# CHAPTER 6

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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

### 6-103.1 General

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. See Chapter 3 for these factors. 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 4-104 for guidance on providing notice to the ACO of the audit.

c. If the contractor has received a significant amount in Federal awards from a non-DoD agency, and the non-DoD agency is unwilling or unable to reimburse DCAA for its portion of DCAA's incurred cost audit services, this may constitute a limitation on the scope of audit, and auditors should follow the procedures in 15-102.2.

### 6-103.2 Coordination with Field Detachment

a. In planning the audit, the regional FAO should determine if audit assistance is required from the Field Detachment auditors. This may be determined by considering prior audit experience with the contractor and through discussions with the contractor at the entrance conference. If the regional FAO does not have access to Federal awards because they are classified, audit assistance from the cognizant Field Detachment FAO should be requested.

b. When regional and Field Detachment FAOs have joint audit responsibilities, the objective is to achieve a comprehensive, coordinated, and integrated incurred cost audit. Annual coordination meetings should be held between the FAOs to determine their respective responsibilities (see 6-405.4a).

c. In all cases where classified work is involved, the regional FAO should request assistance from the Field Detachment. If necessary, the Field Detachment will coordinate audit matters with the other Government audit organization(s). The Field Detachment FAO will communicate the results of audit in an assist audit report to the regional FAO or may use the one audit approach, if appropriate.

d. The scope of the incurred cost audit may be limited when a significant amount of contractor expenditures under Government contracts is excluded from the scope of DCAA's audit because the DCAA auditors (including Field Detachment auditors) do not have access to or cannot rely upon the work of other Government auditors related to cer-

tain restricted or classified information. Depending upon the significance of the excluded costs, these situations may warrant the issuance of a qualified audit opinion or disclaimer of opinion (see 10-210.3 and 10-210.4).

e. DCAA FAOs will rely on the work of other DCAA offices (including Field Detachment) without making reference to the work performed by that office in the audit report (refer to 4-1006.2b). The regional FAO must fully coordinate with the cognizant Field Detachment FAO regarding the manner in which any Field Detachment assist audit findings may be presented in the FAO's incurred cost audit report. Consideration must be given to security concerns and the probable need to present the audit findings without reference to the classified nature of the awards, and without reference to the Field Detachment.

**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 Management 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 audit 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) Execute a rate agreement letter with the contractor for the determined rates (see Figure 6-7-2).

(6) Issue a memorandum to the Administrative Contracting Officer in accordance with 10-506 to provide the rates and recommended direct costs. Enclose the rate agreement letter, including the Cumulative Allowable Cost Worksheet (CACWS) with the memorandum.

(7) Direct the contractor to submit adjustment vouchers to reflect the final determined indirect rates. 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 and will be performed during the incurred cost audit. Concurrent procedures (MAARs 6 and 13) must be applied during the fiscal year being audited. MAARs 5, 8, 12 and 18 should be performed during annual incurred cost audits, however, 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 |

| Number and Title | Objectives | Purpose | Reference |
|---|---|---|---|
| 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. | 3-204.16c |
| 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)<br>6-608.3b(1) |
| 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) |

| Number and Title | Objectives | Purpose | Reference |
|---|---|---|---|
| 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) |
| 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 |

| Number and Title | Objectives | Purpose | Reference |
|---|---|---|---|
| 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,<br>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 therefore, 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. Washing-

ton, 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 and,

(6) the existence of Non-DoD contracts. Contractors may have non-DoD contracts which may affect the scope of audit. Identify any Non-DoD contracts subject to audit and verify the audit effort is reimbursable. Some non-DoD agencies request and reimburse DCAA for audit services. The requirement for our services on non-DoD contracts should be confirmed by discussion with the appropriate agency Office of the Inspector General (see 1-300 and 15-100 for guidance on audit services for non-DoD agencies and DCAAP 7230.1 Reimbursable Audit Program Pamphlet**).** If the Non-DoD agency is not willing to participate, discuss this with the audit supervisor and adjust the scope of the audit appropriately.

