and the host country entered into after November 28, 1989. Effective February 19, 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective October 30, 1992, for DoD contracts.

c. The Defense Appropriations Act of 1992 (Section 346) allows DoD to waive the limitations on allowability of severance payments to foreign nationals for contracts for the operations of overseas military banking services.

7-2107.10 Severance Pay Policies for Paid Absences Under the Worker Adjustment and Retraining Notification (WARN) Act

a. The Worker Adjustment and Retraining Notification Act (WARN), sometimes called the Federal Plant Closure Law, 29 U.S.C. 2101, applies to employers with 100 or more full-time employees or to employers with 100 or more employees who in the aggregate work at least 4,000 hours per week (exclusive of overtime). The Act requires that employees be provided with a 60-day advance notice when a plant is to be closed or there is to be a mass layoff. A plant closure is defined as a permanent or temporary shutdown of a single

site of employment, one or more facilities, or an operating unit, where 50 or more employees (excluding part-time employees) lose their jobs. A mass layoff is defined as a reduction in force which is not a plant closing but which results in at least 33 percent of the work force (with a minimum of 50 employees) or 500 employees being terminated (excluding part-time employees).

b. The WARN Act allows employers to give notice to employees less than 60 days in advance when a business circumstance is such that it is not reasonably foreseeable at the time that the 60 day notice would have been required. In order to be not reasonably foreseeable, the event must be caused by a sudden, dramatic, and unexpected action or condition outside the employer's control.

c. A contract termination may result in a plant closure under the Act if it causes the shutdown of at least one site, facility, or operating unit. Shutdown of an operating unit will occur when there is the discontinuance of an entire product line or the extinction of an organizationally distinct operation or function. The critical factor in determining what constitutes an operating unit will be the organizational or operational structure of the contractor. The circumstances of each contract termination should be reviewed and evaluated to determine if the contract termination resulted in a plant closure under the Act.

d. Where a contract termination results in a plant closure, and the contractor has exercised reasonable and prudent efforts in providing timely notification of the plant closing, costs incurred to comply with the WARN Act are generally considered allowable and reasonable business expenses under FAR 31.201-2 and 31.201-3.

e. Where the termination does not meet the provisions of the WARN Act, the auditor should determine if the contractor's actions were reasonable. For example, if the contractor terminates less employees than the minimum required for application of the WARN Act, any payments made for unproductive effort should generally be questioned as not meeting the test of payments for work accomplished in the current year. However, such payments would be allowable to the extent that the contractor can demonstrate that, given the circumstances at the time, it was reasonable to give the WARN Act notices and make the associated payments to the affected employees.

f. In some instances, contractors may place WARN Act status employees who are in sensitive positions on paid absence because of fear that those employees, if allowed to work during the 60-day period, might use their positions to harm the contractor's assets or records in retaliation for losing their jobs. There is no existing regulation or policy which specifically prohibits payments for such paid absence. The paid absence during the 60-day notice period could be considered additional severance pay. However, the contractor may claim the costs as some other category of cost associated with the reduction in force. FAR 31.205-6(b) requires that the contractor demonstrate reasonableness of compensation items and FAR 31.201-3 requires the contractor demonstrate the reasonableness of all costs claimed. Therefore, it is incumbent upon the contractor to demonstrate why it believes the employees are a high risk and should not be working during the notice period. The contractor must also explain why these employees cannot be reassigned to perform nonsensitive work elsewhere in the plant and what the contractor's policy and procedures are in this situation. Without acceptable justification from the contractor, any claimed costs for paid absence during the 60-day notice period would be considered unreasonable and should be questioned.

7-2108 Industrial Security/Plant Protection Costs

a. The provisions of FAR 31.205-29, Plant Protection Costs, state that costs of protecting the contractor's plant and other property are allowable. The costs of items such as:

(1) wages, uniforms and equipment of personnel engaged in plant protection,

(2) depreciation on plant protection capital assets, and

(3) necessary expenses to comply with military requirements, are allowable provided they are reasonable and allocable.

b. There are now a number of commercial companies that provide plant security protection services, including well-trained uniformed guards. These security service companies often provide efficient plant protection services for less than the cost of such services performed by the contractor's own security employees. Accordingly, evaluation of costs of security guards at the contractor's facilities should include a comparison between the cost of the in-house services and the cost of engaging an outside security service firm. When excessive or unreasonable costs are questioned as a result of the above cost comparison, it is the contractor's responsibility to demonstrate the reasonableness and to justify the costs (see FAR 31.205-6(b)(1)).

7-2109 Correction Costs for Internal Control Deficiencies

An internal control system comprises the plan of organization and all of the coordinated methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Internal controls extend to functions other than those relating to accounting controls; e.g., performance reports, employee training programs, and quality controls (see 5-107). This subsection provides guidance relating to the costs of correcting deficiencies in internal control systems or excessive costs that result from the lack of effective internal controls.

7-2109.1 Correction Costs of Quality Control Program Deficiencies

a. Purpose of Quality Control. Effective contractor quality control or product assurance systems provide systematic control of quality and reliability in all phases of the operation including design, procurement, production, testing, storage, and handling of materials. Quality assurance systems consist of both quality control and inspection. The quality control system is responsible for maintaining the quality of the product within established standards. Inspection is a sorting process that classifies material, parts, or products as acceptable or unacceptable. As quality control becomes increasingly effective, the need for inspection correspondingly decreases. Weaknesses in or lack of effective control can result in:

(1) Inadequate products or services;

(2) Unnecessary and ineffective use of resources, including labor, material, and equipment;

(3) Unreliable and inadequate analysis of quality assurance requirements and inspection results;

(4) Unnecessary inspections and work stoppages;

(5) Unreliable management reporting systems;

(6) Unnecessary administrative effort; and

(7) Unreliable test equipment.

b. Allowability of Costs.

(1) The cost of maintaining an acceptable quality control system is allowable, if reasonable. Where minor deficiencies are cited by the Government, making corrections to the system should be considered to be part of maintaining an acceptable quality control system and related costs are allowable. However, where significant corrections to the quality control system are needed because of the contractor's earlier negligence in establishing and/or maintaining acceptable controls, an unreasonable amount of increased costs to the Government would result through duplicative efforts to reinstitute a quality control program. These costs should be disallowed on a basis of reasonableness (FAR 31.201-3).

(2) FAR 46.311 requires certain contracts to contain the contract clause at FAR 52.246-11, Higher-Level Contract Quality Requirement (Government Specification). This clause requires contractors' compliance with the specified Government quality control specification requirements. Where this clause is contained in a contract, the contractor has a contractual obligation to establish and maintain a quality control program to assure adequate quality throughout all areas of contract performance, including

design, development, fabrication, processing, assembly, inspection, test, maintenance, packaging, shipping, storage, and site installation. In these situations, the contract clause provides a contractual mechanism for requiring contractor corrective actions at no increased cost to the Government. Where a contractor is in violation of the Government quality requirements specified in a solicitation, a comment should be included in DCAA audit reports indicating that contract award should not be made until the deficiencies are corrected by the contractor. In addition, where contractor deficiencies are cited on existing contracts, the auditor should recommend the use of advance agreements for limiting Government liability and segregation of the costs of correcting quality control system deficiencies (to allow audit visibility). If the contractor refuses to segregate these costs, recommend suspension of payment until proper accounting and segregation of costs are made.

7-2109.2 Costs Related to Extraordinary Reviews of Unsettled Overhead Costs

a. All contractors doing business with the Government are required by FAR 31.201-6 to have adequate internal controls to assure that unallowable costs are not included in billings and claims submitted to the Government. Some contractors may undertake large-scale reviews of unsettled overhead costs to identify unallowable costs that may have not been segregated and removed from overhead claims during the original processing of the transactions and/or the initial preparation of the billings or claims. This extraordinary effort is often the result of the contractor's earlier negligence in establishing, maintaining, and/or implementing an adequate system of internal control.

b. When the circumstances cited in paragraph a. above are encountered and the contractor is incurring or is expected to incur significant costs, the auditor should notify the contractor that the costs associated with such extraordinary reviews of unsettled overhead costs are considered to be unreasonable and will be questioned under FAR 31.201-3, Determining reasonableness. The reasons to be cited are:

(1) The costs are not of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of a contract. The costs are duplicative of costs incurred for the same purpose in prior periods. The Government has already reimbursed the contractor for the costs of preparing billings and claims for reimbursement. The fact that this task was not adequately accomplished does not entitle the contractor to additional reimbursement.

(2) The costs are the result of the contractor's failure to follow the requirements of generally accepted sound business practices and contract terms.

(3) The costs result from actions taken which were not those of a prudent businessman in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the Government, and the public at large.

7-2109.3 Costs Related to Contractor Self Governance Programs

Contractor activities under self-governance programs are to be encouraged as a matter of DoD policy. Costs of such activities are allowable if reasonable in amount.

7-2110 Bank and Purchase Card Transaction Fees

a. Administrative costs associated with short-term borrowings for working capital may be classified as “bank fees.” These administrative costs are allowable under FAR 31.205-27, Organization costs.

b. Many contractors allow purchasers, including the Government, to pay for purchases through the use of a purchase card (such as the IMPAC card). When a contractor accepts a purchase card for payment of goods and services, the contractor is charged for transaction costs, generally referred to as “merchant fees”. Merchant fees include fees paid by the contractor to the contractor’s bank, the credit card company (i.e., VISA or MasterCard), and the

card-issuing bank for processing payment through the credit card network. Auditors should not assume these fees represent unallowable interest costs merely because the fee is usually expressed as a percentage of the amount of the transaction. The transaction fees associated with the use of the purchase card represent a charge for administrative processing and do not represent interest on borrowings.

c. Some banks offer financial agreements which grant lines of credit at less than the prime interest rate. The bank may classify this difference as a bank fee which the contractor may be claiming as an allowable cost under Government contracts. However, the difference between the agreement's rate and the prime rate should be considered unallowable under FAR 31.205-20, Interest and other financial costs, which specifically disallows interest on borrowings, however represented. Accordingly, bank fees claimed by contractors should be carefully reviewed to determine whether they are, in fact, interest costs.

d. Where contractors have entered into agreements similar to that discussed in paragraph c. above, and claim the costs under Government contracts, the procedures in 4-702 should be followed as applicable.

7-2111 No Cost Storage Contracts

7-2111.1 Definition

No Cost Storage Contracts are contracts for which the contractor is to provide the Government with storage or warehousing services, but payment of the costs associated with these services is not provided for in the contracts. Some of these contracts specify that storage or warehousing costs are to be charged as an indirect expense. Other such contracts, while not specifically stating that the storage or warehousing costs are to be charged indirect, make no provision for reimbursement of such costs under the contract. The likely result is that the costs associated with the storage or warehousing are allocated to and reimbursed under other non-benefiting Government contracts.

7-2111.2 Audit Considerations

a. Allocability of Costs. The provisions of FAR 31.201-4, Determining Allocability, and CAS 418 set forth criteria for determining the proper allocation of expenses to final cost objectives. Irrespective of whether a contract provides for reimbursement of costs of particular items, the allocability of costs must be determined by the casual or beneficial relationship of the cost to the final cost objectives. Other contracts cannot bear the storage or warehousing costs that are properly allocable to the No Cost Storage Contracts (see 6-606 and 8-418).

b. Consistency in Accounting Treatment of Costs. FAR 31.202, Direct Costs, and CAS 402 state that all costs incurred for the same purpose in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. A noncompliance with FAR 31.202 and CAS 402 arises when some contracts are charged directly for storage costs, as well as indirectly for the storage costs that should have been charged to the No Cost Storage Contracts. Inconsistent accounting treatment of storage or warehousing expense should be reported as a noncompliance with these requirements (see 6-608.3 and 8-402).

c. Anticipated Awards of No Cost Storage Contracts. When an ACO, PCO, or commercial customer has requested the contractor to store property at no cost, the auditor should place the ACO and/or PCO, and the contractor on notice that the cost associated with the storage or warehousing should be allocated in accordance with the contractor's normal accounting practices and the criteria discussed in paragraphs a. and b. above. If necessary, discuss the issues with the cognizant ACO so that a written notice of intent to disallow costs on impacted contracts may be issued in accordance with FAR 42.8.

d. Active No Cost Storage Contracts. Where auditors identify No Cost Storage Contracts, any inappropriate allocation of costs should be questioned. If not already issued, appropriate CAS and/or FAR noncompliance reports and DCAA Forms 1, if applicable, should be issued. In these situations, the contractor may assert that the audit position would involve prejudicial

retroactivity and may introduce estoppel as a defense. The validity of an asserted estoppel claim is a legal issue and the auditor should not attempt to resolve such arguments. Estoppel is a matter which normally should be considered by contracting officers and procurement counsel subsequent to the issuance of the audit results. However, if an auditor perceives that an estoppel issue may affect an audit, the matter should be referred to the Regional Director for appropriate legal consultation.

7-2112 Banked Vacations

7-2112.1 General

a. The term "banked vacations" refers to a situation where contractors have policies that allow employees to carry forward and accumulate (bank) all or a portion of vacation time not taken within the year in which entitlement is earned. The banked vacation can be taken at a later date or not taken at all, in which case payment for the amount of banked vacation time is usually made when the employee terminates employment. Sometimes contractors write up the vacation liability on the books to reflect employees' pay raises received subsequent to the periods in which vacation was earned.

b. CAS 408 does not address the practice of banking vacations, nor does CAS 415 specifically apply to compensated absences. Therefore, auditors should not issue CAS 408 or CAS 415 noncompliances because of problems with the contractors' policies/practices regarding banked vacations.

7-2112.2 Audit Considerations

a. Many contractors have ceased the practice of banking vacations, (i.e., have adopted a use-or-lose policy), or now allow deferral for only one accounting period following the year in which the vacation was earned. Nevertheless, if the situation of banked vacations exists, the auditor must first determine if the contractor's method of accounting for banked vacation accruals is proper, and then look at the reasonableness of the vacation policy and costs as a component of total compensation.

b. A contractor normally accrues vacation liability as each employee earns vacation. It is appropriate for a contractor's books to reflect the liability that will have to eventually be paid. Therefore the contractor, for financial accounting purposes, may decide to write up the vacation accruals; otherwise the accruals on the books may be understated. If banked vacation deferrals extend beyond one year and related write-ups are significant, the auditor should recommend that the ACO seek an advance agreement with the contractor establishing mutually agreeable criteria for calculating banked vacation accruals including consideration of present value methodology.

7-2113 Payments to Contractors Under the Job Training Partnership Act

a. The Job Training Partnership Act was passed by Congress to help turn the hard-core unemployed into productive wage earners. As part of that effort, local Private Industry Councils (PIC) were created to identify, counsel, train, and place unemployed people. One incentive to industry to participate in the program is a partial subsidization of these new workers' wages, up to 50 percent, for the first weeks or months of their employment. The law further specifies that these PIC reimbursements are intended to compensate employers for the increased training costs and reduced productivity associated with hiring the hard-core unemployed.

b. Contractors receiving PIC payments as part of this program should not receive duplicate reimbursements under Government contracts. If the contractor includes costs in its proposals or billings that are subject to PPD reimbursement, an appropriate credit should be given to the Government. Conversely, if the contractor can and in fact does exclude from its proposals or billings increased costs resulting from its participation in

the PIC program, then no credit or offset is required. Such increased costs often result from additional training and supervision that are associated with hiring the hard-core unemployed as well as reduced productivity in the form of additional hours and materials required by these employees.

7-2114 Employee Stock Ownership Plans (ESOPs)

7-2114.1 General

a. An Employee Stock Ownership Plan (ESOP) is an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. An ESOP may be either nonleveraged or leveraged.

b. An Employee Stock Ownership Trust (ESOT) is the entity responsible for administering the ESOP. The contractor's contributions to the ESOT may be in the form of cash, stock, or property.

c. Under a nonleveraged ESOP, annual contributions are made by the corporation to the ESOT in the form of stock, property, or cash. If the contribution is in the form of cash, the ESOT uses this cash to acquire company stock. The ESOT holds the stock for the employees and periodically notifies them of how much they own and how much it is worth. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

d. Under a leveraged ESOP, the ESOT borrows money, usually from a bank, and then uses these funds to make a large purchase of company stock, either from the shareholders or from the company, e.g., treasury stock. This stock then becomes collateral for the bank loan. Each year the company makes a contribution to the ESOT equal to the total amount of the principal and interest on the loan. The ESOT then uses this money to make its annual payment to the bank. Upon receipt of the ESOT loan payment the bank releases an amount of stock in proportion to the loan principal paid by the ESOT. The released stock is then distributed by the ESOT to the accounts of the plan participants in accordance with the provisions of the plan. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

7-2114.2 Applicable FAR/CAS

a. The reasonableness of all ESOP costs must be determined in accordance with FAR 31.205-6(a) and (b). In assessing the reasonableness, the auditor should review the terms of the ESOP to determine if the plan design provides unreasonable compensation to certain employees or groups of employees. In addition, the reasonableness of the amount of stock distributed to employees' ESOP accounts should be reviewed in conjunction with a review of the employees' total compensation (see 5-800).

b. ESOP contributions are subject to the requirements of FAR 31.205-6(q). Contractor ESOP contributions must be measured and assigned in accordance with CAS 415. CAS 415 requires that ESOP contributions be awarded to the employees and allocated to the individual employee ESOP accounts by the Federal income tax deadline. Any amount funded in excess of the cost assigned to the current period is to be assigned to a future cost accounting period when the remaining portion is awarded and allocated to the individual employee accounts (CAS 415.50(f)(2).

c. FAR 31.205-6(q)(2)(iii) – (vi) provides that:

(1) The contractor's annual ESOP contributions in excess of the Internal Revenue Code deductibility limits are unallowable (see FAR 31.205-6(q)(2)(iii)).

(2) The price paid by the ESOT for the stock in excess of its fair value is unallowable. If the ESOT purchases the stock with borrowed funds, the contractor's cash contributions necessary to cover the ESOT loan (principal and interest) that are attributable

to the excess price should be questioned pro rata during the loan repayment period (see FAR 31.205-6(q)(2)(v)).

(3) When contributions are made in the form of stock, the value of that stock is limited to the fair market value on the date the stock is transferred to the ESOT (see FAR 31.205-6(q)(2)(iv)). Therefore, ESOP costs assignable to a cost accounting period will be the fair market value of the stock on the date the contractor transfers the stock to the ESOT, multiplied by the total number of shares actually earned by employees and allocated to individual employee accounts for that period.

(4) FAR 31.205-6(q)(2)(vi) provides that when the fair market value of stock is not readily determinable, the IRS guidelines for valuation will be used on a case by case basis (see 7-2114.4).

d. Under leveraged ESOPs, the contractor's irrevocable cash contribution to the Trust, which is used by the ESOT to service its debt (including principal and interest), is the amount assignable to the cost accounting period, provided that an equivalent amount of shares are released and allocated to the individual participants' accounts in accordance with the terms of the ESOP plan. For any given period, the shares released from collateral under the terms of the loan may exceed the number of shares to be allocated under the terms of the plan. The auditor should be alert to excess shares that might be awarded to ESOP participants and claimed by the contractor. In the absence of the Contracting Officer's prior approval, the award of excess shares to ESOP participants should be questioned, since the excess shares are not awarded according to the established compensation plan.

7-2114.3 ESOP Stock Valuations

a. The auditor should perform audit tests to determine that the contractor is not reimbursed an amount exceeding the fair market value of the stock on the measurement date. For stock that is publicly traded in substantial quantities, the published trading price on the measurement date should reflect the fair market value of the stock. For companies where the stock is not publicly traded in substantial quantities, a valuation is required. The annual appraisal of the ESOP stock should serve as the baseline for the auditor's review.

b. Valuation of stock for a company that is not publicly traded in substantial quantities is a complex process. While there is no formula that can be applied to all circumstances, the auditor should determine if the data used in making the valuation is current, accurate, and complete, and if the assumptions underlying the valuation are reasonable. In addition, the auditor should determine if appropriate adjustments have been made to reflect minority interests and/or lack of marketability.

(1). Discount for Minority Interest - The discount for minority interest represents the additional cost per share needed to obtain a majority (control) interest, divided by the majority cost per share. The fair market value of the ESOP stock should include a discount to reflect a minority interest whenever the ESOT has not purchased a controlling interest in the company, i.e., the ESOT cannot exercise control over company decisions. A discount may also be appropriate even when the ESOT has purchased a majority of the company stock, if circumstances are present which prevent the ESOT from effectively exercising meaningful control, e.g., the ESOP trustee exercises significant voting rights and is not independent of the company. The decision to apply a minority discount in such situations must be made on a case-by-case basis. The decision should consider all relevant factors including the fiduciary responsibility of the trustee which may mitigate the lack of independence.

(a) Where the ESOP stock has been obtained as part of a buyout, the additional cost can generally be computed by taking the difference between the actual cost paid per share and the value of the stock prior to any knowledge or speculation (e.g., leaks or rumors) of the upcoming buyout. This value must be close enough in time to be relevant to the buyout (preferably one or two months) but should not be a time period in which there were significant events that led to changing market conditions (e.g., stock market crash or product boycott).

(b) Where a leveraged buyout is not involved, the discount should be based on historical data regarding similar companies that have been bought or sold within a relevant time period. If no such data exists, then overall market information may be used.

(2). Discount for Lack of Marketability - Where the stock is not publicly traded, it should generally be discounted to reflect its lack of marketability. A marketability discount reflects the fact that the stock of a closely held company is generally less attractive to potential investors than publicly traded stock.

(a) Even when the company has always exercised its option to repurchase the stock, or where the plan requires the company to repurchase the stock (called "put" rights), some discount will usually apply. While the amount of the marketability discount will differ depending upon the specific circumstances involved, such discounts have generally ranged from 5 to 20 percent.

(b) Factors that influence the amount of the marketability discount include the extent to which "put" rights are enforceable, the company's ability to meet its obligations with respect to these "put" rights (taking into account the company's financial strength and liquidity), the company's history of redeeming its ESOP shares for cash when tendered, and the establishment of a funding program for the repurchase liability.

7-2114.4 Dividends Used To Satisfy ESOP Contribution Requirements for Leveraged ESOPs

a. Tax regulations allow companies with leveraged ESOPs to deduct dividend payments used to service ESOP debt, including dividend payments applicable to stock that has been allocated to employee accounts (allocated stock), as well as dividend payments applicable to stock held by the employee stock ownership trust (unallocated stock). As a result, some companies use the dividends applicable to allocated, unallocated, or both allocated and unallocated stock to satisfy their annual ESOP contribution requirements.

b. Dividend payments are expressly unallowable in accordance with FAR 31.205-6(i)(2). This is the case regardless of whether the dividends are paid directly to the employees, credited to employee accounts, used to service the ESOP debt, or used to acquire additional shares.

7-2115 Cooperative Research Consortium Costs

7-2115.1 Introduction

This section provides guidance for performing audits of cooperative research consortiums. This guidance is specifically targeted at partnerships, joint ventures, or corporations (referred to in this section as consortiums) formed pursuant to the National Cooperative Research Act. Guidance on other organizational structures chosen by a contractor to carry on its business or to bid on Government contracts is provided in 7-1800.

7-2115.2 General

In 1984, Congress passed the National Cooperative Research Act. This act eased antitrust laws to allow companies in the same industry to jointly develop new technology. Under the Act, research and development is usually funded cooperatively to develop base technology for use by member firms individually in proprietary applications. The Act covers research and development activities up to the prototype stage. Cooperative research consortiums are usually formed to explore specific research areas.

7-2115.3 Accounting Considerations

a. While the terms and conditions of these agreements may suggest they are contracts, they are not the type of contract contemplated under FAR 31.205-18(a) that

would preclude the recovery of IR&D costs. R&D costs incurred by a defense contractor pursuant to a cooperative agreement may be considered as allowable IR&D costs if the work performed would have resulted in allowable IR&D costs had there been no cooperative agreement.

b. Consortium costs will most likely be charged to indirect cost pools, primarily as Manufacturing and Production Engineering (MPE) or IR&D. The audit review of consortium costs must consider the different accounting treatment afforded MPE costs versus IR&D costs.

c. MPE (FAR 31.205-25) does not cover basic and applied research effort related to new technology, materials, systems, processes, methods, equipment, tools, and techniques. These are all covered by the IR&D/B&P cost principle, FAR 31.205-18. Nor does MPE cover any development effort for manufacturing or production materials, systems, process, methods, equipment, tools and techniques, that are intended for sale. These costs are also covered by the IR&D/B&P cost principle. MPE covers only developing and deploying new or improved methods of producing a product or service when such new or improved technology is to be used in the contractor's own productive facilities.

7-2115.4 Classification of Costs and Audit Considerations

a. To properly classify consortium costs, the nature and purpose of the projects involved must be determined. Although FAR clearly delineates between IR&D and MPE costs, the technical nature of this work may make it difficult to distinguish between independent research and development and development effort not intended for sale. To assist the auditor in making these decisions, Government technical specialist assistance should be sought. Procedures for identifying and obtaining technical specialist assistance are outlined in Appendix D.

b. The contractor should be able to provide documentation to support the nature and purpose of consortium projects. The contractor should also provide all legal documents (e.g., partnership agreements, shareholder agreements, certificates of incorporation, technology agreements) which pertain to the creation of the consortium. These documents often contain valuable information regarding the purpose of the consortium as well as information on other accounting issues such as income/loss distribution, payment schedules, and ownership of products or technology developed by the consortium.

c. When reviewing the nature and purpose of specific projects engaged in by a consortium, the following additional sources of information may prove helpful:

(1) contractor interoffice memos discussing the project,
(2) articles in company newsletters or journals,
(3) slides/charts/minutes from company briefings or conferences,
(4) papers or speeches to professional organizations or conferences, and
(5) newspaper articles.

d. In addition to the distinction between MPE costs and IR&D costs, there are other important audit considerations pertaining to consortiums.

(1) Costs for consortiums may be charged to an account for trade and professional organizations. Included in these costs may be both basic membership fees and sponsorship fees for specialized research and development programs. The classification and allowability of these sponsorship fees will depend upon the nature and purpose of the research programs and the company's intended use of the resulting technology.

(2) An important consideration is the accounting treatment given any income/loss of the consortium. Usually, the consortium agreement provides for distribution of net income/loss to the individual member companies. The applicable portion of any income relating to allowable cost should be credited to the Government in accordance with FAR 31.201-5.

(3) There may be significant related party transactions between the consortium and its members. A consortium may hire one or more member companies to provide a variety of services. For example, a member company may provide a consortium with executive search

services or legal support. The applicable portion of any payment relating to an allowable cost should be credited to the Government in accordance with FAR 31.201-5.

(4) The employees of a member company may be temporarily assigned to the consortium. The consortium may reimburse the company for employees' salary and relocation expenses. The accounting for the employee's salary and any reimbursement a member company receives for the loan of its employee should be determined.

7-2116 Lobbying Costs

Lobbying costs represent amounts incurred to influence the outcome of elections, referendums, legislation, and other governmental actions at all levels of Government.

7-2116.1 Lobbying Cost Principle

a. FAR 31.205-22 disallows most costs incurred to influence elections, public votes on issues, political parties, and legislation. It also disallows costs incurred to induce or tend to induce, either directly or indirectly, executive branch employees to give consideration or to act regarding a Government contract on any basis other than the merits of the matter. FAR 31.205-22(b) states that the following lobbying costs are allowable:

(1) Costs that result from requests by a legislative body for certain types of information.

(2) Costs for influencing state or local legislation in order to directly reduce contract cost or to avoid material impairment of the contractor's authority to perform the contract.

(3) Costs for performing any activity specifically authorized by statute to be undertaken with contract funds.

b. FAR 31.205-22 sets forth requirements for supporting and claiming allowable costs and for disclosing unallowable costs that are not claimed. Unallowable lobbying costs must be separately and specifically disclosed in the submission as voluntary deletions from the contractor's final costs for the period. Lobbying costs may not be removed from the submission as part of an undifferentiated total which includes other types of costs. Likewise, a contractor may not simply exclude the costs without identifying that the costs were incurred and removed. Prior to August 19, 1996, FAR 31.205-22(f) exempted contractors from certain timekeeping requirements when employees spent less than 25 percent of their total time engaged in lobbying activities. This exemption was deleted effective August 19, 1996 because it implied a conflict with other existing record keeping requirements in the FAR and CAS. Contractors were, and still are, required to maintain records adequate to support allowable lobbying costs claimed and to segregate unallowable lobbying costs not claimed, in accordance with the certification requirements (see 6-706).

c. DFARS 231.205-22(a), 231.303(3), 231.603 and 231.703, effective September 8, 1997, implement Section 7202 of the Federal Acquisition Streamlining Act of 1994 pertaining to legislative lobbying costs. The DFARS provisions disallow costs incurred by DoD contractors for preparing any material, report, list, or analysis concerning the actual or projected economic or employment impact in a particular state or congressional district of an acquisition program for which all research, development, testing and evaluation has not been completed.

7-2116.2 Lobbying in Connection with Federal Contracts and Other Federal Actions - Byrd Amendment

a. FAR Subpart 3.8 implements 31 U.S.C. 1352, entitled "Limitation on Use of Appropriated Funds to Influence Certain Federal Contracting and Financial Transactions." This legislation, which was signed into law on October 23, 1989, is commonly referred to as the Byrd Amendment. The legislation has been implemented by contract clause, as opposed to a change in the FAR cost principles. Effective December 23, 1989, solicita-

tions exceeding $100,000 are required to include the clauses at FAR 52.203-11 (Certification and Disclosure Regarding Payments to Influence Certain Federal Transactions). Effective December 23, 1989, both solicitations and contracts are required to include the clause at FAR 52.203-12 (Limitation on Payments to Influence Certain Federal Transactions).

b. FAR clause 52.203-12 makes the cost of certain lobbying activity unallowable. The activity covered is influencing or attempting to influence an officer or employee of an agency, a Member of Congress, an officer or employee of Congress, or an employee of a Member of Congress in connection with any covered Federal action. A covered Federal action is defined as:

(1) the awarding of any Federal contract,
(2) the making of any Federal grant,
(3) the making of any Federal loan,
(4) the entering into of any cooperative agreement, or
(5) the modification of any Federal contract, grant, loan, or cooperative agreement.

c. The Act does not apply to the following activities:

(1) Providing information specifically requested by a Member of Congress, an employee of Congress, an employee of a Member of Congress, or an officer or employee of a Federal agency.

(2) Agency and legislative liaison by a contractor's regularly employed employee, provided the activity is prior to or not directly related to a specific solicitation.

(3) Selling activities by independent sales representatives, provided such activities are prior to formal solicitation and limited to the merits of the matter.

(4) Professional or technical services rendered directly in the preparation, submission, or negotiation of a bid or proposal, provided such services are limited to providing advice and analysis which directly applies a professional or technical discipline and are further limited to the merits of the matter.

7-2116.3 Lobbying Disclosure Act of 1995

a. The Lobbying Disclosure Act (LDA) of 1995, which became effective January 1, 1996, significantly expanded the registration and reporting requirements for those who engage in lobbying activities. An organization must register (Form LD-1) and file semiannual reports (Form LD-2) with the Secretary of the Senate and the Clerk of the House if the organization has at least one employee who meets the statutory definition of lobbyist, and (1) the organization’s total lobbying expenses exceed $20,000 (in the case of in-house lobbyists) or (2) the firm’s total income from lobbying activities for a particular client exceeds $5,000 (in the case of a lobbying firm, including a self-employed lobbyist) during a semiannual reporting period. The Act defines lobbyist as a person who spends 20 percent or more of his or her time on lobbying activities that include more than one lobbying contact. A lobbying contact encompasses virtually any oral or written communication (including an electronic communication) to certain executive and legislative branch officials. The Act requires the dollar thresholds to be adjusted on January 1, 1997 and at 4-year intervals thereafter to reflect changes in the Consumer Price Index (CPI). For the January 1, 1997 adjustment, the $5,000 threshold for lobbying firms remains unchanged, and the threshold applicable to organizations employing in-house lobbyists is adjusted to $20,500. For the January 1, 2001 and 2005 adjustments, the thresholds for lobbying firms are adjusted to $5,500 and $6,000, and the thresholds applicable to organizations employing in-house lobbyists are adjusted to $22,500 and $24,500 respectively.

The Honest Leadership and Open Government Act (HLOGA) of 2007 halved both the original LDA registration thresholds and reporting periods, setting them at $2,500 and $10,000 per quarter, effective January 1, 2008. Effective January 1, 2009, the CPI-adjusted thresholds for lobbying firms and organizations employing in-house lobbyists are $3,000 and $11,500 per quarter, respectively.

b. Lobbying firms are required to file a separate registration and quarterly report for each client, while organizations employing in-house lobbyists file a combined registration and quarterly report covering their entire in-house lobbying activities. Quarterly reporting requires registrants to disclose specific lobbying issues, the name of each employee who acted as a lobbyist, and the organization's total lobbying expenses for in-house lobbyists or the firm's total income for a particular client for a lobbying firm.

c. Auditors should determine whether the contractor is a registrant under the Act and obtain copies of the quarterly reports filed by the contractor in planning and performing audits of lobbying costs and audits of a contractor's Washington Office costs. Unallowable lobbying expenses identified and excluded from the contractor's overhead settlement proposals should be reconciled with the total expenses reported on quarterly reports. If any significant differences are found, the auditor should request an explanation from the contractor. The list of employees and specific lobbying issues disclosed in quarterly reports should also be considered in planning and performing audits of labor costs. However, it should be noted that this list may not include all employees participating in lobbying efforts because of the "20 percent rule" and minimum one lobbying contact requirement.

d. In accordance with the Lobbying Disclosure Act of 1995, the Secretary of the Senate has initiated a program to allow the public to view filings received by the United States Senate Office of Public Records. The filings are available on the internet on the official United States Senate web site at:

http://www.senate.gov/legislative/Public_Disclosure/LDA_reports.htm

The site allows the auditor to search the filings by contractor name.

7-2117 Military Operations -- War Hazard, Reserve Supplements, and Desert Storm

7-2117.1 War Hazard Pay

a. Contractors will sometimes offer hazardous duty pay as an incentive to employees performing work under unusually dangerous situations. These incentives vary among contractors and may reflect differences in individual circumstances. Such incentives are to be evaluated for reasonableness on a case-by-case basis. Each contractor should support the reasonableness of the incentives by presenting evidence that may be relevant to the particular circumstances. War hazard differentials may well be justified in order to ensure that critical functions are maintained in support of our troops.

b. The amount of war hazard pay necessary in a given situation will depend on many factors, such as:

(1) Country and city where assigned,

(2) Distance of work site from actual battlelines and surrounding areas of imminent danger,

(3) War hazard differentials being offered by other defense contractors in the same location,

(4) Employee response to any lower war hazard differential pay offers made by the contractor,

(5) Availability of alternate workers at appropriate skill level, and

(6) Other compensation offered, such as bonuses and insurance coverage.

c. Auditors should review the reasonableness of the process by which the war hazard differentials are set without any preconceived idea of what percentage or dollar amount is to be accepted as reasonable. Whatever policy the contractor sets should be consistent to ensure that the contractor is not paying the war hazard differential only where it can be reimbursed on Government contracts (e.g., flexibly priced contracts). Contractors should also be encouraged to set forth their policy in writing to the cognizant ACO and enter into an advance agreement to avoid misunderstandings.

7-2117.2 Supplemental Reservist Payments

a. Many companies choose to continue certain fringe benefits, such as health insurance, for employees who have been called to military duty. In addition, many companies pay these individuals the difference between their civilian and military salaries in an effort to help mitigate the hardships that those called to active military duty will experience. In accordance with an October 5, 2001 memorandum issued by the Under Secretary of Defense for Acquisition, Technology and Logistics, these types of supplemental benefits for extended military leave are to be considered allowable costs pursuant to FAR 31.205-6, Compensation for personal services.

b. Allowable amounts are limited to the lesser of:

(1) the contractor's extended military leave benefits plus active duty pay, or

(2) the total compensation of an employee at the time of entry into active military duty. For purposes of computing this limitation, active duty pay includes basic pay, all specialty pay, and all allowances, except for subsistence, travel, and uniform allowances.

7-2117.3 Operation Desert Storm Homecoming Celebration Expenses

a. In accordance with a June 3, 1991 memorandum issued by the Director, Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS), Operation Desert Storm homecoming activities are considered to be a national celebration. If costs are incurred for participating in honoring the Desert Storm troops and celebrating the operation's success, this section applies.

b. As a general rule, the costs of participation are allowable because participation costs are considered as being incurred in different circumstances than public relations or advertising costs. However, costs which would otherwise be specifically unallowable are still unallowable (see 7-2117.3e.).

c. Allowable contractor participation costs include labor, material, and other direct costs of the celebration. Employee time to participate in the activities could include time to march in a parade or fabricate a parade float. Contractors should be allowed material and other direct costs of floats, displays, or exhibits appropriate to the celebration activity. Generally, the allowability of such costs is linked to employee morale and will normally involve celebrations in the locality of the contractor facility. While there is no specific limit on the number or location of celebration activities that would be allowable for a contractor, there should be a clear linkage to employee morale.

d. Employee absence from the workplace to attend the celebrations is allowable if the associated costs are reasonable. Most celebration activities were scheduled for holidays or weekends when there would be little or no contractor costs for employee attendance. When activities were scheduled for normal work time, reasonable personal absence costs are allowable.

e. Certain costs remain unallowable even if associated with such celebrations. Any advertisement to the public of any nature is subject to FAR 31.205-1, although the contractor is allowed to include its name and logo on a banner, sign, and/or float used in the celebration activity. Costs of souvenirs, models, imprinted clothing, buttons, and other mementos distributed during the celebration are unallowable under FAR 31.205-1(f)(6). Contributions to local governments or other third parties to pay for celebration activities are unallowable contributions under FAR 31.205-8.

7-2118 Costs Related to Legal and Other Proceedings

a. The specific conditions for allowability of costs associated with legal and other proceedings are addressed in FAR 31.205-47. The cost principle applies to the total costs incurred for the subject purpose including all costs directly associated with legal and other proceedings.

b. “Costs” under FAR 31.205-47 include, but are not limited to, administrative and clerical expenses; the costs of legal services, whether performed by in-house or private counsel; the costs of the services of accountants, consultants, or others retained by the contractor to assist in preparation or presentation; costs of employees, officers, and directors; and any other similar costs incurred before, during, and after commencement of a proceeding (FAR 31.205-47(a)).

c. Cost of outside services should be supported by invoices or billings which itemize such items as amounts applicable to retainer agreements, fees for services not covered by a retainer, expenditures for investigative and other services, and travel and miscellaneous expenses (FAR 31.205-33(f)).

d. In-house costs include salaries and related fringe benefits as well as the costs of secretarial and other support services, space, utilities, and library services. If a contractor maintains a legal capability in-house, the use of outside counsel should be limited to matters beyond the competence or workload capacity of the contractor's own legal department.

e. In addition to FAR 31.205-47 which addresses specific proceedings and FAR 31.205-33 which addresses outside consultant costs (including outside legal costs), the costs of legal proceedings must be reasonable both in nature and amount to be allowable in accordance with FAR 31.201-3.

7-2118.1 General Considerations on Legal Services

a. Outside legal services and outside support for legal services are generally considered as specific kinds of professional or consultant services subject to the provisions of FAR 31.205-33, as discussed in 7-2105.

b. Costs of in-house legal services ordinarily cover a variety of legal activities related to the overall administration and management of the contractor's business. They are usually accounted for without further identification as part of in-house general and administrative expenses. Audit determinations on allowability will generally be made in consideration of the overall amounts involved. The auditor should not undertake, or request the contractor to undertake, a detailed analysis to classify costs by function or specific activity unless an overall review indicates that the amount is obviously excessive or that a significant portion of the effort of legal personnel was devoted to activities designated in FAR 31.205 as unallowable or not allocable to Government business (see 7-2118.9).

7-2118.2 Definitions

a. "Cost," as used in FAR 31.205-47, includes all costs which would not have been incurred but for the proceeding. This includes costs incurred before, during, and after the proceeding. The concept of "before the proceeding" should be interpreted to cover the following: (1) when a contractor anticipates and begins to prepare for a proceeding before it has been officially notified that a governmental unit has initiated a proceeding and (2) when the contractor is conducting its own investigation or inquiry preparatory to initiating a proceeding.

b. A proceeding includes any investigation, administrative process, inquiry, hearing, or trial conducted by a local, state, Federal, or foreign governmental unit or brought by a third party in the name of the United States under the False Claims Act, and appeals from such proceedings.

c. A penalty does not include a payment to make a unit of government whole for damages or the interest accrued on the damages. A penalty is in the nature of a punitive award or fine.

d. A "qui tam" proceeding is a proceeding brought to court by a private citizen (third party) on behalf of the Government. The False Claims Act, 31 U.S.C. 3730, specifically allows private citizens to bring suit to recover and restore funds to the Government which were obtained by fraudulent contractor practices. A legal determination has been made that a "qui tam" proceeding (whether or not the Government elects to intervene) is a "proceeding brought by the Federal Government" as that term is used in FAR 31.205-47(b).

7-2118.3 Allowability of Costs

Costs of some proceedings are allowable subject to a ceiling if the contractor prevails in an action, some are always unallowable, and others are completely allowable if the contractor prevails in an action. Costs associated with routine proceedings, not specifically addressed in the FAR cost principle, are generally allowable if reasonable in nature and amount.

7-2118.4 Allowable Cost Ceiling for Certain Proceedings

a. If the outcome of a proceeding described in FAR 31.205-47(b) determines costs to be allowable, the maximum amount allowable is still limited to the extent that the costs:

(1) are reasonable considering the requirements and underlying cause of the proceeding;

(2) have not been otherwise recovered from any source; and

(3) do not exceed 80 percent of the total otherwise allowable cost. A percentage less than 80 percent could be appropriate considering the circumstances of the case and the legal work involved.

b. The 80 percent limit also applies to the costs related to proceedings settled by consent or compromise under the conditions described in 7-2118.5a.(5).

c. The unallowable portion (amount over the ceiling) is considered to be a co-payment to encourage contractors to incur proceedings costs responsibly even in a winning case.

7-2118.5 Proceedings Allowable Subject to a Ceiling if the Contractor Prevails

a. Costs of the following proceedings commenced by a governmental unit (Federal, state, local, or foreign) or by a third party on behalf of the United States for violation of, or a failure to comply with, law or regulation are unallowable if the proceedings result in the indicated outcomes; otherwise, costs are allowable subject to the ceiling (FAR 31.205-47(b)):

(1) In a criminal proceeding, a conviction.

(2) In a civil or administrative proceeding (including a qui tam proceeding) involving an allegation of fraud or similar misconduct, a finding of liability.

(3) In a civil or administrative proceeding not involving an allegation of fraud or similar misconduct, an assessment of a monetary penalty.

(4) In a proceeding held by an appropriate official of an executive agency for debarment or suspension of the contractor; rescission or voiding of a contract; or termination of a contract for default because of violation of or noncompliance with a law or regulation, a final decision unfavorable to the contractor.

