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CHAPTER 14

14-000 Other Contract Audit Assignments

14-001 Scope of Chapter

This chapter provides guidance for certain miscellaneous or special audit assignments related to the contract audit mission. It covers only those procedures that are special to accomplishing a particular assignment. Auditing concepts, policies, and procedures having general application, as covered in other chapters of this manual, also apply to assignments discussed in this chapter.

14-100 Section 1 --- Postaward Audits of Contractor Cost or Pricing Data

14-101 Introduction

This section describes postaward audits for defective pricing and provides specific audit guidelines and procedures related to this type of audit. General audit procedures that are equally applicable to these audits are in other chapters of this manual.

14-102 The DCAA Postaward Audit Program

a. Defective pricing occurs when a contractor does not submit or disclose to the Government cost or pricing data that is accurate, complete, and current prior to reaching a price agreement. Generally, the auditor establishes the existence of defective pricing in a postaward audit by examining and analyzing the records and data available to the contractor as of the date of prime contract price agreement and comparing them with the submitted cost or pricing data.

b. The objective of a postaward audit is to determine if the negotiated contract price was increased by a significant amount because the contractor did not submit or disclose accurate, complete, and current cost or pricing data. To show that defective pricing exists, the audit must establish each of the following five points:

(1) The information in question fits the definition of cost or pricing data.

(2) Accurate, complete, and current data existed and were reasonably available to the contractor before the agreement on price.

(3) Accurate, complete, and current data were not submitted or disclosed to the contracting officer or one of the authorized representatives of the contracting officer and that these individuals did not have actual knowledge of such data or its significance to the proposal.

(4) The Government relied on the defective data in negotiating with the contractor.

(5) The Government's reliance on the defective data caused an increase in the contract price.

Establishing these five points is a necessary prerequisite to support recommended price adjustments and provide the contracting officer with the information to achieve price reductions to contracts.

c. Based on a 1965 GAO audit, the DoD developed policy designating DCAA to establish and conduct a program for performing regularly scheduled defective pricing (postaward) audits of selected contracts, modifications, subcontracts, and other eligible pricing actions. Based on inter-agency agreements, this program includes contracts awarded by certain non-DoD agencies as well as DoD contracts.

d. Each DCAA branch office, resident office, and suboffice performs postaward audits for defective pricing based on:

(1) the annual requirements and selection plans issued by Headquarters and

(2) specific requests received from contracting officers or other authorized persons or activities.

Audit effort does not stop once the audit is completed and the report is issued. The auditor is also responsible for providing negotiation support to the contracting officer for timely settlement of defective pricing allegations. This audit responsibility

continues until the Government achieves final resolution either by negotiation or litigation.

e. Headquarters, PPD, will periodically issue guidance on program objectives.

14-103 Truth in Negotiations Act (TINA)

14-103.1 Purpose of TINA

a. The purpose of the TINA (Truth in Negotiations Act) is to put the Government on equal footing with contractors when negotiating contracts requiring cost or pricing data. The TINA requires contractors to submit accurate, complete, and current cost or pricing data when negotiating contracts with the Government. It also provides the Government with a price reduction remedy if a contractor fails to comply and includes provisions for interest and penalties. The price reduction remedy takes effect when the contractor does not submit accurate, complete, and current data for a contract and the Government relied on that defective data in determining the contract price.

b. Section 2306a of Title 10, United States Code, contains the TINA as it applies to DoD, NASA, and the U.S. Coast Guard contracts entered into on or after February 15, 1987. Before February 15, 1987, 10 U.S.C. 2306(f) contained the necessary provisions. Similar provisions for other executive agencies are contained in 41 U.S.C. 254(d) and apply to those solicitations for bids or proposals issued after March 31, 1985 and before December 5, 1994. For contracts entered into on or after December 5, 1994 the provisions are contained in 41 U.S.C. 254b. FAR Parts 15 and 52 implement the TINA.