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 con-

tracts 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 non-standard 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 certified cost or pricing data with an estimated value of $12.5 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 certified 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) certified 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 pur-

chase) 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 has 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. This means the receiving organization should be recording and carrying the cost of the items/services at the price charged by the related organization. The existence of an established practice should be readily determinable from evidence such as contractor policies and procedures and supporting records (e.g., job cost summary reports, purchase orders, receiving/acceptance records, and invoices).

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 certified cost or pricing data at FAR 15.403-1(b). These exceptions include:

(1) adequate price competition,
(2) prices set by law or regulation,
(3) commercial item exception,
(4) modification to a commercial contract or subcontract, or
(5) a waiver has been granted.

This information should be determinable from the contract file. (See 14-907 for a detailed discussion of these exceptions)

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 deli-

veries 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) Contractors may have both DoD and non-DoD contracts which may affect the scope of audit. Identify any Non-DoD contracts subject to audit and verify the audit effort is reimbursable. Some non-DoD agencies request and reimburse DCAA for audit services. The requirement for our services on non-DoD contracts should be confirmed by discussion with the appropriate agency Office of the Inspector General (see 1-300 and 15-100 for guidance on audit services for non-DoD agencies and DCAAP 7230.1 Reimbursable Audit Program Pamphlet**).** If the Non-DoD agency is not willing to participate, discuss this with the audit supervisor and adjust the scope of the audit appropriately.

(14) 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.

(15) 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 usually 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 em-

ployees 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 documents. 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 worksite 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 opera-

tion 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 governing 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. In

accordance with FAR 31.205-6(a)(6)(ii) compensation costs must be reasonable for the personal services rendered and not be a distribution of profits (which is not an allowable contract cost). 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 circumstances. [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 benchmarked, 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 securi-

ties 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<br><br>Job Title No. | (1)<br><br>No. of Employees | (2)<br><br>Total Salaries | (3)<br><br>Average Base Salary | (4)<br><br>Total Salaries of Benchmarked Jobs | (5)<br>Survey Weighted Average Salaries | (6)<br>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 | |

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 and Allowability 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 and allowability (see 6-414.6 through 11, 7-2123, FAR 31.205-6(f), (i), (k), (l) and (p)) of compensation of owners, executives, and other high risk employees should be evaluated in incurred cost audits, if the compensation costs are considered material.

### 6-414.2 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.

### 6-414.3 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). Auditors must ascertain whether payments made to owners, such as guaranteed payments to partners or bonuses, that may appear to be a distribution of profits based on the accounting records of the enterprise, are allowable or unallowable compensation costs in accordance with FAR 31.205-6. In addition, auditors must ascertain whether total allowable compensation paid to an individual exceeds a reasonable amount 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. Executive compensation claimed may be well below the compensation ceilings discussed in 6-414.8 and still be unreasonable. Executive compensation claimed should be evaluated for reasonableness in accordance with FAR 31, even if contractors have voluntarily

excluded some executive compensation costs to comply with the appropriate regulatory ceiling amount. Determine if the reasonableness of executive compensation has been evaluated in prior incurred cost audits, or an accounting system audit, if applicable. If not, test compensation reasonableness in the current audit. If compensation was evaluated and determined to be reasonable, determine if claimed compensation (or in some cases the sales revenue of the company) has changed significantly. If there have been changes in claimed compensation levels or size of the company measured in sales, perform an evaluation of the reasonableness of executive compensation. If the prior year's audit of claimed compensation found unreasonable levels of compensation, reasonableness should be evaluated again. Reasonableness testing can be performed in three ways:

(1) If the contractor used survey data to establish executive pay, review the survey data and/or the market pricing analysis used to determine reasonableness. Surveys used by the contractor should be evaluated to determine if they are representative of the contractor's relevant labor market or industry and are appropriate in accordance with FAR 31.205-6(b). (Refer to CAM 5-808.8c(2) for criteria to use in establishing the reliability of the survey data.) This evaluation includes determining if the (i) appropriate survey positions were used based on job descriptions and other data, (ii) appropriate industry factors have been considered, (iii) survey is statistically reliable for the selected survey positions, and (iv) percentile to be used from the survey is based on performance, or in cases lacking demonstrated performance, that the median was used. Surveys used by contractors should be validated using a secondary survey source. The use of only one survey to determine reasonableness of contractor executive compensation is not adequate in most cases. The preference is to use a secondary survey source to which the contractor has access, but has not used in its market pricing. Alternatively, the secondary survey source could be one to which DCAA has access. Do not use free internet salary surveys to evaluate compensation because there is no way to check the statistical accuracy of the data and most practicing compensation specialists regard the free surveys as non-credible sources for determining reasonableness. Coordinate with the regional compensation technical specialist, as needed.