(5) In any proceeding shown in (1) through (4) which could have led to the associated outcome, settlement by consent or compromise. Except for qui tam suits in which the United States did not intervene, if the contractor, its agent, or its employees were at risk of one of the stated outcomes of the above proceedings and the proceeding is settled by consent or compromise, the settlement is treated as a loss for purposes of allowability of the costs. In the event of a settlement of a qui tam suit in which the Government did not intervene, the costs may be considered allowable if the contracting officer, in consultation with his or her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.

b. FAR 31.205-47(b)(5) also makes unallowable any costs of a proceeding involving the same underlying alleged contractor misconduct addressed in another proceeding whose

outcome determined the costs to be unallowable (see a. above). If a contractor loses, settles, or compromises one proceeding associated with alleged contractor misconduct, all litigation costs for all other proceedings related to the same misconduct are also unallowable.

c. Unallowability of costs under FAR 31.205-47(b) or (e) for a non-Federal Government proceeding may be waived when an appropriate cognizant U.S. Government official determines that the costs were incurred either (FAR 31.205-47(d)):

(1) as a direct result of a specific term or condition of a Federal contract; or

(2) as a result of compliance with specific written direction of the cognizant contracting officer.

7-2118.6 Proceedings Which Are Always Unallowable

a. Defense or prosecution of claims or appeals against the Federal Government (FAR 31.205-47(f)(1)). This includes the cost of preparing and presenting an appeal before a board of contract appeals (see Lear Siegler, Inc. (1979) ASBCA No. 20040, 79-1).

b. Organization, reorganization, mergers, or acquisitions, or resistance to merger or acquisition (FAR 31.205-47(f)(2) and FAR 31.205-27).

c. Defense of antitrust suits (FAR 31.205-47(f)(3)).

d. Defense or prosecution of lawsuits or appeals between contractors arising from such agreements as teaming arrangement, dual sourcing, co-production, or similar programs. However, these costs are allowable if incurred as a result of compliance with specific terms and conditions of the contract or written instructions or approval from the contracting officer (FAR 31.205-47(f)(5)).

e. Patent infringement proceedings if not required by the contract. This does not include general counseling services such as advice on patent laws and regulations. (FAR 31.205-30, FAR 31.205-47(f)(6)). Also see 7-702.

7-2118.7 Proceedings Allowable Without Cost Ceiling if the Contractor Prevails

Costs of the following proceedings are unallowable with the stated outcome; otherwise, the costs are allowable without the 80 percent ceiling:

a. Defense of suits brought by employees or ex-employees of the contractor under Section 2 of the Major Fraud Act of 1988 when the contractor was found liable or the case was settled (FAR 31.205-47(f)(4)).

b. Representation of, or assistance to, individuals, groups, or legal entities that the contractor is not "legally bound" to provide, arising from an action where the party being represented or assisted was convicted of a violation of law or regulation or was found liable (FAR 31.205-47(f)(7)).

7-2118.8 Proceedings Related to Bid Protests

Costs of bid protest proceedings may be incurred by both the protester and the contractor who received the award. Bid protest costs and costs of defending against protests are expressly unallowable under FAR 31.205-47(f)(8) for contracts awarded on or after October 7, 1996. A contractor who received the contract award being protested may have incurred legal expenses in defending against a bid protest as an “interested party.” Costs of defending against a protest are allowable, if reasonable, only if the contracting officer requested in writing that the contractor provide assistance in defending against a bid protest.

7-2118.9 Segregation and Withholding of Proceedings' Costs

a. FAR 31.205-47(g) requires that costs of a proceeding whose outcome determines cost allowability be segregated by the contractor and payment be withheld by the con-

tracting officer until the outcome is determined. Thus costs described in 7-2118.5 and 7-2118.7 should be segregated as incurred and not billed to the Government until the outcome is determined.

b. The contracting officer may enter into an advance agreement to make conditional payments to the contractor for such potentially unallowable costs if the contractor agrees to repay the Government with interest if the ultimate outcome of the proceeding makes the cost unallowable. In advising the contracting officer about such agreements, it should be noted that most such proceedings' costs are subject to the 80 percent ceiling even when the contractor wins. Therefore, the 20 percent over-ceiling amounts are not billable even with an advance agreement.

c. Costs related to proceedings which are unallowable regardless of the outcome (7-2118.6) are required to be segregated and removed from Government billings in accordance with CAS 405 and FAR 31.201-6.

d. Costs incurred using outside counsel or other outside resources should be easily identified and segregated. For costs incurred in-house, the contractor will need to have internal controls in place to identify costs as they are being incurred pursuant to the proceedings described in 7-2118.5, 7-2118.6, and 7-2118.7.

e. The contractor is not required to anticipate whether a routine inquiry or action will result in a potentially unallowable cost proceeding. Cost identification to (or incurrence for) a particular proceeding cannot begin before the contractor has notice of the proceeding, unless the contractor anticipates such a proceeding and on its own begins to incur costs. Anticipatory costs incurred by a contractor are considered to be related to a proceeding even if the unit of Government has not notified the contractor of the proceeding, or even if the contractor stops its preparations for a proceeding without notifying the Government. A specific notifying event or a contractor anticipatory decision, accompanied by incurrence of significant costs, triggers the segregation and withholding.

7-2118.10 Defense of Stockholder Suits

a. Auditors should question costs incurred to defend against stockholder suits that are related to contractor wrongdoing. The costs should be questioned as being directly related to an unreasonable action (the wrongdoing).

b. A stockholder suit may be brought by stockholders to protect their own interests or on behalf of the corporation to protect the interests of all the stockholders of the corporation. Not all stockholder suits are related to wrongdoing.

c. The defense of a stockholder suit is unreasonable in its nature if the suit is directly related to wrongdoing against the stockholders or is based on other previously established wrongdoing which the stockholders believe caused loss to the corporation. In either case, the stockholder suit and the associated defense costs would not be incurred but for an unreasonable act by the corporation or its agents. While it may be reasonable (or even required by law) for the corporation to defend itself or its agents against such suits, it would not have been placed in the position of defending itself if the wrongdoing had not taken place.

d. Wrongdoing includes actions such as those described in FAR 31.205-47(b) & (f)(4), intentional harm to other persons, and instances where there has been a reckless disregard for the harmful consequences of an action.

e. A stockholder allegation of wrongdoing, in itself, is not sufficient evidence to establish unallowability of the costs associated with a stockholder suit proceeding. Wrongdoing is demonstrated when a court or other official body has determined that wrongdoing occurred. Wrongdoing may also be established when a contractor reaches a settlement without a court or board finding of wrongdoing if the facts underlying the settlement indicate that the contractor or its agents engaged in wrongdoing.

f. When questioning costs incurred to defend against stockholder suits, the auditor's working papers should document the basis for the auditor's determination that the wrongdoing occurred and that the wrongdoing was the basis for the stockholder suit.

7-2118.11 Audit Considerations

a. The regulatory history for FAR 31.205-47 includes the following guiding principles which should be considered in applying the cost principle to specific cases:

(1) The Government should not pay for wrongdoing, the defense of wrongdoing, or the results or consequences of wrongdoing by contractors.

(2) The Government should not encourage litigation by contractors.

(3) Government contractors should not be put in a better position than contractors in the commercial area.

(4) The Government should not discourage contractors from enforcing the Government's rights and protecting the Government's interests.

b. The auditor should review costs segregated by the contractor to determine that all known unallowable and potentially unallowable proceedings costs have been included.

c. Legal services cost billings and other documents related to unallowable proceedings should be carefully reviewed to identify other unallowable proceedings and professional service costs which should also be segregated. Any in-house support costs (particularly in the legal and accounting departments) incurred for unallowable types of proceedings should also be segregated.

d. The audit of internal controls should include an evaluation of the contractor's practices and policies for approval/payment of bills submitted by outside legal counsel. Adequate internal controls include:

- written policies/procedures regarding the reasonableness and allowability of costs submitted by outside legal counsel;
- an established policy regarding the types of information and provisions to be included in agreements with outside legal firms;
- a designated reviewer(s) of bills submitted by outside legal counsel; and
- a procedure to be followed when the reviewer believes the outside legal bills contain duplicate or excessive charges.

When the contractor's internal controls are inadequate, the auditor should follow the guidance contained in 5-100.

e. The audit of internal controls over legal costs should also determine if the contractor has adequately trained its employees to recognize proceedings subject to the cost principle. Particular attention should be given to non-contract proceedings which might not be obvious and could be handled by attorneys not normally involved in Federal contract law. For example, if a dispute over a municipal ordinance violation or an IRS inquiry was subject to a penalty, the associated costs would be subject to the provisions of FAR 31.205-47(b).

f. In-house legal staff handles routine inquiries from Government agencies. Replies to such inquiries are not considered to be related to proceedings triggering segregation and withholding unless the contractor has specific knowledge that the inquiry is pursuant to a proceeding type listed in the cost principle or the contractor for its own reasons chooses to treat the inquiry as preparatory to an anticipated proceeding. A contractor might make such a choice because of other knowledge it has of the subject of the inquiry or any other reason to believe that it may be at risk.

g. If the contractor's internal controls for its in-house legal services are adequate, segregation of insignificant in-house costs related to minor proceedings (five-minute telephone calls and routine reply letters) should not be required. Aggressive defense or prosecution of proceedings listed in the cost principle cannot be considered insignificant, i.e., pleading not guilty, or appearing in court to make arguments, extensive in-house investigation, or other support activities.

h. Contractor responses to or support of audits by DCAA are not proceedings subject to disallowance within the meaning of the cost principle.

(1) Although criminal and civil proceedings have sometimes started as the result of DCAA audits, there is no presumption of a proceeding subject to the cost principle until an agency with sufficient authority opens such a proceeding and the contractor is notified. If a contractor chooses to treat the audit as a covered proceeding or to begin preparations for an appeal before a final decision is made, then the contractor cost associated with such preparations for a proceeding would be subject to segregation. The level and nature of the contractor's response would determine its treatment.

(2) Questioning costs based on the level or nature of the contractor’s response would be a sensitive matter. Any action which discouraged a full response from the contractor at the earliest point in the audit or negotiation process would be counter-productive to the speedy resolution of issues. Nevertheless, if the contractor begins extensive or specific activities obviously aimed at appeal of a contracting officer's decision or any other listed proceeding before an official decision or proceeding, the costs must be identified and segregated for billing withholding.

i. Contractor response to the assessment of a penalty by the ACO for inclusion of unallowable costs in a certified final overhead cost submission pursuant to FAR 42.709 is a proceeding as described in 7-2118.5a(3). The penalty proceeding is separate from the indirect rate resolution process and proceedings. Contractors should segregate and withhold the legal and accounting costs associated with the penalty proceeding until the outcome is determined.

j. If the contractor is not segregating and withholding costs of proceedings as required by the cost principle, the auditor should attempt to persuade the contractor to comply. The ACO should be notified of such instances concerning progress payments and a DCAA Form 1 (Notice of Costs Suspended and/or Disapproved) should be prepared for disallowance or suspension of such costs included in public vouchers. The auditor should take care in the oversight of this cost area so as not to prematurely disclose the existence of a Government proceeding to the contractor.

7-2119 Accounting for Lump-Sum Wages Resulting from Union Contracts

7-2119.1 General

This section provides audit guidance on the proper accounting for lump-sum wage payments resulting from union contracts. Union contracts may provide that union member employees receive a lump-sum payment in lieu of or in addition to an increase in their base wage rate. The specific terms of lump-sum payments may vary, but ordinarily the employee is not required to refund to the company any portion of the payment if the employee terminates employment prior to the end of the contract period.

7-2119.2 Future Benefit of Lump-Sum Payments

a. Neither the FAR, CAS, or Statements of Financial Accounting Standards (FAS) provide specific guidance on the accounting of lump-sum wages. The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) released Issue Summary (EITFIS) No. 88-23 dated December 1988, "Lump-Sum Payments Under Union Contracts" which provides specific guidance regarding the accounting for lump-sum payments. In the absence of specific guidance in the FAR, CAS, or FAS, the EITFIS which interprets GAAP is the appropriate accounting guidance to follow.

b. EITFIS 88-23 concludes that lump-sum payments are similar to an intangible asset in that the payments provided to the individuals in the current period will benefit future periods in the form of reduced payroll expense. In addition, the EITFIS 88-23 notes that Accounting Principles Board (APB) Opinion No. 12 requires that amounts estimated to be paid under deferred compensation contracts with employees be accrued in a systematic

and rational manner over the period of active employment beginning at the time the union contract is entered into. Although the lump-sum payments are generally made at the beginning of each year, they should receive similar treatment so that the expense is recognized in a systematic and rational manner. EITFIS 88-23 concludes that since the current lump-sum payments clearly benefit future periods, the matching concept requires that they be deferred and amortized over the period benefited; e.g., the period covered by the union contract.

7-2119.3 Multiple Lump-Sum Payments

EITFIS 88-23 addresses a single lump-sum payment. What happens when the union contract requires multiple lump-sum payments to be made over the period of the union contract? Discussions with the FASB staff led to the conclusion that each payment should be amortized from the scheduled date of payment to the date of the next scheduled payment. For example, if the union contract requires three lump-sum payments to be made on October 1, 1990, 1991, and 1992, with the contract expiring on September 30, 1993, then the costs of the October 1, 1990 payment should be amortized from October 1, 1990 to September 30, 1991, the October 1, 1991 payment from October 1, 1991 to September 30, 1992, and the October 1, 1992 payment from October 1, 1992 to September 30, 1993.

7-2119.4 Effect of Delay in Union Contract Execution

a. A union contract may not be signed until some time after the previous contract has expired. Generally, the new contract will be retroactive, with an effective date coinciding with the expiration date of the prior contract. In such cases, the employees will usually receive a lump-sum payment on the date the contract is signed, although the period covered by the contract begins some time earlier. The matching principles discussed in the previous paragraphs should also apply here; i.e., the lump-sum payments should be amortized over the period of the union contract. The question is whether the amortization period begins at the time the contract is executed or at the time it is effective. The key to answering this question is determining the time at which the liability constructively exists.

b. Statement of Financial Accounting Concepts (SFAC) No. 6 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." When employees continue to work after the old union contract expires in anticipation of a new contract, the act of continuing to work may constitute the past event referenced in the SFAC. In some circumstances, by continuing to work, the employees are showing that they anticipate receiving some future benefit. Under these circumstances, it would be difficult for the contractor to avoid making payments (a future transfer of assets) to these employees, either in the form of lump-sum payments, cost of living adjustments, or other benefits. Finally, the probable future sacrifice of benefits would be the lump-sum payments, provided it can be reasonably forecasted that these payments will be included in the new union contract. Therefore, if it can be reasonably forecasted that the payments will be made, then the costs should be amortized over the union contract period beginning on the effective date of the contract. Conversely, if it can be shown that future payments are not probable (e.g., lump-sum payments are not included in the union labor package, lump-sum payments are in dispute, or the union negotiating position includes elimination of the lump-sum payments), then a liability does not exist until the union contract is signed. Thus, if these conditions have been met, the lump-sum payments should be amortized over the period covering the date of contract execution through the date of contract expiration (or the date of the next scheduled payment in the case of multiple payments). The key factor is to determine if there was a prior expectation that the lump-sum payments would be included in the new union contract.

7-2119.5 Accounting Change

For those contractors whose accounting practice is to accrue the payments in advance or to expense the lump-sum when paid, a change from the current method to amortization over the union contract period constitutes a change in the method of assigning costs to cost accounting periods. The contractor is subject to the requirements of FAR 52.230-6, Administration of Cost Accounting Standards, including the preparation of a cost impact proposal for those contracts that contain this clause.

7-2120 Environmental Costs

7-2120.1 Summary

Environmental costs are normal costs of doing business and are generally allowable costs if reasonable and allocable. Some environmental costs must be capitalized when the incurrence of such costs improves the property beyond its acquisition condition or under certain circumstances when the costs are part of the preparation of the property for sale. If environmental clean-up efforts resulted from contamination caused by contractor wrongdoing, the clean-up costs are not allowable. Environmental costs may be subject to future recoveries from insurance companies and other sources, which may not be reasonably predictable at the time the environmental clean-up costs are paid. Some of the sources of recovery may be unknown when the contractor pays for environmental clean-up costs. As such, clean-up costs claimed or forecasted are usually not reflective of the contractor's ultimate liability for the costs. Therefore, the forecasted costs should be treated as contingent costs subject to FAR 31.205-7, Contingencies. Also, any otherwise allowable incurred environmental clean-up costs should be accepted contingent upon the Government sharing in any future recoveries from insurance policies or other sources. Advance agreements should be recommended to protect the Government's interests in any future recoveries of clean-up costs reimbursed by the Government.

7-2120.2 Types of Environmental Cost

Environmental costs include costs to prevent environmental contamination, costs to clean up prior contamination, and costs directly associated with the first two categories including legal costs. Costs associated with fault-based liabilities to third parties are not environmental costs (see 7-2120.12).

7-2120.3 Cost Principles Applicable to Environmental Cost

The costs incurred to clean up environmental contamination are considered to be normal business expenses. The primary cost principles applicable to environmental costs are FAR Subsections: 31.201-2, Allowability; 31.201-3, Reasonableness; and 31.201-4, Allocability. Other cost principles applicable in specific circumstances include FAR Subsections: 31.201-5, Credits; 31.205-3, Bad debts; 31.205-7, Contingencies; 31.205- 15, Fines, penalties, and mischarging costs; and 31.205-47, Costs related to legal and other proceedings.

7-2120.4 Normal Business Expense

Normal business expenses are those expenses that an ordinary, reasonable, prudent businessperson would incur in the course of conducting a competitive for-profit enterprise. In the context of environmental costs, normal business expenses are measured by the actual costs incurred in the period. Not all normal business expenses are allowable for Government contract costing purposes. To be allowable, costs must also be reasonable in amount, allocable to Government contracts, and not be specifically unallowable under Government cost principle provisions.

7-2120.5 Reasonableness of Environmental Cost

a. The key concept for reasonableness of environmental costs (both preventive and remedial) is that the methods employed and the magnitude of the costs incurred must be consistent with the actions expected of an ordinary, reasonable, prudent businessperson performing non-government contracts in a competitive marketplace. A Government contractor should take measures to prevent or reduce contamination which a prudent businessperson would pursue to reduce its environmental costs.

b. Determination of reasonableness of clean-up costs also requires an examination of the circumstances of the contaminating events. Contractors should not be reimbursed for increased costs incurred in the clean-up of contamination which they should have avoided. In order to be allowable, contamination must have occurred despite due care to avoid the contamination, and despite the contractor's compliance with the law. Increased costs due to contractor delay in taking action after discovery of the contamination are not allowable. For forward pricing purposes, the costs should be net of reasonably available recoveries from insurance which would offset the clean-up costs.

7-2120.6 Allocability of Environmental Cost

Costs incurred to prevent environmental contamination will generally be allocated as an indirect expense using a causal or beneficial base. Costs to clean up environmental contamination caused in prior years will generally be period costs allocated through a company's G&A expense pool. Clean-up costs incurred at a home-office, group-office, or other corporate-office level should be allocated to the segment(s) associated with the contamination for inclusion as part of the segment's G&A cost. Clean-up costs incurred by a segment should be allocated through its G&A expense pool if no other segments were associated with the contamination. If other segments participated in the contamination, a fair share of the clean-up costs should be allocated to the other segments for inclusion in their G&A expense pool. This is in accordance with CAS 403 and 410 for CAS-covered contractors.

7-2120.7 Environmental Cost Related to Previous Sites and Closed Segments

a. If costs arise from a site the contractor segment previously occupied, the costs for clean-up would usually be allocated to the segment's site where the work was transferred. However, if the segment is closed with none of its former work remaining within the company, the cost would generally not be directly allocable to other segments of the business. There are many possible variations for the cost accounting treatment of environmental costs for a closed segment, depending on the facts of the particular situation. Information auditors should consider includes:

(1) Are any aspects of the closed segment's business being continued by the remaining segments?

(2) Is the site still owned by the contractor? If it is, what is its current use?

(3) If the site is not currently owned by the contractor, what were the terms of the sale in relation to environmental costs? The contractor may have retained environmental clean-

up liability in exchange for a higher sale price or the buyer may have accepted full liability in exchange for a lower purchase price.

b. Each closed segment case must be reviewed based on its own facts to determine if the costs incurred for the closed segment should be directly allocated to other segments, be allocated as residual home office costs, or be treated as an adjustment of costs associated with the closing of the segment.

7-2120.8 Capitalization of Environmental Cost

a. Generally Accepted Accounting Principles as expressed in the Emerging Issues Task Force (EITF) Issue No. 90-8 indicate that environmental costs would normally be expensed in the period incurred unless the costs constitute a betterment or an improvement, or were for fixing up property held for sale. Betterments and improvements which exceed the contractor's capitalization threshold must be capitalized. Costs of fixing up a property for sale are generally considered to be part of the sales transaction, if realizable from the sale.

b. It would be unreasonable for the Government to accept as current period costs expenditures which increase the value of contractor assets; accordingly, these costs should be capitalized for Government contract costing purposes.

c. The EITF discusses the following situations where capitalization of the expenditures may be appropriate:

(1) Cost incurred to clean-up a site. These costs should be capitalized if the clean-up effort improves the property beyond the original condition of the property at acquisition. The costs incurred to restore a property to its acquisition condition are generally expensed unless they extend the property's useful life.

(2) Costs incurred to fix up property held for sale. These costs are to be capitalized, if they are realizable from the sale. A contractor may be required to incur contamination clean-up costs far in excess of any amount reasonably realizable upon sale. In the case of costs in excess of realizable costs, the excess amounts are expensed or capitalized depending on whether they improved the property beyond the property's condition at acquisition.

(3) Costs incurred to prevent future contamination. These costs would have an economic value in more than one period and should be amortized over their useful life. Capital assets purchased or constructed to prevent future contamination must be capitalized consistent with CAS 404 and GAAP.

d. Examples of capitalization of environmental costs:

(1) A contractor acquires property which was contaminated by a previous owner. Clean-up costs are capitalized as an improvement. Costs of ground and water clean-ups are increases to the book value of the land.

(2) A contractor cleans up contamination from its own operations since acquiring the property. If the property is being held for continuing use, the costs are expensed as period costs.

(3) A contractor incurs $80 million to clean up contamination it caused at a site which has a book value of $100 million and which is being held for sale at a price of $500 million. The $80 million is realizable from the sale and therefore, should be capitalized. If the sales price were $100 million instead, none of the $80 million would be realizable and it should be expensed in the period.

(4) The clean-up in example (3) is related to contamination existing at acquisition. In this situation, the $80 million would be capitalized even for the sale at a price of $100 million and would produce an $80 million loss on the sale. In effect, this would recognize that the contractor overpaid for the land at the time of acquisition.

7-2120.9 Potentially Responsible Party (PRP) for Environmental Clean-Up

a. The environmental laws usually require each Potentially Responsible Party (PRP) for contamination at a site to be individually liable for the complete clean-up of the site. The

allowable environmental cost should only include the contractor's share of the clean-up costs based on the actual percentage of the contamination attributable to the contractor.

b. Contractors with the ability to pay will be required to fund clean-up efforts for sites where they are named as PRPs. If the Government accepted contractor costs on an ability to make payment basis, a Government contractor could end up billing a disproportionate share of a site's clean-up costs to Government contracts instead of recovering the excess payments from other PRPs.

7-2120.10 Environmental Bad Debts of Other PRPs

a. When a contractor pays for more than its share of the site clean-up, the contractor receives a right of contribution (or subrogation) against the other PRPs who did not make an appropriate contribution to the clean-up effort. If a contractor pays out more than its share of clean-up costs, it is up to that contractor to exercise its contribution rights to collect the amount over its share from the other PRPs who did not pay their share.

b. If a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are, in their essential nature, bad debts. Bad debts and associated collection costs, including legal fees, are unallowable costs (FAR 31.205-3 and 31.204(c)). However, see c. below for the exception to this guidance.

c. The guidance under a. and b. above does not apply in situations when all of the following three conditions are met:

(1) a contractor is legally required to pay another PRP's share of the clean-up costs,

(2) that PRP is out of business, and

(3) there is no successor company having assumed that PRP's liabilities.

When these three conditions are met, the clean-up costs which are attributable to the other PRP's contamination should not be disallowed as bad debt type expenses since there is no one against whom the contractor can take recovery action.

7-2120.11 Insurance Recovery for Environmental Cost

a. The insurance industry does not currently consider environmental contamination an insurable risk (at a reasonable cost) in most circumstances. The major exception is a sudden accidental contamination, such as an oil tanker spill resulting from a collision. If such insurance is available and reasonably priced, its cost would be allowable.

b. Some courts have found that policies written before the insurance industry began to specifically exclude environmental coverage do afford coverage for environmental damages. Any insurance recoveries for a contamination clean-up will be applied as credits against any costs which were or would be otherwise allowable for that clean-up effort.

c. Many environmental contamination events now generating costs were insured, either under specific environmental impairment or comprehensive general liability coverages, before the insurance industry developed its current underwriting exclusions. It is the earlier insurance policies which are the source of the potential claims. Most insurance companies are contesting the claims and when payments are made, they are based on partial settlements or are made after lengthy legal battles. When a claim is possible and economically feasible, the contractor should pursue it.

d. The auditor should inquire about the existence of environment contamination policies and comprehensive general liability policies which do not contain environmental clean-up cost exclusions. The kind and amount of policies in effect from the time of the contamination to the current date are significant for the purposes of negotiating costs and prices for Government contracts.

e. The contractor's support for proposed clean-up costs should include a description of any insurance claim the contractor may have which could reduce the ultimate liability. The amount and timing of these claims for contract costing is a potential subject for negotiation which should be addressed by the auditor and ACO (see 7-2120.15b.).

7-2120.12 Fault-Based Liabilities to Third Parties

a. Examples of liabilities to third parties include health impairment, property damage, or property devaluation for residents or property owners near a contaminated site. These third-party claims arise from legal theories of tort and trespass, and losses from such claims would be unreasonable in nature for payment on a Government contract. Such costs are not environmental costs.

b. In the absence of a specific court finding of tort or trespass by the contractor, the facts of each case should be carefully examined to determine if any contractor payments are nonetheless based on those or other fault-based legal theories.

7-2120.13 Environmental Wrongdoing

a. If environmental clean-up costs are the result of contractor violation of laws, regulations, orders or permits, or disregard of warnings for potential contamination, the clean-up costs including any associated costs, such as legal costs, would be unreasonable and thus unallowable.

b. Fines or penalties are expressly unallowable under FAR 31.205-15 and any costs of legal proceedings where a fine or penalty could be imposed are covered by FAR 31.205-47. However, the incurrence of clean-up costs to correct environmental contamination is not a penalty; it is a legal obligation.

c. Most environmental laws do not require the contractor to be guilty of a violation to enforce contractor payment for clean-up costs. Therefore, it is rare for Government agencies to bring criminal, or even administrative, charges for contamination. Auditors should request the contractors to provide documents sufficient to allow a determination as to how the contamination occurred. The Environmental Protection Agency, in designating a company as a Potentially Responsible Party (PRP), will normally provide a written rationale as to how the company contributed to the contamination at a site.

d. For purposes of disallowing the costs, the Government must show that the preponderance of the evidence supports the position that the contractor violated the law, regulation, order or permit, or the contractor disregarded warnings for potential contamination. That is, it must be more likely that the Government's allegation of wrongdoing is correct than that it is not.

e. The contractor should not be denied recovery of clean-up costs, if it complied with the laws, regulations, and permits in effect at the time of the contamination.

7-2120.14 Contingent Nature of Environmental Cost

a. Ideally, the Government wants to negotiate contract prices based on the net environmental costs after recovery of insurance claims and any amounts owed by later-discovered PRPs. At the time that environmental costs are being incurred, it may not be possible to reasonably estimate what the net costs will ultimately be. Even where it is settled that a contractor will be required to clean up a prior contamination, it is rare that projections of the costs necessary to complete the project can be made with a reasonable degree of certainty.

b. Because of the uncertainty of the cost projections and of future recoveries from the insurance companies, as well as the difficulty in identifying all the other PRPs, both forecasted and incurred environmental clean-up costs and related legal costs that are allowable should be accepted contingent upon the Government participating in any insurance recoveries or the identification of other PRPs at a later date. See 7-2120.15.

7-2120.15 Advance Agreements for Environmental Cost

a. There are many areas of judgment involved in the determination of allowability for environmental costs. It is necessary for the auditor and the ACO to coordinate closely during

the audit. Advance agreements should be considered to facilitate negotiations with the contractor.

b. Acceptance of the costs may require some form of agreement to protect the Government's interest. Any agreement to accept costs for clean-ups or for the costs of pursuing insurance recoveries should also provide expressly for Government participation in any insurance claim recoveries and any reductions resulting from later-discovered PRPs. Consideration should also be given to requiring contractor diligence in pursuing insurance recoveries and identifying contamination attributable to other PRPs. Advance agreements should provide for recovery of expenses priced into fixed price contracts if those expenses are later reduced based on subsequent identification of additional PRPs or insurance coverage after the agreement on price.

7-2120.16 Environmental Clean-Up Trust Funds

a. Making payments for clean-up efforts through a trust fund is a device for the administrative and the financing convenience of the PRPs named at a given site. The allowability of costs on Government contracts should be based on the contractor's allocable share of the actual clean-up obligations. Contractor payments into a fund before clean-up costs are incurred are not an expense to the contractor until actual costs have been incurred for the site clean-up work. The excess or early payments are prepaid expenses.

b. It is the contractor's responsibility to support its claimed costs as allowable contract costs. Before accepting the contributions made to a trust fund as contract costs, auditors should obtain and evaluate sufficient supporting data to determine the allowability and the actual payment of the claimed costs. When the claimed "trust fund" costs are significant, the contractor should be requested, as part of its cost support, to arrange for Government audit access to the accounting records of the trust fund.

7-2121 Domestic and Foreign Taxes - Differential Allowances

Tax differential allowances represent employee compensation for additional Federal, state, local, or foreign income taxes resulting from domestic or foreign assignments.

7-2121.1 FAR Applicability

a. For contracts entered into prior to December 31, 1996, under FAR 31.205-6(e), differential tax allowances for foreign assignments are unallowable if calculated directly on the basis of an employee's specific increase in income taxes. A specific increase is evidenced by any calculation that considers the employee's specific income tax liability, regardless of whether the calculation is made before or after the employee's actual taxes are known.

b. For contracts entered into on or after December 31, 1996, differential tax allowances for foreign assignments are allowable under FAR 31.205-6(e), even if the differential tax allowance is calculated directly on the basis of an employee’s specific increase in income tax.

c. FAR 31.205-6(e) disallows any differential tax allowances for domestic assignments.

7-2121.2 Allowable Foreign Tax Differential Allowances

a. A foreign tax differential complies with the FAR provision if it is a fixed payment to employees on foreign assignment, such as a $3,000 annual payment, or if it is computed based on a percentage, such as 15 percent of all other foreign differential pay allowances.

b. Separate foreign tax differentials based on marital status and/or number of dependents comply with the FAR provision. An example would be a payment of 15 percent of the total amount of differential pay for all married employees and 10 percent for all single employees. Another example would be a differential of $3,000 for all employees, with an additional $500 for each dependent.

7-2121.3 Unallowable Foreign Tax Differential Allowances - Contracts Entered Into Prior to December 31, 1996

a. Foreign tax differentials based on the specific tax liability of a specific employee do not comply with the FAR provision in effect prior to December 31, 1996. For example, assume an employee has an estimated (or actual) tax liability of $5,000. Further assume that it is estimated that the tax liability would have been $3,000 had the employee remained on domestic assignment. As a result, the employee receives a tax differential of $2,000. This amount was computed based on the employee's specific tax liability and is therefore unallowable.

b. Foreign tax differentials based on the increase in the tax rate for a specific employee or employees do not comply with the FAR provision. For example, assume that there are three employees, each of whom is single with no dependents. However, because of differing investment income and/or itemized deductions, each employee has a different increase in his/her tax rate as a result of the foreign assignment. If the contractor computes the tax differential payments using 10 percent for Employee A, 12 percent for Employee B, and 14 percent for Employee C, the payments would be unallowable, since they are computed based on specific tax liabilities of specific employees.

7-2122 Mentor-Protégé Program Costs

7-2122.1 General

a. The Mentor-Protégé Program is a socioeconomic program to aid small, disadvantaged businesses. It teams a well-established DoD contractor with one of its small, disadvantaged subcontractors to provide the small business with training and guidance in the art of running a successful business. DoD contractors may submit proposals for Mentor-Protégé agreements through September 30, 2010. The DFARS coverage is in Subpart 219.71 and in DFARS Appendix I.

b. Mentor-Protégé Program costs are generally costs for developmental assistance that are in excess of the costs the prime contractor would normally incur in the administration of its subcontracts with small businesses. The costs can be internal costs of the mentor firm incurred to provide assistance using its own personnel or costs paid to third-party assistance providers that qualify under DFARS Appendix I-106(d).

7-2122.2 Reimbursement or Credit of Developmental Assistance Costs

a. The Mentor-Protégé Program provides two types of incentives for DoD contractors to assist protégé firms in enhancing their capabilities. They are: (1) Reimbursement for developmental assistance costs through (a) a separately priced contract line item on a DoD contract; or (b) a separate contract, upon written determination by the cognizant component Director, Small and Disadvantaged Business Utilization (SADBU), that unusual circumstances justify reimbursement using a separate contract; and, (2) Credit toward applicable subcontracting goals, established under a subcontracting plan negotiated under FAR Subpart 19.7 or under the DoD Comprehensive Subcontracting Test Program (see DFARS 219.702), for developmental assistance costs that are not reimbursed.

b. Mentor-Protégé Program costs will be classified as direct contract costs when the mentor-protégé effort is included as a separately priced line item of a contract or when DoD has awarded a separate contract solely for the mentor-protégé effort.

c. Mentor-Protégé Program costs incurred under agreements entered into prior to December 15, 2004 may be classified as indirect costs if there is no specific contractual requirement provided. Such costs should be allocated using the method normally used by the contractor to allocate indirect subcontract administration expenses.

7-2122.3 Allowability of Costs

a. Normal subcontract administration costs are allowable in accordance with the prime contractor's disclosed or established practices; they are not considered developmental assistance costs eligible for either credit or reimbursement under the Mentor-Protégé Program.

b. Costs incurred in excess of normal subcontract administration costs, for the purposes set forth in DFARS Subpart 219.71, are allowable if the costs are:

(1) incurred in accordance with an approved mentor-protégé agreement;

(2) incurred prior to October 1, 2013;

(3) incurred by using mentor firm personnel to provide direct assistance to the protégé firm or by the mentor firm paying an approved outside provider of assistance; and

(4) otherwise reasonable, allocable, and allowable.

c. Mentor firms are urged to reach advance agreements with ACOs on the allowability of costs under an approved Mentor-Protégé Program agreement.

7-2122.4 Impact on Subcontract Awards

The mentor firm may award subcontracts noncompetitively to the protégé firm as part of an approved agreement. The Director, SADBU of the cognizant military department or defense agency is responsible for approving mentor-protégé agreements. Also, special advance payment and progress payment methods are available to pay the protégé subcontractor.

7-2122.5 Credits Against Small, Disadvantaged Business Subcontracting Goals

a. The Mentor-Protégé Program provides for credits toward subcontracting goals for those mentor firms electing to enter into a credit mentor-protégé agreement. The cost of any developmental assistance incurred pursuant to an approved credit mentor-protégé agreement is not reimbursed to the mentor firm as a direct or indirect contract cost, but is administratively applied toward the attainment of the mentor firm's Small and Disadvantaged Business Subcontracting Goals at the following multiples of the costs incurred (see DFARS Appendix I-110.1(d)):

(1) Four times the total amount of developmental assistance costs attributable to assistance provided by small business development centers, historically Black colleges and universities, minority institutions, and procurement technical assistance centers;

(2) Three times the total amount of developmental assistance costs attributable to assistance furnished by the mentor’s employees; and

(3) Two times the total amount of other developmental assistance costs incurred in carrying out the developmental assistance program.

b. When requested by the contracting officer, the auditor should verify that amounts claimed as subcontracting plan credits represent eligible costs and are properly classified for purposes of the credit calculations.

7-2123 Bonuses and Incentive Compensation

7-2123.1 General

a. Many companies have adopted various bonus and incentive compensation plans to compensate employees. Bonuses and incentive compensation can take many forms, including cash, stock options, stock appreciation rights, phantom stock plans, etc., or some combination thereof and may be paid in the current period or future period(s).

b. Under traditional stock bonus and incentive plans, a company grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price. Stock

bonuses (e.g., stock options and stock appreciation rights) are normally granted for future services of employees.

c. Phantom stock plans differ from stock option plans in that no stock is transferred to the employee and no cash outlays are required. Contingent stock shares are attributed to the employee. The employee's account may be increased by the equivalent dividends issued and any appreciation in the market price of the stock over the price of the stock on the measurement date.

d. Some corporations have replaced or supplemented traditional stock bonus and incentive plans with more complex plans which are often based on variable factors that depend on future events. For example, a corporation may award a fixed number of shares at a fixed price per share based on a stated increase in the company's earnings per share.

7-2123.2 Allowability of Costs and Audit Considerations

a. Auditors should review the bonus and incentive compensation plans to obtain an understanding of the unique terms and conditions of each plan, e.g., corporation awards a variable number of shares of stock at the end of a fixed period based on a fixed percentage increase in stock value over a stated period of time.

b. Bonuses and incentive compensation are allowable as set forth in FAR 31.205-6(f), (i), and (k) provided that the basis of the award is adequately supported and the award is made:

- According to an agreement established between the contractor and the employee before the services are rendered, or
- In conformity with an established plan or policy consistently followed.

c. Allowable costs for stock bonuses (e.g., stock options and stock appreciation rights) are limited to the fair market value of the stock on the measurement date, the first date that the number of shares awarded is known. If the stock option or stock appreciation price is equal to or greater than the market price on the measurement date, then no costs are allowed for contracting purposes.

d. Compensation based on changes in the prices of corporate securities or corporate security ownership (such as stock options, stock appreciation rights, phantom stock plans, and junior stock conversions) are expressly unallowable under FAR 31.205-6(i).

(1) Contracts awarded on or after September 24, 1996. FAR 31.205-6(i) was revised, effective September 24, 1996, to expressly disallow:

- Any compensation which is calculated, or valued, based on changes in the price of corporate securities;
- Any compensation represented by dividend payments or which is calculated based on dividend payments; and
- Payments to an employee in lieu of the employee receiving or exercising a right, option, or benefit which would have been unallowable under paragraph (i).

The September 24, 1996 revision to FAR 31.205-6(i) did not introduce any new policy (i.e., compensation based on changes in corporate securities is unallowable). Rather, the Government decided to be clear regarding its long-standing position that compensation costs based on changes in the price of corporate securities are unallowable, regardless of the name given the plan (e.g. stock options, stock appreciation rights, etc.) as emphasized in the Federal Register preamble language to the September 24, 1996 revision to FAR 31.205-6(i). This point is further emphasized in the Cost Principle Committee's November 7, 1995 report to the DAR Council. The Committee explanation for the revisions to FAR 31.205-6(i) states:

> These revisions highlight the Government's long-standing position that compensation based on changes in securities prices is not compensation based on work actually performed and thus, is unallowable...Further, we believe that dividend payments are essentially a distribution of profits and likewise should not be reimbursed by the Government. Since new stock scenarios are constantly emerging relative to the payment of bonuses for stock price changes, rather than trying to cover each indi-

vidually in the cost principle, we have streamlined this paragraph to include a list of general prohibitions.

(2) Contracts awarded prior to September 24, 1996. Contracts awarded prior to September 24, 1996 are subject to the prior provisions of FAR 31.205-6(i) which did not expressly disallow compensation costs based on changes in the prices of corporate securities or dividend payments.

(a) For audits of compensation costs based on changes in the prices of corporate securities, auditors should question such costs citing FAR 31.205-6(i) and FAR 31.204(c). While it could be argued that compensation based on changes in corporate securities is not specifically addressed in FAR 31.205-6, the lack of specific coverage in the FAR does not make the costs allowable or unallowable. As stipulated by FAR 31.204(c), it is necessary to determine if the treatment of any similar or related items to the cost in question is included in FAR 31.205. It is DCAA's position that compensation based on changes in all types of corporate securities (regardless of the name of the plan) is similar to the treatment of stock options, stock appreciation rights, phantom stock plans, and junior stock conversions specifically addressed in FAR 31.205-6(i). The only costs that are allowable are those costs recognized on the measurement date (see 7-2123.2c.).

(b) Allowability of dividend payments prior to the September 24, 1996 revision to FAR 31.205-6(i) is determined by the nature of the stock awarded to the employee. In the Grumman case (ASBCA No. 34665, 90-1), the board found that dividends on restricted stock represent allowable compensation since the payments are contingent upon continuing employment. Therefore, such costs are allowable prior to the September 24, 1996 revision to FAR 31.205-6(i). Conversely, dividends paid on unrestricted stock vested in the employee are not allowable compensation costs under FAR 31.205-6 since employees have a right to receive the dividends as owners of the stock. Dividend payments on unrestricted stock represent a distribution of profits, not compensation for employee services.

e. The allowability of deferred compensation awards is subject to the provisions of FAR 31.205-6(k) which stipulates that awards made in periods subsequent to the period when the work being remunerated was performed are not allowable. The costs of deferred compensation accruals are subject to the provisions of CAS 415, Accounting for the Cost of Deferred Compensation.

7-2124 Administrative Leave Due to Weather-Related Closures

When contractor personnel receive paid administrative leave due to inclement weather, the allowability and accounting treatment of such payments should be evaluated on a case-by-case basis in accordance with FAR 31.205-6. Paid absences are fringe benefits that, per FAR 31.205-6(m)(1), are allowable to the extent that they are reasonable in nature and amount and are required by law, employer-employee agreement, or an established policy of the contractor. The reasonableness of the amount paid is generally not an issue. The issue is whether or not the circumstances warranted the payment of administrative leave. Some factors to consider in determining reasonableness include the severity of the weather conditions and whether other businesses and organizations in the same geographical location were closed. The fact that the Federal Government suspended similar operations in the area due to the weather generally would support that it was reasonable for the contractor to incur the administrative leave costs. If the costs are determined to be allowable, they should be charged in accordance with the contractor's disclosed or established cost accounting practice for charging paid absences.

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CHAPTER 8

8-000 Cost Accounting Standards

8-001 Scope of Chapter

This chapter presents guidance for implementing DCAA responsibilities in connection with the Cost Accounting Standards Board (CASB) Rules, Regulations, and Standards. The CASB Rules, Regulations and Standards (48 CFR Chapter 99) are included in the FAR as Appendix, Cost Accounting Preambles and Regulations, and are available on the Acquisition Knowledge Sharing System (AKSS) web site.

8-100 Section 1 --- Overview - Cost Accounting Standards Board (CASB) Rules and Regulations

8-101 Introduction

This section provides the legal background and purposes of implementing the Cost Accounting Standards, including the rules and regulations, and audit responsibilities in implementing Section 26 of the Federal Procurement Policy Act, Public Law 100-679 (41 U.S.C. 422).

8-102 Background

8-102.1 Establishment of Cost Accounting Standards Board (CASB)

a. The original CASB was established in 1970 as an agency of Congress in accordance with a provision of Public Law 91-379. It was authorized to (1) promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts in excess of $100,000 and (2) establish regulations to require defense contractors and subcontractors, as a condition of contracting, to disclose in writing their cost accounting practices, to follow the disclosed practices consistently and to comply with duly promulgated cost accounting standards.

b. The original CASB promulgated 19 standards and associated rules, regulations and interpretations. It went out of existence on September 30, 1980.

c. On November 17, 1988, President Reagan signed Public Law 100-679 which reestablished the CASB. The new CASB is located within the Office of Federal Procurement Policy (OFPP) which is under the Office of Management and Budget (OMB). The CASB consists of five members: the Administrator of OFPP who is the Chairman and one member each from DoD, GSA, industry and the private sector (generally expected to be from the accounting profession).