14-103.2 TINA Applicability

a. The TINA applies to negotiated prime contracts, modifications, and subcontracts where the Government required cost or pricing data. (See FAR 15.403-1 and DFARS 215.403-1 for exceptions to this requirement.) In addition, this includes interdivisional work, final price redeterminations, equitable adjustments, and termination settlements. TINA also applies to modifications of advertised contracts when the modification exceeds the applicable dollar threshold. TINA also applies to change orders when the absolute value of the increase and decrease exceeds the applicable dollar thresholds, even though the net change in price itself is under the threshold.

b. Public Laws 101-510, Section 803; 102-25, Section 701; and 102-190, Section 804 have established the dollar thresholds for requiring cost or pricing data as follows:

- $100,000 for prime contracts awarded on or before December 5, 1990 and for any subcontracts or modifications under those prime contracts that are expected to exceed $100,000, unless the prime contract has been modified as provided below.
- $500,000 for contract modifications made after December 5, 1991 to prime contracts entered into on or before December 5, 1990, when the prime contract has been modified to incorporate the $500,000 threshold.
- $500,000 for subcontracts or subcontract modifications entered into after December 5, 1991 under prime contracts entered into on or before December 5, 1990, if the prime contract has been modified to incorporate the $500,000 threshold.
- $500,000 for prime contracts, and for any subcontracts or modifications under those prime contracts that are expected to exceed $500,000, awarded after December 5, 1999 and before October 11, 2000. (However, see FAR 15.403-1, 15.403-4, and DFARS 215.403-1 for certain exceptions and modifications.)
- $550,000 for prime contracts awarded on or after October 11, 2000 and for any subcontracts or modifications under those prime contracts that are expected to exceed $550,000. (However, see FAR 15.403-1, FAR 15.403-4, and DFARS 215.403-1 for certain exceptions and modifications.)

(Note: These thresholds apply to DoD, NASA, and U.S. Coast Guard contracts only. The threshold for civilian agencies remains $100,000 prior to December 5, 1994 and increases to $500,000 on or after that date, as provided for in FAR 15.403-4(a)(1). Contracting officers were instructed, if requested by the prime contrac-

tor, to amend existing contracts without consideration. The $500,000 threshold applicable to all agencies after December 5, 1994 will be adjusted for inflation (in 1994 dollars) every 5 years to the nearest $50,000. The $550,000 threshold effective October 11, 2000 implements the inflation adjustment.

The operative date is the date of prime contract award. The higher threshold does not apply to modifications or subcontracts (or to modifications or changes to subcontracts) awarded after December 5, 1990 if the prime contract was awarded on or before December 5, 1990 and the prime contract was not subsequently modified to incorporate the higher threshold. Also, the higher threshold does not apply to undefinitized contract actions issued on or before December 5, 1990, even though negotiations were completed after December 5, 1990 unless the prime contract was subsequently modified to incorporate the higher threshold. However, contracting officers may modify Basic Ordering Agreements to reflect the higher thresholds for orders issued after December 5, 1990. Contracting officers can request cost or pricing data between the Simplified Acquisition Threshold of $100,000 and the cost or pricing data threshold only with the approval at the Head of the Contracting Activity and provided that an exception at 15.403-1(b) does not apply. For older contract actions note that Public Law 97-86 increased the original $100,000 threshold to $500,000 on December 1, 1981. Public Law 98-369 returned it to $100,000 on April 1, 1985. For older contract actions (including modifications) affected by these public laws, use the 1981 and 1985 dates to determine the appropriate dollar threshold unless the prime contract was subsequently modified to incorporate the higher threshold.

c. As provided in FAR 15.403-1(b), contractors may obtain exceptions from submitting cost or pricing data when:

(1) the price is based on adequate price competition,

(2) the price is based on prices set by law or regulation,

(3) the item meets the definition of a commercial item,

(4) when a waiver has been granted, and

(5) a commercial contract is modified and meets the requirements of 15.403-1(c)(3).