(2) If the contractor is part of a consolidated group and executive pay is established at another location, coordinate with the cognizant DCAA office to determine if an audit of executive compensation has been performed. If not, request an assist audit to evaluate the executive pay for reasonableness.

(3) When the compensation expense is significant, request assistance from the Mid-Atlantic Compensation team. Determine the positions to be evaluated and complete the Contractor Data Form, which is available on the intranet. The Mid-Atlantic Compensation team will evaluate executive compensation using the process delineated in the Techplan ASBCA Case No. 41470, 96-2, BCA 28426, which cited the steps to be taken to evaluate the reasonableness of executive compensation.

h. The following process was the ASBCA's interpretation of how compensation experts would market price executive compensation. This process is used by the Mid-Atlantic Compensation team and 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 6-414.3i 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.

i. 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. 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 Growth
- 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 perfor-

mance, 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.

**6-414.4 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 6-414.7 should be questioned for all applicable periods.

**6-414.5 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.

### 6-414.6 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."

### 6-414.7 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) |
| 2011*** | 763,029 | 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 $763,029 cap amount is to be used for calendar year 2011, 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 com-

pensation, 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 2010. The OFPP set the CFY 2000 through 2010 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 2011, and subsequent years. The OFPP set the 2011 cap amount at $763,029. This new cap applies to costs incurred after January 1, 2011, 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 $763,029 cap amount is to be used for 2011 and subsequent years, until revised by OFPP. No escalation is warranted because the language of OFPP's memorandum states that the $763,029 cap is for all subsequent years until revised. The method for applying the cap is the same as for 1999.

### 6-414.8 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.

e. Executives subject to the compensation cap sometimes perform unallowable activities, such as lobbying, advertising, and organization or reorganization activities. In addition, the executive's compensation may include unallowable elements of cost under the FAR, such as stock appreciation rights and bonuses calculated based on changes in the price of corporate securities. To properly apply the FAR 31.205-6(p) compensation cap, auditors should verify that contractors determined the allowable portion of compensation costs for each executive by identifying the amount of unreasonable compensation, the amount of unallowable compensation elements, the amount attributable to unallowable activities, and deducting those amounts from the executive's total compensation costs subject to the cap. After verifying that the contractors' adjustments for unallowable compensation costs are appropriate, the auditor should then compare the allowable portion of the executive's compensation cost to the benchmark compensation limitation imposed by FAR 31.205-6(p). Figure 6-4-2 includes an example application of the compensation cap.

**Figure 6-4-2**
**Application of the FAR 31.205-6(p) Compensation Cap**

The following example demonstrates the proper application of the compensation cap for two executives. All the amounts noted below are for the contractor fiscal year 2007.

Assumptions:

| Cost Elements | Executive A (Note 1) | Executive B (Note 1) | Reference |
|---|---|---|---|
| Compensation | | | |
| Salary | $1,000,000 | 500,000 | |
| Cash Bonus | 200,000 | 100,000 | Note 2 |
| Defined Benefit Pension Plan | 50,000 | 30,000 | Note 3 |
| Contributions to 401(k) Plan. | 5,000 | 5,000 | Note 4 |
| Stock Appreciation Rights | 200,000 | 100,000 | Note 5 |
| Medical Insurance | 4,000 | 4,000 | Note 6 |
| Company-Furnished Automobile | 11,000 | 11,000 | Note 7 |
| Total | $1,470,000 | $750,000 | |
| | | | |
| FAR Benchmark Compensation Cap for CFY 2007 | $597,912 | $597,912 | |

Note 1: The contractor agrees that both Executives A and B spent fifty percent of their effort performing unallowable lobbying activities (see FAR 31.205-22). The total compensation paid to each executive is considered reasonable in amount.