8-102.2 CAS Working Group

a. To interpret the CASB rules and regulations for implementing in DoD procurement practices, DoD established in 1976 a CAS Steering Committee and Working Group. During its existence, the CAS Working Group issued a number of Interim Guidance Papers on a variety of subjects, most of which are still effective and have been incorporated into this chapter. The Interim Guidance Papers were approved by the Office of the Secretary of Defense (R&E) and given wide distribution.

b. The papers issued by the CAS Working Group that are still in effect are listed below. The full text of the papers can be found in the CCH CAS Guide and as a link in the DCAA Intranet under Headquarters Organization Information, Policy & Plans, Accounting and Cost Principles (PAC):

No.	Subject
76-2	Administration of Cost Accounting Standards
76-3	Policy for Application of CAS to Subcontracts
76-4	Determining Increased Costs to the Government for CAS Covered FFP Contracts
76-5	Treatment of Implementation Costs Related to Changes in Cost Accounting Practices
76-6	Application of CAS Clause to Changes in Contractor's Established Practices when a Disclosure Statement has been Submitted
76-7	Significance of "Effective" and "Applicability" Dates Included in CAS
76-9	Measurement of Cost Impact on FFP Contracts
77-10	Retroactive Implementation of CAS When Timely Compliance is Not Feasible
77-13	Applicability of CAS 405 to Costs Determined to be Unallowable on the Basis of Allocability
77-15	Influence of CAS Regulations on Contract Terminations
77-16	Applicability of CAS to Letter Contracts
77-17	Identification of CAS Contract Universe at a Contractor's Plant
77-18	Implementation of CAS 414 - Cost of Money as an Element of the Cost of Facilities Capital; and DPC 76-3
77-19	Administration of Leased Facilities Under CAS 414
77-20	Policy for Withdrawing Adequacy Determination of Disclosure Statement
78-21	Implementation of CAS 410, Allocation of Business Unit G&A Expenses to Final Cost Objectives
78-22	CAS 409 and the Development of Asset Service Lives
79-23	Administration of Equitable Adjustments for Accounting Changes not Required by New Cost Accounting Standards
79-24	Allocation of Business Unit G&A Expense to Facilities Contracts
81-25	Change in Cost Accounting Practice for State Income and Franchise Taxes as a Result of Change in Method of Reporting Income from Long Term Contracts

8-102.3 Current Status of CAS - Recent Substantive CASB Promulgations

a. On June 6, 1997, the CASB issued a final rule amending 9903.201-1(b)(6) to exempt from the requirements of CAS, firm-fixed-price and fixed-price with economic price adjustments (provided that price adjustment is not based on actual costs incurred) contracts and subcontracts for the acquisition of commercial items. This exemption was effective July 29, 1996, with issuance of an interim rule. The exemption is a result of Section 4205 of the Federal Acquisition Reform Act of 1996 which amends 41 U.S.C. 422(f)(2)(B). The final rule replaces the prior catalog and market price exemption at 48 CFR 9903.201-1(b)(6) and is applicable to all contracts and subcontracts awarded on or after July 29, 1996. The rule rescinds the CASB's December 18, 1995 Memorandum to Agency Senior Procurement Executives.

b. On June 9, 2000, the CASB issued a final rule affecting CAS applicability, thresholds and waiver of CAS coverage to implement provisions included in the National Defense Authorization Act for FY 2000. An interim rule had previously been issued effective April 2, 2000. The main features of the rule are:

- Increases the threshold for full CAS coverage and Disclosure Statements from $25 million to $50 million,
- Adds an exemption from CAS for contracts less than $7.5 million, provided the business unit is not currently performing any CAS-covered contracts valued at $7.5 million or more,
- Replaces the previous exemption at 48 CFR 9903.201-1(b)(15) (firm-fixed-price (FFP) contracts awarded without any cost data) with an exemption for FFP contracts awarded based on adequate price competition without cost or pricing data, and

- Delegates CAS waiver authority to heads of executive agencies under certain circumstances.

The FAR implemented the CAS changes on waiver authority in an interim rule effective June 6, 2000 (subsequently issued as a final rule without change). The waiver authority is discussed in 8-103.10.

c. On June 14, 2000, the CASB issued a final rule on Changes in Cost Accounting Practices. The CASB streamlined the final rule as a result of the expected decline in CAS-covered contracts resulting from the recent changes in applicability and thresholds and as a result of a proposed FAR rule on cost impact administration. The following summarizes the key aspects of the rule:

- Clarifies the applicable interest rate to use when recovering increased cost paid as a result of a noncompliance,
- Provides definitions of required, unilateral, and desirable changes to cost accounting practices,
- Expands existing guidance regarding "findings" determinations by the contracting officer,
- Clarifies the aggregate value of contract adjustments for unilateral changes and estimating noncompliances, and
- Includes an exemption from the cost impact process for cost accounting practice changes directly associated with external restructuring activities.

8-103 CAS Coverage Requirements and CAS Exemptions

The following subsections contain a summary of CAS coverage requirements (see Figure 8-1-1).

8-103.1 Educational Institutions - CAS

Contracts and subcontracts with educational institutions are subject to special CAS coverage (see 13-209). Contracts and subcontracts performed by federally funded research and development centers operated by educational institutions are subject to CAS coverage for commercial companies.

8-103.2 CAS Exemptions

The following categories of contracts and subcontracts are exempt from all CAS requirements (48 CFR 9903.201-1):

a. Sealed bid contracts.

b. Negotiated contracts and subcontracts (including interdivisional work orders) less than $650,000.

c. Contracts and subcontracts with small businesses. FAR Subpart 19.3 addresses determination of status as a small business. A small business (offeror) is one which represents, through a written self-certification, that it is a small business concern in connection with a specific solicitation and has not been determined by the Small Business Administration (SBA) to be other than a small business. The contracting officer accepts an offeror's representation unless that representation is challenged or questioned. If the status is challenged, the SBA will evaluate the status of the concern and make a determination. (Specific standards appear in Part 121 of Title 13 of the Code of Federal Regulations.)

d. Contracts and subcontracts with foreign governments or their agents or instrumentalities or, insofar as the requirements of CAS other than CAS 401 and 402 are concerned, any contract or subcontract awarded to a foreign concern.

e. Contracts and subcontracts in which the price is set by law or regulation.

f. Firm-fixed-price contracts and subcontracts for the acquisition of commercial items.

g. Contracts or subcontracts less than $7.5 million, provided that, at the time of award, the business unit of the contractor or subcontractor is not currently performing any CAS-

covered contracts or subcontracts valued at $7.5 million or greater. “Currently performing” is defined in 48 CFR 9903.301, Definitions. A contract is being currently performed if the contractor has not yet received notification of final acceptance of all supplies, services, and data deliverable under the contract (including options). “Currently performing” is intended to reflect the period of time when work is being performed on contractual effort. The period ends when the Government notifies the contractor of final acceptance of all items under the contract. If a contractor is currently performing a CAS-covered contract of $7.5 million or greater, CAS coverage is triggered and new awards are subject to CAS (unless they meet another exemption under 9903.201-1(b)).

h. Subcontracts under the NATO PHM Ship program to be performed outside the United States by a foreign concern.

i. Contracts and subcontracts to be executed and performed entirely outside the United States, its territories, and possessions.

j. Firm-fixed-price contracts and subcontracts awarded on the basis of adequate price competition without submission of cost or pricing data.

8-103.3 Types of Coverage

a. Full coverage requires that the business unit (as defined in CAS 410-30(a)(2))comply with all of the CAS in effect on the contract award date and with any CAS that become applicable because of new standards (CAS clause at FAR 52.230-2). Full coverage applies to contractor business units that:

(1) Received a single CAS-covered contract award, including option amounts, of $50 million or more; or

(2) Received $50 million or more in CAS-covered contract awards during the immediately preceding cost accounting period.

The $50 million threshold became effective April 2, 2000. The previous $25 million threshold was effective from November 4, 1993 through April 1, 2000. Prior to November 4, 1993 the threshold was $10 million.

b. Modified CAS coverage (CAS clause at FAR 52.230-3) requires only that the contractor comply with CAS 401, 402, 405, and 406. Contracts with modified CAS coverage awarded prior to November 4, 1993 are subject to CAS 401 and 402 only. Modified CAS coverage applies to contractor business units that received less than $50 million in net CAS-covered awards in the immediately preceding cost accounting period.

c. When any one contract is awarded with modified CAS coverage, all CAS-covered contracts awarded to that business unit during that cost accounting period are also subject to modified coverage, except that when a business unit receives a single CAS-covered contract award of $50 million or more, that contract is subject to full coverage. Thereafter, any covered contract awarded during that accounting period and the subsequent accounting period is subject to full CAS coverage.

d. The CAS status of a contract or subcontract (full coverage, modified coverage, or exempt from CAS), remains the same throughout its life regardless of changes in the business unit’s CAS status in the current or subsequent cost accounting periods (i.e., a contract awarded with modified coverage remains subject to such coverage throughout its life even if subsequent period contracts are awarded with full coverage).

e. Subcontract coverage. (1) When a subcontract is awarded under a CAS-covered prime contract (and higher-tier subcontract), CAS coverage of the subcontract is determined in the same manner as prime contracts awarded to the subcontractor's business unit; i.e., determine if any of the exemptions from CAS at 48 CFR 9903.201-1 apply to the subcontract (see 8-103.2). (2) Working Group Paper 76-3, Policy for Application of CAS to Subcontracts, states that the standards applicable to the prime contract at the time it was awarded are also applicable to the subcontract. One might interpret this to mean that if a prime contract is subject to full CAS coverage, the subcontract is also subject to full CAS coverage. This appears to conflict with the guidance at 8-103.3e(1) that states that CAS coverage for subcontracts is determined in the same manner as it is determined for prime

contracts awarded to the subcontractor's business unit. There is no conflict, however, because the Working Group Paper was issued before the category of modified coverage was created. When the Working Group Paper was issued, no distinction was made between full and modified coverage. As stated in 8-103.3e(1), CAS coverage at the subcontract level should continue to reflect the same CAS coverage as prime contracts awarded to the same business unit.

8-103.4 Effect of Contract Modifications

Contract modifications made under the terms and conditions of the contract do not affect its status with respect to CAS applicability. Therefore, if CAS was applicable to the basic contract, it will apply to the modification. Conversely, if the basic contract was exempt from CAS, the modification will also be exempt regardless of the amount of the modification. However, if the contract modification adds new work it must be treated for CAS purposes as if it were a new contract. In this case, if the modification exceeds the threshold, it will be CAS-covered (see CAS Working Group Paper 76-2).

8-103.5 Effect of Basic Ordering Agreements

Basic agreements and basic ordering agreements (BOAs) are not considered contracts (FAR 16.702(a) and 16-703(a)). Since orders must be considered individually in determining CAS applicability, only orders that exceed the threshold will be CAS-covered (see CAS Working Group Paper 76-2).

8-103.6 Effect of Letter Contracts

CAS is applicable to letter contracts exceeding the threshold as of the date of the award. Definitizing the contract will not activate any new standards since definitization is a contract modification rather than a new contract (see CAS Working Group Paper 77-16).

8-103.7 CAS Flowdown Clause - FAR 52.230-2

The CAS clauses at FAR 52.230-2(d) and FAR 52.230-3(d) (for full and modified coverage, respectively) require a contractor to include the substance of the CAS clause in all negotiated subcontracts (at any tier) into which the contractor enters. This is commonly referred to as the "CAS flow down clause." However, as discussed in 8-103.3e, if a subcontract meets one of the CAS exemptions at 48 CFR 9903.201-1 (see 8-103.2), the subcontract will not be subject to CAS. For example, a CAS-covered prime contractor could not place the requirement for CAS compliance on a subcontract with a small business because 9903.201-1(b)(3) specifically exempts contracts and subcontracts with small businesses from CAS requirements.

8-103.8 Submission of Disclosure Statement

The requirements for submission of a Disclosure Statement (48 CFR 9903.202-1(b)) are:

a. Any business unit (as defined in CAS 410.30(a)(2)) that is selected to receive a CAS-covered contract or subcontract of $50 million or more, including option amounts, shall submit a Disclosure Statement before award.

b. Any company which, together with its segments (as defined in CAS 410.30(a)(7)), received net CAS-covered awards totaling more than $50 million in its most recent cost accounting period shall submit a Disclosure Statement. When a Disclosure Statement is required under this criteria, it must be submitted before award of the first CAS-covered contract in the immediately following cost accounting period. However, if the first cov-

ered award is made within 90 days of the start of the cost accounting period, the contractor is not required to file until the end of the 90 days.

c. When required, a separate Disclosure Statement must be submitted for each segment having more than $650,000 of costs included in the total price of any CAS-covered contract or subcontract, unless:

(1) The contract or subcontract is of the type or value exempted by 48 CFR 9903.201-1; or

(2) In the most recently completed accounting period, the segment's CAS-covered awards are less than 30 percent of total segment sales for the period and less than $10 million.

d. Any home office (as defined in CAS 403.30(a)(2)) that allocates costs to one or more disclosing segments performing CAS-covered contracts must submit a part VIII of the Disclosure Statement.

8-103.9 Additional Exemptions on a Particular Standard

Subsection 62 of each cost accounting standard will provide for any additional exemptions associated with a particular standard.

8-103.10 CAS Waivers

a. The CAS statute (Pub. Law 100-679) authorizes the CAS Board to waive CAS requirements on individual contracts and subcontracts. CAS 9903.201-5 addresses CAS waivers.

b. Effective April 2, 2000, the CAS Board granted authority to waive CAS to heads of executive agencies. Implementing guidance is in FAR 30.201-5 and DFARS 230.201-5. FAR 2.101 defines “executive agency” as executive, military, and independent departments. Delegation of waiver authority may not be made lower than the senior contract policymaking level of the agency.

c. Heads of executive agencies may waive CAS under the following two circumstances:

- The contract or subcontract is less than $15 million, and the segment performing the work is primarily engaged in the sale of commercial items and has no contracts or subcontracts subject to CAS, or
- “Exceptional circumstances” exist whereby a waiver of CAS is necessary to meet the needs of the agency. Exceptional circumstances are deemed to exist only when the benefits to be derived from waiving CAS outweigh the risk associated with the waiver. A waiver for exceptional circumstances must be in writing and include a statement of the specific circumstances that justify granting the waiver. The Defense Procurement and Acquisition Policy on January 31, 2003 issued guidance which provides that all three of the following criteria must be met for a waiver of CAS to be considered under “exceptional circumstances” for DOD contracts.

  (1) The property or services cannot reasonably be obtained under the contract, subcontract, or modification, as the case may be, without the grant of the waiver;

  (2) The price can be determined to be fair and reasonable without the application of the Cost Accounting Standards; and

  (3) There are demonstrated benefits to granting the waiver.

8-104 CAS Audit Responsibility

8-104.1 Basic Functions

FAR 30.202-6, 30.202-7, and 30.601 outline the basic functions of the contract auditor in the implementation of the standards. They provide that the contract auditor shall be responsible for making recommendations to the cognizant Federal agency official (CFAO). The CFAO is the contracting officer assigned by the cognizant Federal agency to

administer CAS. Within DoD, the CFAO is the cognizant ACO. The auditor's recommendations to the CFAO include whether:

- a contractor's Disclosure Statement, submitted as a condition of contracting, adequately describes the actual or proposed cost accounting practices as required by 41 U.S.C. 422 as implemented by the CASB;
- a contractor's disclosed cost accounting practices are in compliance with FAR Part 31 and applicable cost accounting standards;
- a contractor's or subcontractor's failure to comply with applicable cost accounting standards or to follow consistently its disclosed or established cost accounting practices has resulted, or may result, in any increased cost paid by the Government; and
- a contractor's or subcontractor's proposed price changes, submitted as a result of changes made to previously disclosed or established cost accounting practices, are fair and reasonable.

8-104.2 Auditor's Function on Subcontracts Subject to CAS

As specifically related to subcontracts subject to CAS, the auditor's functions tend to fall into the following areas:

a. The auditor will audit the books and records of prime contractors and higher tier subcontractors to determine that appropriate CAS clauses are included (FAR 52.230-2 or 52.230-3, and FAR 52.230-6) in awarded subcontracts. In addition, the auditor will determine that, when applicable, subcontractor Disclosure Statements have been obtained.

b. 48 CFR 9903.202-8(a) and FAR 42.204(b) provide that the company awarding the CAS-covered subcontract is responsible, except as noted in c. and d. below, for securing subcontractor compliance with CASB rules, regulations, and standards. Notwithstanding these provisions, in most cases compliance audits of CAS-covered subcontracts will be performed by the auditor cognizant of the subcontractor in conjunction with the performance of other regularly scheduled audit assignments. When DCAA audits a prime contractor that also holds covered subcontracts, the auditor should routinely include the subcontracts in the CAS-covered audits. Even though the audit responsibility may not have been formally assigned, the auditor, to protect the Government's interest, must consider all covered work held by the contractor when making CAS-related audits. At locations where no Government prime contracts exist, the auditor should attempt to identify the existence of CAS-covered subcontracts either during the performance of regular ongoing audits or through routine examinations of existing acquisition records. Once identified, these subcontracts will also be subject to audit tests for CAS compliance.

c. Under the provisions of 48 CFR 9903.202-8(b) a subcontractor may satisfy disclosure requirements by identifying to the prime contractor the CFAO to whom its Disclosure Statement was previously submitted. 48 CFR 9903.202-8(c)(1) provides that the subcontractor may submit a Disclosure Statement that contains privileged and confidential information directly to the subcontractor's CFAO. In this case a preaward determination of adequacy is not required. Instead, the CFAO will advise the auditor to perform postaward audits of adequacy and compliance.

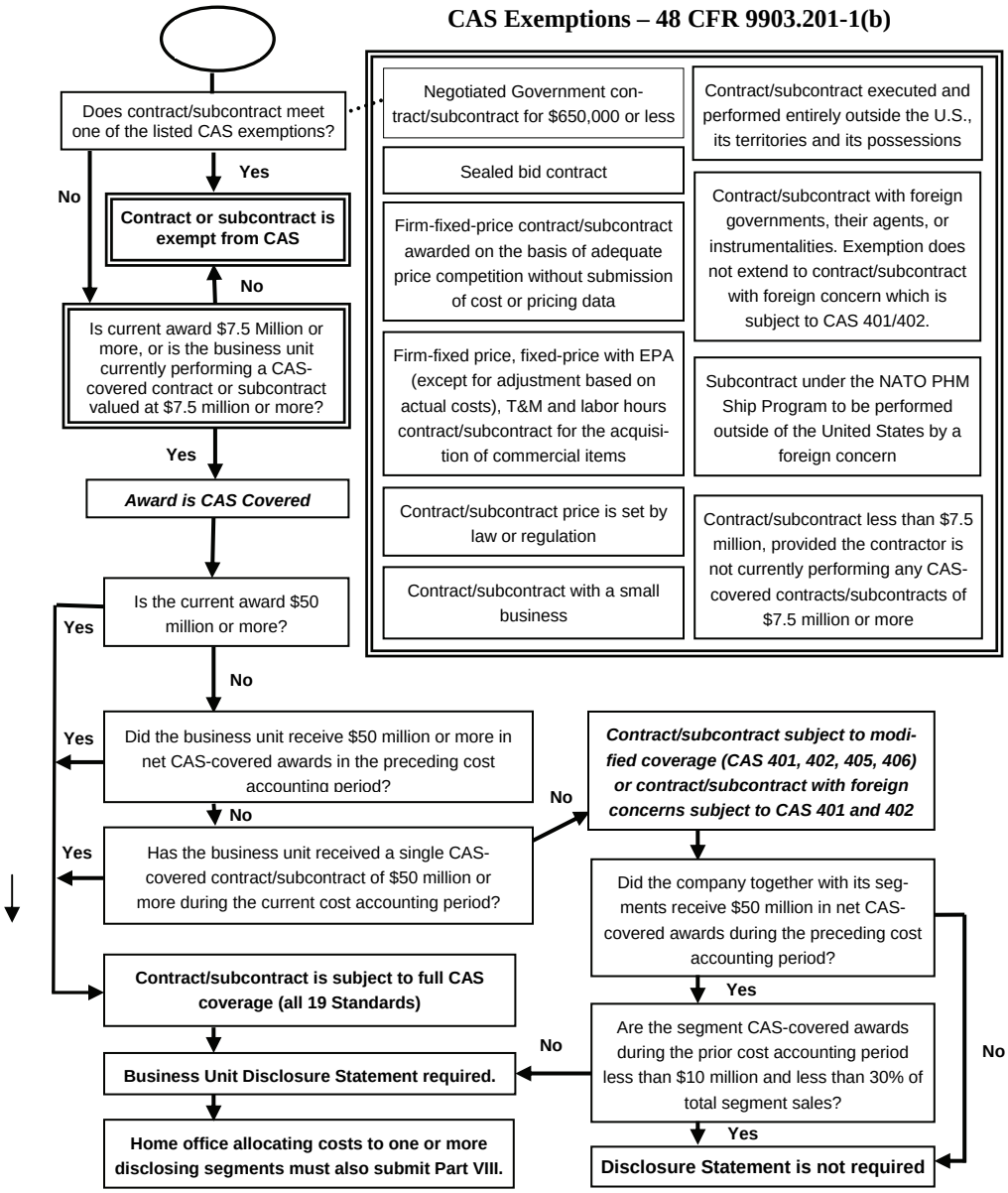
d. In accordance with 48 CFR 9903.202-8(c)(2), subcontractors not subject to Disclosure Statement requirements may claim that other CAS-related audits by prime contractors would jeopardize their proprietary data or competitive position. In such cases, the subcontractor may request the Government to perform the audits.

8-104.3 Contract Audit Coordinator (CAC)

The CAC will be responsible for assuring, for all organizational units of the assigned company, that consistent and compatible audit conclusions are reached by all FAOs involved. Specific responsibilities for all auditors in the coordination process are in subsequent sections of this chapter. If a CAC has not been assigned to a multidivisional contrac-

tor, the regional director cognizant of the corporate home office will designate a Corporate Home Office Auditor (CHOA) or Group Audit Coordinator (GAC), as applicable (see also 8-204 for audit coordination within multiorganizational companies).

Figure 8-1-1
CAS Coverage and Disclosure Statement Determination



8-200 Section 2 --- Audits of Disclosure Statement for Adequacy

8-201 Introduction

This section contains guidance on auditing the adequacy of Disclosure Statements. The audit for adequacy is to ascertain whether a Disclosure Statement adequately describes the cost accounting practices to be used by a contractor for estimating, accumulating and reporting contract costs. Because an adequacy determination by the cognizant CFAO is a condition of contract award, the audit of the initial Disclosure Statement's adequacy should be performed before compliance so that the audit report on adequacy will not be delayed.

8-202 General

a. Contractors and subcontractors meeting certain criteria are required, as a condition of contracting, to disclose in writing their cost accounting practices. The Disclosure Statement has been designed to provide an authoritative description of the contractor's cost accounting practices to be used on federal contracts for those contractors required to file. The more important objectives of the disclosure requirement include:

(1) establishing a clear understanding of the cost accounting practices the contractor intends to follow,

(2) defining costs charged directly to contracts and disclosing the methods used to make such charges, and

(3) delineating the contractor's methods of distinguishing direct costs from indirect costs and the basis for allocating indirect costs to contracts.

An adequate Disclosure Statement should minimize future controversies between contracting parties regarding whether the contractor has consistently followed the disclosed practices.

b. FAR 30.202-7 states that the auditor is to advise the cognizant Federal agency official (CFAO) on the adequacy of the contractor's Disclosure Statement. To meet this responsibility, the auditor will audit the Disclosure Statement to ascertain if it adequately describes the cost accounting practices to be used for contracts containing the CAS clause. FAR 30.202-7(a) provides that a Disclosure Statement is adequate if it is current, accurate, and complete.

c. When a CFAO determines that the contractor's Disclosure Statement is adequate, it does not necessarily indicate that the CFAO is certifying that all cost accounting practices have been disclosed. It does indicate that those practices disclosed have been adequately described and the CFAO currently is not aware of any additional practices that should have been disclosed.

Subsequently, it may be discovered that a contractor had a cost accounting practice that was not required to be described in the Disclosure Statement. Such a practice will be considered an "established cost accounting practice," for which appropriate guidance in 48 CFR 9903.302-2 on changes and noncompliances will be followed. In addition, CFAOs do have authority to withdraw an adequacy determination previously given for a Disclosure Statement. Action to withdraw the determination should not be taken unless the issue is material and the contractor will not make the revision. Contractors should be immediately advised in writing when a revision to the Disclosure Statement is necessary. (See 8-208g and CAS Working Group Papers 76-6 and 77-20.)

d. Unless permission is granted for a postaward submission, FAR 30.202-6(b) requires the CFAO to determine that the offeror has made an adequate disclosure before a covered contract can be awarded to a prime contractor. Consequently, the auditor shall expedite the issuance of the reports citing inadequate conditions. To be responsive to the requirements of the acquisition offices, audit report due dates and other planning considerations should be coordinated with the CFAO in accordance with 4-103. These due dates should allow the CFAO enough time before contract award to:

(1) render a formal determination,

(2) request a revised Disclosure Statement, if required, and

(3) obtain audit assistance in evaluating the revised descriptions.

When unforeseen circumstances delay the audit report, the CFAO should be advised immediately and a revised mutually acceptable due date established. 48 CFR 9903.202-8(c)(1) does permit postaward adequacy determinations of subcontractor Disclosure Statements (see 8-104.2).

e. The auditor should expedite the issuance of the audit report even when a contractor submits a Disclosure Statement well in advance of an award of a covered contract. The lack of an imminent procurement action should not be used as the basis for extending the report due date.

f. The submission of a Disclosure Statement is required as a condition of contracting for all contractors meeting certain criteria. 48 CFR 9903.202-1(b) specifies the thresholds that contractors and subcontractors must meet to be required to file a Disclosure Statement. (See 8-103.8) FAR 52.230-1 Part I(c)(3) provides for the submission of a certificate of monetary exemption for those contractors who do not meet the current filing thresholds.

g. Contractors and subcontractors who are required to file Disclosure Statements must submit a separate disclosure statement for each segment that meets the criteria specified in 48 CFR 9903.202-1(c). (See 8-103.8.c.) The previous CAS Board rule allowing the submission of a single Disclosure Statement for segments that have identical cost accounting practices has been deleted. General Instruction No. 3 of the revised CASB DS-1(Rev 2/96) provides that each segment or business unit required to disclose its cost accounting practices should complete the Cover Sheet, the Certification, and Parts I through VII. Each corporate or group office is required to complete Part VIII of the Disclosure Statement if its costs are allocated to one or more disclosing segments performing CAS-covered contracts or subcontracts (48 CFR 9903.202-1(d)).

h. Amendments to Disclosure Statements are required whenever the contractor changes any of its disclosed accounting practices (48 CFR 9903.202-3). For each revision of the Disclosure Statement (addition, change, or deletion), only the pages containing such revision shall be resubmitted. Detailed procedures for submitting amended Disclosure Statements have been provided in the CASB regulations. These regulations also allow agencies to prescribe criteria under which submission of a complete, updated Disclosure Statement will be required. As stipulated in General Instruction No. 11 of the revised CASB DS-1 (Rev 2/96), each amendment, or set of amendments, should be accompanied by an amended cover sheet (indicating revision number and effective date of the change) and a signed certification. For all revised Disclosure Statement submissions, the contractor should mark each page "Revision Number __" and "Effective Date __" in the Item Description block; and insert a revision mark (e.g., "R") in the right hand margin of any line that is revised. It is important to note that the annual revision to Item 1.3.0 and column (3) of Item 8.1.0. are not changes to accounting practices.

i. Contractors are required to submit the Disclosure Statement and any changes directly to the CFAO and the cognizant auditor (48 CFR 9903.202-5). The responsibility of obtaining a proper resubmission rests with the CFAO. The auditor should not consider a statement inadequate solely on questions concerning whether an amended or revised statement has been submitted in accordance with the requirements cited in paragraph h. above. However, the auditor should include in the adequacy report specific recommendations on the proper filing procedure.

j. The auditor will not distribute Disclosure Statements outside DCAA. All requests for copies of Disclosure Statements by other components of DoD or other Government agencies should be referred to the CFAO. Strict adherence to this requirement is critical since the CASB regulations provide that a Disclosure Statement will not be made public if the contractor files it specifically conditioned on the Government's agreement to treat its contents as confidential information. Additionally, a subcontractor's Disclosure Statement will not be divulged to its prime contractor if the subcontractor makes a claim of privileged and confidential information and the prime contractor authorizes filing it directly with the Government.

8-203 Proper Filing

a. After receiving a Disclosure Statement or an amendment, the auditor should ascertain if the data were filed in accordance with 48 CFR 9903.202. If the contractor has filed incorrectly (e.g., a single Disclosure Statement submitted for more than one segment, the disclosure statement should be considered inadequate (see 8-202g), and the matter should be reported to the CFAO (see 8-208e).

b. On February 28, 1996, the CASB issued a final rule revising the CASB DS-1. Contractors are to use the revised DS-1 for all initial Disclosure Statement submissions or significant revisions dated on or after February 28, 1996. All contractors subject to Disclosure Statement requirements must submit a complete Disclosure Statement using the revised DS-1 form by the beginning of the first fiscal year after December 31, 1998. For example, calendar year contractors with no revisions to their existing Disclosure Statement would have until January 1, 1999 to submit a complete Disclosure Statement using the revised DS-1. Initial or revised submissions made on or after February 28, 1996 that are not submitted using the revised CASB DS-1 should be considered inadequate and reported to the CFAO using the procedures set out in 8-208e. Auditors should follow the guidance in 8-208g for situations in which the contractor failed to provide a complete Disclosure Statement using the revised form by the required due date.

c. Unless specifically requested by the CFAO, no audit effort will be expended verifying the contractor's basis for filing a certificate of monetary exemption. If such a request is received, the CFAO should be asked to obtain the contractor's documentation or working papers supporting the claim for a monetary exemption.

d. Obvious mistakes, such as a subsidiary filing a certificate of monetary exemption when the parent company is required to file a Disclosure Statement, should be reported to the CFAO immediately.

8-204 Audit Coordination within Multiorganizational Companies

The specific responsibilities of the CAC, CHOA, GAC and the FAOs within multiorganizational companies are as follows:

a. CAC/CHOA/GAC

(1) Determine the extent of the CAC network by obtaining a list from the contractor of all organizational units which will be submitting Disclosure Statements.

(2) For all reporting organizational units, obtain from the contractor a list of the Disclosure Statement items which will be answered by the corporate office. When determining which items are addressed by the corporate office, the CAC/CHOA/GAC should consider the requirements of General Instruction No. 4 of the February 28, 1996 revision to the DS-1. General Instruction No. 4 stipulates:

(a) Each home office is required to disclose its cost accounting practices for measuring, assigning, and allocating its costs to segments performing Federal contracts or similar cost objectives, and shall complete the Cover Sheet, the Certification, Part I and Part VIII of the Disclosure Statement.

(b) If a home office either establishes practices or procedures for the types of cost covered by Parts V, VI, and VII, or incurs and then allocates these types of cost to its segments, then the home office may complete Parts V, VI, and VII to be included in the Disclosure Statement submitted by its segments. Auditors should refer to item 8.2.0. of the home office Disclosure Statement to determine which parts were completed by the home office. Even though the corporate home office may complete Parts V, VI, and VII for the segment, the segment is still responsible for including these parts in its Disclosure Statement submission.

(c) While a home office may have more than one segment submitting a Disclosure Statement, only one statement described in subparagraph (a) above needs to be submitted to cover home office operations.

(3) Notify the auditors in the network of the items that will be prepared by the corporate office.

(4) Notify the auditors in the network of the date on which the corporate office Disclosure Statement is expected and establish the due date of the adequacy report.

(5) Obtain copies of all Disclosure Statements and evaluate and compare the applicable items to assure consistency in the items answered by the home office.

(6) Distribute copies of the corporate and group office Disclosure Statements to the FAOs in the network. Notify the FAOs when changes are made to the corporate Disclosure Statement and establish the due date for the audit report on the revised statement.

(7) Establish a system to receive and distribute information within the network concerning problem areas.

(8) Conduct CAS workshops involving network auditors to assure consistency and uniformity among the various FAOs regarding the audit position for common or similar descriptions.

(9) Obtain copies of reports on all the Disclosure Statements in the network and make comparisons to assure that auditors are consistent in the treatment of common disclosures. This action should be accomplished before reports are issued.

b. FAOs

(1) Establish a target date for the issuance of audit report covering the examination of the Disclosure Statements submitted by the organizational units.

(2) Inform the CAC, CHOA, or GAC of the target reporting date established in (1) above. This report due date should provide the CFAO with the time needed to take appropriate action before the award of the first covered contract. The earliest report due date for an organizational unit's Disclosure Statement should become the report due date for the corporate and group office Disclosure Statement reports.

(3) Evaluate the items prepared by the corporate office to ascertain whether the corporate office items are compatible with the described practices of the reporting organizational unit. The cognizant FAO should advise the CAC, CHOA, or GAC of any significant areas of incompatibility between the data reported by the corporate office (Part 8 of the Disclosure Statement) and the data provided by the organizational unit (Parts 1 through 7 of the Disclosure Statement).

(4) Attend the CAS workshops.

(5) Plan the audit so that the audit report can be furnished to the CAC, CHOA, or GAC before it is issued to the CFAO.

(6) Request assist audits of the corporate office and all intermediate organizations that perform home office functions on behalf of the operating segment involved. The assist audits should include a review of the methods used by the home office organization(s) to identify, measure, and allocate costs to segments. In most instances such evaluations will be made on an assist audit basis because the pertinent data are normally unavailable at the reporting segment level.

8-205 Audit Programs and Working Papers for Disclosure Statement Adequacy Audits

a. The auditor should observe government auditing standards in preparing audit programs and working papers. Agency standard audit programs with appropriate modifications should be used where available. The audit program should be in sufficient detail to indicate the purpose of the audit step, the manner in which the work will be done, and the scope of the audit. Audit programs prepared for contractors who are subject to frequent or continuous audits should require an evaluation of data in existing files (e.g., permanent files, system audits, estimating system surveys, price proposal evaluations, indirect cost audits, etc.) as a major step in verifying the described cost accounting practices. For those contractors with whom DCAA has had limited or no audit experience, the potential dollar volume of covered contracts should be a major consideration in establishing the scope of the adequacy audit.

b. Audit working papers should contain, at least:

(1) the basis for accepting a description,

(2) a record of discussions and written communications from the CFAO and contractor, and

(3) the auditor's rationale in resolving questionable items.

The working papers should identify those descriptions accepted without audit verification. This identification is especially important for those described practices which may involve significant cost. In this way, the auditor will have a basis for identifying these practices and evaluating such items for compliance when future audits are performed.

8-206 Criteria for Adequacy Determination

a. To be considered adequate, a Disclosure Statement must be current, accurate, and complete.

(1) A Disclosure Statement is current if it describes the cost accounting practices which the contractor intends to follow for estimating, accumulating and reporting costs associated with covered contracts. The Disclosure Statement, therefore, could possibly include practices that are currently in use; will be instituted at some future date; will be followed with the incurrence of a new cost; or a combination of these.

(a) Existing audit files should be reviewed to ascertain whether the cost accounting practices identified in the Disclosure Statement are, in fact, the contractor's current practices. For example, data in the permanent file and in recent reports on pricing proposals, system audits, indirect cost rate proposals, and accounting system surveys cover many features of the contractor's cost accounting practices. When the adequacy audit discloses a difference between a described practice and an existing practice, the auditor should discuss it with the contractor to assure that a change is intended. Conversely, if the auditor is aware of an intended change in the contractor's practice and the practice has not been described, she or he should recommend the contractor describe the intended practice as well as the existing practice.

(b) Where the contractor already has covered contracts, but was not previously required to file a Disclosure Statement, the practices subsequently described should be the same as those used to estimate and accumulate costs for the contracts entered into before the Disclosure Statement was required. If there are any known differences, an audit should be scheduled to ascertain if the contractor is consistently following its established cost accounting practices that were effective when the initial covered contract was awarded or has made a change to a cost accounting practice without notifying the CFAO.

(2) A Disclosure Statement is accurate if it correctly, clearly, and distinctly describes the actual method of accounting the prime contractor or subcontractor uses or intends to use on contracts subject to 41 U.S.C. 422. Vague, ambiguous, and contradictory descriptions of the contractor's cost accounting practices may hinder subsequent compliance audits, cause disputes and litigation between contracting parties, and ultimately result in additional cost to the Government. Consequently, the auditor should carefully evaluate the described practices for specificity and clarity. Clerical accuracy is also a requirement for the Disclosure Statement. Therefore, the auditor should verify whether the contractor has checked the appropriate boxes, inserted the applicable code letters, omitted any questions, etc.

(3) A Disclosure Statement is complete if it includes all significant cost accounting practices the contractor intends to use and provides enough information for the Government to fully understand the accounting system being described. Accordingly, auditors should be alert for vague, incomplete or ambiguous answers which could lead to alternative accounting interpretations. Where such responses are noted, the auditor should discuss them with the contractor to ascertain the specific meaning. If the item is material and the meaning is not clarified, the auditor should recommend that the CFAO find the statement inadequate.

b. During the Disclosure Statement adequacy audit, auditors should keep in mind General Instruction No. 8 of the February 28, 1996 revision to the CASB DS-1. General Instruction No. 8 allows contractors to incorporate, by reference, existing written accounting policies and procedures when the cost accounting practice being disclosed is clearly set forth in the policies and procedures. As an alternative, the Instruction allows contractors to attach as appendices to the pertinent part of the Disclosure Statement, copies of the relevant parts of existing written accounting policies and procedures. For instances where either the accounting policies and procedures are incorporated by reference or attached as an appendix, the auditor should treat the description in these documents the same as a description in the Disclosure Statement itself for the purpose of determining whether the Disclosure Statement is current, accurate, and complete.

c. Materiality should be a major factor in deciding the level of detail required to be disclosed. A prime consideration should be whether a change in accounting procedure at the level of detail under consideration would have a material effect on the flow of costs, now or in the near future.

d. The auditor need not audit or report to the ACO the validity of the statistical data submitted annually by the contractor to update sales and regulated information.

8-207 Discussion with the Contractor

Before issuing the report to the CFAO, discuss with the contractor all items considered inadequate (see 4-300).

8-208 Reporting

a. Since FAR 30.202-7(a) assigns the contract auditor responsibility for ascertaining the adequacy of the Disclosure Statement and its amendments, the required audits will be initiated and audit reports will be issued without the need for a request for audit services.

b. Prepare reports on initial adequacy audits in accordance with 10-800. If the report identifies inadequate descriptions and the CFAO agrees the statement is inadequate, the CFAO will formally notify the contractor, identify the inadequate items, and request that the statement be revised. The auditor will audit the revised statement to ensure that the contractor has taken corrective actions.

c. For each operating segment required to submit a Disclosure Statement, the cognizant auditor will be responsible for reporting the results of the adequacy audit of Parts 1 through 7. Even though data relating to Parts 1 through 7 may have been audited by other auditors who have cognizance over home office organizations, the report covering the operating segment will also include the results of the assist audits.

d. All reports on the adequacy of initial Disclosure Statements will be submitted separately from reports on compliance and other audit reports. When a Disclosure Statement is audited in connection with a pricing proposal, two reports will be required: one on the adequacy audit and the other on the evaluation of the pricing proposal. The report on the adequacy audit will not include recommendations concerning any actual or potential noncompliances. Noncompliance issues will be reported separately (see 10-808). Compliance of the initial disclosure statement will also be reported separately (see 10-805).

e. When a company submits proposed revisions to the Disclosure Statement which has previously been determined to be adequate, the auditor is required to follow reporting procedures that differ from those outlined in d. above. The auditor will audit the revisions for adequacy and compliance with CAS and FAR. The results of this audit will be included in a single report to the CFAO if there are no noncompliance issues. If there are noncompliance issues, there will be two reports because noncompliances found in Disclosure Statement adequacy and compliance audits will be treated in the same manner as noncompliances found in other types of audits. That is, in addition to issuing the report on the adequacy of the Disclosure Statement, a separate noncompliance report will also be issued (see 10-808).

f. The auditor should always be aware of the importance of meeting the established due dates for adequacy reports. When unforeseen circumstances delay the issuance of the report, the CFAO should be notified immediately and arrangements made for a new report due date. The CFAO is responsible for determining the adequacy of the Disclosure Statement and a delay in submitting the audit report will delay the official notice to the contractor concerning the acceptability of the statement.

g. If subsequent audits indicate that a previously accepted disclosure statement is inadequate, the contractor should be immediately advised in writing that a revision to the Disclosure Statement is necessary. For example, the contractor did not describe cost accounting practices related to a cost because it did not have a significant impact on the flow of costs to Government contracts. Subsequently the cost becomes material and significantly affects the flow of costs. The contractor should revise its disclosure statement to adequately describe the practices related to the previously immaterial cost. If the contractor will not make the revision, the auditor should issue an audit report recommending that the CFAO withdraw the adequacy determination and request the contractor to submit a revised disclosure statement (see 8-202c).

8-209 Maintenance of CFAO Letters of Adequacy Determination

FAR 30.202-7(a) requires that the CFAO generally notify the contractor, within 30 days after the receipt of the Disclosure Statement, whether or not the statement is adequate, and provide copies of letters of adequacy determination to the auditor and contracting officer. A copy of the most recent CFAO letter of adequacy determination should be included in FAO files. Auditors should follow up with CFAOs if a CFAO letter of adequacy determination has not been received within 60 days after an adequacy report has been issued.

8-300 Section 3 --- Audits of Compliance with Cost Accounting Standards Board (CASB) Rules, Regulations, and Standards, and with FAR

8-301 Introduction

a. This section provides audit guidance for the evaluation of the contractor's Disclosure Statement and the practices used for estimating, accumulating and reporting costs on contracts subject to 41 U.S.C. 422. The purpose of the audit is to ascertain whether the disclosed or established practices are in compliance with both the CASB rules, regulations, and standards and appropriate acquisition regulations. The initial audit of a Disclosure Statement's compliance should be scheduled for completion within 60 days after the CFAO's determination of adequacy of the Disclosure Statement. The aspects of compliance audits covered in this section are:

(1) General requirements including audit considerations and reporting procedures.

(2) Audit considerations involved in the initial audit of the Disclosure Statement for compliance.

(3) Audit requirements associated with the audit of cost accounting practices for compliance during the proposal evaluation and contract performance.

b. Not only should the audit and subsequent reporting cover those conditions that constitute actual noncompliances but should also include circumstances where the occurrence of a planned or pending action will result in a violation of CASB rules, regulations, or standards. A condition of potential noncompliance exists when:

(1) a contractor with a covered contract proposes a practice that when implemented will violate a cost accounting standard or FAR cost principle (see 8-302.7f), or

(2) a contractor who does not have a covered contract but currently has or proposes to implement a practice which, with the award of the initial covered contract, will result in a violation of the CASB rules, regulations, and standards or appropriate acquisition regulations.

It is important to note that in each of the potential noncompliance conditions described above, some future action is required before the contractor is in violation of 41 U.S.C. 422. For example, the offeror must be awarded a CAS-covered contract before it becomes subject to the rules and regulations of the CASB. Similarly, a covered contractor must implement an unacceptable practice to be in actual noncompliance.

c. To facilitate the implementation process, each promulgated standard contains in subparagraph .63 an effective date and an applicability date. The CASB defers the applicability date beyond the effective date in order to provide contractors adequate time to prepare for compliance and make any required accounting changes. Under the regulation, a contractor becomes subject to a new standard only after receiving the first CAS-covered contract following the effective date.

(1) The distinction between the effective and applicability dates is important. The effective date designates when the pricing of future CAS-covered contracts must reflect the new standard. It also identifies those CAS-covered contracts eligible for an equitable adjustment, since only contracts in existence on the effective date can be equitably adjusted to reflect the prospective application of a new or revised standard.

(2) The applicability date marks the beginning of the period when the contractor's accounting and reporting systems must comply with a new or revised standard. Proposals for contracts to be awarded after the effective date of a standard should be evaluated carefully for compliance with the new or revised standard. The proposal need only reflect compliance with the standard from the applicability date forward. Therefore, it is important that the auditor determine the applicability date of the particular Standard (including any revisions) under audit. Any change resulting from early implementation by the contractor is to be administered as a unilateral change. It will result in an equitable adjustment under FAR 52.230-2(a)(4)(iii) for the period prior to the applicability if the CFAO determines that the unilateral change is a desirable change.

(3). In unusual situations, the short lead time between the effective and applicability dates may create a difficult situation for the contractor. In such a case, the contactor may request the change be retroactive. The CFAO shall determine whether the contractor's request is approved or not; however, the CFAO can not approve a date for the retroactive change before the beginning of the year in which the request was made. Where a contractor can demonstrate to the CFAO that it would be virtually impossible to comply with the effective or applicability dates of a standard, contracts can be negotiated after the effective date of the standard based on the accounting system used before the standard became effective.

(4) Contract terms should include provisions for price adjustments, retroactive to the applicability date, for significant cost impact resulting from the change in accounting practice to comply with the standard. In addition, the CFAO should establish a specific date for the contractor to complete the changes to its estimating, accounting, and reporting systems and Disclosure Statement to comply with the standard. When this procedure is followed, noncompliances will not be reported. Equitable adjustments computed as of the applicability date will be submitted as provided in FAR 30.604(h)(4). (See CAS Working Group Papers 76-7 and 77-10.)

d. Questions have been raised regarding the CAS compliance of termination claims since:

(1) costs in termination claims may be arranged differently than the cost presentations in the original estimates, and

(2) termination claims often include as direct costs such items as settlement costs or unexpired leases which would have been charged indirect if the contract had been completed. Termination costing procedures as detailed in FAR 31.205-42 are still effective. DoD does not view these procedures as violating either CAS 401 or 402, since terminating a contract creates a situation that is totally unlike completing a contract. Therefore, these costs would not be considered costs incurred for the same purpose in like circumstances. Termination contracting officers should assure themselves that within the context of termination situations, consistency is honored to the extent that the circumstances are similar. To that end, it would be advisable for a contractor to document its termination accounting procedures as part of its disclosed practices. Indirect cost rates used in termination claims must represent full accounting periods as required by CAS 406. (See CAS Working Group Paper 77-15.)

8-302 Noncompliance with CAS

8-302.1 Requirements

a. In accordance with FAR 30.605(b) when the CFAO determines a disclosed or an established practice is not in compliance, the CFAO shall notify the contractor and provide a copy of the notice to the auditor. The CFAO also makes a determination of materiality.

(1) If the CFAO determines that the noncompliance is immaterial, the contractor must correct the noncompliance and the Government reserves the right to make contract adjustments if the contractor fails to correct the noncompliance and it becomes material.

(2) If the CFAO determines that the noncompliance is material, the contractor is required to submit a description of any accounting practice change needed to bring the practices into compliance, which the auditor will review for adequacy and compliance. If the proposed change is both adequate and compliant, the contractor must submit a general dollar magnitude (GDM) proposal. In addition, adjustment of the prime contract price or cost allowance in accordance with FAR 30.605 may be required. (See 8-500)

b. As in FAR 30.202-6 and 30.202-7, the contract auditor shall be responsible for conducting audits as necessary to advise the CFAO as to whether the contractor's disclosed or established practices comply with CAS and FAR Part 31. Because the audit responsibility

is a continuous requirement, instances of noncompliance may be detected and reported at various stages of the procurement action.

8-302.2 Types of Noncompliance

a. Eight types of noncompliance can be identified based on CASB rules, regulations, and standards and FAR Part 31:

(1) Disclosed practices not in compliance with CAS.
(2) Disclosed practices not in compliance with FAR.
(3) Actual practices of estimating costs not in compliance with CAS.
(4) Actual practices of estimating costs not in compliance with FAR.
(5) Actual practices of estimating costs not in compliance with Disclosure Statement.
(6) Actual practices of accumulating or reporting costs not in compliance with CAS.
(7) Actual practices of accumulating or reporting costs not in compliance with FAR.
(8) Actual practices of accumulating or reporting costs not in compliance with Disclosure Statement.

b. The first two noncompliance situations may be detected either during the initial Disclosure Statement audit, during normal audits such as price proposal evaluations, or during audits of incurred cost, as discussed in 8-304. Conditions three through five would likely be detected during a proposal evaluation or an estimating system survey. Situations six through eight would generally be detected during normal or routine audits of actual costs.

c. In some cases multiple noncompliance conditions may exist. For example, a contractor normally allocates the costs of preparing initial bid proposals to cost objectives on the basis of total cost input. This practice, which conforms with FAR 31.205-18 and CAS 420, was previously disclosed to the Government. For a new proposal, however, the associated B&P expenses were charged to the engineering overhead which was subsequently allocated to the resulting contract on the basis of direct engineering labor dollars. Under the conditions described above, noncompliance types (6), (7), and (8) would apply.

d. A new cost accounting standard could also result in instances of multiple noncompliance. For example, with the issuance of a new standard, a disclosed practice previously considered to be in compliance could be rendered unacceptable in the following areas:

(1) the described practice could be in noncompliance with CAS or FAR, and
(2) the practices used to record costs, although in conformance with the Disclosure Statement, could be in noncompliance with CAS or FAR.

8-302.3 Compliance Considerations

In auditing the contractor's cost accounting practices to ascertain whether they are in compliance with the cost accounting standards and FAR Part 31, the auditor should follow the guidelines below:

a. In evaluating price proposals and performing estimating system surveys, the auditor is required to describe inconsistencies between the contractor's estimating and cost accumulating practices. The auditor may, therefore, be in a position, based on past audits, to ascertain whether the contractor complies with the standard requiring consistency in estimating, accumulating, and reporting costs.

b. The standard prohibiting double counting (CAS 402) did not introduce an entirely new ground rule since acquisition regulations contained similar provisions. The prohibition against double counting in the acquisition regulations, however, was narrower in scope since it basically applied to individual contracts. CAS 402 has extended the scope by adding the requirement that each type of cost incurred for the same purpose, in like circumstances, must be either direct or indirect for all final cost objectives. Prior audits

of the contractor's incurred costs may provide information on whether the cost accounting practices comply with this standard.

c. With respect to noncompliance with FAR Part 31, if a cost accounting practice has been questioned by the auditor in the past and the CFAO has not made a final determination, the practice should be questioned again. Once the CFAO makes a determination on the issue, the decisions will be followed. If the FAR is subsequently changed or a change in circumstance occurs, a practice should again be evaluated for compliance.

d. If a cost accounting practice has been questioned because of noncompliance with FAR Part 31 and the CFAO supported the auditor's position, but the ASBCA or Court of Claims ruled against the Government, the auditor will not question the practice again unless there is a subsequent change in FAR or the cost accounting standards which would negate the decision. However, if the ASBCA or the Court of Claims ruled in favor of the Government, the practice should be questioned at all other contractor locations where circumstances are substantially the same.

8-302.4 Discussions with the CFAO and the Contractor

a. The auditor should discuss noncompliance matters with the CFAO at the earliest possible opportunity. It is important to keep the CFAO informed of the auditor's actions and to identify areas where the auditor may need to provide further information regarding his or her recommendations.

b. As an integral part of the audit, discuss the findings with the contractor. (See 4-300.)

8-302.5 Coordination for Consistent Treatment

a. Because of the consolidated contract audit function and the relationship of CASB rules, regulations, and standards to the DCAA mission, DCAA is in an advantageous position to ascertain whether the promulgated standards, rules, and regulations are applied consistently. To fulfill this responsibility, DCAA must effectively coordinate all phases of audits involving CAS.

b. Consistency in implementing CASB rules, regulations, and standards should be one of the auditor's primary concerns. Contractors are justifiably sensitive to unwarranted variations in the audit treatment of similar situations. To assure the provisions of 41 U.S.C. 422 are applied consistently, audit findings that are significant in amount or nature should ordinarily be coordinated with the region and CAC before the reports are issued.

c. When coordination involves other DCAA regional offices, the cognizant auditor should refer to his or her region those matters that cannot be resolved by the FAOs involved. The region may forward the matter to Headquarters, Attention PAC, if agreement is not achievable at the regional level. (See 4-900.)

d. Information on other significant problems or controversial situations will also be provided to Headquarters, Attention PAC. (See 4-900.) This information will assist in developing guidance to improve auditing and reporting techniques or in referring matters to the Office of the Secretary of Defense (OSD) when DoD-wide guidance is needed to achieve uniform and consistent implementation of CAS.

8-302.6 CAS Coordination in CAC/CHOA/GAC Complexes

a. The DCAA CAC program, for major multi-segment contractors and other specific groups of contractors, is described in 15-200. For multi-segment contractors outside a CAC complex, a CHOA or GAC will be designated in accordance with 8-104.3. The CAC, CHOA, and GAC complexes play a significant part in promoting consistent treatment of CAS compliance issues among related or similar contractor segments.

b. Each CAC/CHOA/GAC will:

(1) Obtain from the cognizant FAOs the necessary data to compile a listing of all known noncompliance issues at each of the segments that comprise the complex. The listing, along with information on resolution of the issues, should be distributed to all FAOs that have cognizance of any segment within the complex.

(2) Review and update the listing for new instances of noncompliance and include information regarding noncompliance issues resolved. Circulate this data to the cognizant FAOs to keep them informed about current developments.

(3) Before issuing a noncompliance report, discuss the recommendations with the FAO. This should be done to assure consistent treatment of similar conditions at the various segments of the complex.

(4) Recommend workshops if needed to evaluate mutual CAS problems, in accordance with 15-200.

c. FAOs in the complex will:

(1) Inform the CAC/CHOA/GAC of known problem areas.

(2) Inform the CAC/CHOA/GAC immediately when new problem areas are encountered.

(3) Evaluate problem areas of other organizational units to determine if similar problems exist or could exist at your location.

(4) Plan audits so findings can be coordinated before reports are issued.

8-302.7 Reporting Noncompliance

a. In assigning responsibilities to the CFAO and the contract auditor, the regulations (FAR 42.302(a)(11)), FAR 30.601, and FAR 30.202-6), require the auditor to conduct audits of Disclosure Statements for adequacy and compliance and report practices that do not comply with CASB rules, regulations, and standards. The CFAO is to determine whether the reported practices actually do not comply with the CASB promulgations or FAR Part 31. Noncompliance reports should include only CAS violations that the auditor considers significant. The auditor should report:

(1) Violations of major requirements of CAS regardless of their effect on contract costs.

(2) Noncompliances having a significant cost effect on CAS-covered contracts.

(3) Noncompliances that currently have no significant effect on contract costs but could eventually result in a significant adjustment because of changed circumstances. However, a noncompliance report will not be issued when the auditor determines the noncompliance will never result in a significant adjustment.

(4) Noncompliances that are an inherent part of the contractor's cost accounting system and that are of such a nature that the cost effect on CAS-covered contracts would be difficult or impossible to determine. (In ASBCA Case No. 20998, the Board upheld the Government's right to determine a contractor to be in noncompliance even though the Government was unable to determine that increased costs resulted from the noncompliance. This ASBCA decision should be referenced in all audit reports recommending noncompliance where the cost impact cannot be determined.)

b. The following are examples of practices that deviate from CAS. Even if such practices have not resulted in increased cost or no increased cost can be determined, the conditions described are reportable as noncompliances.

(1) A contractor allocates home office expenses to divisions as fixed management charges. The charges are less than the amounts which would have been allocated had the contractor followed CAS 403. The auditor should recommend that the CFAO advise the contractor that costs will be disapproved when the method used by the contractor results in an amount exceeding that which would have been allocated under the standard.

(2) Another contractor estimates labor cost by category, i.e., fabrication assembly, inspection, etc. The actual costs are accumulated in one undifferentiated account. Under these circumstances, the auditor would not be able to determine if there is any cost effect since there are no records to compare. The auditor should report the noncompliance and

recommend that the contractor be required to follow consistent practices in estimating and accumulating labor costs.

c. The following guidance should be followed in reporting instances of noncompliance with CAS.

(1) The auditor may discover instances of noncompliance while performing any of his or her other audit functions, i.e., price evaluations, audit of incurred costs, Disclosure Statement adequacy and CAS compliance audits, and system audits. Regardless of the circumstances under which noncompliance items are found, the auditor will include noncompliance issues in a separate report (activity code 19200). To avoid unnecessary and duplicative reporting, the CAS noncompliance will be fully described in the noncompliance report and other reports may merely cross-reference that report.

(2) Generally, when the audit discloses noncompliances with more than one cost accounting standard, a separate noncompliance audit report should be issued for each standard. However, noncompliances with two or more standards should be issued in the same report when the noncompliances are related or inseparable. Noncompliances are related or inseparable if the resolution of one resolves the other. Usually, auditors should not issue multiple audit reports for noncompliances with a single CAS.

(3) Reports will be issued as the auditor discovers instances of noncompliance during normal audit functions. There is no requirement for contract audit closing statements and audit reports on final pricing to include a "clearance" statement with respect to compliance with 41 U.S.C. 422.

d. The auditor is responsible for conducting audits as necessary to ascertain that contractors are complying with CAS. Therefore, a general request by a CFAO for reports and/or comments on contractor compliance is not needed. If such a request is received, inform the CFAO that although DCAA does perform compliance audits of specific Cost Accounting Standards, we do not issue reports on contractor overall compliance. (However, see 8-304.2 regarding scheduled annual compliance audits.) Offer to audit and report on any specific area that the CFAO may suspect is noncompliant. If a CAS compliance audit is already planned in the area of concern specified by the CFAO, the audit should be rescheduled to coincide with the CFAO request. When an audit relating to a particular identified practice is requested, the auditor and the CFAO will establish a mutually acceptable date for submitting the audit results. The auditor will then include the required audit steps to cover the questioned practice in the next scheduled audit or, if necessary, will schedule a special audit. The CFAO's request to audit a specific practice should be given prompt consideration but should not receive higher priority than proposal evaluations. Acknowledge the audit request or notify the CFAO of the planned audit in accordance with 4-103. After the audit, issue either a report on noncompliance or a brief report to inform the CFAO that the audit disclosed no noncompliance in the specific area cited by the CFAO.

e. Reports on noncompliance will be prepared and distributed per 10-808.

f. FAR 30.202-7(b)(2) establishes a policy that noncompliance with FAR Part 31 shall be processed separately. Noncompliance with CAS comes under FAR 52.230-2(a)(5), whereas noncompliance with FAR must be treated as a Government-proposed accounting practice revision under FAR 52.230-2(a)(4)(iii) (see 8-502.8). Consequently, the separate audit reports citing noncompliance with FAR should recommend that the CFAO process the accounting practice revision as a Government-proposed accounting practice revision pursuant to FAR 52.230-2(a)(4)(iii).

g. Outstanding noncompliance issues (issues included in a previous noncompliance report) may affect evaluations and reports related to other audits. Price proposal evaluations and other audit reports should not reference any situation as noncompliant unless a separate noncompliance report has been issued, except as noted in 8-414.3c. If a noncompliance report has been issued, the evaluation of a price proposal must comment on and should question the impact of the noncompliance item on the proposal being evaluated.

8-303 Audit of Disclosure Statement and/or Established Practices to Ascertain Compliance with CAS and FAR

8-303.1 Requirements

a. FAR 52.230-2 (full CAS coverage) require the contractor to adequately disclose its cost accounting practices for all covered contracts. FAR 52.230-3 (modified CAS coverage) also requires a contractor to adequately disclose its cost accounting practices under certain circumstances (see 8-103.8.c). An audit of the initial Disclosure Statement will be made to ascertain compliance with Public Law 100-679 (41 U.S.C 422). While this audit may be performed concurrently with the adequacy audit, separate audit reports should be issued for the adequacy and compliance of the initial Disclosure Statement. However, the report on the Disclosure Statement adequacy should not be deferred until the audit for compliance is completed.

b. A noncompliance disclosed during an evaluation of a price proposal should be included in a separate report and submitted to the CFAO with the evaluation report.

c. Audit files may contain sufficient information to determine whether the Disclosure Statement complies with 41 U.S.C. 422, related regulatory provisions, and FAR. The auditor should identify all significant areas where the contractor's disclosed practices are not in compliance. Audit working papers should sufficiently document the auditor's opinion regarding whether the contractor’s disclosed practices comply with CAS and FAR.

d. FAR 30.202-7(b) provides that the contractor’s cost accounting practices should comply with FAR Part 31 as well as CAS. However, the auditor should report as noncompliances only those FAR violations that involve the direct and indirect allocation or classification of costs. Essentially, this limitation excludes reporting as noncompliance those FAR violations based solely on reasonableness or allowability.

8-303.2 Initial Audits of Compliance

a. An initial compliance audit of a contractor’s Disclosure Statement, as a rule, should be scheduled for completion within 60 days after the CFAO has made a determination of adequacy of the Disclosure Statement. Notify the CFAO of the audit in accordance with 4-103. To avoid unnecessary effort at contractors having limited Government business, the auditor should find out whether a covered contract has been awarded before engaging in extensive audit effort to ascertain compliance.

b. The scope of compliance audits of initial Disclosure Statements should be limited to determining whether the described practices comply with CAS and FAR Part 31. The auditor should not conduct transaction testing to determine if the contractor’s actual practices comply with the described practices. Testing of actual compliance will be tested later in accordance with the routine audit planning cycle. However, the auditor may be aware through other audit work that an actual practice is noncompliant with the disclosed practice. In this case, the auditor will report the noncompliance in accordance with 10-808.

c. Upon completion of the compliance audit of the initial Disclosure Statement, the auditor should issue an audit report in accordance with 10-805.

8-303.3 Changes to Disclosure Statements and/or Established Practices

a. In accordance with FAR 52.230-6, the contractor must submit proposed accounting changes to the CFAO together with an estimate of the general dollar magnitude of the cost impact. The time frames for submission of the proposed changes are referenced in FAR 52.230-6(b). CFR 9903.302 provides definitions of "cost accounting practice", "change to a cost accounting practice" and contains illustrations of changes. CAS Working Group Guidance 81-25 concluded that a change from a percentage of completion to a completed contract method of computing state taxes was an accounting change. A change from a completed con-

tract to a percentage of completion or a percentage of completion - capitalized cost method as required by the Tax Reform Act of 1986 is also to be considered an accounting change.

b. An important CAS audit responsibility is to ascertain whether accounting changes made by a contractor require a revision to the Disclosure Statement. Therefore, auditors should request contractors to establish procedures to promptly notify the Government of all proposed accounting changes. The auditor will evaluate the acceptability of the contractor's proposed accounting changes. When a Disclosure Statement revision is required but is not made, a noncompliance report should be issued (e.g., practices used to record costs are not in compliance with Disclosure Statement). A condition of noncompliance could also result from the contractor's failure to follow the administrative procedures prescribed by FAR 52.230-6 in making an accounting change. When the CFAO determines that the description of the change is adequate and compliant and that the cost impact is material, the CFAO will request submission of a cost impact proposal in accordance with FAR 30.604.

c. A condition of noncompliance exists if, for example, a contractor estimates a contract using a cost accounting practice consistent with its Disclosure Statement and, at some point during the performance, changes the methods for computing and accumulating a labor class, whether or not it was listed as a principal class of labor in the Disclosure Statement. Costs are being accumulated in a manner inconsistent with estimating practices and not in accordance with the Disclosure Statement. The report to the CFAO should recommend that:

(1) determination of noncompliance (CAS 401) be made,

(2) a general dollar magnitude submission be requested from the contractor to evaluate the effect of the changed practice, and

(3) a revised Disclosure Statement be requested from the contractor describing all principal classes of labor.

d. Preamble J of the CASB's rules, regulations, and standards (see Appendix B to FAR) contains a discussion by the CASB on organizational changes. The preamble states in part that,

". . . business changes by themselves are not changes in cost accounting practices." However, it also states that "The decision as to whether there is a change in cost accounting practice is made through an analysis of the circumstances of each individual situation being promulgated in these regulations." Organizational changes which result in a change in the measurement of costs, the assignment of costs to cost accounting periods, or the allocation of costs to cost objectives should be considered to be changes in cost accounting practice requiring an adjustment to CAS-covered contracts for any increased costs. As a result of U.S. Court of Appeals for the Federal Circuit No. 93-1164, a corporate reorganization that involves a change in the grouping of segments for home office expense allocation purposes should not be considered a change in accounting practice unless the method or technique used to allocate the costs changes. For all other circumstances, auditors need to evaluate the specifics of each situation on a case-by-case basis to determine whether a change in accounting practice has resulted from a change in the measurement, allocation, and assignment of costs.

e. When a Disclosure Statement change is submitted, the auditor should ascertain its adequacy and compliance before the effective date. The time frame for completing these audits should be coordinated with the CFAO (see 4-103). The auditor will issue a single report including his or her opinions on both adequacy and compliance. (See 8-208e and 10-806.)

8-304 Audit of Estimated, Accumulated, and Reported Costs to Ascertain Compliance with CAS and FAR

8-304.1 Requirements

a. The cognizant contract auditor is responsible for conducting audits to ascertain whether a contractor's actual cost accounting practices comply with CAS and FAR Part 31. Compliance with CAS is required for all contractors that have contracts containing the CAS clause without regard to whether a Disclosure Statement has been submitted.

b. FAR Part 31 has incorporated many of the same CAS requirements for contracts which do not contain the CAS clause. Therefore the auditor is responsible for assuring compliance with these FAR provisions as well; however, non-compliance with Part 31 shall be reported separately from CAS non-compliances.

8-304.2 Compliance Audits

a. Compliance with FAR Part 31 and CAS is an inherent part of every contract audit. Auditors are expected to be knowledgeable of compliance requirements and consider them as applicable in examination of contract proposals and incurred cost. In addition a comprehensive audit of a contractor's compliance with each applicable cost accounting standard, except for CAS 401, 402, 405, and 406, shall be conducted once every three years, unless circumstances at the contractor warrant conducting the audit sooner. The comprehensive compliance audits will cover the incurred cost in the last completed contractor fiscal year and serve to provide added assurance to the overall consideration of all applicable CAS requirements in audit work performed during the intervening years.

b. During annual audit planning (see Chapter 3 and the Planning section of the DMIS User Guide), identify those standards for which tests of CAS compliance are necessary. Establish separate audit assignments for each standard to be tested. The auditor's assessment of risk for each standard should identify those provisions of a standard which are significant to the particular contractor. The materiality criteria provided in 48 CFR 9903.305 must be considered in developing the nature and extent of CAS compliance tests.

c. The initial Disclosure Statement adequacy and compliance audit for a new standard should be scheduled as soon as possible after the effective date of the new standard. The timeliness of the audit is especially important for those practices which may involve significant costs. If the audit is performed soon after a new standard's effective date, the auditor will have a basis for determining whether the accounting practices reflected in pricing proposals comply with the new standard.

8-304.3 Reporting of Compliance Audit Results

a. An audit report should be issued whether the audit disclosed instances of noncompliance or not. The audit report should inform the CFAO of the specific area being audited even if the audit disclosed no instances of noncompliance. If noncompliance is disclosed, the audit report should explain in detail the issues involved.

b. The auditor may detect noncompliance at any stage of a procurement action. Noncompliance should be reported whenever detected. Special care is necessary to ensure that proposal evaluation reports that reveal instances of noncompliance are accompanied by a noncompliance report.

8-400 Section 4 --- Cost Accounting Standards

8-400 Introduction

This section contains guidance on implementing specific cost accounting standards (CAS). Additional illustrations are included in an attempt to provide auditors with a common understanding of the standards. This section will be amended to include specific audit guidance for the standards promulgated in the future. The cost accounting standards (48 CFR Chapter 99) are included in the FAR as Appendix, Cost Accounting Preambles and Regulations, and are available on the Acquisition Knowledge Sharing System (AKSS) web site.

8-401 Cost Accounting Standard 401 --- Consistency in Estimating, Accumulating and Reporting Costs

a. The purposes of this standard are:

(1) to achieve consistency in the cost accounting practices used by a contractor in estimating costs for its proposals with those practices used in accumulating and reporting costs during contract performance, and

(2) to provide a basis for comparing such costs. The standard was effective and applicable to all CAS-covered contracts awarded after July 1, 1972.

b. Cost accounting practices should be applied consistently so that comparable transactions are treated alike. The consistent application of cost accounting practices will facilitate the preparation of reliable cost estimates used in pricing a proposal and the comparison of those cost estimates with the actual costs of contract performance. Such comparisons of estimated and incurred costs provide:

(1) an important basis for financial control over costs during contract performance,

(2) means for establishing accountability for costs in the manner agreed to by both parties at the time of contracting, and

(3) an improved basis for evaluating estimating capabilities.

8-401.1 Consistency between Estimating and Accumulating Costs

a. The consistency requirement between estimating and accumulating costs is a two-part requirement. First, the contractor's practices used to estimate costs in pricing proposals must be consistent with practices used in accumulating actual costs. Second, the contractor's practices used in accumulating costs must be consistent with practices used to estimate costs in pricing the related proposal. Thus, noncompliance with the standard can exist because a contractor has failed to estimate its cost in accordance with its established or disclosed accounting practices; noncompliance can also occur when a contractor estimates in accordance with its disclosed or established practices but accumulates on a different basis without obtaining the prior agreement of the Government.

b. One of the primary problems involved in the implementation of this standard relates to the consistency in the level of detail provided in estimating contract costs and accumulating contract costs. Greater detail in the accumulating and reporting of contract costs than in the pricing of proposals is permitted by CAS 401.40(c) which states that, "The grouping of homogeneous costs in estimates prepared for proposal purposes shall not per se be deemed an inconsistent application of cost accounting practices. . . ." Although the grouping of homogeneous costs for estimating purposes is permitted, the auditor should be aware that CAS 401.50(a) requires that ". . . . costs estimated for proposal purposes shall be presented in such a manner and in such detail that any significant cost can be compared with the actual cost accumulated and reported therefor." In other words, the grouping of costs for proposal purposes does not result in noncompliance as long as the costs are homogeneous and if comparisons between actual costs and proposed costs are possible. The following are examples of permissible grouping of costs as presented in CAS 401.60(a)1 and 3.

". . . 1. Contractor estimates an average direct labor rate for manufacturing direct labor by labor category or function. Contractor records manufacturing direct labor based on actual cost for each individual and collects such costs by labor category or function."

". . . 3. Contractor uses an estimated rate for manufacturing overhead to be applied to an estimated direct labor base. It identifies the items included in its estimate of manufacturing overhead and provides supporting data for the estimated direct labor base. The contractor accounts for manufacturing overhead by individual items of cost which are accumulated in a cost pool allocated to final cost objectives on a direct labor base."

c. Noncompliance can occur when there is greater detail in the estimating of contract costs than in the accumulating and reporting of costs as indicated by the following example in CAS 401.60(b):

". . . 5. Contractor estimates engineering labor by cost function, i.e., drafting, production engineering, etc. Contractor accumulates total engineering labor in one undifferentiated account."

(1) In the above circumstances, should the potential noncompliance with CAS 401 be rectified by providing less detail in estimating or more detail in accumulating costs? If the contractor revises its price proposal and shows the estimate for engineering labor as one amount, it achieves consistency with its method of accumulating these costs and technically corrects the noncompliance. However, an agreement to eliminate all details in the estimate would deprive the Government of information needed to effectively evaluate the pricing proposal. This extreme approach should be rejected and cited as an estimating system deficiency.

(2) FAR 15.403, DFARS 215.403, and Contract Pricing Resource Guides contain guidance as to the level of detail required for cost or pricing data submitted in connection with negotiated noncompetitive contracts. FAR 15.408, Table 15-2, constitutes an appropriate baseline for establishing the detail to be furnished. If the contractor's estimates are in accordance with this baseline, and are in greater detail than costs in the records, the auditor should normally recommend that costs be accumulated in a manner consistent with the estimate. A reduction in the estimating details would be acceptable only if the contractor's submission satisfies the FAR/DFARS provisions cited above and the requirements of acquisition officials.

(3) In determining the appropriate level of detail for consistent use in estimating and accumulating costs, the auditor should bear in mind that in many instances procuring contracting officers (PCOs) may request contractors to furnish estimates in a special manner. Such a request may require more information than needed for cost accumulation purposes or cause information to be arranged in a way that is not consistent with the manner in which the contractor intends to accumulate the actual costs.

(4) If the auditor finds estimates of significant items of costs in a pricing proposal which will not be comparable with the actual cost accumulated, he or she should discuss the inconsistency with the contractor. The auditor should point out the areas of potential noncompliance and advise the contractor of the audit recommendations she or he proposes to make to the cognizant Federal agency official (CFAO). If the contractor contends that it presented the information in the price proposal for negotiation purposes only and did not intend to accumulate costs in such a manner, the auditor should inform the contractor that she or he will recommend the contracting officer request a cost estimate that summarizes the cost data in a manner compatible with the cost accumulation plan. The auditor should evaluate the cost summaries to determine if sufficient data are presented to meet the requirement of the Request for Proposal. The auditor's opinion on whether the summaries contain an acceptable level of detail for accumulation purposes should be included in the report to the CFAO.

d. The promulgation of CAS 401 raised a question among auditors as to whether applying a percentage factor to proposed material costs to cover expected losses would comply with the standard if the contractor maintained no separate historical loss records. The CASB issued Interpretation No. 1 to CAS 401 in 1976 to deal with that particular issue. The interpretation provides that contractors who estimate material losses

by applying a percentage factor to a base, such as total material requirements, must support the factor with historical experience. The interpretation does not prescribe the type or level of detail necessary to comply with the standard. Government contracting authorities should decide the amount of statistical or accounting data required based on the individual circumstances. It should be emphasized that the contractor should be cited for noncompliance whenever factors are applied to totals or subtotals of material requirements, and during contract performance the contractor does not maintain a separate record of the costs represented by the proposed factor. Adding a uniform percentage to each line item in the bill of material is the same as adding a single percentage to the total basic material cost. In the two examples above, the contractor would have to maintain a separate accounting record for the additional material purchased during contract performance to be in compliance with the CAS 401. However, when the contractor adjusts the quantities of individual line items in the bill of material, either by applying a factor or by adding a specific quantity of additional units, the contractor is deemed to have complied with the standard. This is because the estimate is a representation of the total cost of individual parts. In most situations, the cost and quantity of individual parts used can be determined from the accounting records. Nothing in the Interpretation No. 1 to CAS 401 should be construed to alter or modify the requirements that the contractor submit adequate cost or pricing data. Refer to 9-200 for evaluating the adequacy of cost or pricing data in proposals.

8-401.2 Consistency in Reporting Costs

a. As used in the standard, "Reporting of Costs" refers to:

(1) data presented in reports required by the contract such as budget and management reports for cost control purposes and

(2) the data contained on public vouchers or any other request for payment.

b. The primary interest is to ascertain whether the accounting practices used to determine the costs presented in these reports are consistent with the accounting practices used to estimate and accumulate the costs. It would not be expected that a public voucher will contain the same level of detail as a pricing proposal or that the details in a budget or management report will be limited to that in the proposal. The auditor will ascertain whether the accounting practices for selecting indirect cost pools and methods of distributing the indirect costs used to determine the amounts on those reports are consistent with those used for estimating and accumulating. In addition, the standard does not prohibit the use of reporting systems with unique requirements such as the applied cost concept used for EVMS purposes and certain estimating techniques used to project contract estimates at completion under EVMS contracts. Further, the standard does not prevent the use of forecasted indirect cost rates for billing as long as the pools and allocation bases used to develop those rates are consistent with those used for estimating and accumulating costs.

c. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendation as outlined in 8-302.7.

8-401.3 Illustrations

The following illustrations are intended to supplement those in paragraph 401.60 of the standard. They are to be used as a guide in determining the contractor's compliance with the standard.

a. **Problem.** A contractor's proposal shows the cost of engineering labor by class, i.e., Engineer I, Engineer II, etc. However, it is the contractor's practice to accumulate engineering labor by type, i.e., Electrical Engineer, Design Engineer, etc. Such practices would violate CAS 401.

Solution. If the contractor submits a summary of the proposal by type of engineer which:

(1) reconciles with the proposed cost by class of engineer,

(2) meets the requirements of the solicitation (for example, the format provided in FAR 15.408, Table 15-2,) and

(3) further explains that this is the manner in which cost will be accumulated, then consistency with CAS 401 will have been achieved.

The auditor should be careful to determine whether the PCO intended to buy a specific number of hours by class of engineers. In such a case, the contracting officer should require the contractor to estimate and accumulate by the same classes of engineers. By this requirement, consistency with the cost accumulation records will be achieved without diminishing the level of detail in the estimate. In this regard, it should be remembered that any special breakdown required by the contracting officer is a matter for discussion between the contracting parties and is not dealt with by CAS 401.

b. **Problem.** A contractor estimates cost by line item, i.e., data, first article test, and hardware, and then submits a single proposal for all three items. The contractor does not intend to accumulate the cost of each item separately but rather, in accordance with its established accounting practice, accumulate labor, material, and indirect costs for the contract as a whole. In this instance, the contractor's accumulation records are in lesser detail than its estimating constituting a noncompliance with CAS 401.

Solution. (1) An acceptable approach to correcting the apparent inconsistency between the estimating and accumulating practices is to require the contractor to develop an estimate in accordance with the requirements of the solicitation, for example, FAR 15.408, Table 15-2. Where the contractor elects to estimate and accumulate the combined costs of the three line items by cost elements (direct labor, material, indirect costs, etc.), such a practice does not necessarily constitute a violation of CAS 401. This is true because the level of detail required by FAR 15.408, Table 15-2, has been authoritatively established as an acceptable baseline for compliance with the standard. However, when the contractor chooses this alternative, the contracting officer should be promptly advised in the event that a level of detail of costs incurred that go beyond the essential requirements of CAS 401 is needed for proper contract administration.

(2) On the other hand, if the contractor is required to submit a separate proposal for individual contract line items and the cost of each item is material in amount and inherently distinct from other items for which costs are separately accumulated, the contractor probably should be required to accumulate cost by line items. In effect, where required by the contracting officer, the cost of each line item should be estimated and accumulated as if each were a separate contract. Examples of contracts whose costs should be estimated and accumulated in such a way are those which provide for:

(1) design, prototype development, and production or

(2) distinct and disparate end items of production.

c. **Problem.** A contractor prepares separate estimates for the cost of raw material, subcontracts, purchased parts, and interdivisional transfers. The costs of these items are not separately identified in the accounting records.

Solution. The practice is in noncompliance with the standard and the contractor should be required to accumulate costs consistent with its estimates. However, the standard permits supplemental records if they are reconcilable to the formal accounting records.

d. **Problem.** During the audit of a price proposal, an auditor finds that a contractor uses a material additive factor to cover the cost of small common-usage items. In preparing the price proposal, the cost of this factor is estimated as an historical percentage of direct material requirements. In accumulating costs, these items are computed as a percentage of direct productive labor hours.

Solution. The condition described above contravenes the provisions of CAS 401. The auditor should recommend a determination of noncompliance and that the contractor change its actual practices to conform with the practices disclosed or established. For example, if the contractor's disclosed or established practice is to accumulate the cost of small common-usage items as a percentage of direct productive labor hours, then the estimating practice should be changed to be compatible with the method of accumulating such

costs. In the price evaluation report, the excess cost estimated as a direct result of using a practice that is inconsistent with the contractor's disclosed or established practices will be quantified and questioned. The validity of alternative methods of estimating and costing will be determined in accordance with guidelines included in 6-300 and 9-400.

8-402 Cost Accounting Standard 402 --- Consistency in Allocating Costs Incurred for the Same Purpose

a. The purpose of this standard is to ensure that each type of cost is allocated only once and on only one basis to any contract or other cost objective. The fundamental requirement is that all costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. The standard was effective and applicable to all CAS-covered contracts awarded after July 1, 1972.

b. The key words in applying this standard are "costs incurred for the same purpose in like circumstances." The illustrations in CAS 402.60 show the need for a thorough examination of the facts before concluding whether or not an accounting practice is resulting in noncompliance with the standard. For example, CAS 402.60(b)(2) demonstrates how a cost, although incurred for the same general purpose, (i.e., fire fighting) should be viewed in terms of its more specific purposes (i.e., protection of the entire plant versus protection of a special area) which permits the costs to be allocated to final costs objectives in a different manner. It is essential to examine all of the facts and to avoid making determinations on the basis of general information or nomenclature.

c. CAS 400.1(a) defines a proposal as: "any offer or other submission used as a basis for pricing a contract, contract modification or determination settlement or for securing payments thereunder." Interpretation No. 1 to CAS 402 was promulgated in 1976 to clarify the circumstances under which a contractor could charge proposal costs both direct and indirect without violating the standard. The interpretation concludes that not all proposal costs are incurred in like circumstances. Proposal costs incurred pursuant to the specific requirement of an existing contract, such as proposal cost incurred in connection with the definitization of letter contracts and with orders issued under basic ordering agreements, are considered to have been incurred in a different circumstance than other proposal costs and may be charged direct to the specific contract. Costs of preparing proposals will be treated as indirect costs except where such effort is specifically required by contract provision.

d. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-402.1 Illustrations

The following illustrations are intended to supplement those in section 402.60. They are to be used as a guide in determining whether the contractor complies with the standard.

a. **Problem.** A contractor has a Government contract which requires extra effort for planning and cost management. It hired extra people to accomplish this effort and accounted for all their labor cost as a direct charge to the contract. The contractor has other people performing the same functions for more than one contract and their labor is charged to indirect costs.

Solution. Since the work being performed is the same and the only difference is in the amount of effort required to accomplish the function, this practice would not comply with the standard. The contractor could correct the situation by:

(1) charging all of these costs to indirect costs and developing an equitable distribution base or

(2) direct charging all of these costs.

b. **Problem.** A contractor charges engineering consultant costs incurred on IR&D projects to engineering overhead; the same costs incurred for research and development contracts are charged direct to the contracts.

Solution. This practice does not comply with the standard because the same type of costs incurred in similar circumstances are charged to cost objectives on different bases. Also, the practice does not comply with FAR 31.205-18, and CAS 420 which requires that direct and indirect costs for IR&D projects be determined on the same basis as if the IR&D projects were under contract. Since the benefiting projects can be specifically identified, the consultant costs should be charged directly to those projects.

c. **Problem.** A contractor has hundreds of cranes located throughout a shipyard. Their maintenance, taxes, and depreciation costs are recorded in a general account and then allocated to departmental overhead pools for distribution to contracts. The Dry Dock has the cost of eight cranes charged directly to its departmental overhead pool because their use is unique to the Dry Dock operations.

Solution. Since the Dry Dock cranes are used for a special purpose and the Yard cranes for general purposes, this practice would not result in double counting. However, if any of the Yard cranes are also used for a special purpose, such as new ship construction, the practice would result in double counting and noncompliance with the standard. Under those conditions all of the special purpose cranes should be eliminated from the general account and charged directly to the using department to correct the problem.

8-403 Cost Accounting Standard 403 --- Allocation of Home Office Expenses to Segments

a. The purpose of this standard is to establish criteria for allocation of home office expenses to the segments of the organization on the basis of a beneficial or causal relationship. The appropriate implementation of this standard will limit the amount of home office expenses classified as residual to the expenses of managing the organization as a whole.

b. The standard was effective July 1, 1973 and, after receipt of a CAS-covered contract, is to be followed by each contractor as of the beginning of its next fiscal year. The standard exempts contractors who are subject to the provisions of Office of Management and Budget Circular Nos. A-21 and A-87 (Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Educational Institutions and Principles for Determining Costs Applicable to Training and Other Educational Services under Grants and Contracts with State and Local Governments).

8-403.1 General

a. With the adoption of this standard, contractor and Government personnel have a specific, authoritative accounting rule prescribing criteria for allocating home office and group office expenses to segments of an organization. For purposes of the standard, the term "home office" is defined in CAS 403.30(a)(2) as an "office responsible for directing or managing two or more but not necessarily all segments of an organization." The definition expressly includes intermediate levels, such as group organizations which report to a common home office. An intermediate level may be both a segment and a home office.

b. The basic concept of the standard recognizes that some home office expenses incurred for specific segments can be assigned directly. Other expenses, not incurred for specific segments, have a clear relationship (i.e., measurable with reasonable objectivity) to two or more segments. Lastly, the standard recognizes a third type of home office expense (i.e., residual) which possesses no readily measurable relationship to segments. Consistent with this concept of home office expenses the standard requires that:

(1) Those expenses incurred for specific segments are to be allocated directly to those segments to the maximum extent practical.

(2) Those expenses not directly allocable, but possessing an objective measurable relationship to segments, should be grouped in logical and homogeneous expense pools and

distributed on allocation bases reflecting the relationship of the expenses to the segments concerned.

(3) When the residual expenses are considered material because they exceed a specified percentage of total company operating revenue (as defined in CAS 403.40(c)(2)), a three-factor formula must be used to allocate these expenses. The three-factor formula consists of payroll dollars, operating revenue (net of interdivisional purchases), and average net book values of tangible capital assets and inventories (net of progress payment billings). If the residual expenses do not exceed this threshold, they may be allocated to all segments by means of any allocation base representing the total activity of such segments. Regardless of the method, there may be instances where a particular segment receives significantly more or less benefit from residual expenses than would be reflected by the allocation of such expenses pursuant to the standard. In these cases, a special allocation may be agreed to by the parties provided such special allocation is commensurate with the benefits received (CAS 403.40(c)(3)).When a special allocation under CAS 403.40(c)(3) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices.

c. A requirement of the standard is that home office expenses shall be allocated on the basis of the beneficial or causal relationship between supporting and receiving segments. In establishing this requirement, the CASB stated that materiality is an important consideration in determining whether an expense should be allocated directly or accumulated in a homogeneous expense pool and allocated on a basis reflecting the causal or beneficial relationship of the pooled expenses to the receiving segments. In addition, CAS 403.40(b) provides criteria for allocating six groupings of home office expenses. Residual expenses are defined in CAS 403.40(c) as all home office expenses which are not otherwise allocable pursuant to the standard.

d. The standard provides for an annual test to ascertain whether the residual expenses must be allocated on the basis of the prescribed three-factor formula or if the contractor may use any appropriate base. For the first year the contractor is subject to this standard the determination "shall be based on the pro forma application of this standard to the home office expenses and aggregate operating revenue for the contractor's previous fiscal year" (CAS 403.40(c)(2)). The contractor is responsible for determining whether or not the company should propose the use of any base representative of the total activity of the segments or if the three-factor formula must be used. The pro forma submission must comply with the standard.