Note 2: The cash bonus is paid in accordance with a plan that makes awards based on the executive's performance during the year. The cost is allowable per FAR 31.205-6(f)).

Note 3: Costs for defined benefit pension benefits are not included in the definition of compensation (FAR 31.205-6(p)(2)(i)) subject to the cap.

Note 4: The contractor contributes to the 401(k) retirement plan in accordance with the plan provision. The cost is considered allowable per FAR 31.205-6(j)(4).

Note 5: Stock appreciation rights (SAR) represent deferred compensation that is calculated based on changes in the prices of corporate securities, which is unallowable per FAR 31.205-6(i).

Note 6: The contractor provides group medical insurance to all of its employees. The cost is considered allowable per FAR 31.205-6(m)(1).

Note 7: The contractor provides a company automobile for the executive's personal use. The cost is unallowable per FAR 31.205-6(m)(2).

**Application of the FAR 31.205-6(p) Compensation Cap:**

Calculate Allowable Compensation in accordance with FAR 31.205-6(p):

| Cost Elements | FAR | Executive A | Executive B |
|---|---|---|---|
| 1. Comp Elements Subject to Limitation | | | |
| Salary | 31.205-6(p)(2)(i) | $1,000,000 | $500,000 |
| Cash Bonus | 31.205-6(p)(2)(i) | 200,000 | 100,000 |
| Employer Contributions to 401(k) Plan. | 31.205-6(p)(2)(i) | 5,000 | 5,000 |
| Stock Appreciation Rights | 31.205-6(p)(2)(i) | 200,000 | 100,000 |
| Subtotal | | $1,405,000 | $705,000 |
| 2. Subtract Unallowable Costs | | | |
| a. Stock Appreciation Rights | 31.205-6(i) | (200,000) | (100,000) |
| Subtotal | | $1,205,000 | $605,000 |
| | | | |
| b. Lobbying Activity (50%) | 31.205-22 | (602,500) | (302,500) |
| 3. Allowable Comp Subject to the Limitation at FAR 31.205-6(p) | | $602,500 | $302,500 |
| | | | |
| FAR Benchmark Compensation Cap, CFY 2007 | | $597,912 | $597,912 |
| | | | |
| 4. Net Allowable Compensation in Accordance with FAR 31.205-6(p) | 31.205-6(p)(1) | $597,912 | $302,500 |

**6-414.9 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 6-4-3.

(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 flexi-

bly-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 6-4-3**
**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 6-4-3**

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 6-4-3**

* 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.

**6-414.10 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 6-4-4 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 6-4-4**
**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<br>[FAR 31.205-6(p)(2)(i)(A)/DFARS 231.205-6(a)(2)(ii)(A)] | $310 |
| Plus Elective Deferred Compensation<br>[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 4-104 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. Auditors should use their professional judgment to determine if more than one fiscal year should be audited on a multi-year basis.

b. To enable an auditor to appropriately and effectively plan a multi-year audit it is essential the auditor have a clear and documented understanding of the contractor's internal controls that are material for the fiscal years under review. An environment of dynamic change in contrast to a stable one may result in unbalanced audit risk among the fiscal years under consideration for multi-year auditing. Multi-year auditing may only be employed where the auditor has determined and documented that the contractor's business and organizational structure for the years being audited has been relatively stable and consistent. Some of key elements to be considered include changes in the following areas:

- Contract type mix, sales, customer base;
- Profitability, financial position;
- Business product line, services;
- Organizational structure and operations;
- Business acquisitions, loss or mergers;
- Employee turnover, key management positions and accounting staff turnover;
- Number of employees;
- Accounting practices, policies and procedures;
- Business software, i.e. timekeeping systems or accounting software etc;
- Plant and transportation facilities; and
- Business systems and internal control environment.

c. Multi-year auditing techniques should be based on the following guidelines:

(1) Perform all MAARs for each year being audited, if appropriate, based on materiality and assessed risk.