8-403.2 Guidance

a. Contractors becoming subject to this standard must:

(1) Revise their home office expense pool structure and methods of distributing the expenses where necessary to comply with CAS 403.40.

(2) Amend Disclosure Statements to describe the new pool structures and methods of distribution.

(3) Estimate the cost of the first and all subsequent contracts subject to this standard using the new pool structures and methods of distribution. Failure to do so would result in noncompliance with CAS 401 when costs are subsequently recorded in accordance with CAS 403.

(4) Submit a proposal for the equitable adjustment of all CAS-covered contracts that were negotiated before the effective date of the standard and are affected by the change in cost accounting practices.

b. Amendments to a Disclosure Statement are subject to the same audit and reporting requirements as the original Disclosure Statement. Auditors should be especially careful in evaluating the adequacy of responses to Item 8.3.2 of the Disclosure Statement concerning the composition of the allocation base. The description should provide enough information to determine that the contractor is treating all of the elements in the base in the same manner at all divisions.

c. To ascertain that the accounting practices comply with the standard, the auditor should determine that:

(1) expenses have been properly classified as directly allocable, indirectly allocable, or residual;

(2) the "logical and relatively homogeneous pools" are "allocated on bases reflecting the relationship of the expenses to the segments concerned;" and

(3) residual expenses are allocated on a base "representative of the total activity" of the company or the prescribed three-factor formula.

d. Appropriate steps must be included in all audits, i.e., price proposals, forward pricing rate proposals, defective pricing, etc., to assure that adjustments were made for the changes in the accounting practices.

e. Because changes in the home office accounting practices will normally affect more than one organizational unit of the company, arrangements should be made by the CAC, CHOA, or GAC as soon as possible to coordinate the audits of the price adjustment proposal.

f. Auditors should encourage contractors becoming subject to the standard to submit their Disclosure Statement revisions and a pro forma submission of their revised home office expense structure as soon as possible. The early submission and audit of this data could permit the contractor and auditor to resolve any significant problems before the contract award due dates and thereby preclude delays in the awarding of contracts.

g. This standard requires contractors to use a base representative of the total activity of the segments for distributing residual expenses, unless the criteria for special allocation or for the three-factor formula method are met. If the residual expenses exceed the levels in CAS 403.40(c)(2), the contractor must distribute them on the basis of the three-factor formula beginning with the next fiscal year. In addition, the contractor may also choose to use the three-factor formula even though not required by the standard. The first time the contractor must use the three-factor formula, it may submit a proposal for an equitable adjustment. After the contractor uses the three-factor formula for the first time, any change to the base for distribution of the residual expenses, is subject to not only the provisions of this standard but also the provisions of CAS 401 and FAR 52.230-2(a)(4)(ii), (a)(4)(iii), or (a)(5). The prefatory comments to CAS 420 state that the amount of IR&D and B&P costs at a home office is not to be added to the residual pool to determine whether use of the three-factor formula is required. Where the three-factor formula is not required to be used, selection of an appropriate base should consider the effect of CAS 420.50(e)(2) which, in certain circumstances, ties the allocation of IR&D and B&P costs to the home office residual expense allocation base.

h. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-404 Cost Accounting Standard 404 --- Capitalization of Tangible Assets

a. This standard establishes criteria for determining the acquisition costs of tangible assets which are to be capitalized. It does not cover depreciation or disposition of fixed assets, which is covered by CAS 409.

b. The initial standard was effective July 1, 1973 and, after the receipt of a CAS-covered contract, must be applied to all tangible capital assets acquired during the contractor's next fiscal year. On February 13, 1996, the CAS Board amended CAS 404.50(d)(1) relating to the measurement of assets acquired through mergers or business combinations. The CAS Board also amended CAS 404.40(b)(1) to increase the minimum acquisition cost for capitalization of tangible capital assets from $1,500 to $5,000. The effective date of these amendments is April 15, 1996. The amendments are applicable to contracts in the next cost accounting period beginning after receipt of a contract that incorporates the revised standard. Amendments to CAS 409, also effective April 15, 1996, are discussed in 8-409.

c. The amended CAS 404, effective April 15, 1996, applies to tangible capital assets acquired in a business combination that takes place after the applicability date (see 8-404.4 for illustrations of the amended CAS 404/409 applicability date).

8-404.1 General

a. The standard requires contractors to capitalize the acquisition cost of tangible assets in accordance with a written policy that is reasonable and consistently applied. The policy shall include the following:

(1) A minimum service life criterion which shall not exceed two years but which may be a shorter period.

(2) A minimum acquisition cost criterion which shall not exceed $5,000 but which may be a smaller amount.

(3) Identification of asset accountability units to the maximum extent practical. The standard defines these units as "A tangible capital asset which is a component of plant and equipment that is capitalized when acquired or whose replacement is capitalized when the unit is removed, transferred, sold, abandoned, demolished, or otherwise disposed of." These units should be identified and separately capitalized upon acquisition. Even though they may not have been separately capitalized, the units should be removed from the asset accounts at disposition.

(4) Establishment of minimum dollar amounts for the capitalization of original complements of low cost equipment and for betterments and improvements. These minimum amounts may exceed the $5,000 limitation provided the higher limitations are reasonable in the contractor's circumstances. The primary purpose in requiring the capitalization of original complements is to assure allocation of incurred cost to applicable current and future periods. The total original complement should be treated as a tangible capital asset. Therefore, the CASB expected that a contractor will identify and control the original complement as an entity rather than account separately for each individual item which comprises the total complement.

b. The acquisition cost of tangible assets includes the purchase price adjustment to the extent practical for premiums paid or discounts received and the costs necessary to prepare the asset for use.

(1) CAS 404.50(a)(1)(i) states that the purchase price is the consideration given in exchange for an asset and is determined by cash paid or to the extent payment is not paid in cash, in an amount equivalent to what would be the cash basis. This provision requires the gain or loss realized on assets traded-in to be included as part of the purchase price of the acquired asset. CAS 404 does not permit alternative treatment.

(2) Costs necessary to prepare the asset for use include the cost of placing the asset in location and bringing the asset to a condition necessary for normal or expected use. Where material in amount, such costs including initial inspection and testing, installation, and similar expenses shall be capitalized.

(3) Donated assets which meet the contractor's criteria for capitalization shall be capitalized at their fair value. This requirement also includes those assets donated by the Federal Government.

c. Tangible capital assets constructed or fabricated by a contractor for its own use shall be capitalized at amounts which include all indirect costs properly allocable to such assets. This requires the capitalization of G&A expenses and the cost of money when such expenses are identifiable with the constructed asset and are material in amount. Application of the full costing techniques to Government contract costing requires that full consideration be given to the applicability of fixed overhead including G&A expenses and the cost of money to constructed assets. Therefore, constructed tangible capital assets which are identical with or similar to the contractor's normal product should receive an appropriate share of all indirect cost including G&A expenses and the cost of money. In addition, other constructed tangible capital assets requiring significant indirect support also should be burdened with their allocable share of these sup-

porting indirect costs including supporting G&A expenditures, where such costs are material.

d. The provisions of the standard do not apply to special tooling and special test equipment which are properly chargeable against the contracts for which the acquisition is authorized.

e. In connection with lease agreements, contractors must determine whether they consider the acquisition to be a capital lease under FASB Statement No. 13 and subject to the standard or an operating lease under FASB Statement No. 13 and subject to the requirements of FAR 31.205-36. In either case, the CASB has stated that the reasonableness of the lease costs remains the responsibility of the acquisition agencies.

f. The standard does not extend to the specific type of records to be maintained. Therefore, contractors may continue to account for their assets on a unit basis or in logical groups in accordance with other appropriate regulations.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-404.2 Assets Acquired in a Business Combination Using the Purchase Method of Accounting.

a. Pre - April 15, 1996 Requirements. Fully CAS-covered contractors would measure the assets acquired in a business combination using the purchase method of accounting required by the original CAS 404.50(d) (i.e., step-up or step-down of asset bases), but depreciation expense would be subject to the allowability ceiling of FAR 31.205-52 (7-1705.3). The FAR 31.205-52 ceiling amount is the amount that would have been allowable had the business combination not taken place (i.e., no step-up of asset values). Accordingly, the unallowable depreciation expense (i.e., excess depreciation based on a stepped-up asset value over depreciation based on no stepped-up asset value) should be included in any allocation base which normally includes such costs, e.g., the total cost input G&A base. See 8-410.1a(2) for further guidance.

b. Requirements Effective April 15, 1996. The prior CAS 404.50(d) was deleted and replaced by an amended CAS 404.50(d)(1) and (2).

(1) CAS 404.50(d)(1):

(a) CAS 404.50(d)(1) provides that all tangible capital assets of the acquired company that during the most recent cost accounting period prior to a business combination generated either depreciation expense or cost of money charges that were allocated to Federal Government contracts or subcontracts negotiated on the basis of cost, to be capitalized by the buyer at the net book value(s) of the asset(s) as reported by the seller at the time of the transaction.

(b) The requirements of CAS 404.50(d)(1) deviate from the purchase method of accounting required by GAAP, and instead, provide “no step-up, no step-down” of asset values for Government contract cost accounting purposes. Consequently, the buyer will use the net book value of the tangible capital asset in the seller’s accounting records as the capitalized value of the asset and for all contract costing purposes. For instance, depreciation expense will be based on the seller’s net book value. Likewise, cost of money will be calculated using the seller’s net book value. Further, the asset values used in the CAS 403 three-factor formula for distributing the home office costs will be based on the seller’s net book value.

(2) CAS 404.50(d)(2):

(a) The provisions of CAS 404.50(d)(2) apply to tangible capital assets acquired in a business combination that did not generate either depreciation expense or cost of money charges during the most recent cost accounting period. CAS 404.50(d)(2) provides that all tangible capital assets of the acquired company that during the most recent cost accounting period prior to a business combination did not generate either depreciation expense or cost of money charges that were allocated to Federal Government contracts or subcontracts negotiated on the basis of cost, are to be assigned a portion of the cost of

the acquired company not to exceed their fair values at the date of acquisition. When the fair value of identifiable acquired assets less liabilities assumed exceeds the purchase price of the acquired company in an acquisition under the "purchase method," the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.

(b) The requirements of CAS 404.50(d)(2) are similar to the purchase method of accounting required by GAAP. Consequently, tangible capital asset values would be written-up or written-down depending on the circumstances of the transaction. However, tangible capital assets meeting the requirements of CAS 404.50(d)(2) must still comply with the requirements of FAR 31.205-52 (7-1705.3). Therefore, although the asset values may be measured based on the "step-up" or "step-down" rule, allowable depreciation and cost of money will be limited to the total of the amounts that would have been allowed had the combination not taken place (i.e., costs resulting from asset write-ups are unallowable). This limitation was removed by FAC 97-04, effective April 24, 1998, which revised FAR 31.205-52 and 31.205-10(a)(5) to conform to the revised CAS 404 and 409. Therefore, allowable depreciation and cost of money would be measured in accordance with CAS 404.50(d).

8-404.3 Illustrations - Compliance with the Standard

The following illustrations are intended to supplement the illustrations in paragraph 404.60 of the Standard. They are to be used as a guide in determining if noncompliance exists.

a. **Problem**. A contractor has an established policy of capitalizing tangible assets which have a service life in excess of two years and a cost of more than $6,500. It enters into a contract which makes it subject to this standard.

Solution. The contractor must change its policy to conform to the maximum limitations of not more than two years and $5,000. If costs are affected on CAS-covered contracts in existence before the requirement for the contractor to follow this standard, they are subject to the equitable adjustment provision of FAR 52.230-2(a)(4)(i).

b. **Problem**. A contractor has an existing policy of capitalizing tangible assets which have a service life of more than one year and a cost of more than $3000. It enters into a contract which makes it subject to the standard and suggests that the capitalization policy should be changed to two years and $5,000.

Solution. The contractor's existing policy is in conformance with the provisions of the standard. Therefore, it is not required to make any changes to the policy. However, if it should choose to do so, the change must be made in accordance with the provisions of FAR 52.230-2(a)(4)(ii). Under that paragraph the change may not result in any increased cost to the Government.

c. **Problem**. A contractor has a policy of capitalizing betterments and improvements when the expenditures exceed five percent of the current replacement value of buildings or 25 percent of the current replacement value of machinery and equipment. The policy does not contain any dollar limitations.

Solution. CAS 404.40(b)(4) of the standard provides that "The contractor's policy may designate higher minimum dollar limitations . . . for betterments and improvements than the limitation established in accordance with paragraph (b)(1) of this section, provided such higher limitations are reasonable in the contractor's circumstances." Since the contractor's policy does not contain specific dollar limits, it does not comply with the standard. To correct the situation, the contractor could add specific not-to-exceed dollar limitations. Betterments and improvements whose values are in excess of the established limitations would be capitalized without regard to the percentage relationship. However, the dollar limitations established by the contractor must be reasonable in its circumstances.

d. **Problem**. An asset having a net book value of $1.5 million and cash of $1 million is given in exchange for the acquisition of a new asset commonly sold for $2 million. The contractor's policy is to capitalize the replacement as the sum of the cash paid and the net book value of the old asset.

Solution. The contractor's policy does not comply with the standard. CAS 404.50(a)(1)(i) requires the contractor to determine the amount equivalent to the cash price. The acquisition cost in this instance would be $2 million. The contractor is required to remove the undepreciated value of the traded asset from the asset accounts and capitalize the replacement asset for $2 million.

e. **Problem**. A contractor proposes to construct a facility and install equipment for the Government. The proposed price does not include an allocation of G&A expenses or cost of money. However, G&A expenses are allocated to similar facilities constructed or fabricated by the contractor for its own use.

Solution. CAS 404 applies only to tangible capital assets acquired or constructed for the contractor's own account. Assets provided by a contractor in fulfilling contract terms are not covered by this standard. However, even though facilities contracts are not subject to CAS 404, they should be allocated G&A expense under CAS 410. In addition, cost of money should be considered an allowable cost under FAR 31.205-10.

f. **Problem**. The contractor manufactures Model X for the Government. The contractor produces one unit of Model X for its own use. The contractor capitalized the asset at $37,500 ($25,000 material, $5,000 production labor and $7,500 overhead, reflecting the 150 percent annual overhead rate).

Solution. Model X was not capitalized in accordance with CAS 404.50(b). When constructed assets are identical with the contractor's regular product, such assets must be allocated their full share of indirect costs, including G&A expenses and cost of money. Assuming that G&A expenses, production overhead cost of money, and G&A expense cost of money rate for the year are 10%, 10% and 1% respectively, the asset should have been capitalized at $42,180, computed as follows:

Production Labor		5,000
Production Overhead	(150%)	7,500
Cost of Money related to Production Overhead	(10%)	500
Materials		25,000
Subtotal		38,000
G&A Expense	(10%)	3,800
Cost of Money related to G&A Expense	(1%)	380
		$42,180

g. **Problem**. Contractor A acquires Contractor B and accounts for the business combination using the purchase method of accounting. Prior to the business combination, the net book value of Contractor B's assets was $10.5 million. Contractor B's assets generated depreciation expense and cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. For GAAP purposes, Contractor A recorded the assets at their fair market value of $18 million. The revised CAS 404 applies to the business combination.

Solution. The provisions of the amended CAS 404.50(d)(1) would apply to the business combination because the seller's (Contractor B's) assets generated depreciation or cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. For CAS purposes, Contractor A would capitalize the acquired assets at $10.5 million, the net book value of the assets in Contractor B's accounting records. The $10.5 million would be used as the basis of Contractor A's depreciation expense, cost of money, and asset values used in the CAS 403 three-factor formula. The $7.5 million difference between the net book value and fair market value would not be questioned because the costs were not "measured" for CAS purposes. Consequently, any depreciation related to the $7.5 million would not be included in Contractor A's total cost input G&A base.

h. **Problem**. Same facts as Problem g. above, except that Contractor B has not performed Government contracts for several years and consequently, its assets did not gen-

erate depreciation expense or cost of money charges that were allocated to Government contracts negotiated on the basis of cost, in its most recent cost accounting period.

Solution. The provisions of the amended CAS 404.50(d)(2) would apply to the business combination because the seller's (Contractor B's) assets did not generate depreciation expense or cost of money charges on Government contracts in its most recent cost accounting period. For CAS purposes, Contractor A would capitalize the acquired assets at $18 million, the fair market value of Contractor B's assets. However, for contracts awarded prior to April 24, 1998, costs resulting from the $7.5 million fair market value in excess of the net book value are unallowable in accordance with the provisions of FAR 31.205-52. Consequently, the allowable depreciation and cost of money charges would be based on the $10.5 million. The asset values used for the CAS 403 three-factor formula would be the CAS 404 measured amount of $18 million. The unallowable $7.5 million would be included in any of Contractor A's allocation bases which normally include such costs, e.g., the total cost input G&A base, because the CAS 404 measured cost is the fair market value of $18 million, even though the FAR 31.205-52 allowable ceiling amount is based on the asset value of $10.5 million. For contracts awarded on or after April 24, 1998, the allowable depreciation and cost of money would be based on $18 million in accordance with the revised FAR 31.205-52.

8-404.4 Illustrations - Applicability Date of Amended CAS 404/409, Effective April 15, 1996

The following illustrations are intended to demonstrate the applicability date of the amended CAS 404/409, effective April 15, 1996.

a. **Situation**. Contractor A uses a calendar year as its accounting period and receives its "first" CAS-covered contract on May 20, 1996, after the April 15, 1996 effective date of the revised CAS 404/409. Contractor A completes a business combination using the "purchase method" of accounting on February 15, 1997.

Applicability Date. The applicability date of the revised CAS 404/409 would be January 1, 1997, the beginning of Contractor A's next full cost accounting period beginning after receipt of a contract to which the revised CAS 404/409 is applicable. Assets acquired in the business combination would be subject to the revised CAS 404/409 because the combination takes place after the applicability date of the revised CAS 404/409.

b. **Situation**. Same facts as a. above, but Contractor A completes the business combination on June 15, 1996.

Applicability Date. As explained in a. above, the applicability date of the revised CAS 404/409 is January 1, 1997. Accordingly, the business combination would not be subject to the revised CAS 404/409 because the combination was completed prior to the applicability date.

c. **Situation**. Contractor B uses a cost accounting period of July 1 - June 30 and receives its "first" CAS-covered contract on December 10, 1996, after the April 15, 1996 effective date of the revised CAS 404/409. Contractor B completes a business combination using the "purchase method" of accounting on January 30, 1997.

Applicability Date. The applicability date of the revised CAS 404/409 would be July 1, 1997, the beginning of Contractor B's next full cost accounting period after receipt of a contract (December 10, 1996) to which the revised CAS 404/409 is applicable. The business combination would not be subject to the revised CAS 404/409 because the combination was completed prior to the July 1, 1997 applicability date.

d. **Situation**. Contractor C uses a calendar year as its cost accounting period. Prior to 1996, Contractor C was awarded contracts subject to full CAS coverage. During 1996, Contractor C became subject to only modified CAS coverage and received a modified CAS-covered contract on May 15, 1996. Contract C completes a business combination on February 15, 1997.

Applicability Date. Contractor C would not be subject to the revised CAS 404/409 because it did not receive a contract subject to full CAS coverage after the April 15, 1996 effective date of the revised CAS 404/409. Although Contractor C may continue to perform contracts awarded in prior accounting periods that are subject to full CAS coverage, these contracts would not be subject to the revised CAS 404/409.

8-405 Cost Accounting Standard 405 --- Accounting for Unallowable Costs

The purpose of this standard is to facilitate the negotiation, audit, administration, and settlement of contracts. It contains guidelines on:

(1) identification of costs specifically described as unallowable, at the time such costs first become defined or authoritatively designated as unallowable and

(2) the cost accounting treatment to be accorded such identified unallowable costs to promote the consistent application of sound cost accounting principles covering all incurred costs.

The standard does not govern the allowability of costs which is a function of the appropriate acquisition or reviewing authority. The standard was effective April 1, 1974, and is applicable to all CAS-covered contracts awarded after that date.

8-405.1 General

a. Costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. An expressly unallowable cost is that which is specifically named and stated to be unallowable by law, regulation, or contract.

b. Costs specifically designated as unallowable or as directly associated unallowable costs in a written decision of a contracting officer pursuant to contract disputes procedures shall be identified if included or used in computing any billing, claim, or proposal applicable to a Government contract.

c. Costs which are stated to be unallowable in a written decision issued by a contracting officer pursuant to disputes clause procedures are required to be identified by the contractor. This includes costs claimed by a contractor to be allowable but stated by a contracting officer in a written decision to be unallowable because the costs are not allocable costs of the contract under which they are being claimed. Therefore if the contractor fails to identify claimed costs determined by the contracting officer to be unallowable because they are not allocable, the contractor is in noncompliance and the procedures in CAS 405 should be followed. (See CAS Working Group Paper 77-13.)

d. A directly associated cost is any cost which is generated solely as a result of another incurred cost and which would not have been incurred otherwise.

e. Guidance concerning accounting for unallowable costs and directly associated costs is set forth in FAR 31.201-6.

f. The costs of any work project not contractually authorized, whether or not related to a proposed or existing contract, shall be accounted for separately from costs of authorized work projects.

g. All unallowable costs shall be subject to the same cost accounting principles governing cost allocability as allowable costs.

(1) In circumstances where these unallowable costs normally would be part of a regular indirect cost allocation base or bases, they shall remain in such base or bases. This provision is based on the concept that ". . . the issues concerning cost allocation and those relating to cost allowance are distinct and separate. Allowability should not be a factor in the selection or in the determination of the content of an allocation base used to distribute a pool of indirect costs. The appropriateness of a particular allocation base should be determined primarily in terms of its distributive characteristics. Any selective fragmentation of that base which eliminates given base elements for only some of

the relevant cost objectives would produce a distortion in the resulting allocations." (see 8-410.1a(2))

(2) Where directly associated costs are part of an indirect cost pool that will be allocated over a base containing the unallowable cost with which it is associated, they shall remain in the pool and be allocated through the regular allocation process. According to the CASB, to do otherwise under these circumstances, could result in double counting.

h. The standard does not specify the nature of records required except that they be adequate to establish and maintain visibility of identified unallowable costs (including directly associated costs), their accounting status in terms of their allocability to contract cost objectives, and their cost accounting treatment. Unallowable costs do not have to be identified when, based upon considerations of materiality, the Government and the contractor agree on an alternate method that satisfies the purpose of the standard.

i. If noncompliances are found, the auditor must ascertain the significance of the problem and make recommendations as outlined in 8-302.7.

8-405.2 Illustrations

The following illustrations are intended to supplement those in paragraph 405.60 of the standard. They will help auditors determine if the contractor is complying with the standard.

a. **Problem.** For the past several years, an auditor has questioned the allowability of part of the costs in a contractor's business luncheon account as entertainment expenses. The final cost questioned as negotiated by the contracting officer for those years has always included a large portion of the amount the auditor recommended for disapproval. In estimating the new forward pricing and provisional billing rates, the contractor reduced the estimated rates in anticipation of similar cost questioned. The contractor rates are based on a projection of cost incurred in prior years.

Solution. CAS 405.50(c) permits the Government and the contractor to agree on a method, other than specific identification, as long as that method satisfies the standard. If applicable, the Disclosure Statement should be amended to reflect this.

b. **Problem.** Another contractor under circumstances similar to those above declines to adjust the estimated forward pricing and provisional billing rates.

Solution. The auditor should report this noncompliance with the standard as described in 8-302.7.

c. **Problem.** A contractor performed some unauthorized work under a cost type prime contract. The contracting officer decided to disallow the cost (direct and indirect cost) specifically related to the unauthorized work. The contractor adjusted the accounting records and the billings to identify the unallowable production costs. However, in calculating the G&A total cost input base, the contractor excluded the unallowable contract cost. It stated that the incurred cost for unauthorized work did not affect the amount of G&A expenses incurred; consequently, the contractor should be permitted to recover its total G&A expense pool.

Solution. The auditor should report this to the contracting officer as noncompliance with CAS 405.40(d) and (e).

d. **Problem.** The contractor's established practice is to include overtime premium applicable to direct and indirect labor in overhead. The contractor allocates total overhead to total direct labor. The contractor performs and separately accounts for certain direct labor associated with a work project which a Government contract specifically does not authorize. Both the unauthorized and authorized projects under the contract required overtime work. The contractor computes the overhead rate applicable to final billing under the contract by including overtime premium applicable to all work projects in the overhead pool and direct labor applicable to all work projects in the base.

Solution. The contractor complies with CAS 405.40(e) since it separately accounts for costs of unauthorized and authorized work projects. Also, the contractor's overhead rate computation complies with CAS 405.40(e) which states, "Where a directly associated cost

(overtime premium, in this illustration) is part of a category of costs normally included in an indirect cost pool that will be allocated over a base containing the unallowable cost with which it is associated, such a directly associated cost shall be retained in the indirect cost pool and be allocated through the regular allocation process."

8-406 Cost Accounting Standard 406 --- Cost Accounting Period

The purpose of this standard is to provide criteria for selecting the time periods to be used as cost accounting periods for contract cost estimating, accumulating, and reporting. It will reduce the effects of variations in the flow of costs within each cost accounting period. It will also enhance objectivity, consistency, and verifiability and promote uniformity and comparability in contract cost measurements. The standard was effective July 1, 1974 and must be applied in the next fiscal year after receipt of a CAS-covered contract.

8-406.1 General

a. The cost accounting period used by a contractor must be either (1) its fiscal year or (2) a fixed annual period other than its fiscal year if agreed to by the Government. Where a contractor's cost accounting period is different from the reporting period used for Federal income tax reporting purposes, the latter may be used for such reporting. All rates used for estimating, accumulating, and reporting (including public vouchers and progress payment billings) must be based on the contractor cost accounting period.

b. A transitional cost accounting period other than a year shall be used whenever a change of fiscal year occurs. It may be a period more or less than a year, but not more than 15 months.

c. Costs of an indirect function which exist for only a part of a cost accounting period may be allocated to cost objectives of that same part of the period. However, such cost must be material, accumulated in a separate indirect cost pool, and allocated on the basis of an appropriate direct measure of the activity or output of the function during that part of the period.

d. The same cost accounting period shall be used for accumulating costs in an indirect cost pool as for establishing its allocation base. However, in the prefatory comments the Cost Accounting Standards Board stated that although as a matter of principle it does not agree that mismatched periods are proper, it recognizes the value of appropriate expedients where cost allocations are not expected to be materially affected. Therefore, the standard provides for the use of a different period for establishing an allocation base when agreed to by the parties if:

(1) the practice is necessary to obtain significant administrative convenience,

(2) the practice is consistently followed by the contractor,

(3) the annual period used is representative of the activity of the cost accounting period for which the indirect costs to be allocated are accumulated, and

(4) the practice can reasonably be expected to provide a distribution to cost objectives of the cost accounting period not materially different from that which otherwise would be obtained.

e. Contractors shall follow consistent practices in selecting the cost accounting period or periods in which any types of expense and any types of adjustment to expense (including prior period adjustments) are accumulated and allocated.

f. Indirect cost allocation rates, based on estimates, which are used for the purpose of expediting the closing of contracts which are terminated or completed prior to the end of a cost accounting period need not be those finally determined or negotiated for that cost accounting period (see 6-711.1 and 6-711.2). They shall, however, be developed to represent a full cost accounting period, except as provided in c. above.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-406.2 Restructuring Costs

a. The Cost Accounting Standards Board promulgated an interpretation at CAS 406.61 that addresses the assignment of restructuring costs to accounting periods. According to the interpretation, it clarifies whether restructuring costs are to be treated as an expense of the current period or as a deferred charge that is subsequently amortized over future periods. CAS 406.61, which was issued on June 6, 1997, is applicable to contractor restructuring costs paid or approved on or after August 15, 1994.

b. CAS 406.61(e) provides that restructuring costs should be accounted for as a deferred charge unless the contractor proposes, and the contracting officer agrees, to expense the costs for a specific event in a current accounting period. Deferred restructuring costs should be amortized over the same period of time that benefits of restructuring are expected to accrue. However, CAS 406.61(h) limits the amortization period to no more than 5 years. See 7-1909 for further guidance.

8-407 Cost Accounting Standard 407 --- Use of Standard Costs for Direct Material and Direct Labor

a. The purpose of this standard is to provide criteria:

(1) under which standard costs may be used for estimating accumulating, and reporting costs of direct material and direct labor and

(2) relating to the establishment of standards, accumulation of standard costs, and accumulation and disposition of variances from standard costs.

The standard was effective October 1, 1974 and must be followed in the next fiscal year after the award of a CAS-covered contract.

b. The standard does not cover standards used for overhead, service centers, nor preestablished measures used solely for estimating.

c. Using the standard for Government contract costing is the contractor's option. Contractors are not required to establish standard cost accounting systems or use established standard cost accounting systems, intended for management purposes, for costing Government work. However, they are required to follow the provisions of the standard if they choose to cost Government contracts through a standard cost accounting system.

8-407.1 General

Use of a standard cost accounting system to cost Government contracts is permitted only when it meets the following criteria:

a. The standard costs must be entered into the books of account. However, properly computed variances may be allocated by memorandum worksheet adjustments rather than entered in the books of account.

b. The standard costs and related variances must be appropriately accounted for at the level of the production unit. A production unit is defined as "A grouping of activities which either uses homogeneous inputs of direct material and direct labor or yields homogeneous outputs such that the costs or statistics related to these homogeneous inputs or outputs are appropriate as bases for allocating variances." This concept of homogeneity should permit contractors a degree of flexibility in setting and revising standards on the basis of individual needs and circumstances and still provide for the proper cost assignment of variances. Under this concept a single product manufacturer would be permitted to have one labor variance account for the entire plant, while a multiproduct manufacturer would be required to have a variance account for each product line and/or for the various common part subproduct lines.

c. The practices with respect to the setting and revising of standards, use of standard costs, and disposition of variances must be stated in writing and consistently followed. The written statement of practices shall include bases and criteria used in setting and revising standards; the period during which standards are to remain effective; the level, such as ideal or realistic, at which material-quantity standards and labor-time standards

are set; and conditions, such as those expected to prevail at the beginning of a period, which material-price standards and labor-rate standards are designed to reflect.

d. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-407.2 Illustrations

The following illustrations are intended to supplement those in paragraph 407.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** A contractor who manufactures radios of various configurations has established labor-rate standards and variance accounts by department; i.e., fabrication, minor assembly, final assembly, and test. The functions performed within each department are similar, the employees involved are interchangeable, and the inputs of direct material are homogeneous. Each variance account is distributed annually on the basis of the department's labor dollars. The contractor's practices are stated in writing, consistently followed, and the standard costs are entered into the books of account.

Solution. The contractor's practice complies with the standard because it meets the following requirements.

(1) The practices are written, entered into the books, and consistently followed (CAS 407.40(a) and (c)).

(2) The labor-rate standards cover employees performing similar functions within each category, and the employees are interchangeable with respect to the functions performed (CAS 407.50(a)(3)).

(3) Each department qualifies as a production unit because:

(a) each is a grouping of activities which use homogeneous inputs of direct material and direct labor, in this case labor with similar skills and efforts, and

(b) the direct labor costs (homogeneous inputs) are an appropriate basis for allocating variances (CAS 407.30(a)(7)).

NOTE: Since the employees are interchangeable and efforts performed on the radios are similar, the allocation on the basis of direct labor dollars will result in a reasonably valid assignment of the labor rate variances (differences between actual and standard rates) among the radio configurations (units of output).

(4) Standard cost and related variances are appropriately accounted for at the level of the production unit (CAS 407.40(b) and 407.50(c)).

(5) The variances are allocated to cost objectives annually on the basis of labor cost at standard (CAS 407.50(d)(1)).

NOTE: CAS 407.50(a)(2) states, ". . . where only either the labor rate or labor time is set at standard, with the other component stated at actual, the result of the multiplication shall be treated as labor cost at standard."

b. **Problem.** Another contractor who manufactures the same general types of radios having various configurations has established labor-time standards by department; i.e., fabrication, assembly, final assembly, and test. The functions performed within each department are not materially disparate except for the fabrication and testing of A and D radio configurations. The functions required for the A and D configurations differ significantly from the others in terms of operations and complexity (complicated circuitry, finer tolerances, more detailed wiring, etc.). The employees involved are interchangeable, and the inputs of direct material are homogeneous. The labor hours required for efforts performed within the departments for each configuration of the radios differ; however, this has been recognized in establishing the standards for each configuration. The labor-time variances (difference between total department standard hours and total department actual hours) are accumulated by department and distributed annually to each configuration within each department on the basis of the department's direct labor dollars (standard labor hours at actual rates). The contractor's practices are stated in writing and consistently followed and standard cost is entered into the books of account.

Solution. The contractor's practice as applicable to the fabrication and testing departments does not comply with the standard. These departments do not qualify as production units because direct labor dollars are not an appropriate base for allocating the labor-time variance to all radios on a pro rata basis since functions performed on the A and D radios are significantly disparate from the functions performed on the other radios. The standard's definition of production unit includes the requirement that, ". . . the costs or statistics relating to these homogeneous inputs or outputs are appropriate as basis for allocating variances" (CAS 407.30(b)(7)). One course of corrective action would be to subdivide the fabrication and testing departments in a manner which would permit separate accounting for the labor cost variances applicable to A and D configurations separate from the other configurations. This correction would result in establishing separate bases and would then be appropriate for allocating the separate variance accounts.

c. **Problem.** In a current proposal, a contractor with a standard cost system prices the bill of materials with quotations rather than with its material price standards. The contractor's written statement of practices, prepared to comply with paragraph 407.50(a)(1), states that material price standards are revised effective 1 January each year and remain in effect until the end of the calendar year. The proposed contract will be performed in the current calendar year.

Solution. The use of quotations to price the bill of materials violates CAS 401. It is inconsistent with the practice of measuring direct material cost by standards and variances. The bill of materials should be priced with the material price standards currently in effect. The amount of material price variances that will be allocated to the contract from production units should be estimated separately. [Note: There could be significant difference between the amount of material cost estimated with quotations and the amount estimated by standards and variances. A difference would result, for example, if quotations are for the quantities required for the proposed contract and standards are based on economic order quantities for all of the contractor's business.]

d. **Problem.** Same as c., with the exception that the proposed contract will be performed in the next calendar year. Material price standards have not been established for that year.

Solution. The use of quotations would be acceptable provided they are the basis for estimates of next year's material price standards.

8-408 Cost Accounting Standard 408 --- Accounting for Costs of Compensated Personal Absence

The purpose of this standard is to establish criteria for measuring and allocating the costs of compensated personal absences to final cost objectives. These costs include compensation paid by contractors to their employees for such benefits as vacation, sick leave, holiday, military leave, etc. The standard was effective July 1, 1975. It must be followed in the next fiscal year after receiving a CAS-covered contract.

8-408.1 General

a. The provisions of the standard require that the costs of compensated personal absence be assigned to the cost accounting period in which entitlement is earned in accordance with the contractor's plan or custom. The standard defines compensated personal absence as "any absence from work for reasons such as illness, vacation, holidays, jury duty, military training, or personal activities, for which an employer pays compensation directly to an employee." Additionally it defines entitlement as "an employee's right, whether conditional or unconditional to receive a determinable amount of compensated personal absence, or pay in lieu thereof." These conditions required many contractors which had previously recorded such costs when paid to revise their accounting practices to accrue the costs over the period during which the qualifying service was performed.

b. Entitlement is recognized on the accrual basis only in the cost accounting period in which there arises a liability to pay compensation in the event of layoff or other non-disciplinary termination of employment.

c. The standard supplements these requirements with the following clarifying comments:

(1) If the employer's plan or custom provides that a new employee must complete a probationary period before the employer is liable to pay the employee for compensated personal absence, such service may be treated as creating entitlement, provided the contractor does so consistently.

(2) If the employer's plan or custom provides that entitlement is to be determined on the first calendar day or the first business day of a cost accounting period, entitlement will be considered earned in the preceding cost accounting period.

d. When there is no liability for payment of unused entitlement on layoff, such costs will be considered to be earned in the period in which paid. In this case, the accrual method is not permitted.

e. Each plan or custom must be evaluated individually to determine when entitlement is earned. If a plan or custom is changed, a new determination of entitlement must also be made. In evaluating each individual plan, the auditor will make use of the contractor's written policies and procedures and any prior examinations included in the FAO permanent files. However, there may be instances, particularly at smaller contractor locations, where written policies and procedures do not exist. In these circumstances, the auditor will evaluate the "custom" of the employer for paying compensation for personal absences.

f. Various contractor sources may provide the needed information for determining entitlement. Examples include personnel records and memoranda, corporate minutes relating to costs of personal absences, financial statements and accounts relating to compensation for personal absence, and the appropriate journal entries supporting the books of account.

g. The liability to be accrued is the total amount the contractor is obligated to pay for each plan in the event of layoff, notwithstanding that the employee may forfeit some or all of the entitlement if she or he were to resign voluntarily. The liability will be adjusted for anticipated nonutilization, if it is expected to be material.

(1) The use of either current wage rates or anticipated wage rates at the time of payment is permitted provided such rates are applied consistently.

(2) The standard also permits the option of calculating the accrued liability either on an individual employee basis or on a total plan basis. A contractor choosing to estimate the total cost of all employees in the plan may use sample data, experience, etc. The auditor should evaluate the data used to assure that the classes and types of employees included are representative of the employee group during the period for which the liability is being accrued.

h. As noted previously, many contractors record costs of personal absences only when paid, but under the standard they will now be required to accrue such costs. Therefore, in the year of conversion, two years' expenses are recorded - the costs paid during the year and the accrual for costs earned during the year but to be paid in a future year. To prevent a double charge to Government contracts, the standard requires contractors to defer the initial accrual through the use of a suspense account. Whenever the balance in the suspense account at the beginning of the cost accounting period exceeds the contractor's corresponding liability for compensated absence at the end of the same cost accounting period, the contractor is permitted to reduce the suspense account until it is equal to the liability. The amount by which the suspense account is so reduced becomes an additional cost of compensated personal absence for that cost accounting period.

i. There may also be instances where the contractor's practice is to accrue only a portion of the estimated liability required by the standard. In such cases, the contractor must revise its accounting practices to accrue the balance of the liability, as required by the standard. The amount of the additional accrual must be placed in a suspense account, as described above. In such cases, it should also be noted that, in comparing the amount in suspense to the year end liability, only that part of the liability which corresponds to the

suspense account, i.e., the liability for benefits not recognized under the previous accounting practice, should be used.

j. If a plan or custom is changed or a new plan or custom is adopted by the employer, an initial or additional accrual may also be required. This accrual is also to be placed in suspense. The suspense amount to be charged in each cost accounting period will be computed as described above.

k. The costs of personal absence must be allocated among cost objectives on an annualized basis, except as permitted by the provisions of CAS 406 - Cost Accounting Period. However, the allocation rate may be revised during a cost accounting period based on revised estimates of period totals.

l. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-408.2 Illustrations

The following illustrations are intended to supplement those in paragraph 408.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** A contractor has a program whereby an employee on reaching a certain level within the management structure becomes entitled to a 3-month sabbatical vacation with pay on completion of five years of service. No entitlement to the sabbatical vests in the employee until it is actually taken. If the employee were to be terminated prior to the completion of five years, she or he would not be paid. The contractor becomes subject to CAS 408 and wishes to accrue the cost of the sabbatical vacation ratably over the 5-year eligibility period.

Solution. This contractor may not accrue the cost of the sabbatical vacation since its present policy does not meet the criteria for accrual required by CAS 408.50(b)(1). Under this provision, entitlement is recognized on the accrual basis in the same cost accounting period in which the employer becomes liable to pay compensation in the event of layoff (vested). However, under this contractor's policy, the employee would not be paid if terminated prior to the completion of 5 years. In this case, the contractor would be subject to the provisions of CAS 408.50(b)(3) which require that when no liability exists for the payment of unused entitlement on layoff, the cost of the compensated personal absence is to be recorded in the cost accounting period in which the leave is taken and/or paid. If the contractor changed its present policy to provide for a pro rata vesting (that is, payment on a pro rata basis in the event of termination) over the 5-year eligibility period, then the accrual for the sabbatical vacation would be acceptable.

b. **Problem.** The contractor has a vacation plan which provides that an employee who has been employed at least one year at December 31st becomes entitled to 80 hours of vacation, starting no earlier than the following May 1st , provided the individual is still employed at that time. If the employee were to be laid off prior to May 1, 1988, he or she would be paid on May 1. 1988 for the vacation earned as of December 31, 1987. If the employee were still in layoff status as of May 1, 1989, she or he would then be paid for any vacation earned between January 1, 1988 and the date of layoff. However, if the employee were to quit voluntarily before May 1, 1988, he or she would forfeit the right to vacation pay. The contractor's fiscal year ends March 31, 1988 under CAS 408 to reflect its liability for vacation pay.

Solution. CAS 408-40(a) requires that the cost of vacation pay be assigned to the cost accounting period or periods in which the entitlement was earned. In this case, vacation was earned during the annual period ending on December 31, 1987. Although retention on the payroll or reemployment status is required to actually receive the vacation at May 1, 1988, the estimated vacation liability amount has already been determined by the preceding December 31. In addition, CAS 408.50(b)(1) establishes the liability to be recognized as that amount of vacation pay which would be payable on layoff, even though some employees may voluntarily terminate and forfeit their entitlement. Therefore, the contractor,

in determining its liability at March 31, 1988, should include both the amount earned for service between April 1, 1987 and December 31, 1987, and the amount earned for service between January 1, 1988 and March 31, 1988. This liability should be reduced for anticipated forfeitures, if material, as required by CAS 408.50(c)(2). It should be noted that in fiscal year ended March 31, 1987, if this is the contractor's initial compliance with the standard, the contractor would have been required under CAS 408.50(d)(1) and (3) to place in suspense the excess of any accrual required by the standard as of March 31, 1987 over the amount it would have accrued under the previous accounting method and amortize such suspense account in accordance with the terms of the standard.

c. **Problem.** The following is an example of how to use the suspense account in a partial accrual situation: Company A has a union agreement which requires it to pay hourly employees for unused vacation on layoff. The company follows a similar custom with salaried employees, although, it is not required to do so by any written agreement. Company A's practice has been to accrue the cost of the vested vacation for the hourly employees but to recognize the cost of salaried vacations only at the time of payment. Company A must comply with CAS 408 beginning on January 1, 1986 and must revise its accounting practice accordingly.

Solution. The total vacation cost determination is shown below in the form illustrated in the standard, followed by the same calculation in columnar form, as follows:

Format Used in CAS 408.60

	Hourly Employees (000)	Salaried Employees (000)	Total Employees (000)
1986 beginning liability:			
With standard	$ 500	$ 100	$ 600
Without standard	500		500
Amount to be held in suspense (CAS 408.50(d) (1))	0	100	100
1986 ending liability	400	80	480
Plus paid in 1986	475	95	570
Subtotal	875	175	1,050
Less 1986 beginning liability	500	100	600
1986 vacation cost, basic amount	375	75	450
Amount in suspense at beginning of 1986	0	100	100
Less 1986 ending liability	0	80	80
Suspense to be written off in 1986:			
additional 1986 vacation cost (CAS 408,50(d)(3))	0	20	20
1986 basic vacation cost	375	75	450
Plus 1986 writeoff of suspense (CAS 408.50(d)(3))	0	20	20
1986 total vacation cost	$ 375	$ 95	$ 470

Columnar Format

	Vacation Liability (000)	Vacation Cost (000)	Cash (000)	Suspense Account (000)	Vacation Ref. Note
Beginning Liability without standard	$ 500				a
Suspense account	100			$100	c
Beginning liability with standard	600			100	b
1986 earned vacation	450	$ 450			d
1986 vacation pay	570		$ 570		e
Subtotal	480	450	570	100	b
Adjust suspense account		20		20	g
Balances, 12/31/86	$ 480	$ 470	$ 570	$ 80	f

Notes to Columnar Format

a. Represents the beginning liability amount accrued for the hourly employees under the contractor's previous method.

b. Represents the beginning liability amount accrued for both the hourly and salaried employees as required by the standard.

c. Represents the setup of the suspense amount for the increase in vacation liability for salaried vacations as required by the standard.

d. Represents the increase in liability for the total vacation cost earned by employees during the cost accounting period.

e. Represents the reduction in liability for the amount paid to employees during the cost accounting period.

f. Represents the ending liability amount for the cost accounting period as well as other account balances resulting from the transactions discussed above. The total ending liability of $480 thousand is composed of $400 thousand for hourly vacations and $80 thousand for salaried vacations.

g. The amount in suspense ($100 thousand as discussed in c. above) should be compared with that portion of the vacation liability at the end of the year, which represents the same type of expense charged to suspense account ($80 thousand for salaried vacations as discussed in f. above). As the amount in suspense exceeds the ending liability, the excess ($20 thousand) will be charged to the vacation cost earned during the year and the suspense account balance will be reduced by the amount of the excess.

This illustration presented one acceptable method for comparing the amount in suspense with the liability at the end of the year. Other methods, such as specific employee identification, may also provide a reasonable satisfaction of the standard's requirements. The method used should achieve a comparison of like items for authorization of the amount held in suspense.

d. **Problem.** A contractor has a fiscal year ending December 31. Under this existing practice, the contractor begins to accrue for each holiday one year in advance. For example, the anticipated cost of holiday pay for July 4, 1987 would be accrued in 12 monthly increments beginning July 1986 and extending through June 1987. However, under the contractor's policy, entitlement for holiday pay occurs only in the cost accounting period when the holiday is taken.

Solution. The contractor's practice does not comply with CAS 408. CAS 408.40(a) requires that holiday pay be assigned to the cost accounting period in which it is earned. Under the contractor's policy, entitlement occurs when the holiday is taken. Therefore, the contractor may recognize in 1986 only the costs of holidays which occurred in

1986. It should be noted that a contractor whose fiscal year ends on December 31 may elect to recognize the costs of the January 1 holiday either in the year in which it occurs or in the preceding year, provided whichever policy is adopted, it is followed consistently.

8-409 Cost Accounting Standard 409 --- Depreciation of Tangible Capital Assets

a. This standard provides criteria for assigning costs of tangible capital assets to cost accounting periods and should enhance objectivity and consistency in their allocation.

b. The initial standard was effective July 1, 1975 and must be followed for all tangible assets acquired in the next fiscal year after receipt of a CAS-covered contract. On February 13, 1996, the CAS Board amended CAS 409.50(j) relating to the recapture of gains and losses on disposition of tangible capital assets that are transferred subsequent to a business combination. The effective date of this amendment is April 15, 1996. The amendment is applicable to contracts in the next cost accounting period beginning after receipt of a contract that incorporates the revised standard. Amendments to CAS 404, also effective April 15, 1996, are discussed in 8-404.

c. The amended CAS 409 , effective April 15, 1996, applies to tangible capital assets transferred in a business combination that takes place after the applicability date (see 8-404.4 for illustrations of the amended CAS 404/409 applicability date).

d. The standard does not apply where compensation for tangible capital asset usage is based on use allowances as provided in Office of Management and Budget Circular No. A-21 and A-87 or other appropriate acquisition regulations.

8-409.1 General

a. Estimated residual values must be determined for all tangible capital assets or groups of assets. The residual values must be deducted from the capitalized value in computing the depreciable cost base, except where; (1) the estimated residual value of tangible personal property does not exceed 10 percent of the capitalized cost or (2) either the declining balance method or class-life-asset-range system is used.

b. The standard prohibits the depreciation of assets or asset groups below their residual value, if the residual value is greater than ten percent of the capitalized cost of the asset, or if the asset is real property. For personal property that has a residual value less than or equal to ten percent of the capitalized cost of the asset, the asset or asset group may be depreciated below residual value if the residual value is immaterial. Materiality should be determined based on the general criteria contained in 48 CFR 9903.305, Materiality. The auditor should test asset values identified on contractor depreciation schedules or tax returns to ensure that residual values are properly deducted from capitalized costs.

c. The estimated service life of the tangible capital asset, over which the depreciated cost is assigned, must reasonably approximate the actual period of usefulness to its current owner, considering such factors as obsolescence and required quality and quantity of output. The estimated service life can exclude standby or incidental use periods, provided adequate records substantiate the withdrawal of such assets from active use. Expected periods of useful life must be based on recorded past experience, as modified for expected changes in operating practices, obsolescence, or quantity of products produced. However, the contractor must justify estimated service lives which deviate from the previously experienced lives. (See CAS Working Group Paper 78-22.)

(1) The standard requires the contractor to maintain adequate records which identify the age of the asset or asset group at retirement or withdrawal from active use. The record should contain such information as asset acquisition/disposition dates, date asset was withdrawn from active service, and any other factors that directly influence asset lives. The record need not be maintained solely for fixed asset accounting; it may be a record used for such other purposes as property insurance, income/property taxes, property control, or maintenance.

(2) If supporting records are not available on the date the contractor must first comply with the standard, the estimated service lives should be those used for financial accounting. However, the required supporting records must be developed by the end of the second fiscal year after that date and used as a basis for estimated service lives on assets subsequently acquired.

(3) When a new asset is acquired for which the contractor has no available data or prior experience, the estimated service life must be based on projection of the expected useful life. CAS 409.50(e)(4) states the projection cannot be less than the mid-range established for asset guideline classes under the IRS Revenue Procedure in effect the year the asset is acquired. For property placed in service after 1986, IRS Revenue Procedure 87-56, as modified by Revenue Procedure 88-22, does not provide a depreciation range for asset guideline classes, it provides the applicable class lives and specific recovery periods. The recovery period used will depend on the depreciation system (General Depreciation System (GDS) or Alternate Depreciation System (ADS)) selected. The depreciation method (e.g., declining balance or straight line) selected by the contractor will determine the depreciation system used and the resulting recovery period. Information in IRS Revenue Procedure 87-56, as modified by Revenue Procedure 88-22 is available in IRS Publication 946, How to Depreciate Property, which is available at http://www.irs.gov/. IRS Publication 946 will identify the depreciation method(s) that may be used for each depreciation system. For example, declining balance method can only be used over a GDS recovery period, while the straight line method may be used over a GDS or ADS recovery period. The estimated service lives provided in these IRS documents will be used only until the required records are available.

(4) In special circumstances, contracting parties may negotiate a shorter estimated service life if it can be reasonably projected.

d. The contractor may select any appropriate method of depreciation which reflects the pattern of consumption of services over the life of the asset. For example, an accelerated method is appropriate where the expected consumption of services is greatest in the early years of the asset life. The method used for financial accounting must be used for contract costing unless it does not reasonably reflect expected consumption or is unacceptable for Federal income tax purposes.

(1) Financial accounting methods are expected to approximate the pattern of consumption of services. Therefore, if the contractor continues to use previous methods found to be acceptable to the Government on similar assets for financial accounting, no additional support of existing method will ordinarily be required. The auditor, however, is responsible for ensuring that the depreciation methods generally reflect the pattern of consumption of services. Consequently, the auditor's compliance audit should include limited tests of existing usage records to determine that no gross distortions in depreciation costs result from these depreciation methods. If a gross distortion is indicated as a result of that limited test, the testing should be expanded to determine whether the distortion is material enough to warrant a change in the contractor's depreciation method.

(2) A depreciation method selected for newly acquired assets which differs from the depreciation method currently used for like assets in similar circumstances must be supported by the contractor's projection of expected consumption of services.

e. Depreciation costs are generally allocated as indirect costs to the cost objectives for which the assets provide service. They may be charged directly to cost objectives at average rates only if the charges are based on usage and the costs of all like assets used for similar purposes are also charged directly. Depreciation costs for assets included in service centers, where significant, must be charged to the service center.

f. Changes to estimated service lives, residual values, or consumption of services may be required as a result of significantly changed circumstances. Any resulting adjustment to the undepreciated cost will be assigned only to the cost accounting period in which the change occurs and to subsequent periods. No retroactive adjustments will be made.

g. The standard outlines the following accounting treatment for gains or losses associated with the disposition of tangible capital assets. Note that an impairment loss under

FASB Statement No. 144 (formerly no. 121) is recognized only upon disposal of the impaired asset (see 7-412b).

(1) Where the asset is disposed of without an exchange, the gain or loss is generally treated as an adjustment to the appropriate indirect expense pool in the cost accounting period in which the disposition occurs. However, the auditor should be aware that, in such circumstances, the standard limits the gain to be recognized for contract costing purposes to the difference between the asset's original acquisition cost and its net book value.

(2) Where an asset is exchanged for like property, two options are available to the contractor: either the gain or loss can be recognized as discussed above, or the depreciable cost base of the new asset may be adjusted for the entire gain or loss.

(3) Where an asset disposition results from an involuntary conversion and the asset is replaced by a similar asset, the same two options as described above for exchanges of like property are available to the contractor.

(4) Where assets are grouped, gains or losses are not recognized. Instead they are processed through the accumulated depreciation account.

(5) Assets dispositioned in a business combination meeting the criteria in CAS 404.50(d)(1). The revised CAS 409, effective April 15, 1996, added a new subparagraph CAS 409.50(j)(5) to make it clear that the CAS 409.50(j) provision dealing with the recapture of gains and losses on disposition of tangible capital assets should not apply when assets are transferred subsequent to a business combination meeting the criteria in CAS 404.50(d)(1). The revised CAS 409.50(j)(5) stipulates that the provisions of CAS 409.50(j) do not apply to business combinations and that the carrying values of tangible capital assets acquired subsequent to a business combination are to be established by the acquiring company in accordance with the provisions of CAS 404.50(d)(1). Consequently, since CAS 404.50(d)(1) does not recognize an increase or decrease in the asset values as a result of a business combination, any gain or loss realized by the seller on disposition of assets as a result of the business combination is also not recognized. Auditors at the seller location should be alert for contractors claiming a loss on disposition of assets as a result of a business combination meeting the provisions of CAS 404.50(d)(1) and question it, if claimed. See 8-404.2b.(1) for additional guidance regarding the measurement of assets acquired in a business combination using the purchase method of accounting.

(6) Assets dispositioned in a business combination meeting the criteria in CAS 404.50(d)(2). The April 15, 1996 revision to CAS 409.50(j)(5) does not apply to assets dispositioned in a business combination meeting the criteria in CAS 404.50(d)(2), i.e., the tangible capital assets acquired in the business combination did not generate either depreciation expense or cost of money charges during the most recent cost accounting period. Therefore, the provision on the recapture of gains and losses would apply to the dispositioned assets. However, for contracts awarded prior to April 24, 1998, tangible capital assets meeting the requirements of CAS 404.50(d)(2) must still comply with the requirements of FAR 31.205-16 and 52. Consequently, although the gain or loss may be recognized for CAS purposes, no gain or loss would be allowed per FAR. Effective April 24, 1998 (FAC 97-04), FAR 31.205-52 was revised to conform to the revised CAS 404 and 409. Therefore, gain or loss would be allowed for assets dispositioned in a business combination meeting the criteria in CAS 404.50(d)(2).

h. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-409.2 Illustrations

The following illustrations are intended to supplement those in paragraph 409.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem**. Based on a sample of asset dispositions/withdrawals for the last three years, the contractor now estimates 10 years service life for lathes. The records in the sample supporting the 10-year life classified several machines as "withdrawn from active

use" although the machines are still on hand, in good working condition, and physically located in the plant machine shop. Neither the property records nor any other records reflected any change in the assets from active to inactive status. Records reflect a comparatively low usage of these specific machines for the past year due to a slack period.

Solution. The machines should not be classified as "Withdrawn from active use" unless the contractor provides adequate documentation substantiating the change in status. Machines temporarily idled for lack of work are not "withdrawn from active service." The contractor's written policies and procedures should define (1) the conditions under which capital assets may be withdrawn from active use and (2) the property records which must be prepared for processing the asset from active to inactive status. The records should clearly support that assets "withdrawn from active service" are in actuality intended only for standby or incidental use.

b. **Problem**. Contractor purchases various tangible capital assets in FY 19XX and sells them seven years later. Information pertinent to the acquisition and sale is as follows:

Capital Equipment	Acquisition Cost	Capitalized Current Net Book Value	Sales Price
Lathe	$30,000	$10,000	$32,000
Truck	$5,000	$ -0-	$ 100
Fork Lift	$10,000	$3,000	$2,000

Depreciation expense over the seven years was allocated to manufacturing overhead.

Solution. The contractor will allocate gains and losses to manufacturing overhead in the year of sale as follows:

Capital Equipment	(Gain)* or Loss
Lathe	($20,000)
Truck	($100)
Fork Lift	$1,000

* Gain or loss is the difference between amount realized on disposition and its undepreciated balance ($32,000 - $10,000 = $22,000); however, per CAS 409.50(j)(l), for contract costing purposes, the gain must be limited to the difference between the original acquisition cost of the asset and its undepreciated balance ($30,000 - $10,000 = $20,000).

c. **Problem**. The capitalized cost of a lathe is $50,000. The lathe is projected to have a residual value of $4,500, which is determined to be immaterial in amount based on the criteria in 48 CFR 9903.305, and an estimated service life of 10 years. The contractor utilizes a straight-line depreciation method. The asset is sold in Year 11 for $5,000.

Solution. Because the $4,500 residual value is less than 10 percent of the capitalized cost, the annual depreciation charges may be based on a depreciable cost base of $50,000. In addition, since the $4,500 is immaterial, the asset is depreciated to zero. However, since the contractor is required to provide a credit for the difference between the sales price and the book value, a credit of $5,000 is recognized in Year 11, as shown below:

Depreciable cost base	$50,000
Accumulated depreciation: 10 years @ $5,000 per year	50,000
Net book value at end of 10th year	$ -0-
Year 11: Credit for Gain on Sale of Asset (Sales price of $5,000 less book value of zero)	$5,000

d. **Problem**. Contractor A acquires Contractor B and accounts for the business combination using the purchase method of accounting. Prior to the business combination, the net book value of Contractor B's assets was $10.5 million. Contractor B's assets generated depreciation expense and cost of money charges that were allocated to Government con-

tracts negotiated on the basis of cost in its most recent cost accounting period. The difference between the original acquisition cost of Contractor B's assets and its undepreciated balance is $3.0 million. For GAAP purposes, the difference between the sales price and net book value of assets results in a gain of $4.0 million. The revised CAS 409 applies to the business combination.

Solution. The provisions of the amended CAS 404.50(d)(1), effective April 15, 1996, would apply to the business combination because the seller's (Contractor B's) assets generated depreciation or cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. Therefore, the provisions of CAS 409.50(j) dealing with the recapture of gains and losses on disposition of capital assets would not apply to the business combination. For CAS purposes, Contractor B would not recognize the gain. Consequently, the gain would not be reflected in Contractor B's total cost input G&A base because the gain was not measured for CAS purposes.

e. **Problem**. Same facts as Problem d. above, except that Contractor B has not performed Government contracts for several years and consequently, its assets did not generate depreciation expense or cost of money changes that were allocated Government contracts negotiated on the basis of cost, in its most recent cost accounting period.

Solution. The provisions of the amended CAS 404.50(d)(2), effective April 15, 1996, would apply to the business combination because the seller's (Contractor B's) assets did not generate depreciation expense or cost of money charges on Government contracts in its most recent cost accounting period. Therefore, the provisions of CAS 409.50(j) dealing with the recapture of gains and losses on disposition of capital assets would apply to the business combination. For CAS purposes, Contractor B would recognize the $3.0 million difference between the original acquisition cost and the undepreciated balance and credit the appropriate indirect cost pool(s). For contracts awarded prior to April 24, 1998, the gain would not be recognized under FAR 31.205-16 and 31.205-52. However, for contracts awarded on or after April 24, 1998, the gain would be recognized.

8-410 Cost Accounting Standard 410 --- Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives

a. This standard provides criteria for the allocation of general and administrative (G&A) expenses to final cost objectives and furnishes guidelines for the type of expense that should be included in the G&A expense pool. It also establishes that G&A expense shall be allocated on a cost input base which represents total activity. Contractors presently using the sales or cost of sales allocation base have the option of changing to the cost input allocation base as soon as they become subject to the standard or selecting the special transition method described in Appendix A of the standard. Notably, the special transition method permits the continued use of the sales or cost of sales base to cost those CAS-covered contracts existing on the date the contractor is required to comply with this standard. The standard will increase the likelihood of achieving objectivity in the allocation of expenses to final cost objectives and comparability of cost data among contractors in similar circumstances.

b. The standard was effective October 1, 1976 and must be followed in the next fiscal year after receipt of a CAS-covered contract to which the standard is applicable.

c. See CAS Working Group Papers 78-21 and 79-24 for guidance issued by the CAS Working Group on CAS 410.

8-410.1 General

a. Business Unit G&A Expense Pool

(1) The G&A expenses must be grouped in a separate indirect cost pool and allocated only to final cost objectives. For an expense to be classified as G&A, it must be incurred for managing and administering the whole business unit. Therefore, those management

expenses that can be more directly measured by a base other than cost input should be removed from the G&A expense pool. For example, expenses such as program management, procurement, subcontract administration, G&A-type expenses incurred for another segment, etc. should not be identified as G&A expenses. They should be the subject of a separate distribution in reasonable proportion to the benefits received. However, immaterial expenses which are not G&A may be included in the G&A expense pool. The G&A expense pool may be combined with other expenses allocated to final cost objectives if (a) the base for the combined pool is appropriate for allocating both the G&A expense pool and the other expenses, and (b) the individual and total expenses of the G&A expense pool can be identified separately from the other expenses.

(2) FAR 31.203(d) requires that G&A expenses be allocated to final cost objectives through a base that contains unallowable costs. FAR 31.203(d) states that "all items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs." The CASB has also recognized this principle in the prefatory comments to CAS 405 (last paragraph of comment no. 4) stating "the allowance or disallowance of these costs is subject to the cognizant agency's cost principles." In ASBCA Case No. 35895, Martin Marietta Corp. challenged the Government's position that a portion of G&A expense allocated to contracts is unallowable in the same ratio as unallowable base costs are to total base costs allocated to a contract. The issue was resolved on December 28, 1993 by the U.S. Court of Appeals for the Federal Circuit (No. 93-1025). The Court upheld the Government position, stating that FAR 31.203(d) is primarily an allowability provision which does not conflict with the CAS 410 requirement that G&A be allocated only to final cost objectives.

(3) Selling costs may be accounted for in the G&A expense pool or in a separate pool. CAS 410 takes a permissive position. CAS 410.40(d) requires a separate allocation of costs, if the costs can be allocated to business unit cost objectives on a beneficial or causal relationship which is best measured by a base other than a cost input base. Therefore, if the inclusion of selling costs in the G&A pool results in an inequitable allocation, auditors should carefully evaluate the selling activities to determine whether selling costs should be separately allocated on a beneficial or causal relationship by a different base. The Court in Aydin Corporation (West) (U.S. Court of Appeals for the Federal Circuit, No. 94-1441, dated August 10, 1995) decided, reversing the ASBCA decision (ASBCA No. 42760, dated April 18, 1994) that the foreign sales commission need not be excluded from the G&A pool based solely on its disproportionately large dollar amount. Accordingly, although the disproportionate allocation to Government contracts may be an indication that the G&A base is not the best measure of the beneficial or causal relationship, the disproportionate allocation itself does not result in a noncompliance with CAS 410. If it is determined that selling costs should be allocated over a base other than the G&A base, CAS 418 governs the proper allocation of such costs. See 7-1304 for additional discussion on the allocability of selling costs.

(4) Home office expenses allocated to a segment may or may not be included in the segment's G&A expense pool. The standard states that allocations of line management expenses, residual expenses, and directly allocated expenses related to managing and administering the receiving segments are to be included in the G&A expense pool. Separate allocations of home office centralized service functions, staff management of specific activities of segments, and significant central payments or accruals must be allocated to the benefiting cost objective. However, when there is no discernible causal or beneficial relationship with any of the cost objectives, these expenses may be included in the segment's G&A expense pool. When separate allocations are reflected in home office cost accounting, they must be identified in the cost transfers to the segments under CAS 403. To support that home office expenses were allocated to the segment in compliance with CAS 403, the contractor must identify the allocation base and components of the expense pool. Segments that perform both home office and operating segment functions must segregate the expenses of the home office function. These ex-

penses must be allocated to the benefiting segments, including the segment performing the home office function. G&A expenses incurred by a segment for another segment will be removed from the incurring segment's G&A expense pool and transferred to the other segment.

(5) Any other costs which do not satisfy the definition of G&A expenses may be included in the G&A expense pool if they were previously a part of G&A and cannot be allocated to final cost objectives on a beneficial or causal relationship best measured by a base other than a cost input base.

b. Business Unit G&A Allocation Base

(1) The standard requires that the cost input base used to allocate the G&A expense pool include all significant elements of that cost input which represent the total activity of the business unit. The cost input base selected may be total cost input, value-added cost input, or single-element cost input. Modified bases are not permitted unless the item is an insignificant element of the selected cost input base and its exclusion does not invalidate the chosen base's representation of total activity. The “insignificant element” should not be automatically equated to insignificant amounts. An insignificant element is one that, when excluded from the base, does not alter the base’s representation of the total activity. In the prefatory comments the term "total activity" refers to the production of goods and services during a cost accounting period. What is being pursued for the base is a flow of costs bearing a reasonable relationship with the production of goods and services.

(a) While the standard says that, "A total cost input base is generally acceptable as an appropriate measure of total activity of a business unit," two other bases may be used when they best represent "the total activity" of the business unit. The selection of the best base involves judgments on whether inclusion of certain base costs cause "distortions" in allocating G&A to some contracts. The specific circumstances of the business unit shall be considered in determining which base best represents total activity. The ASBCA, in essence, ruled that there is no preferred allocation base to distribute G&A expenses other than the one which best represents total activity (Ford Aerospace and Communications Corporation, Aeronutronic Division, ASBCA No. 23833). The following are some examples where the value-added or single-element base may be appropriate:

- Large subcontracts of the type that clearly contrast with arrangements which require close supervision and participation on the part of the prime contractor, for example, drop shipments. These subcontracts generally do not bear the same relationship to G&A as other cost elements. The existence of these types of contracts as a stable part of the business may be evidence that total cost input may not be an appropriate measure of total activity as it may cause an inequitable amount of G&A to be allocated to the contract with the large subcontracts. Consideration should be given to changing to a value-added base.
- Large amounts of Government-furnished material on some contracts with the same type of material purchased on other contracts. This may cause an inequitable shift of G&A to the contract with purchased materials. Consideration should be given to changing to a value-added base.
- Contractors whose business activity is clearly labor intensive, but have contracts that include major purchasing and subcontracting responsibility on a "pass-through" basis which causes significant distortions in allocated G&A. Consideration should be given to a value-added or single element base.
- When a contractor has demonstrated by a detailed analysis of the G&A pool elements to individual base elements, that a certain base element does not have significant causal or beneficial relationships to that G&A expense. When this is found, an analysis must be done to decide which of the three bases best measures total activity of that business unit. There may not exist one perfect base. Purifying the G&A expense pool is the best way to minimize any potential inequities which may surface in implementing a cost input base which does not perfectly eliminate distortions.

(b) Interdivisional transfers may be excluded from the receiving division's G&A base only when:

- circumstances warrant the use of a base whose constituent parts do not include material such as a value-added or a single-element base, or
- the interdivisional receipts are not significant. Facilities contracts as defined in FAR 45.301 should also be included in the total cost input base unless the provisions of CAS 410.50(j) apply.

(c) The costs deducted from total costs to determine the value-added base should be limited to direct material and subcontract costs. FAR 15.408, Table 15-2, II. Cost Elements, under the heading of Materials, states "Include raw materials, parts, components, assemblies, and services to be produced or performed by others." FAR 44.101 provides an authoritative definition of subcontract costs which states 'Subcontract,' as used in this part, means any contract as defined in Subpart 2.1 entered into by a subcontractor to furnish supplies or services for performance of a prime contract or a subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders." In applying this definition take care to avoid inappropriate inclusions or exclusions from the value-added base resulting from broad application of terminology or individual contractor account classifications. For example, subcontract labor of the "body shop" type often supplements the normal work force and is used interchangeably with the regular employees under the same supervisors. This work does not fit the definition of services to be performed by other than the contractor. Thus, it would be inappropriate to deduct these amounts from the total costs. On the other hand, it would be appropriate to deduct the cost of subcontracts for items such as interior decoration of aircraft even though a contractor accounts for them as part of other direct costs.

(d) The criteria for use of a single-element cost input base are very specific. A single-element cost input base may be used when a contractor can demonstrate that it best represents the total activity of a business unit and produces equitable results. Thus, a single-element base, such as direct labor dollars, may be used when the direct labor dollars are significant and the other measures of activity are less significant related to total activity. The contractor should periodically analyze the single-element base to assure that it best represents total activity and produces equitable results. When other measures of activity become significant, a single-element base may not produce equitable results. A single-element base is inappropriate when it is an insignificant part of the total cost of some of the final cost objectives.

(2) Initial changes from one type of input base to another which are required to comply with the standard would be subject to equitable adjustment. For example, a contractor previously used a direct labor hour base for allocating G&A expense. On the applicability date of CAS 410, the contractor changes its G&A allocation base to total cost input because other measures of activity besides direct labor are significant in relation to total activity. Since the base change is required in order to comply with section 410.50(d), the contractor is entitled to an equitable adjustment. Once a G&A base has been selected, it should not be changed unless the underlying business activity changes. When a base change is elected, adequate notice must be given to the CFAO.

(3) A special allocation of G&A expenses is permitted if a particular final cost objective (e.g., contract) would receive a disproportionate allocation of G&A expenses by using the cost input base. However, the allocation from the G&A expense pool to the particular final cost objective must be commensurate with the benefits received. The amount of the special allocation must also be removed from the existing G&A expense pool and the particular final cost objective's base costs must be removed from the base used to allocate the G&A pool. The CAS 410.50(j) provision is applicable to a particular final cost objective which is an exception to the contractor's normal operation, rather than to classes of contracts or final cost objectives. It appears that the intent is to use the special allocation provision in exceptional cases to resolve situations where equitable allocation cannot be achieved by normal methods. The use of a special allocation to a particular contract or other final cost objective is the only alternative to the uniform

allocation requirements of the standard. The standard does not permit the use of an abated or reduced rate for certain costs (e.g., a lesser rate for subcontract costs). Before approving a special allocation, the G&A expense pool should be carefully evaluated to purify it of any expenses which may be allocated to cost objectives more directly than by a cost input base. When a special allocation under CAS 410.50(j) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices.

(4) The standard provides that work on stock or product inventory items represents part of the productive activity of the business unit for a cost accounting period, and therefore should receive an allocation of G&A expense. The costs of such items must be included in the G&A allocation base for the period in which the items are produced or worked on rather than the period in which they are issued to final cost objectives. The cost must be included only once in computing the allocation base and rate. The time these items are issued from inventory to final cost objective is irrelevant for computing the G&A base and for calculating the G&A expense rate.

(a) Where it was the previous practice of the business unit to include G&A expense as part of the product inventory, the cost of all units produced in a period should include the G&A expenses of the cost accounting period in which the items are produced, including those remaining in inventory at the end of the year. Since G&A has already been applied to items in inventory, no additional G&A will be applied when those items are issued.

(b) If the previous practice was not to include G&A expense as part of the cost of product inventory, the business unit must consistently use one of two methods to cost G&A expenses to the cost of product inventory. The first method permits the business unit to allocate G&A to the costs of items produced for stock, including those remaining in inventory at the end of the period, using the G&A rate of the period the items were worked on. This is the same method as allowed for business units that costed G&A expense as part of the costs of product inventory. The second method permits a business unit to allocate G&A to such costs using the rate of the period the items were issued. For example, if a business unit produces 100 items for stock and issues 50 items in period 1 and 50 items in period 2, the cost of 100 items produced would be included in the allocation base of period 1. No costs for these items would be included in the allocation base of period 2. However, for purposes of allocating G&A expense to the inventory, the G&A rate of period 1 would be applied to the 50 items issued in that period, and the G&A rate of period 2 would be applied to the 50 items issued during that period. The CASB believed that the differences in the G&A rates applied to the final cost objectives by using the G&A rate of the year the items are issued rather than produced will not be material.

(c) The auditor should note that the standard only covers the treatment of items produced for stock after the applicability date. It does not cover the treatment of items held in inventory on the first date the contractor must apply the standard. Therefore, items produced for stock and included in inventory on the date the standard becomes applicable should be included in the G&A allocation base of the period in which the items are assigned to final cost objectives.

(5) Questions have been raised as to the relationship between CAS 410 and the methods used by contractors with parts cost accounting systems to transfer Work-in-Process (WIP) to cost of sales. CAS 410 addresses the application of G&A expense to WIP cost input but does not prescribe the cost methods for relieving WIP and charging cost of sales. To comply with CAS 410, a contractor with a parts cost accounting system must compute a fiscal year cost input G&A expense rate to allocate G&A expenses to WIP cost input. However, the contractor may use any inventory valuation method recognized under generally accepted accounting principles, such as FIFO or average, to transfer costs including G&A expense from WIP to cost of sales.

c. If noncompliances are found regarding either the G&A expense pool or the allocation base, the auditor should ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-410.2 Illustrations

The following illustrations supplement those in paragraph 410.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Division X excludes from its total cost input base, the cost of intercompany transfers from Division Y.

Solution. The intent of the standard is that all actions which represent the total productive activity of the segment should be included in total cost input. The costs of the intercompany transfers should, therefore, be included in the total cost input base used to allocate G&A expenses. Division X's exclusion of the intracompany transfers from the base does not comply with the standard.

b. **Problem.** Division X uses a total cost input base. In making its product there is extensive amount of costs for ODC, material, subcontracts, consultants, and special tooling. As these costs are all represented in approximate proportions on all of Division X's contracts, total cost input has been considered the best measure of the division's total business activity. The contractor is now contemplating entering a new business area. New contracts are planned to be bid in 20X2 and may have up to 60 percent of their value in subcontracting of the type that clearly contrasts with arrangements which require close supervision and participation on the part of the prime contractor, for example, drop shipments. Because of the dollar value of these contracts ($50 million) and anticipated follow-on effort compared to Division X's normal contracts ($150 million), the G&A allocated to the new contracts on a total cost input base would far exceed the beneficial relationships to these contracts. Division X notifies the CFAO and the auditor at the beginning of 20X1 that they intend to change their base to value-added. They subsequently change their Disclosure Statement to show the prospective G&A allocation base.

Solution. Division X's criteria for base selection complies with that contained in CAS 410, and the choice of the value-added base complies with the standard. However, this example is only hypothetical. Auditors must exercise professional judgment in assessing each situation individually. No two circumstances are the same.

c. **Problem.** Contractor Z has a number of contracts with large amounts of subcontract costs. The contractor does not believe that the use of the regular G&A rate for the subcontract costs is equitable because the subcontracts do not benefit from all of the G&A pool costs in the same relationship as the other base costs. It is therefore proposing a reduced G&A rate for the subcontract costs.

Solution. The contractor's proposal of a reduced G&A rate for the subcontract costs is in noncompliance with the standard. The only alternative to the uniform allocation requirements of the standard is the special allocation procedures which pertain to particular contracts or other final cost objectives. Special allocations to classes of contracts or to specific cost elements or types of expenses are not permitted by the standard.

8-411 Cost Accounting Standard 411 --- Accounting for Acquisition Costs of Material

a. This standard provides criteria for the accounting of acquisition costs of material, provides guidance on using inventory costing methods, and improves the measurement and assignment of costs to cost objectives.

b. This standard does not cover accounting for the acquisition costs of tangible capital assets nor accountability for Government-furnished materials.

c. The standard was effective January 1, 1976, and must be applied to all materials purchased or produced in the next fiscal year after receipt of the CAS-covered contract to which the standard is applicable.

8-411.1 General

a. The standard requires contractors to accumulate the cost of material and allocate it to cost objectives according to written statements of accounting policies and practices.

b. The end use of a category of material must be identified at the time of purchase or production if the cost is to be allocated directly to a cost objective. A category of material may be allocated directly even though the company maintains an inventory of this material, as long as the cost objective was specifically identified and the cost allocated at the time of purchase or production. Thus, units of a category of material could be allocated at different costs to the same cost objective, that is by direct allocation and issuance from inventory. The auditor should assure that the contractor's written statements of accounting policies and practices for accumulating and allocating costs of materials clearly set out (1) the specific conditions under which these costs may be directly allocated to cost objectives and (2) the inventory costing method to be used for allocating material costs issued from inventory. During regular audits of material, following the procedures in 5-710.1, these written statements will enable the auditor to determine that the contractor's practices comply with the standard and that deviations from the standard (which may arise as a result of contractor actions) are reported.

c. Materials used solely in performing indirect functions or which are not a significant element of production cost may be allocated to an indirect cost pool. However, when the ending inventory significantly exceeds the beginning inventory of such material in an indirect cost pool in relating to the total cost included in the indirect cost pool, the pool should be credited for the unused portion and an asset account established for a like amount. The standard does not require the contractor to take a physical count of the ending inventories for these indirect materials. However, in the absence of a physical inventory, the auditor should make certain that a reasonable method for estimating the cost of unconsumed indirect materials at year end has been used.

d. All materials, except those directly allocated to final cost objectives (CAS 411.40(b)) and those allocated to an indirect cost pool (CAS 411.40(c)), must be accounted for in material inventory records. "Material inventory record" means any record for accumulating the cost of material for issue to one or more cost objectives. Such records need not be general or subsidiary ledger accounts but may be card files, computer data, bin tags, or any other such informal record. The written statement of accounting policies and practices should describe a material inventory record and explain how it is used.

e. When issuing material from a company-owned inventory, any of the following inventory costing methods are acceptable, provided the same costing method is consistently used for similar categories of material within the same business unit:

(1) The first-in, first-out (FIFO) method.
(2) The moving average cost method.
(3) The weighted average cost method.
(4) The standard cost method.
(5) The last-in, first-out (LIFO) method.

f. Material cost is the acquisition cost of a category of material. The purchase price must be adjusted by extra charges incurred or discounts and credits earned. These adjustments must be charged or credited to the same cost objective as the material price; when this is not practical, charges or credits may be included in an appropriate indirect cost pool, provided this practice is consistent.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-411.2 Illustration

The following illustration is intended to supplement those in paragraph 411.60 of the standard. It should assist as a guide in determining whether a contractor's practices comply with the standard.

Problem. A contractor's written statements of accounting policies and practices provide that the cost of a category of material used solely in performing an indirect function will be allocated to an indirect cost pool when the material is received. The contractor does not estimate the cost of unconsumed indirect materials at year end, nor does it compare this ending inventory cost with the cost of the beginning inventory of indirect materials to determine if the excess is significant in relation to the total cost included in the indirect cost pool. All costs of indirect material allocated to the indirect cost pool during the cost accounting period remain in the indirect cost pool at year end.

Solution. The practice does not comply with CAS 411.40(c). The contractor must determine the significance of the excess of the ending inventory over the beginning inventory of such materials in relation to the total cost included in the indirect cost pool. If significant, the indirect expense pool must be credited and an asset account established in a corresponding amount.

8-412 Cost Accounting Standard 412 --- Composition and Measurement of Pension Costs

a. This standard establishes the composition of pension costs, the basis of measurement, and the criteria for assigning pension costs to cost accounting periods. CAS 413 addresses the accounting treatment of actuarial gains and losses and the allocation of pension costs to segments of an organization.

b. The standard is basically compatible with the Employee Retirement Income Security Act of 1974 (ERISA), although some of its provisions may be more restrictive than ERISA funding requirements. The fundamental objectives of CAS 412 differ from the objectives of ERISA. ERISA is primarily a funding law; it is designed to ensure financial integrity of pension plans through minimum funding standards. CAS 412 was promulgated to ensure that pension costs are properly measured and allocated to cost objectives.

c. CAS 412 was effective January 1, 1976 and must be followed in the next fiscal year after receiving a CAS-covered contract to which the standard is applicable. This standard was revised effective March 30, 1995. The revisions are applicable to contracts in the next cost accounting period beginning after receipt of a contract that incorporates the revised standard.

d. FAR 31.205-6(j)(1) makes CAS 412 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed pension costs, where significant, are in compliance with the provisions of CAS 412.

8-412.1 General

a. The CASB defines a pension plan as a deferred compensation plan, established and maintained by one or more employers, to provide for systematic payment of benefits for life (or life at the option of the employees) to participants after their retirement. There are basically two kinds of pension plans: defined contribution plans and defined benefit plans. A defined contribution plan provides benefits to retirees according to the amount of the fixed contribution to be made by a contractor. The standard provides that the following types of plans shall be treated as defined contribution plans:

(1) plans which are funded through permanent insurance or annuity contracts,

(2) multi-employer plans established under collective bargaining agreements, and

(3) state pension plans applicable to Federally Funded Research and Development Centers (FFRDCs).

In a defined benefit plan, the contributions to be made by the contractor are calculated actuarially to provide preestablished benefits. The cost of benefits under a pay-as-you-go plan must be measured in the same manner as the costs under a defined benefit plan. During the compliance audit, the auditor should identify the types of all pension plans in effect at the contractor locations.

b. Under the defined contribution plan, the pension cost of a cost accounting period is the net contribution required to be made, after adjustment for dividends and other credits. For a defined benefit plan the pension cost for a period may consist of four elements:

(1) Normal cost (annual cost attributable to years after a particular valuation date).

(2) Amortization of any unfunded actuarial liability (excess of the actuarial liability over the value of the pension fund assets).

(3) Interest equivalent on the unfunded actuarial liability and actuarial gains or losses being amortized.

(4) Adjustment for actuarial gains and losses (differences between forecasted assumptions and actual experience).

c. All portions of unfunded actuarial liability resulting from various events or circumstances (e.g., plan improvements or assumption changes) are to be included as separately identified parts of pension cost. In general, an unfunded actuarial liability will be amortized in equal installments over a period of not less than 10 and not more than 30 years (40 years if the plan predates January 1, 1974). CAS 412.50(a)(1) specifies a maximum and minimum amortization period for each portion of unfunded actuarial liability. If amortization has begun before the applicability date of the standard, the amortization period need not be changed. An interest equivalent on the unpaid balance of the liability must be included with each installment. Contractors must establish and consistently follow a policy for selecting specific amortization periods for unfunded actuarial liabilities. When selecting the specific amortization period with the above limits, the contractor's amortization policy may give consideration to the size and nature of the unfunded actuarial liability as a component of pension costs. Once the amortization period for a portion of unfunded actuarial liability is selected, the amortization process must continue to completion.

d. Pension costs applicable to prior periods which were specifically unallowable under then-existing contractual provisions should be separately identified and excluded from an amortization of unfunded liability or from future normal costs if the unfunded liability is not identified. Also excludable from pension costs are excise taxes and interest costs incurred as a result of inadequate or delayed funding.

e. Actuarial methods used by contractors may be classified as either the accrued benefit cost method or one of the acceptable projected benefit cost methods. A major difference between methods is that, under the accrued benefit cost method, costs are based on units of future benefits which have been accrued to employees to the present date; whereas under the various projected benefit methods, costs are based on benefits which will accrue over the entire expected period of credited service of the individuals involved. The accrued and projected benefit cost methods are also grouped as either spread-gain or immediate-gain cost methods. Under the spread-gain method actuarial gains and losses are included as part of the normal cost for current and future years. Under the immediate-gain method actuarial gains and losses are separately identified and amortized over a period of years. The standard does not require the use of a specific actuarial cost method; however, the method selected by the contractor must provide for separate measurement of the pension cost elements listed in paragraph b. above. The cost elements are identified under the immediate-gain cost methods. They are not identified under spread-gain methods, which neither disclose actuarial gains and losses nor develop the amount of unfunded liability. Consequently, CAS 412 does not permit the use of spread-gain methods in calculation of pension cost for contract costing purposes

f. During the compliance audit, the auditor should identify the actuarial method used by the contractor for each plan in effect. The auditor should evaluate actuarial reports and statements, as well as accounting records.

g. The normal costs computed under the accrued benefit cost method are the present value of future benefits earned by employees during the year. For defined benefit pension plans other than those accounted for under the pay-as-you-go cost method where the pension benefit is a function of salaries and wages, the normal cost shall be computed using a projected benefit cost method. The normal cost for the projected benefit shall be expressed either as a percentage of payroll or as annual accrual based on the service attribution of the benefit formula. Where the pension benefit is not a function of salaries and wages; the normal cost shall be based on employee service.

h. While pension costs must be based on the provisions of existing plans, contractors may consider (1) salary projections for plans whose benefits are based on salaries and wages and (2) improved benefit projections for plans specifically providing for such improvements.

i. Actuarial assumptions are related to (1) interest or return on funds invested and (2) other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits. Each actuarial assumption used by the contractor in calculating pension costs must be identified separately. The assumptions should represent the contractor's estimated future experience based on long-term trends to avoid short-term fluctuations. Pursuant to CAS 412 in effect prior to March 30, 1995, the validity or the reasonableness of the actuarial assumptions can be measured in the aggregate of gains and losses rather than by a separate gain or loss analysis for each assumption. However, if the assumptions prove to be unreasonable in total; that is, the total gain or loss is significant, the contractor must be able to identify the major causes and give reasons for either retaining or revising the assumptions. Under the revised CAS 412, the validity of each assumption used shall be evaluated solely with respect to that assumption. If the actuarial assumptions are revised, any resulting increase or decrease in the unfunded actuarial liability will be amortized over not less than 10 or more than 30 years. Support for each actuarial assumption used by the contractor should be critically examined by the auditor. The compliance audit should include steps to identify and evaluate the reasonableness of the assumptions and to monitor actuarial gains and losses to assure that the assumptions remain valid.

j. FAR has retained the requirement that pension contributions be funded in order to be allowable. Therefore, even though the standard provides criteria for measurement and assignment of pension costs, the auditor will continue to establish the allowability of pension costs in accordance with FAR requirements.

k. In accordance with FAR 52.230-6, a contractor is required to describe to the CFAO the kind of changes made in order to comply with a new or modified cost accounting standard. This includes the modifications to CAS 412 effective March 30, 1995. The description should be submitted within 60 days after the award of a contract to which the standard or a modification to the standard is applicable. This should be done whether or not the contractor has filed a Disclosure Statement. If it appears that accounting changes will be required as a result of CAS 412, or the March 30, 1995 modifications thereto, and the contractor has not submitted the description on time, the auditor should advise the CFAO.

l. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-412.2 Assignment of Pension Cost

a. Pre - March 30, 1995 Requirements:

(1) Pension costs computed for a cost accounting period are assignable to that period only, except when a payment deferral has been granted under the provisions of ERISA. ERISA permits a contractor which has received a funding deficiency waiver for a particular year to amortize related pension costs over the immediately succeeding 15 years. Pension costs deferred to future periods under this provision must be assigned to the periods in which the funding actually takes place. However, in accordance with the first sentence of

FAR 31.205-6(j)(3)(iii) (FAR 31.205-6(j) was revised January 12, 2004; therefore, that provision is currently at FAR 31.205-6(j)(2)(iii)) and CAS 412.50(a)(7), the interest equivalent on the unfunded actuarial liability which results from this delayed funding would be unallowable.