(2) Tests of details must be performed in all years in order to obtain sufficient appropriate evidence to provide a reasonable basis for the conclusions and opinion stated in the report (i.e. opinion on all indirect and direct costs for each audited year).

(3) The audit approach for each year should be risk-based and based on the auditor's documented risk assessment and understanding of the contractors systems/internal controls. For example, the auditor may select an account in one year for the initial detailed testing and then adjust (expand or limit) the level of testing required for that account in the remaining years based on the results for the one year of testing. Alternatively, the auditor may sample a homogeneous population of like transactions across all years for detailed testing. Auditor should clearly document their rationale and judgments used for determining the nature, timing and extent of the audit procedures performed.

(4) Transaction tests of any new accounts should be performed in the year they first appear, if the accounts are material.

d. Substantive tests of details must be performed on significant and/or sensitive account balances and transaction classes as indentified in the transaction testing plan. Auditors may employ audit sampling, judgmental selection, or a combination of these methods to accomplish the audit objectives consistent with the assessed level of risk. As a possible audit approach for consideration, auditors may perform statistical sampling on one year and use the results to plan the audit approach (i.e., statistical sampling or judgmental selection) and the extent of testing in the other years involved in the multi-year audit. For example, if statistical sampling is used in one year and it yields significant findings, the best approach for the other years will likely also be statistical sampling with sample sizes consistent with the audit risk identified in the first sampling application. In contrast, if statistical sampling is used in one year and it yields few findings, auditors may consider limiting testing in the other years to only those transactions determined to be of the most risk (i.e., judgmental selection). When utilizing statistical sampling, the auditor must ensure the findings are appropriately assessed before projecting. For guidance on audit sampling and judgmental selection refer to CAM 4-600.

e. Some of the possible advantages of multi-year auditing include increased efficiency and effectiveness in designing and applying audit procedures while allowing for one set of working papers and one audit report.

## 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 unsupported 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 oper-

ational 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 does not have CAS-covered contracts and 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 manufactured 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. How-

ever, 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;

unreasonable 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 & e) 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 contracts except Fixed-Price contracts without cost incentives or any Firm Fixed price contracts for the purpose of commercial items, 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 as described in FAR 42.709-3(b). 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 31.2 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 determina-

tion 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" as provided under FAR 31.201-6 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. The mutually agreed to be unallowable costs that the contractor failed to identify and exclude from final indirect cost rate proposal or final statement of costs incurred or estimated to be incurred under a fixed- price incentive contract are subject to a second-level penalty.

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 4-602.9h.

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. Typically, provisional billing rates are used for the period in which the unallowable costs subject to penalty were incurred; therefore, calculate the applicable interest assuming all unallowable costs were paid at the midpoint. Additional considerations regarding provisional billing rates are discussed in (c) below. 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. "Signed" as used in this section means a verifiable symbol of an individual, including electronic symbols (see FAR 2.101, Definitions). 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 percentage disallowance factors computed from the results of prior audits, or any other sup-

porting 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 corporate 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 correc-

tive 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 adequate 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 adequate 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 and should be sent via e-mail, if possible.

(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 adequate 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 (http://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 indi-

rect 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.

d. If during this process, the contractor submits their final indirect cost rate proposal and it is subsequently returned as inadequate, auditors should continue where they left off in the process by issuing the next appropriate letter. Auditors should tailor the letter to include the significant inadequacies identified in the final indirect cost rate proposal (see 6-707.1.)

### 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 4-104. If a request is not received, notify the cognizant contracting officer at the beginning of the audit as discussed in 4-104. 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 ful-

lest 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 instance, 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 re-

spect 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

FOR OFFICIAL USE ONLY

**Figure 6-7-3**
**ACC, Inc.**
**Cumulative Allowable Costs/Amounts**
**Through 12/31/2009**
**For Flexibly Priced Contracts and Subcontracts**
**SECTION I**