(2) Except for pay-as-you-go plans, the cost assignable to a period is allocable to cost objectives of that period if (a) costs are funded in the period or (b) funding can be compelled. Costs will be considered funded for a period if payment is made by the Federal income tax return due date, including any extension. Funding provisions in ERISA, contractual funding agreements, or existence of third-party rights to required funding would constitute evidence that funding can be compelled. Excess funding is considered applicable to future periods.

b. Requirements Effective March 30, 1995:

(1) Pension cost computed for a cost accounting period is assignable only to that period, except for costs assigned to future periods pursuant to CAS 412.50(c)(2) and (5). The provisions at CAS 412.50(c)(2) establish a ceiling and floor (assignable cost corridor) on the amount of pension cost assignable to a period. According to the new rules, the pension cost assignable to a cost accounting period may not be less than zero (floor) nor exceed the ERISA maximum tax-deductible (ceiling) amount. The pension costs initially computed for a cost accounting period are adjusted for amounts that fall outside the assignable cost corridor. The adjustments (amounts falling outside the corridor) are reassigned to future periods as an assignable cost credit (amount less than zero), or assignable cost deficit (amount over ceiling). The credit or deficit amounts are amortized over a 10 year period in accordance with provisions prescribed at CAS 412.50(a)(1)(vi). Also, in accordance with CAS 412.50(c)(5), pension cost not funded pursuant to an ERISA funding waiver is reassigned to future periods as an assignable cost deficit subject to amortization using the same amortization period as used for ERISA purposes.

(2) Under the pre - March 30, 1995 rule, pension costs assigned to a cost accounting period were allocable to cost objectives of that period if liquidation of the liability could be compelled. However, pursuant to the revised standard, except for nonqualified defined benefit plans, the entire pension cost assigned to a cost accounting period must be funded in order to be allocable to cost objectives (CAS 412.50(d)(1)).

8-412.3 Full Funding Limitation

a. Requirements Effective March 30, 1995: The revised standard at CAS 412-30(a)(9) defines the CAS full funding limit (Assignable Cost Limitation) as the excess, if any, of the actuarial liability plus the current normal cost over the actuarial value of the pension plan assets. The amount of pension cost assigned to a cost accounting period cannot exceed the CAS full funding limit. Thus, when the Assignable Cost Limitation applies all prior year amortization bases are considered fully amortized (Fresh Start). The revised standard also eliminates the conflict between the CAS and ERISA/IRC full funding limitation by limiting the amount of pension cost assignable to a cost accounting period to the maximum tax-deductible amount. The amount of pension cost computed for a period in excess of the tax-deductible limit is reassigned to future periods as an assignable cost deficit which is amortized over a ten year period.

8-412.4 Nonqualified Plans

a. Pre - March 30, 1995 Requirements: Pay-as-you-go plans are different from trusteed or insured plans in that they are not funded. Therefore, the cost of benefits under a pay-as-you-go plan shall be measured the same as costs of defined benefit plans whose benefits are funded. Costs assignable to a period under a pay-as-you-go plan are allocable to the cost objectives of the period only if the payment of benefits is made in that period or can be compelled. If payment is optional with the contractor, costs allocable to cost objectives

of the period are the lesser of the amount of benefits actually paid to beneficiaries in that period or the amount computed as assignable to that period.

b. Requirements Effective March 30, 1995: The pre - March 30, 1995 provision at CAS 412.40(c) which allowed contractors to accrue pension cost for nonqualified plans if benefits could be compelled has been deleted. The revised standard permits contractors to accrue pension cost for nonqualified plans only if the requirements set forth in CAS 412.50(c)(3) are satisfied. The three requirements specified in this provision are (1) the contractor elects to use accrual accounting, (2) the plan is funded through a funding agency, and (3) the benefits are nonforfeitable. The costs of nonqualified plans which do not meet these requirements shall be assigned to cost accounting periods using the pay-as-you-go cost method. With regard to the funding requirement for nonqualified plans, the standard requires partial funding at the tax rate complement (i.e., 100% - tax rate %).

8-412.5 Illustrations

The following illustrations are intended to supplement those in paragraph 412.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** A contractor uses an immediate-gain actuarial cost method in computing pension cost for contract costing purposes. The contractor has proposed $2.3 million pension costs for the current cost accounting period. The auditor’s analysis of the actuarial valuation report disclosed that:

(1) the value of the pension fund assets was $12.6 million,
(2) the actuarial liability was $10 million, and
(3) the experienced actuarial gain for the previous period was $1 million.

Solution. The pension cost assignable to the cost accounting period is $-0-, because the value of the pension assets exceeds the actuarial liability plus the normal cost for the period. In other words, there is no valid liability and therefore no basis for recognition of pension accruals on Government contracts. Furthermore, the significance of the experienced actuarial gain would indicate that the actuarial assumptions may not be reasonable. The contractor should be required to identify the actuarial assumptions which were responsible for the gain and to provide rationale for either retaining or revising those assumptions.

b. **Problem.** As a result of a temporary cash shortage, a contractor's payments into the pension fund were not adequate to meet the ERISA funding requirements for the period. A 5-percent excise tax on the accumulated funding deficiency was therefore assessed against the contractor. In computing the pension cost for the fiscal year, the contractor included the assessment of the 5-percent tax plus an interest equivalent on the unpaid amount.

Solution. Both the excise tax, which was assessed as a penalty for the delayed payment, and the interest equivalent on the delayed payment should be excluded from the pension costs allocated to Government contracts. The CASB, in its prefatory comments to the standard, acknowledged that an interest equivalent should be recognized to determine whether a pension plan is properly funded. However, since interest resulting from delayed funding is caused by a management decision to use funds for other purposes, the interest should be considered as investment cost rather than a component of pension cost.

8-413 Cost Accounting Standard 413 --- Adjustment and Allocation of Pension Cost

a. This standard establishes criteria for:

(1) assigning actuarial gains and losses to cost accounting periods,
(2) valuing pension fund assets, and
(3) allocating pension costs to segments.

b. Provisions in the standard are somewhat more stringent than ERISA requirements, concerning frequency of actuarial valuations and methods of valuing pension fund assets. Consequently, some accounting changes may be required for compliance with the standard in addition to those which were previously made to comply with ERISA.

c. FAR 31.205-6(j)(1) makes CAS 413 applicable to all contracts, even contracts which are not CAS-covered or are subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed pension costs, where significant, are in compliance with the provisions of CAS 413.

d. CAS 413 was effective March 10, 1978 and must be followed in the next fiscal year after award of a CAS covered contract to which it is applicable. CAS 413 was revised effective March 30, 1995 and the revised CAS 413 must be followed in the next fiscal year after award of a CAS covered contract to which it is applicable. However, a significant feature of the revised CAS 413 is the CAS Board's clarification on application of CAS 413.50(c)(12) with respect to adjustments to previously determined pension costs in the event of segment closing, pension plan termination or curtailment of pension plan benefits. The revisions to CAS 413.50(c)(12) clarify and specify techniques for determining such adjustments. According to CAS 413 transition coverage, these clarifications should be used to resolve outstanding issues on existing CAS covered contracts.

8-413.1 General

a. Actuarial gains and losses represent differences between actuarial assumptions and actual experience. As previously noted in 8-412.1i., actuarial assumptions are related to:

(1) interest or return on funds invested and

(2) other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits.

CAS 413 requires that actuarial gains and losses for defined benefit plans be calculated annually and assigned to current and subsequent cost accounting periods. Under pension plans whose costs are determined by an immediate gain actuarial cost method, gains and losses that are material will be amortized equally over 15 years beginning with the current period. The annual installment will include an interest equivalent on the unamortized balance at the beginning of the period. Immaterial gains or losses may be assigned to the current period. An immediate gain method is one in which actuarial gains and losses are determined separately as an adjustment to the unfunded actuarial liability. Included in this category are the accrued benefit and entry age normal (sometimes referred to as the individual level premium with supplemental liability) actuarial cost methods.

b. The original and revised standard permits use of any recognized method for valuing pension fund assets used in measuring pension cost components provided it reflects appreciation and depreciation of pension fund assets and is used consistently from year to year. The illustration in CAS 413.60(b) identifies some commonly used asset valuation methods:

Type of Asset	Basis for Valuation
Equity securities and debt securities not expected to be held to maturity	5-year moving average of market values
Debt securities expected to be held to maturity	Amortization of differences between cost at purchase and par value at maturity
Real Estate	Cost less accumulated depreciation

If the method produces a value of less than 80 percent or more than 120 percent of market value, the asset values in a given year must be adjusted to the nearest 80 percent or 120 percent boundary. The adjusted asset values are then considered in calculating the actuarial gain or loss subject to the amortization criteria described above. The standard's provi-

sions regarding the valuation of assets do not apply to plans funded with insurance companies via contracts with guaranteed benefits.

8-413.2 Segment Accounting

a. Pre - March 30, 1995 Requirements:

(1) Except where certain significant disparities in actuarial factors exist between segments, contractors have the option to calculate pension costs either separately for segments or on a composite basis for allocation to segments on a base which represents the factors used in computing pension benefits. Separate calculations of pension costs for each segment are acceptable. CAS 413.50(c)(2) and (3) provide that pension costs must be separately calculated for a segment (on a prospective basis) when the pension costs at the segment are materially affected by any of the following conditions:

(a) The segment experiences material termination gains or losses.

(b) The level of benefits, eligibility for benefits, or age distribution is materially different for the segment than for the average of all segments.

(c) The aggregate of actuarial assumptions for termination, retirement age, or salary scale is materially different for the segment than for the average of the segments.

(d) The ratios of assets to actuarial liabilities for merged segments are different from one another after applying the benefits in effect after the merger. Differences between segments as to level of benefits and eligibility of benefits should be obtainable from the provisions of the pension plan. Segment data for termination experience, age distribution, and actuarial assumptions for termination, retirement age or salary scale will generally not be included in actuarial reports, CPA reports, Schedule B to IRS Form 5500 or other pension source documents. Thus, the auditor should attempt to gain an understanding at the onset of the pension evaluation as to the segment data to be provided by the contractor which are necessary for audit determination of compliance with CAS 413.50(c)(2) and (3).

(2) When separate pension fund calculations are required because of disparities in termination gains or losses, level of or eligibility for benefits, or actuarial assumptions for termination, retirement age or salary scale, undivided pension fund assets must be initially allocated to the segment for which the separate calculation is being made. The value of the pension fund assets allocated shall equal the segment's pension fund contributions, adjusted for earned interest and paid benefits/expenses, if such information is determinable; if not, the assets can be allocated among segments on any ratio which is consistent with the actuarial cost method(s) used to compute pension costs. The initial allocation of assets to merged segments must be the market value of the segment's pension fund assets when the merger occurred.

(3) Employees participating in a multisegment pension plan occasionally transfer between segments. However, the applicable pension fund assets and liabilities need not follow the employees from one segment to the other unless the transfers involve such a large number of employees that a segment's ratio of fund assets to actuarial liabilities would be distorted.

(4) Contractors who separately calculate pension costs for one or more segments have the option of establishing a separate segment for inactive participants (e.g., retirees). If this action is taken, the pension fund assets and actuarial liabilities should be transferred to the inactive segment when employees participating in the pension plan become inactive. The funds transferred are to reflect the funded portion of the inactive participants' actuarial liability. CAS 413.50(c)(1) and 413.50(c)(9) provide that inactive segment costs shall be allocated to the segments with active lives on a basis representative of the factors upon which pension costs are based. Thus, pension cost calculated for the inactive participants should be allocated to the segments with active lives on a basis which is relatively comparable to the amounts that would have been computed if a separate segment for inactives had never been established.

b. Requirements Effective March 30, 1995:

(1) The provisions of CAS 413.40(c) now provide clear and concise criteria for determining the funding status for pension plans at contractors that compute pension cost on a segmented basis. Specifically, the revised coverage provides that computation of the assignable cost limitation shall be based on the assets and liabilities of the individual segment. The revi-

sions also provide that in computing the limit on the amount of assignable cost for a segment, the measurement of the ERISA tax deductible amount is computed for the plan as a whole and apportioned among the segments. Amounts funded (contributions) can be allocated to Government segments first.

(2) The revised Standard provides specific coverage for calculation of segmented pension cost for segments that have disproportionate ratios of assets to liabilities. Under the revised coverage, when the assignable cost limitation applies to a particular segment, all existing amortization bases maintained for that segment are considered fully amortized (fresh-start) pursuant to the provisions of CAS 412.50(c)(2). For those segments not affected by the assignable cost limitation, the amortization of the unfunded actuarial liability continues unabated. In addition, any amount of pension cost not assignable to a segment due to application of the ERISA tax deductible limit is reassigned to future periods as an assignable cost deficit.

8-413.3 CAS 413.50(c)(12) Adjustment For Segment Closing, Plan Termination or Benefit Curtailment

a. When a segment is closed, a plan is terminated, or benefits are curtailed, the contractor must determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment as of the closure date. Although this difference represents an adjustment of previously determined pension costs, the general rule is that the contractor should make a refund or give credit to the Government for its equitable share in the cost accounting period of closure, not prior cost accounting periods. However, if the contractor continues to perform Government contracts, the contracting parties may agree to apply the credit or charge in costing of future contracts.

b. A new definition has been added at CAS 413.30(a)(20) with specific criteria for determining when a segment is closed. The definition describes three events that would give rise to a segment closing within the context of CAS 413.50(c)(12). The first event is when a change in ownership takes place and such change involves more than a mere reorganization within the contractor's internal structure. The second event is when the segment operationally ceases to exist. The third is when the segment ends its contractual relationship with the Government irrespective of whether the segment continues in operation.

c. Clarifications on Application of CAS 413.50(c)(12):

(1) In lieu of requiring contractors to recognize negative pension cost for severely overfunded plans, specific language has been added to CAS 413.50(c)(12) that clarifies the Government's rights to an adjustment in the case of a segment closing, plan termination, or freezing of benefits (curtailment of benefit gain/loss). The revised Standard retains the principle of deferring the Government's recovery of excess assets until the occurrence of an event that triggers the application of CAS 413.50(c)(12).

(2) The coverage has been strengthened to provide greater specificity regarding the methodology and assumptions to be used in calculating the adjustment. The revised coverage also clarifies that the adjustment results in a charge to Government contracts when the liabilities of the plan exceed the assets. The revised Standard also provides clarification on the application of CAS 413.50(c)(12) in the following areas:

(a) **Actuarial Assumptions - 413.50(c)(12)(i)**: The actuarial liability shall be determined using the accrued benefit cost method based on the long term assumptions used by the contractor in measurement of pension cost on Government contracts. This clarification resolves the issue of whether measurement of the liability is based on the Accumulated Benefit Obligation (an ABO calculation) or the Projected Benefit Obligation (PBO). Clarified coverage requires that the liability be based on the accrued benefit cost method (ABO). The coverage also clarifies that in the absence of a plan termination or settlement of liabilities, contractors are required to use the plan's existing long term actuarial interest rate assumption in measurement of the segment's actuarial liabil-

ity. As such, the use of the PBGC or ERISA interest assumption would be inappropriate unless the plan is terminated or the pension obligations are settled by the purchase of annuity contracts.

(b) **Plan Improvements -413.50(c)(12)(iv):** The revised coverage incorporates a 5 year phase-in rule in which increased liabilities are recognized on a prorata basis using the number of months that the plan amendment preceded the date of the event that triggers an adjustment. This provision provides clarification in accounting for plan improvements adopted within 60 months of the event date. The revised coverage makes it clear that contractors must give consideration to this ERISA requirement in measurement of liabilities due to plan amendments. The cost of increased benefits that are not required by law or by a collective bargaining agreement are subject to the sixty month phase-in requirement.

(c) **Transfer of Assets/Liabilities - 413.50(c)(12)(v):** This provision provides clarification on the accounting for pension adjustments when the segment closing involves the transfer of pension assets and liabilities. According to the clarified coverage, no adjustment is required when all the pension assets and liabilities are transferred to a successor in interest to the contracts. On the other hand, if only a portion of the assets and liabilities are transferred, the standard requires that the adjustment be determined after consideration for any transfer of assets and liabilities to a successor contractor.

(d) **Adjustment to Pension costs - 413.50(c)(12)(vi):** The Government’s share of the pension adjustment is determined based on the cost allocated to all contracts that are subject to the provisions of CAS 412/413. This coverage makes it clear that CAS covered firm-fixed-price contracts are included in calculation of the segment closing adjustment.

d. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-413.4 Illustrations

The following illustrations are intended to supplement those in paragraph 413.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Contractor X was acquired by Contractor Y and renamed Segment B. The entire work force of X was retained by Y following the acquisition. Pursuant to terms of X's pension plan, X employees were paid all vested pension benefits at the time of dissolution of X. The employees, upon coming to work for Contractor Y, were considered "new employees" with no actuarial liability attributable to their past service with Contractor X. Contractor Y's unfunded actuarial liability (UAL) at the time of the merger was $25 million. Contractor Y has consistently made a composite pension cost calculation for all of its segments and wishes to continue doing so.

Solution. Since Y's pension plan had a disproportionately larger UAL than X's plan at the time of acquisition (i.e., $25 million vs. -0-), any combining of assets and actuarial liabilities of the two plans would result in a materially different pension cost allocation to Y's segments than if pension costs for Segment B were computed as though it had a separate pension plan. Pension costs must be calculated separately for Segment B.

b. **Problem.** Contractor X computes pension costs separately for Segments A, B, and C. As permitted in CAS 413.50(c)(9), the contractor elects to establish a separate segment for inactive plan participants. Pension costs for the inactive segment are allocated back to A, B, and C on the ratios of the remaining working lives of the work force of the three segments. This method results in the following allocation of inactive segment pension costs:

	Costs	%
Segment A	$2.5 million	25
Segment B	4.0 million	40
Segment C	3.5 million	35
Total inactive segment costs allocated	$10.0 million	100%

The actuarial report discloses that the inactive plan participants retired from the following segments:

Segment Retired From	Number of Retirees	%
A	5950	85
B	350	5
C	700	10
	7000	100%

Due to the geographical dispersion of the three segments, few employees had transferred among segments prior to retirement. The high ratio of retirees from Segment A was attributable to a major plant layoff which had occurred 10 years previously.

Solution. The contractor's allocation of inactive segment costs to Segments A, B, and C results in a substantially different amount than would have been allocated if a separate segment for inactive participants had never been established. The auditor should recommend an allocation of inactive segment costs to A, B, and C based on the ratios of the number of retirees from each segment to total retirees.

8-414 Cost Accounting Standard 414 --- Cost of Money as an Element of the Cost of Facilities Capital

a. The standard recognizes the cost of facilities capital as a contract cost. It provides criteria for measuring and allocating an appropriate share of the cost of money which can be identified with the facilities employed in a business.

b. The effective date of this standard was October 1, 1976. Contractors must follow its requirements on all contracts subject to CAS negotiated on or after this date.

c. CAS 414 and the FAR cost principle do not apply to facilities where compensation for the use of the facilities is based on use rates or allowances in accordance with Federal regulation. Where contractors are compensated for some facilities by use rates and others by depreciation, the contractor should apply CAS 414 to those facilities which are being depreciated.

d. FAR 31.205-10 makes CAS 414 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed cost of money, where significant, are in compliance with the provisions of CAS 414.

e. See CAS Working Group Papers 77-18 and 77-19 for guidance issued by the CAS Working Group on CAS 414.

8-414.1 General

a. The CAS 414 techniques must be used to compute the cost of money in connection with individual price proposals, forward pricing rate agreements, and with the establishment of final indirect cost rates. The cost of money is an imputed cost which is identified with the total facilities capital associated with each indirect cost pool, and is allocated to contracts over the same base used to allocate the other expenses included in the cost pool. The cost of

money may be considered an indirect expense associated with an individual cost pool but separately identified. The cost of money is subject to all the same allocation procedures as any other indirect expense which is allocated on a selected base, and each element of such base, whether allowable or unallowable, should bear its pro rata share of the cost of money.

b. Use of the cost of money factors in final indirect rate determinations and forward pricing proposals is discussed in paragraphs 8-414.2 and 8-414.3 below. The calculation of the cost of money for each contract involves several steps.

(1) The average net book value of facilities for each indirect expense pool having a significant allocation of facilities is identified from accounting data used for contract costing.

(2) The cost of money devoted to facilities capital for each indirect expense pool is the product of these net book values multiplied by the cost of money rates per the Secretary of the Treasury under Public Law 92-41, 85 Statute 97 (distributed semi-annually by Headquarters.

(3) Facilities capital cost of money factors are computed by dividing the cost of money for each pool by the corresponding allocation base. The allocation bases used in this computation must be compatible with the bases used for applying indirect costs in determining contract costs.

(4) The cost of capital committed to facilities is separately estimated, accumulated, and reported for each contract. Each contract's share of the facilities capital cost of money is determined by multiplying the portion of the allocation bases for each indirect expense pool applicable to the contract by the facilities cost of money factor for that pool and adding the products together.

c. The facilities capital cost of money factors, wherever applicable, must be computed in accordance with the CASB-CMF form, Facilities Capital Cost of Money Factors and Computation. The CASB-CMF form and instructions are included as an appendix to CAS 414.

(1) On the CASB-CMF form, facilities capital items are classified as Recorded Facilities, Leased Property, and Corporate or Group Facilities. Capital leases are to be considered as Leased Property for purposes of the CASB-CMF form. In accordance with CAS Working Group Paper 77-19, operating leases, for which constructive cost of ownership is allowed in lieu of rental costs under Government acquisition regulations, are also to be classified as Leased Property. Since cost of money would be an allowable cost if the contractor had purchased the property, the cost of money should be included as an ownership cost in determining whether the allowable cost will be based on constructive ownership cost or leasing cost. Land which is an integral part of the leased facility is subject to the same treatment as the leased facility in computing the cost of money. Land leases for which the land is used in the regular business activity will also be included on the form even though land lease costs themselves do not generate allowable costs.

(2) Facilities costs are further identified on the CASB-CMF as either "distributed" or "undistributed." Distributed facilities are those capital items which can be identified in the contractor's records as solely applicable to those specific indirect expense pools for which a cost of money rate is to be computed. Undistributed items, which represent the remainder of the business unit's facilities capital, consist primarily of items charged to service centers. Under the regular method, undistributed assets are allocated to the appropriate indirect expense pools on a basis that approximates the actual absorption of depreciation/amortization of the facilities. Under the alternative method provided for in the standard, the undistributed assets are allocated to the G&A expense pool. The alternative method may be used only if the contracting parties agree that depreciation/amortization generated by the undistributed assets is immaterial or the results obtained from this alternative procedure are comparable to those which would have been obtained under the regular method.

(3) In determining the average net book values for facilities employed by the business unit, auditors will be required to examine asset records to the extent necessary in the circumstances.

(a) Initially, the auditor should establish the validity of the average values used by the contractor. The standard provides that, where there has been a major fluctuation in the level of facilities during the cost accounting period, the simple average of the beginning and ending net book values may not be appropriate. Where significant variations have occurred, the auditor should recommend a procedure for calculating the average that more accurately reflects the actual experience.

(b) The facilities capital values used as a basis for the cost of money must, in general, be the same values used to generate allowable depreciation or amortization cost (ASBCA Case No. 32419, Raytheon Co.). Land which is integral to the regular operation of the business unit will be included. Operating leases which are treated as constructive ownership will be included at net book value on the CASB-CMF form starting with beginning of the lease term. Where leasing costs have previously been accepted as less costly to the Government under the lease period, renewal of the lease requires a new comparison of lease/ownership costs. If this comparison results in the allowance of constructive ownership costs in lieu of rental costs, the lease will be included at net book value on the CASB-CMF starting with the beginning of the lease renewal. The net book value will be based on fair value at asset acquisition (date that lease was entered into or renewed if appropriate) less the amount, if any, which would have been depreciated had the asset been purchased. The net book value assigned to the leased asset will not include the cost of money. Leasehold improvements may be considered in computing the cost of money if they are subject to amortization. Goodwill is not to be included in the cost of money computation. The acquisition value for all contractor-owned tangible assets and those leased assets for which constructive cost of ownership is allowed in lieu of rental costs should be determined in accordance with CAS 404. Depreciation charges applicable to assets included in the cost of money computation will be determined in accordance with CAS 409.

(c) To be included in the base for the cost of money computation, the asset must be used in regular business activity. Where a contractor maintains depreciation records for groups of assets, the auditor should evaluate the assets in the group to see if they should be included in the cost of money computation. In addition, the auditors should carefully evaluate contractor land purchases and leases to determine if they are an integral part of the regular operation of the business. The auditor should request the contractor to demonstrate that land purchases and leases in question were acquired as a reasonable response to a prudent forecast of the contractor's regular business activity and therefore are integral to the regular operations of the business. If the purchase/lease costs do not meet this requirement then the auditor should assure that these costs are properly excluded from the CAS 414 computation. The following would not be considered as being used in the regular business activity.

- Land held for speculation.
- Facilities or capacity which have been determined to be idle in accordance with FAR 31.205-17.
- Assets which are under construction for a contractor's own use (see 8-417.2a.).
- Assets which have been constructed or purchased but have not yet been placed into service.

8-414.2 Interest Rates – Cost of Facilities Capital

a. The cost of money rate to be used in computing the cost of money factors is determined by the Secretary of the Treasury under Public Law 92-41, 85 Statute 97. This rate is published semiannually in the Federal Register. The rate published in December is applicable to the period from January 1 through June 30; the rate published in June is applicable to the period from July 1 through December 31. Although the interest rates are published semiannually, they are annual rates. Rates in effect since January 1, 1982 are as follows:

	January-June	July-December
1982	14.75%	15.5%
1983	11.25%	11.5%
1984	12.375%	14.375%
1985	12.125%	10.375%
1986	9.75%	8.5%
1987	7.625%	8.875%
1988	9.375%	9.25%
1989	9.75%	9.125%
1990	8.5%	9.0%
1991	8.375%	8.5%
1992	6.875%	7.0%
1993	6.5%	5.625%
1994	5.5%	7.0%
1995	8.125%	6.375%
1996	5.875%	7.0%
1997	6.375%	6.75%
1998	6.250%	6.0%
1999	5.0%	6.5%
2000	6.75%	7.25%
2001	6.375%	5.875%
2002	5.5%	5.25%
2003	4.25%	3.125%
2004	4.00%	4.5%
2005	4.25%	4.5%
2006	5.125%	5.75%
2007	5.25%	5.75%
2008	4.75%	5.125%
2009	5.625%	4.875%
2010	3.25%	3.125%

b. In calculating final facilities capital cost of money factors, the cost of money rate is the prorated average of the treasury rates. For example, the cost of money rate for fiscal year ending October 31, 1995 would be computed as follows:

Period	Treasury Rate	Weighting	Cost of Money Rate
1994 2nd Half	7.0%	2/12	1.167%
1995 1st Half	8.125%	6/12	4.063%
1995 2nd Half	6.375%	4/12	2.125%
			7.355%

The contractor must compute and support the cost of money factors. Based on the auditor's recommendation, the CFAO determines whether the factors are valid for contract cost and pricing purposes.

c. A contractor may change its fiscal year due to a merger, business combination, or other valid reason. When a cost accounting period is not a 12-month period, the cost of money rates must be adjusted to reflect the applicable accounting period. This is because the cost of money rates are annual rates, whereas the asset net book values of the contractor’s assets and allocation bases reflect a period other than the normal 12-month period. For example, the cost of money rate for a 6 and 15 month accounting period ending December 31, 1995 would be computed as follows:

6-Month Accounting Period

Period	Treasury Rate	Weighting	Cost of Money Rate
1995 2nd Half	6.375%	6/12	3.1875%

15-Month Accounting Period

Period	Treasury Rate	Weighting	Cost of Money Rate
1994 2nd Half	7.000%	3/12	1.7500%
1995 1st Half	8.125%	6/12	4.0625%
1995 2nd Half	6.375%	6/12	3.1875%
			9.0000%

8-414.3 Evaluating the Contractor's Computations

a. The CASB-CMF form will be used to support the cost of money factors used in incurred cost allocations and forward pricing proposals. In developing the factors used in forward pricing proposals, the contractor should take into account the latest available cost of money rate and a forecast of the facilities net book values and allocation bases for each cost accounting period of contract performance. In some instances, where projected asset value and allocation bases are not expected to vary significantly from the latest completed cost accounting period, the same facilities values and allocation bases as are required for retroactive cost determination may be used for forward pricing purposes.

(1) In as much as significant changes in any of the variables, i.e., net book value of facilities, the treasury rate or the allocation base may change the relationship and affect the cost of money factor, the auditor should closely evaluate any proposed cost of money calculation before it is accepted as a basis for negotiation. The latest available semiannual interest rate should be verified and known or anticipated additions/deletions of assets, as well as the effect of the annual depreciation on the net book value, should be examined. The allocation bases used in the cost of money computation should be compared for consistency with those used in estimating indirect cost rates.

(2) When the average cost of money rate to be used in costing the contract is known, this average rate should be used in lieu of the latest semiannual treasury rate. This situation could occur when a short-term contract is negotiated and performed within the 6-month period after all the rates to be weighted in the actual historical cost of money are known. As an example, a contractor on a calendar year basis receives a contract on July 1, 1987, with a performance period of July 1, 1987 to December 31, 1987. The treasury rate for July 1, 1987 to December 31, 1987 was published in June 1987. Since the contract will be costed after-the-fact using the arithmetic average of the two semiannual rates for 1987, 7.625% + 8.875%/2 = 8.25%, the 8.25 percent rate should also be used for pricing the contract. Auditors should be aware that the interest rate which will be in effect during the negotiation and applied to the contractor's estimate may not be known when the audit report is written. If this is the case, we should qualify the audit report regarding the allocable cost of money. The qualification should advise that if a new rate is available, the PCO should consider recomputing the cost of money amount before finalizing negotiations.

b. In accordance with CAS 414, cost of money is allocable to IR&D and B&P projects.

c. Contractors will include the amount proposed for cost of money in the proposal, supported by Form CASB-CMF and any other detail required to comply with 10 U.S.C. 2306a, Truth in Negotiations. Where the contractor elects to exclude the cost of money from its proposal or claim for reimbursement, such costs should be designated as unallow-

able and may not be included in profit. In addition, the contractor is still required to compute the cost of money factors in accordance with CAS 414. The failure to make the computation is considered a violation of a major requirement of the standard. In virtually all cases, however, the noncompliance will not result in increased cost paid by the Government. We should therefore issue noncompliance reports only if the acquisition office or the CFAO requests them. If no such request is made, we will advise the CFAO by memorandum of the technical noncompliance. We will also include appropriate comments in the proposal audit report as well.

d. Request for audits of the contractor's computation of the cost of money may be received in connection with individual price proposals, forward pricing rate agreements, and the establishment of final indirect cost rates. With each of these audits, the report to the CFAO will state whether the contractor has complied with the standard and the requirements of the acquisition regulations.

e. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-415 Cost Accounting Standard 415 --- Accounting for the Cost of Deferred Compensation

a. The purpose of this standard is to provide criteria for measuring deferred compensation costs and assigning those costs to cost accounting periods. It applies to all deferred compensation costs except for compensated absences and pension costs covered in CAS 408 and CAS 412.

b. The standard was effective July 10, 1977. It must be applied to all new deferred compensation awards made in the next fiscal year after receipt of a CAS-covered contract to which the standard is applicable. It does not disturb the contractual provisions applicable to prior awards. It allows the deferred compensation cost awarded before the applicability date to be allocated as a cost when paid under existing contracts.

c. FAR 31.205-6(k) makes CAS 415 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed deferred compensation costs, where significant, are in compliance with the provisions of CAS 415.

8-415.1 General

a. Deferred compensation is an award made by an employer to compensate an employee in a future cost accounting period for services rendered prior to receipt of compensation. It does not include normal year-end salary, wage, or bonus accruals.

b. Deferred compensation costs are measured by the present value of future benefits to be paid and are assigned to the cost accounting period in which the contractor becomes obligated to compensate the employee. The contractor incurs this obligation when:

(1) The requirement for future payment cannot be unilaterally avoided by the contractor.

(2) The award is to be paid in money, other assets, or shares of the contractor's stock.

(3) The future payment can be measured reasonably accurately.

(4) The recipient of the award is known.

(5) Events entitling an employee to receive an award have a reasonable probability of occurrence.

(6) There is reasonable probability that stock options will be exercised. These conditions are basically those recognized under generally accepted accounting principles for establishing a liability. Where these conditions are not met, the deferred compensation cost will be assigned to the period of payment.

c. If the award is based on employee's performance of future service to receive benefits, the contractor's obligation is established as the future service is performed.

d. The treasury rate determined by the Secretary of the Treasury pursuant to Public Law 92-41, 85 Statute 97, effective when the cost is assigned, will be used for computing the present value of future benefits. The treasury rate considers current private commercial interest rates for loans maturing in approximately five years and is considered the most appropriate rate for discounting deferred compensation costs.

e. The measurement and assignment of present values of future benefits to cost accounting periods should be separate for each award. However, the cost estimated on a group basis for employees covered by a deferred compensation plan will be acceptable if the cost can be measured with reasonable accuracy and includes an adjustment for probable forfeitures.

f. The auditor's evaluation should:

(1) Identify all deferred compensation awards currently provided to employees.

(2) Determine what accounting changes, if any, are contemplated as a result of the standard. (According to FAR 52.230-6, the contractor is required to describe to the ACO the kind of changes required by the standard.) If the contractor previously utilized a cash basis of accounting for deferred compensation costs on Government contracts, a change from a cash to an accrual basis will be required for all new awards made after the applicability date of the standard.

(3) Verify, through examination of the award provisions, that all applicable conditions for establishing the obligation for compensation have been met for those awards in which the entire cost is recognized in the year of award.

(4) Evaluate the present-value calculations to determine that the treasury rate specified in the standard has been used correctly.

(5) Evaluate costs for proper credit of estimated forfeitures, based on past experience and future expectations, where deferred compensation costs are accounted for on a group basis.

g. Interest cost will be included in computing future benefits for all deferred compensation cash awards which provide for the payment of interest. The allowability of such interest cost will be determined in accordance with applicable acquisition regulations. If the award stipulates a fixed interest rate, the interest cost is assigned at the fixed rate to the cost accounting period in which the contractor is obligated to compensate the employee. Some deferred compensation awards provide for the payment of interest at variable rates from the date of the award until payment. When the variable rate is based on specified index which is determinable by cost accounting period, the interest cost is assigned to the applicable period at the actual rate for the index at the close of the period. Since that rate may vary from the actual rates in future periods, adjustments will be made in any future period in which the variable rate materially affects the cost of deferred compensation. When the variable rate is not based on a specified index and is not determinable by year, the total interest cost will be assigned to the period of payment. The auditor should evaluate each deferred compensation plan which provides for a cash award, to determine whether the payment of interest is required. For each plan which provides for interest, the auditor should check the contractor's annual interest cost calculation to ascertain that only interest costs for which the rates are fixed or based on specific indices have been accrued.

h. If a deferred compensation plan for a cash award requires irrevocable funding (including interest) of future payments to employees, the amount irrevocably funded will be assigned to the cost accounting period in which the funding occurs.

i. The deferred compensation cost of an award of contractor stock will be based on the current or prevailing market value of the stock (as indicated by market quotations) on the date the number of shares awarded becomes known. It should be noted that the standard does not provide for present value discounting of the market price for stock. Since the market price is presumed to reflect future expectations, further discounting would not be appropriate.

j. The cost of an award of an asset other than cash, will be based on the market value of the asset when the award is made. If the market value is not available, a fair value of the asset will be established. The auditor should verify that the claimed market value of the asset is supported by a valid appraisal obtained from an outside source.

k. If the terms of an award of either cash, other assets, or stock require that an employee perform future service to receive benefits, the deferred compensation cost will be assigned on a pro rata basis to those applicable periods of current and future service. The standard does not specify the method or proration but provides that the proration be based on the circumstances of the award. The requirement of the standard conforms with Accounting Principles Board Opinion No. 12 which states that only the portion applicable to the current period should be accrued if elements of both current and future services are present. The auditor should determine the basis on which the contractor prorates costs between current and future periods. Where deferred compensation plans do not clearly establish a basis for prorating costs between accounting periods, the contractor will be required to support the prorations. In most instances the contractor, because of the ease of computation, will prorate the costs evenly over the number of years of additional service required before exercise of the award. For example, a contractor, declaring a year-end cash award to key employees under a plan requiring three additional years of service before payment, prorates the cost evenly over the following three years (excluding adjustment for present value factors). The contractor's proration would be accepted by the auditor unless the circumstances of the award clearly indicated that the award was related in total, or in part, to past services rendered.

l. Any forfeitures which reduce the contractor's obligation for payment of deferred compensation will be credited to contract costs in the period the forfeiture occurs. The reduction will be the amount of the award assigned to the prior period(s), plus interest compounded annually at the Secretary of the Treasury rate under Public Law 92-41, 85 Statute 97. For irrevocably funded plans, the reduction will be the amount initially funded, adjusted for a pro rata share of fund gains or losses. The voluntary failure of a recipient to exercise a stock option is not considered a forfeiture. If the cost of a cash award for a group deferred compensation plan is later determined to be greater than the amount initially assigned due to an overestimate of forfeitures, the additional cost attributable to the incorrect estimate will be assigned to the cost accounting period in which the revised cost becomes known.

m. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-415.2 Illustrations

The following illustrations are intended to supplement those in paragraph 415.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** The cost of a contractor's deferred compensation plan for a cash award is assigned to the cost accounting period in which the award is made. Under the provisions of the plan, the contractor has complete authority over forfeiture. If an employee is reassigned or laid off before he is eligible for benefits, the contractor may forfeit the employee's rights to the benefits.

Solution. Under CAS 415.50(a), one criteria for incurring an obligation is that the contractor cannot unilaterally avoid future payment. As a result of the contractor's discretionary control over the forfeiture provisions, this would not be considered a valid obligation. The cost should therefore be assigned to the year paid, not the year awarded.

b. **Problem.** The contractor's deferred compensation requires all cash awards to be increased by an eight percent interest factor.

Solution. The cost of future benefits assigned to the current accounting period should include interest cost calculated at eight percent compounded annually according to CAS 415.50(d)(1).

c. **Problem.** The contractor accounts for the cost of a cash award deferred compensation plan on a group basis, adjusted for an estimated four percent forfeiture allowance. At the close of its fiscal year 1987 the actual cost of forfeitures amounted to only three percent as a result of a lower employee turnover than was originally anticipated.

Solution. The additional cost resulting from the overestimated forfeiture allowance should be charged to deferred compensations costs in fiscal year 1987.

d. **Problem.** The contractor has a deferred compensation plan which specifies that an employee receiving a cash award must remain with the company for three years after the award to receive benefits. On March 31, 1987 (fiscal year-end) the contractor awards $5,000 to an employee to be paid on March 31, 1990. According to the plan's requirement for irrevocable funding of future payments, the cost payable to the employee on March 31, 1990 was funded on March 31, 1987.

Solution. The entire amount irrevocably funded must be assigned to the fiscal year ending March 31, 1987 according to CAS 415.50(d)(6).

e. **Problem.** The circumstances are the same as for problem d. above except the employee voluntarily terminates his employment on May 30, 1987. On the date of termination the fund has appreciated eight percent.

Solution. The amount irrevocably funded plus eight percent for the fund gain will be credited to deferred compensation costs in fiscal year-end March 31, 1988 as a forfeiture reduction.

f. **Problem.** The contractor maintains a self-insured retiree death benefit plan for which costs are recorded at the time the death benefit is paid. Questions have been raised as to whether these benefits should be considered deferred compensation subject to CAS 415 and whether the liability for currently retired employees should be accrued.

Solution. These benefits are not deferred compensation as contemplated in CAS 415. CAS 415.50(a)(3) requires a reasonably accurate measurement of future payments as a condition for accrual. Retiree death benefits could only be accrued by introducing mortality assumptions and this was not considered to fall within the meaning of "reasonable accuracy" as used in the standard.

8-416 Cost Accounting Standard 416 --- Accounting for Insurance Cost

CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and their allocation to cost objectives. The standard was effective July 10, 1979 and is applicable to a contractor on or after the start of its next accounting period beginning after the receipt of a CAS-covered contract.

8-416.1 General

a. CAS 416 covers accounting for purchased insurance, self-insurance, and payments to a trustee of an insurance fund. When coverage is obtained through purchase of insurance or payment into an insurance fund, the premium or payment normally should represent the insurance cost. Amounts representing coverage for more than one year should be assigned pro rata among the cost accounting periods covered by the policy term. When coverage is not obtained through purchased insurance or payment into an insurance fund, the contractor should follow a program of self-insurance in accordance with criteria in the standard. Self-insurance is defined as the assumption or retention of the risk of loss by a contractor, either voluntarily or involuntarily. Absence of insurance is regarded as one form of self-insurance. The contractor should make a self-insurance charge for each period for each type of self-insured risk based on an estimate of the projected average loss for that period. Insurance administration expenses which are material in relation to total insurance costs should be allocated on the same basis as the related costs.

b. FAR 31.205-19 makes the self insurance provisions of CAS 416 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed insurance costs, where significant, are in compliance with the provisions of CAS 416.

8-416.2 Guidance

a. The standard requires the contractor to maintain records to substantiate the amounts of premiums, refunds, dividends, losses, and self-insurance charges. Records should also show the frequency, amount, and location of actual losses by major type of risk.

b. A contractor may need memorandum records to reflect material differences between insurance costs determined in accordance with CAS 416 and those includable in financial statements prepared in accordance with Financial Accounting Standards Board (FASB) Statement 5, Accounting for Contingencies. FASB Statement 5 does not permit an accrual for loss contingencies in a contractor's financial accounting records unless (1) an asset has been impaired or a liability incurred at the date of financial statements and (2) the amount can be reasonably estimated. Insurance costs determined in accordance with CAS 416 cannot be accrued in financial accounting records unless they represent purchased insurance, actual payment to a trustee, or the recognition of an actual loss. A self-insurance charge which only represents exposure to the risk of loss cannot be accrued.

c. Exposure to the risk of loss may differ significantly between defense and commercial operations and products. When risks differ significantly, defense and commercial insurance costs should be accumulated and allocated separately.

d. The audit of insurance premiums and payments to trustees should include:

(1) Examining insurance policies to determine the basis for establishing and adjusting premiums, and any provision for deposits and reserves.

(2) Determining whether the contractor controls or has a financial interest in the insurer. Purchase of insurance from a related organization may be a form of self-insurance which should be audited in accordance with 8-416.2e.

(3) Examining the transactions in connection with an insurance reserve or fund in order to establish compliance with CAS 416.50(a)(iv) and (v).

(4) Evaluating direct allocations of premium costs to final cost objectives to detect possible noncompliance with CAS 402.

(5) Evaluating the assignment of premiums, refunds, and assessments to and among cost accounting periods.

e. CAS 416 does not establish minimum financial requirements for a contractor's self-insurance program. In order to assure that a contractor has adequate financial resources for a self-insurance program, FAR 31.205-19 requires contracting officer approval of a self-insurance program before the related costs are allowable. Auditors may be requested to furnish data in connection with the evaluation of the proposed self-insurance program. Self-insurance charges should be audited for compliance with CAS 416 and the approved program. The audit of self-insurance charges should include:

(1) Evaluating the contractor's overall self-insurance program and the adequacy of supporting records.

(2) Analyzing the nature, amount and pattern of actual insurance losses.

(3) Evaluating the contractor's method of estimating projected average loss from actual loss data.

(4) Comparing the self-insurance charge with the cost of purchased insurance when it is available.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-416.3 Illustrations

The following illustrations are intended to supplement those in paragraph 416.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

a. **Problem.** Contractor X establishes an approved self-insurance program to cover employee group health plans beginning with its next accounting period. The contractor makes a self-insurance charge based on analysis of its actual loss experience over the prior 10-year

period and an evaluation of anticipated conditions. The auditor determines that a well-known insurance company offers coverage at a cost materially lower than the self-insurance charge. The contractor refuses to purchase insurance because the insurance company is a subsidiary of a competitor and has a poor reputation.

Solution. The contractor's practice complies with CAS 416 even though purchased insurance is available at a lesser cost. Paragraph 5 of the supplemental information published with CAS 416 states that the limitation in CAS 416.50(a)(2)(i) is intended to apply only when the cost of comparable purchased insurance is used as a convenient method of estimating the projected average loss. The contractor's action is still subject to the test of reasonableness contained in FAR 31.201-3 as well as the allowability requirements of FAR 31.205-19, which disallows the difference between the cost of self-insurance and comparable purchased insurance (plus associated administrative expenses). The difference should be questioned if the purchased insurance is determined to be comparable.

b. **Problem.** Contractor Y proposes to discontinue its purchased insurance coverage and become self-insured without setting aside specific financial resources to cover future losses.

Solution. If the self-insurance charge is measured and allocated properly following the criteria in CAS 416.50(a)(2), the proposed practice complies with the standard regardless of the availability of specific financial resources to cover future losses. The same cost, however, may be unallowable under provisions of FAR 31.205-19 if the self-insurance program has not been approved by the CFAO.

8-417 Cost Accounting Standard 417 --- Cost of Money as an Element of the Cost of Capital Assets Under Construction

a. This standard establishes criteria for the measurement of the cost of money attributable to capital assets under construction, fabrication, or development as an element of the cost of those assets. The standard was effective December 15, 1980. It is applicable on or after the start of the next fiscal year beginning after receipt of a contract to which the standard applies.

b. FAR 31.205-10 makes CAS 417 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed cost of money costs, where significant, are in compliance with the provisions of CAS 417.

8-417.1 General

a. The standard's fundamental requirement provides that the cost of money applicable to the investment in tangible and intangible capital assets being constructed, fabricated, or developed for a contractor's own use, shall be included in the capitalized acquisition cost of such assets.

b. For each capital asset being constructed, fabricated, or developed, a representative investment amount shall be determined each cost accounting period, giving appropriate consideration to the rate at which costs of construction are incurred. The cost of money applicable to each asset shall be calculated using the applicable interest rates determined by the Secretary of the Treasury under Public Law 92-41, 85 Statute 97 (distributed semi-annually by Headquarters).

c. Cost of money shall not be capitalized for any period during which substantially all the activities necessary to get the asset ready for its intended use are discontinued unless such discontinuance arises out of causes beyond the control and without the fault or negligence of the contractor.

8-417.2 Guidance

a. CAS 417 applies to both tangible and intangible assets being constructed, fabricated, or developed for a contractor's own use. Cost of money applicable to land should be added to the basis of the land rather than to the depreciable portion of the asset under construction.

Land should not be included in the representative cost until the start of activity necessary to get it ready for its intended use, such as foundation development, landscaping, etc.

b. Cost of money should be computed only once for each cost accounting period that the asset is under construction based on the representative investment during the cost accounting period. Amounts capitalized as cost of money in one cost accounting period should be included in the representative investment for succeeding periods. Cost of money shall be calculated using the time-weighted interest rates determined by the Secretary of the Treasury. It is not necessary to enter the cost of money on the accounting records; however, the contractor should make a memorandum entry of the cost and maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry.

c. The representative investment is the calculated amount considered invested by the contractor in the project to construct, fabricate, or develop the asset during the cost accounting period. In calculating the representative investment, consideration must be given to the rate of expenditure pattern of this investment. For example, if most of the investment was at the end of the cost accounting period, the representative investment calculation must reflect this fact. DFARS Subpart 230.71 provides guidance in computing representative investment where a contractor experiences an uneven or irregular expenditure pattern.

d. The standard requires that if substantially all activity necessary to get the asset ready for its intended use is discontinued, cost of money shall not be capitalized for the period of discontinuance. However, when such discontinuance occurs beyond the control and without the fault or negligence of the contractor, the cost of money will continue to be capitalized. Therefore, the construction-in-progress accounts should be scrutinized to see if activity has ceased or dropped to a nominal amount. If this occurs, the circumstances should be examined. Brief interruptions and delays because of technical construction problems, labor disputes, inclement weather, shortage of material, etc. will not require discontinuance of capitalization of cost of money.

e. Assets purchased but not immediately put into service because they require installation are permitted to be included in the base for determining cost of money during the period of installation. However, caution should be taken to ensure that the activities necessary to get the asset ready for its intended use are not discontinued.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-417.3 Illustrations

The following illustration is intended to supplement those in paragraph 417.60 of the standard. It is to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

Problem. A contractor purchases a turbine for $1 million on January 1, 1986. The installation requires six months and is completed on June 3, 1986. The contractor capitalizes cost of money during the six-month period of installation stating that it was the CASB's intent that contractor investment be recognized through cost of money.

Solution. The contractor is entitled to capitalize cost of money during the six-month installation period. However, in the event that the activities necessary to get the asset ready for its intended use are discontinued, cost of money will not be capitalized for the period of discontinuance.

8-418 Cost Accounting Standard 418 --- Allocation of Direct and Indirect Costs

CAS 418 requires the consistent classification of costs as direct or indirect, establishes criteria for accumulating indirect costs in indirect cost pools, and provides guidance on allocating indirect cost pools. The standard was effective September 20, 1980. It is applicable on or after the start of the second fiscal year beginning after receipt of a contract to which the standard applies.

8-418.1 General

The standard's fundamental requirements provide that:

(1) a business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied;

(2) indirect costs shall be accumulated in indirect cost pools which are homogeneous; and

(3) pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationships of the pooled costs to cost objectives.

While the CAS and the FAR are similar with regard to the conceptual basis, the standard goes beyond the requirements of the FAR and provides more definitive guidance for allocation base selection.

8-418.2 Guidance

a. The requirement for a written statement of accounting policies for classifying costs as direct or indirect is a critical aspect for assuring consistent implementation of this standard. If information disclosed by the contractor in "Part III, Direct vs. Indirect," Item 3.1.0, of the Disclosure Statement is insufficient to meet this requirement, the contractor should be requested to furnish additional detail.

b. Materiality is emphasized in evaluating any perceived need for change in cost accounting practices. Materiality criteria are in 48 CFR 9903.305.

c. When a noncompliance condition is not reported because the amounts are not material, periodic evaluations are required to ascertain that the amounts remain immaterial. Noncompliant conditions that currently involve immaterial amounts but which may involve material amounts in the future should be reported to the CFAO in accordance with 8-302.7.

d. The creation of additional indirect cost pools should be required only if changes will result in materially different cost allocations.

e. Homogeneity of indirect cost pools is a significant requirement of the standard; however, a pool may be considered homogeneous if the separate allocation of costs of the dissimilar activities would not result in a materially different allocation of cost to cost objectives. Where there are no audit problems with the existing structure, it is not anticipated that CAS 418 would require further audit of the homogeneity of indirect cost pools. However, the allocation base for those pools must still be audited for compliance with the standard.

f. Where current problems regarding the allocation of direct and/or indirect costs do exist, CAS 418 provides authoritative support and criteria which may be helpful in formulating an acceptable solution.

g. Where the contractor is establishing new indirect cost pools, careful attention should be directed toward whether the pools meet the requirements of the standard. Audit considerations, applicable to conditions both before and after the establishment of a new pool, should include propriety of the allocation base, homogeneity of the cost pools, and materiality.

h. For purposes of selecting an allocation base, CAS 418 distinguishes between two types of indirect cost pools: (a) those which include a material amount of the costs of management and supervision of activities involving direct labor or direct material, and (b) those which do not.

(1) If an indirect cost pool contains a material amount of the costs of management or supervision of activities involving direct labor or direct material, the standard requires selecting an allocation base representative of the activity being supervised. Allocation bases are limited to direct labor hours or dollars, machine hours, units of production, or material costs, whichever is more likely to vary in proportion to the costs included in the cost pool being allocated.

(2) If an indirect cost pool does not contain material amounts of the costs of management or supervision of activities involving direct labor or direct material, the standard specifies criteria for selecting a base representing an appropriate measure of resource consumption. The standard establishes a hierarchy of acceptable representations of beneficial or causal relationships between the activities in the pool and benefiting cost objectives. The best representation is a measure of the resource consumption of the activities of the indirect cost pool. If consumption measures are unavailable, or impractical to ascertain, the next best representation is a measure of the output of the activities of the indirect cost pool. If neither resources consumed nor output of the activities can be measured practically, the standard requires the use of a surrogate that varies in proportion to the services received to be used as a measure of resources consumed.

i. The allocation base used should result in an allocation to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives. Where the allocation base used is direct labor hours or dollars, all work accomplished, including hours worked in excess of 8 hours per day/40 hours per week by exempt employees or assigned costs, should be included as appropriate in the base for allocation of overhead costs. (See 6-410.3d.)

j. A special allocation of indirect costs is permitted if a particular final cost objective (e.g., contract) would receive a disproportionate allocation of indirect costs from an indirect cost pool. However, the allocation from the indirect cost pool to a particular final cost objective must be commensurate with the benefits received. The amount of special allocation must be removed from the indirect cost pool and the particular final cost objective's base costs must be removed for the base used to allocate the indirect cost pool. The CAS 418.50(f) provision is applicable to a particular final cost objective, rather than to classes of contracts or final cost objectives. It appears the intent is to use the special allocation provision in exceptional cases to resolve situations where equitable allocation cannot be achieved by normal methods. When a special allocation under CAS 418.50(f) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices.

k. The criteria in CAS 407 should be applied to the use of average and preestablished direct labor rates. Material variances must be allocated annually to cost objectives in proportion to costs previously allocated.

l. Contractors are required to review preestablished rates for indirect costing at least annually, and revise the rates to reflect anticipated conditions. In addition, variances between actual or anticipated rates and preestablished rates must be disposed of at least annually, if material.

m. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-418.3 Illustrations

The following illustrations are intended to supplement those in paragraph 418.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

a. **Problem**. Contractor A proposes to establish an allocation method for the central reproduction cost center. The contractor wants to use the number of personnel in each department as the base for allocation of the cost center.

Solution. A central reproduction cost center does not contain a material amount of management and supervision of activities involving direct labor and direct material.

Hence, the selection of a base is governed by CAS 418.50(e). Number of personnel is a surrogate for resource consumption which may be representative of the beneficial or causal relationship between the cost center and the benefiting cost objectives. However, acceptability of this base requires an analysis of the availability of more preferred bases:

(1) The best measure of resource consumption related to a central reproduction cost center may be equipment usage (hours). However, if the reproduction equipment does not have time meters and installation is not cost-effective, the use of such a base would be impractical.

(2) The next best representation of beneficial or causal relationship is output. A base consisting of the number of reproduced pages might be selected as an appropriate allocation measure of the output of the activities of the central reproduction cost center. However, if it is not practical to measure the number of pages reproduced for each requesting activity, a surrogate that varies in proportion to the services rendered may be used to measure the resources consumed.

(3) Such a surrogate could be the number of personnel in each department if past experience demonstrates that the number of requisitions varies in reasonable proportion to departmental population, thereby constituting a reasonable measure of the activity of the cost objectives receiving the service. Accordingly, the method adopted by the contractor could constitute an acceptable allocation basis, depending upon the circumstances.

b. **Problem**. An audit of contractor B reveals that several indirect cost pools contain costs of activities having dissimilar beneficial or causal relationships to cost objectives to which the pool is allocated. Further analysis indicates that allocation of the costs of the activities, included in the cost pool, result in an allocation to cost objectives which is not materially different from the allocation that would result if the costs of the activities were allocated separately.

Solution. The contractor's practice is currently in compliance with CAS 418.50(b)(1). However, if it is expected that the practice will have a material impact in the future and the probability of this impact can be specifically commented upon, the situation should be reported to the cognizant CFAO. In addition, periodic followup audits should be performed to ascertain whether circumstances have changed the allocation differences from immaterial to material.

c. **Problem**. The base for allocation of overhead costs at contractor C is direct labor hours. Although contractor C's salaried employees work on the average 60 hours a week, only 8 hours per day and 40 hours per week are recorded on the employees' timesheets. Floor checks and employee interviews have revealed that the excess hours worked by salaried employees are, in many cases, incurred on cost type contracts in an overrun situation, bid and proposal costs in excess of the negotiated ceiling, and other fixed price and commercial work.

Solution. Subject to the criteria of materiality, the contractor should be cited as being in noncompliance with CAS 418.50(d) in that the base selected to measure the allocation of the pooled costs to cost objectives is not a base representative of the activity being managed or supervised and all significant elements of the selected base have not been included. The contractor should be required to record excess hours worked by salaried employees and include all direct labor hours worked in the base for allocation of overhead costs. (See 6-410.)

8-419 Reserved

8-420 Cost Accounting Standard 420 --- Accounting for Independent Research and Development Costs and Bid and Proposal Costs (IR&D and B&P)

a. This standard provides criteria for the accumulation of IR&D/B&P costs and for the allocation of such costs to cost objectives. The standard was effective March 15, 1980 and must be followed as of the start of the second fiscal year beginning after the receipt of a CAS-covered contract. It does not apply to contractors subject to Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments.

b. FAR 31.205-18 makes CAS 420 partially applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed IR&D/B&P costs, where significant, are in compliance with the provisions of CAS 420.

8-420.1 General

The standard provides that IR&D/B&P costs are to be accumulated by project. Under specific conditions, costs of IR&D/B&P projects performed by a segment but benefiting more than one segment must be accumulated at the home office. Home office IR&D/B&P costs are to be allocated to segments through (1) allocation to specific segment(s) when beneficial or causal identification can be made, or (2) use of the CAS 403 residual expense allocation base. Special allocations are also permitted. IR&D/B&P costs accumulated at segments (including home office allocations and transfers from other segments) will be allocated to final cost objectives using the same base used for G&A expenses under CAS 410; however, special allocations are permitted.

8-420.2 Guidance

a. The requirements for accumulation of IR&D/B&P costs by project and home office accumulation of IR&D/B&P projects benefiting more than one segment increase the need for maintaining close coordination between the CAC, CHOA, or GAC and auditors at operating segments. It is necessary that project identification be retained on costs transferred from a segment to a home office in order that appropriate allocations from the home office to all benefiting segments can be accomplished. The coordination process includes audits of advance agreement proposals and audits of incurred costs.

b. The standard provides that IR&D/B&P costs accumulated at the home office which can be identified with one or more specific segments shall be allocated to the specific segment(s). The standard does not specify the allocation method to be used when two or more (but not all) segments of an organization benefit from a specific IR&D/B&P project. In evaluating the method used, consideration must be given to whether the base will reasonably match cost distributions with the beneficial or causal relationships between the IR&D/B&P projects and the segments. The most straightforward base would consist of the same components used to allocate home office residual expenses. However, among other potentially acceptable bases are total cost input and production labor hours or dollars. This listing is not all inclusive and any base which reasonably matches cost with the beneficial or causal relationships between IR&D and B&P projects and benefiting segments would be acceptable under the provision of the standard.

c. The standard's prefatory comments indicate that a definition for B&P administrative costs was proposed by commentators, i.e., "B&P administrative costs, when not separately identified and classified as B&P costs in accordance with the contractor's normal accounting practice, are not considered B&P costs for the purpose of this standard." The CASB concluded that the proposed definition was not necessary because it dealt with allocation requirements which are addressed in CAS 420.50(a)(1). CAS 420.50(a)(1) states that

IR&D/B&P project costs shall include ". . . costs, which if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective . . . ." B&P administrative costs, when not separately identified, may be excluded from the B&P pool if in accordance with the contractor's normal accounting practice. B&P administrative costs which are charged to an overhead (non-B&P) pool are not construed as being incurred "in like circumstances for a final cost objective." Therefore, the standard does not disturb the accounting treatment of B&P administrative costs under the FAR provisions.

d. Special allocations of IR&D/B&P costs are permitted from the home office to specific segments and from segment cost pools to specific final cost objectives provided the particular segment or final cost objective would receive a disproportionate allocation of the costs by using the prescribed allocation base. However, the special allocation must be commensurate with the benefits received. The provisions governing special allocations (CAS 420.50(e)(2) and 420.50(f)(2)) are applicable to occurrences which are exceptions to the contractor's normal operation, and are not intended for application to segment groups or classes of contracts or final costs objectives. As is the case with special allocations under CAS 403.40(c)(3) and 410.50(j), it appears the CASB's intent is to use the special allocation provisions to resolve specific situations where equitable allocation cannot be achieved by normal methods. When a special allocation under CAS 420.50(e)(2) or 420.50(f)(2) is used, it must be described in the contractor's disclosure statement.

e. The standard provides that any work performed by one segment for another segment shall not be treated as IR&D or B&P costs of the performing segment unless the work is part of an IR&D or B&P project of the performing segment (CAS 420.50(d)). If the work of the performing segment does not qualify as IR&D or B&P effort, the costs, including business unit G&A expenses, are transferred directly to the receiving segment. Auditors at the performing segment will have the primary responsibility for evaluating the propriety of the accounting treatment of these interdivisional costs.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-420.3 Illustrations

The following illustrations are intended to supplement those in paragraph 420.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** A contractor currently uses a total cost input allocation base for G&A. In implementing CAS 420, this contractor proposes to exclude purchased services and major subcontracts from the allocation base for IR&D/B&P costs, citing the special allocation provisions of CAS 420.50(f)(2). The contractor points out that this practice, i.e., the exclusion of these costs from allocation of IR&D/B&P, has been accepted in previous years.

Solution. This practice would not be in compliance with the standard. Allocation of IR&D/B&P costs to final cost objectives is to be on the same allocation base used for G&A. Special allocations for classes of contracts (e.g., exclusions of major subcontracts from the base) are not appropriate under CAS 420.50(f)(2). The special allocation provision in CAS 420.50(f)(2) is limited to circumstances of a particular final cost objective.

b. **Problem.** Contractor H charges an engineering department's typing services for proposal preparation direct to B&P projects. General support typing services applicable to B&P and other departmental effort are not separately identified but are charged to an intermediate overhead pool and allocated to B&P projects, contract engineering projects, and other cost objectives based on labor hours.

Solution. The contractor's practice of charging general support B&P typing services to an intermediate overhead pool is in compliance with CAS 420.50(a). The B&P general support typing effort is not separately identified and classified as B&P cost and is not construed as being incurred "in like circumstances for a final cost objective." There-

fore, B&P general support typing effort is allocable to an overhead account, providing the allocation practice is otherwise considered acceptable and equitable.

c. **Problem.** Company R has eight segments. Segment A performs IR&D projects which have technical application to it and two other segments. Technical application is not identifiable to the remaining five segments. The cost of those projects performed by Segment A is transferred to the home office and allocated in equal parts (one-third) to the three segments.

Solution. Company R is in compliance with CAS 420.50(e)(1) and 420.50(f)(1) providing the technical applications received by the three segments are equal. If an allocation of equal shares does not reflect the participation in technical applications, other allocation bases that could be considered include total cost input (for the three segments) or a base consisting of the same components used to allocate home office residual expenses.

8-500 Section 5 --- Audit of Cost Impact Proposals Submitted Pursuant to the Cost Accounting Standards (CAS) Clause

8-501 Introduction

This section contains guidance on the audit of contractor cost impact proposals that are submitted in accordance with the price adjustment provisions of the CAS clause.

8-502 General - Cost Impact Proposals

8-502.1 CAS Clause Requiring Price Adjustments

Paragraph (a)(5) of the CAS clause (FAR 52.230-2) requires that contractors agree to contract and subcontract price adjustments, with interest, if increased costs to the Government result from their failure to comply with CAS or to follow consistently their disclosed cost accounting practices in estimating, accumulating and reporting costs on contracts and subcontracts containing the CAS clause. The CAS clause provides in paragraph (a)(4)(i) for an equitable price adjustment when a change from one accounting practice to another is required to comply with a CAS that subsequently becomes applicable to a contract or subcontract, or is necessary for the contractor to remain in compliance (required change). Paragraph (a)(4)(iii) also provides for an equitable price adjustment when the cognizant Federal agency official (CFAO) determines that a change from one compliant practice to another is desirable and not detrimental to the Government (desirable change). However, paragraph (a)(4)(ii) provides that adjustments resulting from a change which is a compliant change, but which the CFAO has not deemed desirable, may not result in increased costs to the Government in the aggregate (unilateral change).

8-502.2 FAR Requirement for Submission of Cost Impact Proposal

a. After a CFAO determines that costs paid by the Government may be materially affected by a cost accounting practice change or CAS noncompliance, FAR 52.230-6(c) requires that contractors submit cost impact proposals in the following instances:

(1) Required Accounting Practice Changes. A required change arises when the CFAO determines that a contractor is required to make a change in cost accounting practices to comply prospectively with a new or modified cost accounting standard. A required change also arises for prospective changes from one compliant cost accounting practice (disclosed or established) to another compliant practice when the planned change is necessary for the contractor to remain in compliance with CAS (see 48 CFR 9903.201-6(a)).

An example of a prospective accounting practice change necessary to remain in compliance with CAS may arise when a labor-intensive contractor receives several material-intensive contracts. The contractor's total cost input G&A allocation base would cause disproportionate allocations of G&A expense to the material-intensive contracts. Therefore, in order to remain in compliance with CAS 410, the contractor changes to a value-added G&A allocation base. Prior to award of these contracts, the contractor was in compliance with CAS 410. In order to remain in compliance with CAS 410, the contractor must change to a value-added allocation base.

The cost impact proposal for a required change provides the CFAO with a basis for equitable adjustment to CAS-covered contracts and subcontracts existing on the effective date of the changed practice in accordance with FAR 52.230-2(a)(4)(i), and may result in either price or cost increases or decreases.

(2) Unilateral Accounting Practice Changes. A unilateral change is a change from one compliant practice to another compliant practice that a contractor elects to make,

but that the CFAO has not determined to be desirable (see 48 CFR 9903.201-6(b)). A unilateral change is subject to the provisions of FAR 52.230-2(a)(4)(ii). Because the change is neither required nor determined to be desirable, no increased costs may be paid by the Government on affected CAS-covered contracts and subcontracts as a result of the unilateral change. Unilateral changes are applied prospectively in accordance with FAR 52.230-2(a)(2). The cost impact proposal for a unilateral change provides the CFAO with a basis for determining the extent of increased costs, if any, to the Government in the aggregate on affected CAS-covered contracts and subcontracts as a result of the unilateral change. The cost impact proposal also provides the CFAO with a basis for determining the appropriate settlement alternative for the recovery of increased costs.

(3) Desirable Accounting Practice Changes. A desirable change occurs when the contractor elects to make a change from one compliant practice to another, and the CFAO determines that the change is desirable and not detrimental to the Government (see 48 CFR 9903.201-6(c)). A change may be considered desirable even though costs increase on existing CAS-covered contracts and subcontracts. If the parties agree, such changes may include early implementation of new CAS. The cost impact proposal for a desirable change provides the CFAO with a basis for equitable adjustments to affected CAS-covered contracts and subcontracts in accordance with FAR 52.230-2(a)(4)(iii), and may result in either increased or decreased costs.

Changes to 48 CFR 9903.201-6(c), effective June 14, 2000, provide that, for accounting practice changes that the CFAO has determined are desirable, the cost impact of associated management actions that have an impact on contract and subcontract costs should be considered. This means that there may be other events occurring at the same time as the accounting practice change that should be considered to equitably resolve the overall cost impact. Examples of “associated management actions” include internal restructuring activities. In order to consider the impact of this management action in the cost impact calculation, the cost impact of the changed practices should be calculated as the difference between the former accounting practice using the cost level without the effect of the management action, and the new accounting practice using the cost estimate with the effect of the management action as reflected in the new forward pricing rates.

(4) Noncompliances. Noncompliances arise when the contractor fails to comply with an applicable CAS or to consistently follow any disclosed or established cost accounting practice. FAR 52.230-2(a)(5), 52.230-3(a)(4), and 52.230-4 implement the statutory requirement that the Government shall not pay increased costs as a result of a CAS noncompliance. 48 CFR 9903.306 further explains the statutory requirements. These FAR provisions also require that the Government recover interest from the time the payment of increased costs was made by the Government until the time the adjustment is effected. FAR 32.604(b)(4)(i) provides that interest on increased costs paid by the Government is computed using the annual underpayment rate established under 26 U.S.C. 6621(a)(2) of the 1986 Internal Revenue Code. This is the same interest rate used to compute interest when defective pricing is found (see 14-124).

b. The cost impact proposal must be submitted within 60 days (or other mutually agreed-upon date) after the proposed change is determined adequate and compliant, the date of the contractor’s agreement with the initial finding of noncompliance, or the date the contractor is notified by the CFAO of a determination of noncompliance.

c. An integral part of the cost impact proposal is the list of CAS-covered contracts and subcontracts that are, or will be, affected by the change or noncompliance. To comply with the requirements of FAR 52.230-6, contractors should maintain a system for identifying accurately and completely all contracts and subcontracts containing the CAS clause. The auditor should evaluate the adequacy of contractors' procedures and report to the CFAO if the contractor does not maintain the required records. Once the contractor has established such procedures, the auditor should perform limited testing of contract and subcontract listings on specific cost impact proposals to assure the continuing effectiveness of the contractor's system. Report exceptions in the cost impact proposal

examination audit report. For smaller contractors, test the listing of CAS-covered contracts and subcontracts included in specific cost impact proposals against FAO files of active cost reimbursable contracts and subcontracts, and listings of CAS-covered fixed price procurement actions available within DoD. (See CAS Working Group Paper 77-17.)

8-502.3 Accounting Practice Changes Related to External Restructuring

Often cost accounting practice changes occur in conjunction with organizational changes. Under 48 CFR 9903.201-8, effective June 14, 2000, the cost impact process does not apply to compliant cost accounting practice changes directly associated with external restructuring activities that are subject to and meet the requirements of 10 U.S.C. 2325. This statute established the allowability requirements and two-to-one savings requirements for external restructures, implemented by DFARS 231.205-70. This type of restructuring activity is described in 7-1900. One of the requirements associated with this type of restructure is that savings for DoD exceed the costs allowed by a factor of two-to-one, or that savings exceed costs and the Secretary of Defense determines that the restructuring activities will result in the preservation of a critical capability that might otherwise be lost to the Department. Since the Government is achieving overall cost savings in this type of restructuring effort, the CASB decided to exempt changes to cost accounting practices directly associated with external restructuring activities from the cost impact process.

8-502.4 Cost Impact Proposal Data Requirements

FAR 52.230-6 requires cost impact proposals to be prepared in the manner and form (level of detail) prescribed by the CFAO (usually with audit advice). Any cost impact proposal format specified by the CFAO should provide the same approximate result as if the cost impact for each CAS-covered contract was calculated individually. FAR 52.230-6(b) requires that cost impact proposals be prepared in sufficient detail to permit the evaluation, determination, and negotiation of the cost impact. The basic required data include (i) identification of each CAS-covered contract and subcontract and the cost impact (including cost, profit/fee, and price/amount) on each CAS-covered contract and subcontract or, if agreed to by the CFAO, a representative selection of contracts and subcontracts which will give the same approximate result as if the cost impact on each CAS-covered contract and subcontract was calculated individually and (ii) grouping the CAS-covered contracts and subcontracts by contract type (e.g., FFP, FPI, CPFF, CPIF) and by the various Departments/agencies (e.g., Army, Navy, Air Force, NASA, DOE).

8-502.5 Adequacy of Cost Impact Proposals

Contractors are required to submit proposals that reflect the cost impact of changes made to their disclosed or established cost accounting practices, or noncompliances with CAS or disclosed accounting practices.

a. Auditors should work closely with the CFAO to encourage contractors to submit timely and adequate cost impact proposals. If an adequate cost impact proposal is not submitted by a stipulated date, it may be necessary for the CFAO to exercise the withhold provisions of FAR 30.604(i) (see also FAR 52.230-6(j)).

b. The auditor should initially evaluate the cost impact proposal for adequacy of content and method of presentation. If inadequately prepared, return the proposal to the contractor through the CFAO with the deficiencies specifically identified.

c. The auditor should not return the cost impact proposal to the contractor solely because a certificate of current cost or pricing data did not accompany the proposal. Contract modifications made under the CAS clause are subject to FAR 15.403-4, which requires cost or pricing data and which incorporates the certification requirement at FAR 15.406-2. This requirement applies to the individual modification, not to the cost impact

proposal itself. The timing of the certificate is as of the date of agreement on price. Therefore, no certificate is required at the time of submission of the cost impact proposal. It is the CFAO's responsibility to obtain a certificate of current cost or pricing data before completing the contract modification(s).

d. For defense contracts, a certification is required per DFARS 243.204-70 and 252.243-7002 at the time of submission of the cost impact proposal if the contractor requests an equitable adjustment that exceeds the simplified acquisition threshold ($150,000) to any defense contract as a result of required or desirable cost accounting practice changes under the CAS clause. The threshold applies to equitable adjustment on a contract-by-contract basis, not to the cost impact proposal itself.

8-502.6 Audit of Cost Impact Proposals

FAR 30.601(c) provides that the CFAO shall request and consider the advice of the auditor when performing CAS Administration, which would include audits of cost impact proposals. The purpose of the audit is to assist the CFAO in negotiating contract price adjustments on all affected CAS-covered contracts and subcontracts. Audit advice should be provided considering materiality and risk criteria. Auditors should consider an array of audit procedures as appropriate during the audit of cost impact proposals, including statistical and judgmental sampling, risk assessment, past experience, discussion with contractor personnel, and comparison with previous cost estimates. The results of these evaluations will be reported to the CFAO responsible for negotiating the price adjustment.

8-502.7 Inclusion of Implementation Costs

Implementation costs may be included in cost impact proposals only to the extent they are a part of appropriate indirect expense pools and allocated in accordance with the contractor's normal accounting practices. (See CAS Working Group Paper 76-5.)

8-502.8 Noncompliance with FAR Part 31

The CAS clause, FAR 52.230-2, does not provide for price adjustment for noncompliance with FAR Part 31. Therefore, if a contractor fails to follow FAR, cost disapprovals will be processed in accordance with existing procedures. However, if the contractor is required to change an accounting practice because of failure to follow FAR (for example, a change to an allocation base previously used for pricing and/or recording purposes), then prospective adjustments to all CAS-covered contracts and subcontracts would be required, as described at 8-502.2(a)(3), above (see 8-302.7f).

8-503 Guidance on Evaluation of Cost Impact Proposals

8-503.1 Five-Step Process to Calculate Cost Impact

Auditors should use the five-step process described below to evaluate cost impact proposals and assist the CFAO in resolving cost impacts resulting from cost accounting practice changes and CAS noncompliances. Auditors should use only steps a. through c. of the process to evaluate cost impacts resulting from required and desirable cost accounting practice changes which are subject to equitable adjustment. Auditors should use all steps to determine increased or decreased costs to the Government in the aggregate resulting from unilateral cost accounting practice changes and CAS noncompliances. Steps a. and b. involve ascertaining the impact of the accounting practice change or noncompliance on cost estimates and accumulations (i.e., cost measurement, assignment, and allocation). Step c. translates the resulting cost estimation/accumulation impact into its effect on contract and subcontract prices. Step d. calculates increased or decreased costs paid by the

Government in the aggregate, using the CAS Board's (CASB's) definitions of increased costs paid. Finally, step e. addresses settlement alternatives available to the CFAO, who is responsible for administration of CAS matters.

a. Compute the increased/decreased cost estimates and/or accumulations for CAS-covered contracts and subcontracts.

(1) Accounting practice changes. The increase or decrease in cost accumulations is the difference between the estimated cost to complete (ETC) using the old accounting practice and the ETC using the new accounting practice. It is prospective from the effective date of the change and continues through the end of the period of performance of each affected contract and subcontract.

(2) Noncompliance in cost accumulation. The increase or decrease in cost accumulations is the difference between costs accumulated using the noncompliant practice and costs that would have been accumulated if a compliant practice had been used. The cost accumulations affect only flexibly-priced contracts and subcontracts, and only for the period during which the contractor accumulated costs in a noncompliant manner.

(3) Noncompliance in cost estimating. The increase or decrease in cost estimates is the difference between the costs estimated using the noncompliant practice and the costs that would have been estimated if the contracts and subcontracts had been priced using a compliant practice. Estimating noncompliances affect fixed price contracts and subcontracts, and fixed, target, and incentive fees on flexibly priced contracts and subcontracts. Estimating noncompliances affect the entire period of performance for each affected contract and subcontract.

b. Combine the increased/decreased cost estimates and/or accumulations within each contract group. In this step, we consider two groups of CAS-covered contracts - flexibly priced and fixed price (FP).

(1) Flexibly priced contracts include cost-reimbursement contracts/subcontracts and other contracts/subcontracts subject to adjustment based on actual costs incurred; incentive contracts/subcontracts where the price may be adjusted based on actual costs incurred; and the flexibly priced portions of time-and-materials contracts/subcontracts.

(2) FP contracts include those contracts and subcontracts where the price does not vary based on the contractor's actual costs, including the fixed hourly rate portion of time-and-materials and labor-hour contracts and subcontracts.

(3) In this step, the increased/decreased cost estimates and/or accumulations developed in a. above are combined within each contract group. Combining the increased/decreased cost estimates and/or accumulations within a contract group is done for administrative convenience so the CFAO may adjust a few contracts, rather than all contracts.

(4) The impact on cost estimates and/or accumulations is combined only within a contract group, not between contract groups, for the following reasons:

(a) Increased costs paid by the Government on flexibly priced contracts and subcontracts result from increased cost accumulations arising from cost accounting practice changes or accumulation noncompliances. Increased costs paid by the Government on FP contracts and subcontracts result from decreased cost accumulations resulting from cost accounting practice changes, or from higher costs estimated by using noncompliant practices (48 CFR 9903.306). These differences make it improper and mathematically unworkable to simply combine the cost accumulations across contract groups.

(b) Combining the increase/decrease in cost estimates and/or accumulations between contract groups could result in inequitable results. For instance, assume cost accumulations on FFP contracts and subcontracts decreased by a net $200, while cost accumulations on CPFF contracts and subcontracts increased by a net $200. If the cost accumulations are combined mathematically between contract groups, the Government would recover nothing, which is not equitable since increased costs paid by the Government occurred on both FFP and CPFF contracts and subcontracts.

(c) Combining the increase/decrease in cost estimates and/or accumulations between contract groups presumes that cost shifts occur only within CAS-covered contracts and subcon-

tracts. Cost shifts also affect existing non-CAS-covered contracts and subcontracts, and/or future awards. Future awards are affected because the CAS-covered contracts and subcontracts usually have different periods of performance. In the case of an estimating noncompliance, the periods of performance for the individual affected CAS-covered FP contracts and subcontracts cover different cost accounting periods. Therefore, cost shifts also affect existing non-CAS-covered and/or future contracts not included in the cost impact proposal.

c. Determine the increased/decreased cost paid by the Government for each contract group, using the net impact on cost estimates, accumulations and profits/fees.

(1) Increased costs paid by the Government.

(a) Flexibly priced contracts. Increased costs paid by the Government occur when more costs are accumulated on flexibly priced contracts and subcontracts as a result of an accounting practice change or cost accumulation noncompliance.

(b) FP contracts. Increased costs paid by the Government occur when fewer costs are accumulated on FP contracts and subcontracts as a result of an accounting practice change or when the negotiated contract or subcontract price is higher as a result of a cost estimate using a noncompliant practice.

(c) Profit/fee. Increased costs paid by the Government also occur when more profit/fee was negotiated than would have been contemplated by the contracting parties if the cost estimate had been based on changed or compliant practices. Accounting practice changes and estimating noncompliances affect fixed, target, and incentive fees. Accumulation noncompliances also affect incentive fees. Profit/fee that is not based on estimated costs (e.g., award fees) is generally not subject to adjustment.

(2) Decreased costs paid by the Government. Decreased costs paid by the Government are not defined by the CASB, although the CAS statute presumes that there can be decreased costs paid by the Government, since it provides for adjustments to remove only increased costs paid in the aggregate. We interpret "decreased costs" to be the conceptual opposite of the CASB's definition of "increased costs."

(a) Flexibly priced contracts. Decreased costs paid by the Government occur when fewer costs are accumulated on flexibly priced contracts and subcontracts as a result of an accounting practice change or noncompliance in cost accumulation. This occurs automatically as fewer costs are recorded on the contracts and subcontracts.

(b) FP contracts. Decreased costs paid by the Government occur when more costs are accumulated on FP contracts and subcontracts as a result of an accounting practice change or when the negotiated contract or subcontract price is lower as a result of estimating using a noncompliant practice.

(c) Profit/fee. Decreased costs paid by the Government also occur when less profit/fee was negotiated than would have been contemplated by the contracting parties if the cost estimate had been based on compliant or changed practices. Cost accounting practice changes and estimating noncompliances affect fixed, target, and incentive fees. Accumulation noncompliances also affect incentive fees. Profit/fee that is not based on estimated costs (e.g., award fees) is generally not subject to adjustment.

The results of this step are used as the basis for negotiation of equitable adjustments for required and desirable accounting practice changes. In these cases, it is not necessary to determine increased costs in the aggregate and steps d. and e. need not be performed.

d. Determine the increased costs paid by the Government in the aggregate by combining across contract groups the increased/decreased costs paid by the Government for both contract groups, as determined in step c. Combining the increased/decreased costs paid by the Government between the two contract groups to determine increased costs in the aggregate is consistent with CAS regulations (see 48 CFR 9903.306(e)). However, there may be rare instances when combining the increased/decreased costs paid by the government across the two contract groups produces inequitable results. In these instances, auditors should apply another aggregation method to determine the increased costs in the aggregate. Increased costs in the aggregate represent the total amount owed to and to be recovered by the Government as a result of the unilateral change or noncompliance. Should there be decreased

costs in the aggregate resulting from unilateral changes or noncompliances, there will be no recovery by the contractor.

e. Settlement Alternatives. It is the CFAO's responsibility to administer CAS, including the resolution of cost impacts. Once the aggregate increased costs paid by the Government as a result of unilateral changes and noncompliances are determined, it is the CFAO's responsibility to work toward a settlement that precludes payment by the Government of this amount. There are a number of settlement alternatives available to the CFAO to resolve cost impacts. The auditor should assist the CFAO as necessary in settlement of these issues. Some of the options for recovery of increased costs include:

(1) Contract adjustment. Adjustments may be made to all contracts and subcontracts, or limited to certain contracts, and may include reduced cost allowances on flexibly priced contracts, downward adjustment of contract prices, target costs, ceilings, and profit/fee.

(2) Indirect rate adjustments. Any adjustment to indirect cost pools should be designed to ensure the recovery of the total amount of the aggregate increased costs paid by the Government (i.e., the impact on all CAS-covered contracts and subcontracts regardless of contract type). Indirect rate adjustments should be made only to final indirect rates, rather than on forward pricing rates, to ensure that the Government recovers the full amount it is owed.

(3) Cash payment. This option may be appropriate when the amount of increased costs in the aggregate is small or when writing a check is less burdensome than making contract or indirect rate adjustments.

8-503.2 Interest

FAR 52.230-2(a)(5), 52.230-3(a)(4), 52.230-4 and 52.230-5(a)(5) provide that the Government will also recover interest on overpayments made to the contractor, including increased costs paid due to CAS noncompliances. Interest will be compounded daily from the date payment is made by the United States until the date the adjustment is effected, using the annual rate established under section 26 U.S.C. 6621 of the 1986 Internal Revenue Code. This is the same interest rate used when defective pricing is found (see 14-124). The auditor should be alert to the potential significance of interest and offer to provide assistance to the CFAO in calculating interest due to the Government once the CFAO makes the final determination on the cost impact proposal audit report. The auditor should calculate daily compound interest using the CAS Noncompliance Cost Impact Interest Calculator located on DCAA's Intranet under DCAA SOFTWARE / APPLICATIONS LIBRARY. Calculating daily compound interest is in accordance with the Unites States Court of Appeals for the Federal Circuit (CAFC) ruling dated September 14, 2009; Case No. 2008-1543.

8-503.3 Offsetting Cost Impacts

FAR 30.606 specifically states that cost impacts may not be combined except under limited circumstances provided at FAR 30.606(a)(3).

8-504 Failure to Submit Cost Impact Proposals

a. FAR 52.230-6(j) provides that if the contractor fails to submit a cost impact proposal, FAR provides that the CFAO, with the assistance of the auditor, shall estimate the cost impact on contracts and subcontracts containing the CAS clause. The auditor should base the estimate, as much as possible, on readily available data. The auditor's objective is not to relieve the contractor of its responsibility for preparing the proposal, but merely to provide sufficient information upon which the CFAO can base a decision to withhold payment. Once the CFAO has made the decision to withhold payment, the burden of proof should rest with the contractor to demonstrate, through a detailed analysis, the cost impact its each CAS-covered contracts and subcontracts, rather than to debate the merits of the Government estimate. (This is similar to the procedure established in FAR 49.109-7 for termination settlement by unilateral determination.) The associated audit report should include:

(1) the scope of the audit,

(2) a description of the circumstances relating to the contractor's failure to submit a cost impact proposal, and

(3) the basis used to develop the estimate.

If the auditor is unable to provide the estimate, the report should give the reasons and identify the data needed to comply with the CFAO's request.

b. The FAR withhold provisions provide that the CFAO may withhold an amount not to exceed 10 percent of each subsequent payment request related to the contractor's CAS covered prime contracts which contain the appropriate withholding provisions until the cost impact proposal has been furnished. In these situations, the estimate of the cost impact will be used by the CFAO to determine a maximum amount that should be withheld. Although not specifically provided for in the FAR, the auditor should recommend to the CFAO that withholding begin immediately and continue while the estimate of the cost impact is being developed.

8-505 Conferences and Reports on Audits-Cost Impact Proposals

a. See 4-300 for guidance on entrance, interim, and exit conferences with the contractor. When appropriate (e.g., when there are numerous CAS-covered contracts and subcontracts, a series of changes, or complicated changes), the contractor and the Government should discuss and agree in advance on the manner and form of a cost impact proposal in order to ease the administrative process.

b. After completing each cost impact proposal audit, prepare and distribute a report using the guidance in 10-809.

8-506 Coordination

Extensive coordination will be required when the adjustments are for changes to or failure to follow home office accounting practices. Such adjustments will affect all CAS-covered contracts and subcontracts at all organizational units that receive cost allocations from the home office. It is expected, therefore, that the CAC, the CHOA, the GAC, and/or the auditor cognizant of an intermediate management organization will furnish the auditors cognizant of all segments with the results of the audit on distributing home office expenses, so that the proposed effect on contracts and subcontracts at the receiving segments can be verified. The cognizant auditors would then report back to the CAC, CHOA, or GAC who would issue a consolidated report to the CFAO responsible for the home office.

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