| Contract Number | Order | Subject To Penalty Clause | Prior Settled Years | Direct & Indirect Costs Using Settled Rates FYE 12/31/2009 | 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 or Sch H* | | | | *Per Assist Audit Requests* | *Sch O* | *Sch O* | *Sch O* | |
| **Cost Type** | | | | | | | | | | | | |
| N00039-99-C-0069 | | Yes | $298,389 | $8,250 | $306,639 | | $306,639 | $140,000 | 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** | | | | *Sch K* | | | | | | | | |
| 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 12/31/2009**
**For Flexibly Priced Contracts and Subcontracts**
**SECTION II**

| | | | | Claimed Subcontract & Intercompany Costs (Note 7) | | | | | Allowable Subcontract & Intercompany Assist Audit Amts Thru FY 2009 | Subcontract Complete? |
|---|---|---|---|---|---|---|---|---|---|---|
| **Contract No. Delivery/Task Order** | **Subcontract/ Intercompany No** | **Subcontractor's Name** | **Address** | **FY 2007** | **FY 2008** | **FY 2009** | **FY 2010** | **Total** | **(Note 8)** | |
| N00039-99-C-0069 | 0069-SUBKA | Subcontractor A | 1234 Any Street | | | | | | | |
| | | | Town, USA | $25,000 | $25,000 | $25,000 | | $75,000 | $75,000 | Yes |
| | | | | | | | | | | |
| | 0069-SUBKB | Subcontractor B | 567 Road | | | | | | | |
| | | | City, USA | $25,000 | $30,000 | $10,000 | | $65,000 | $55,000 | No |
| | | | | | | | | | | |
| N00039-99-C-0069 **Total** | | | | | | | | $140,000 | $130,000 | |

**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 and in excess of $650,000 for contracts issued on or after September 28, 2006 and before October 1, 2010, and in excess of $700,000 for contracts issued on or after October 1, 2010.

(2) These costs, by contract, are computed using the negotiation or rate agreement document. Some fiscal years [Insert Fiscal Years] were dispositioned based on the Defense Procurement and Acquisition Policy Class Deviation– DCAA Policy and Procedure for Sampling Low-Risk Incurred Cost Proposals (No. 2012-O0013) dated July 24, 2012, and as a result were not audited. 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.

(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 Column 5.

(5) Costs in this column are considered unresolved pending subcontract completion and receipt of final cumulative allowable subcontract and Intercompany costs. See Section II for details of subcontracts/Intercompany included in this amount.

(6) Subcontract/Intercompany under Prime Contract No. DASW01-94-D-0038 awarded to XYZ Company.

(7) Costs in these columns represent the subcontract/Intercompany 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 allowable costs from the subcontract/Intercompany 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/Intercompany billing cycles or submissions of rate adjustment vouchers, subcontract fee or withholds, or different fiscal year end dates. At the completion of the subcontract/Intercompany closing actions, these two amounts are expected to be the same, unless there were questioned costs in assist audit report(s).

## 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 or Intercompany 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 contractor’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 al-

ready 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 10-206.3. 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, Home Office or Service Center 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 contractors' 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. When the auditor cognizant of a subcontractor determines that certain amounts should be suspended or disapproved, he/she is responsible for immediately notifying the prime contract auditor of the suspension or disapproval (see 6-802.5h.)

l. For special administrative procedures to be followed in processing suspensions and disapprovals related to non-DoD contracts refer to 15-100.

m. 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 should conform with the following instructions. (see Figure 6-9-1) DCAA Forms 1 can be found in the DCAA Intranet Library under 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 digitally sign the electronic form or manually sign the hard copy 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.

c. Also see 15-100 for distribution requirements pertaining to non-DoD agencies.

**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

_____ CLASSIFICATION

## NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED

| 1. NAME AND ADDRESS OF CONTRACTOR: | 2. CONTRACT NUMBER: | 3. NOTICE NUMBER: |
|---|---|---|
| | 4. DISBURSING OFFICE: | 5. CONTRACTING ADMINISTRATIVE OFFICE |

(A). 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.

(B). 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.

(C). 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.

(D). 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).

(E). The auditor will submit copies of the acknowledged notice to the cognizant disbursing officer for appropriate action and to the cognizant contracting officer.

**DCAA AUDITOR**

| 6. DATE OF NOTICE: | 7. NAME: (Last, First, Middle Initial) | 8. ADDRESS: |
|---|---|---|
| | 9. SIGNATURE: | |

**CONTRACTOR'S ACKNOWLEDGMENT OF RECEIPT**
(The contractor or its authorized representative shall acknowledge receipt of this notice to the DCAA auditor)

| 10. DATE: | 11. NAME OF TITLE OF AUTHORIZED OFFICIAL: | 12. SIGNATURE: |
|---|---|---|

| 13. ITEM NO. | 14. DESCRIPTION OF ITEMS AND REASONS FOR ACTION: | 15. AMOUNT OF COSTS: | |
|---|---|---|---|
| | | 15a. Suspended | 15b. Disapproved |
| | | | |

**DCAA FORM 1, JUN 2011** _____ CLASSIFICATION Adobe LiveCycle Forms v8.2 PAGE: ___ OF: ___

**Figure 6-9-1**
**DCAA Form 1 (cont.)**

CLASSIFICATION

| 16. CONTRACTOR: | 17. NOTICE NUMBER: (Same as block #3) |
|---|---|
| | |

| 18. ITEM NO. | 19. DESCRIPTION OF ITEMS AND REASONS FOR ACTION CONTINUED |
|---|---|
| | |

DCAA FORM 1, JUN 2011 Add CLASSIFICATION PAGE: ___ OF: ___

# Figure 6-9-1
# DCAA Form 1 Instructions

| INSTRUCTIONS | |
|---|---|
| 1. Enter the name and address of the contractor.<br><br>2. Insert the contract number, and if appropriate, the job, task, or project order they're under where the cost element to suspended or disapproved is applicable to only one contract (See DCAAM 7640.1, DCAA Contract Audit Manual (CAM), 6-904.1).<br><br>Where the cost element to be suspended or disapproved is applicable to more than one contract, Insert "see enclosed contract list" (see CAM 6-904.2).<br><br>3. Insert the sequence number of this DCAA Form 1, A separate series of consecutive numbers 1 will be used for each contract, job, task, or project order for which a separate voucher series of number is used. (see DCAAP 7641.90) The sequence number of this Form will automatically generated by the system.<br><br>4. Insert the name and address of the applicable disbursing office "DFAS."<br><br>5. Insert the name and address of the applicable Administrative Contracting Officer (ACO) name, and address.<br><br>6. Insert the date Form signed by the Branch Manager.<br><br>7. Insert the Branch Manager Full name.<br><br>8. Insert the DCAA cognizant name and address.<br><br>9. Signature of Branch Manager. In accordance with the provisions of DCAAR 5600.1, the FAO manager responsible for issuing the DCAA Form 1 will manually sign the original Form. | *Do not fill in these three blocks (10, 11, 12) when the form is prepared. Obtained the contractor's acknowledgement per 6-905b.*<br><br>10. Date the contractor signs the Form 1. Where the DCAA Form 1 is mailed to the contractor, it should be the date contractor sign the return receipt.<br><br>11. Insert name and address of the contractor authorized official.<br><br>12. Signature of contractor authorized official. If the contractor refuses to sign the form, insert "refusal to sign."<br><br>13. Insert sequential number of the item will be reported in this Form 1.<br><br>14. 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 suspensions, or disapproval.<br><br>15. Insert the amount in dispute. The amount suspended and/or disapproved applicable to contract (s) will be deducted on a current public voucher (see CAM 6-906).<br><br>16. The same as item 1.<br><br>17. The same as item 3.<br><br>18. Continuation of item 13.<br><br>19. Continuation of item 14. |

DCAA FORM 1 INST, JUN 2011

## 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 vouchers found acceptable,

(3) reject vouchers found not acceptable for payment, and

(4) 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 available on the Defense Contract Audit Agency's public web site at http://www.dcaa.mil. 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 procedures 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 has procedures established to ensure costs incurred in the performance of the contracts which it is delinquent in payment for, are not included in interim vouchers. The contractor's aging of accounts payable may be used as part of its procedures.

(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 ensure 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. The auditor's review of the interim public voucher does not constitute an audit. Rather, it is a review of the voucher to verify that the amounts claimed are not in excess of that which is properly due the contractor in accordance with the terms of the contract prior to approval of provisional payment. 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 based on identified risk factors 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. At a minimum, the review of sampled vouchers will include 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) If the auditor has not previously verified that the contractor is not delinquent in the payment of costs incurred in the performance of its contracts during other assignments (e.g. 11010, 11015, or 17741), and there are significant material or subcontract costs included in the current billings, the auditor should trace selected current costs on the voucher (e.g., material, subcontract, or ODC, etc) to cancelled checks or other evidence that identifies the date that the payment was made, or is planned to be made and the risk that the contractor will not make the payment in the normal course of business is low. If the contractor is delinquent in paying accrued costs in the ordinary course of business, those costs are not reimbursable in accordance with FAR 52.216-7 and the voucher should be rejected. If the contractor does not agree to revise the voucher to deduct the cost not paid from the current billing, the auditor should issue a DCAA Form 1 in accordance with CAM 6-900 to suspend the costs and eliminate any overpayments.

(8) Reconciliation of billed costs to the contractor’s accounting records. [For nonmajor 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.]

(9) Contact the Contracting Officer (PCO and/or ACO) and the Contracting Officer's Representative (COR) to ascertain any known concerns or unusual circumstances or risk associated with the COR's contract performance surveillance responsibilities.

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 provisional 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 contract_closeout@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 fiscal year of the period of performance under a contract is generally less than a full fiscal year. The direct and indirect costs incurred on an individual contract, task order, or delivery order in the last fiscal year of its performance may be relatively small in amount, particularly if the contract, task order, or delivery order is physically completed early in the year. In such cases it is generally mutually advantageous to the Government and the contractor to close such contracts, task orders, or delivery orders 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 direct and indirect costs for a specific contract, task order, or delivery order, to be closed in advance of the determination of final direct and indirect costs under specified circumstances. The provision for quick-closeout procedures can be applied not only to the final fiscal year of a contract, task order, or delivery order but also to all other open fiscal years with unsettled direct and indirect costs if the criteria contained in FAR 42.708 are met.

c. To enhance the contract closeout process, FAR 42.708 was revised effective June 30, 2011. The revised procedures require that the contracting officer negotiate the settlement of direct and indirect costs for a specific contract, task order, or delivery order to be closed, in advance of the determination of the final direct and indirect costs if the criteria in FAR 42.708 are met. The FAR 42.708 criteria for applying quick-closeout procedures are:

(1) the contract, task order, or delivery order is physically complete;

(2) the total unsettled direct and indirect cost allocable to that contract, task order, or delivery order is relatively insignificant. The cost is considered relatively insignificant when the total unsettled direct and indirect cost to be allocated to any one contract, task order, or delivery order does not exceed the lesser of
$1 million; or
10 percent of the total contract, task order, or delivery order amount;

(3) The contracting officer performs a risk assessment and determines that the use of the quick-closeout procedures is appropriate. The risk assessment should include

- consideration of the contractor's accounting, estimating, and purchasing systems;
- other concerns of the cognizant contract auditors; and
- any other pertinent information, such as documented history of Federal Government approved indirect cost rate agreements, changes to contractor's rate structure, volatility of rate fluctuations during affected periods, mergers or acquisitions, special contract provisions limiting contractor's recovery of otherwise allowable indirect costs under cost reimbursement or time and material contracts; and

(4) Agreement can be reached on a reasonable estimate of allocable dollars.

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 an evaluation is not required when the contracting officer exercises quick-closeout procedures, the auditor should provide comments regarding any contract, task order, or delivery order being considered for quick-closeout if the auditor has specific concerns related to the criteria in c. above (e.g. the 10 percent ceiling is being approached). The rates recommended should be representative of conditions during the final fiscal year of contract, task order, or delivery order 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, task order, or delivery order 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 direct and indirect costs applied to the contract, task order, or delivery order for the closeout period as compared with the amount which would be applied if the contract, task order, or delivery order 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 payments. 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.