14-104 Cost or Pricing Data

14-104.1 Legislative and Regulatory Background

The TINA, when enacted in 1962, did not originally define cost or pricing data. The definition was established through legislative intent, regulations, and in decisions by the courts and BCA (Board of Contract Appeals). Congress' initial concern in 1962 was to assure the disclosure of historical cost facts that can be verified objectively to assure that the disclosure of such facts is accurate, complete, and current. The Armed Services Procurement Regulations in 1964 specified that such cost or pricing data are factual only, but also expanded the concept to include more than just historical accounting data. These regulations also emphasized distinctions between facts and judgment. Court and Board cases often attempt to distinguish between cost or pricing data and judgment, and frequently address other concepts such as disclosure, government reliance, and increase in contract price. Court and Board decisions are based on the specific issues of each particular case, but do establish precedent for current audit work. Observing the principles established in those decisions improves the chances for sustaining issues in current audit work. Results of appeals are determined on a case-by-case basis, but those results are reached through application of fairly constant principles established through statutes, regulations, and case law. Congress eventually amended the TINA in 1986 and again in 1987 to provide a statutory definition of cost or pricing data.

14-104.2 TINA Definition

TINA defines the term "cost or pricing data" to mean all facts that, as of the date of agreement on the price of a contract (or the price of a contract modification), a prudent buyer or seller would reasonably expect to affect price negotiations signifi-

cantly. Such term does not include information that is judgmental, but does include the factual information from which a judgment was derived.

14-104.3 FAR Definition

FAR 2.101 states that "cost or pricing data" mean all facts as of the date of price agreement or, if applicable, another date agreed upon between the parties that is close as practicable to the date of agreement on price, that prudent buyers and sellers would reasonably expect to affect price negotiations significantly. Cost or pricing data are data requiring certification in accordance with 15.406-2. Cost or pricing data are factual, not judgmental, and are therefore verifiable. While they do not indicate the accuracy of the prospective contractor's judgment about estimated future costs or projections, they do include the data forming the basis for that judgment. Cost or pricing data are more than historical accounting data; they are all facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred. They also include such factors as

(1) vendor quotations;

(2) nonrecurring costs;

(3) information on changes in production methods and in production or purchasing volume;

(4) data supporting projections of business prospects and objectives and related operations costs;

(5) unit-cost trends such as those associated with labor efficiency;

(6) make-or-buy decisions;

(7) estimated resources to attain business goals; and

(8) information on management decisions that could have a significant bearing on costs.

When reporting a finding of defective pricing, in the section of the audit report addressing the first point to establish defective pricing, the auditor should discuss the FAR definition of cost or pricing data and explain the connection between the FAR definition and the data identified as defective.

14-104.4 Determining What Data are Cost or Pricing Data

Distinguishing between data that are cost or pricing data and data that are not requires careful analysis in each case. The auditor must separate facts from judgment when analyzing data. Consider the following issues:

a. A purchase order or vendor quote for material is generally considered cost or pricing data. Escalation applied to the purchase order or vendor quote is most likely an estimate. However, the contractor may have based the escalation on prior purchases or usage. Any judgments the contractor applies to such prior purchases or usage to estimate escalation are not cost or pricing data, but the actual purchases or usage are.

b. Are contemplated management actions cost or pricing data and, if so, when do such contemplated actions become facts subject to disclosure? At the time a decision to act was made or when the decision was acted upon? To assess contemplated management actions and business strategies begin with the definitions of cost or pricing data and then assess the facts in each circumstance in relation to the contract price agreement.

What management decisions have been made?

When were the management decisions made?

When were the management decisions carried out or acted upon?

How do such decisions affect the contract price?

For example, management discussions about whether or not to modernize a production line would not be cost or pricing data. It is a fact that discussions have been held, but a decision to act has not yet happened. On the other hand, a decision to modernize, even though the particular method of modernization has not been established, is cost or pricing data which must be disclosed.

14-104.5 Judgments Intertwined With Facts

Judgments are not cost or pricing data and do not become cost or pricing data

when intertwined with facts. However, when data contains judgments and facts that are so intertwined they cannot practically be segregated, then the entire data is subject to disclosure, but only the facts require certification. For example, a production planning schedule shows both estimated production on potential orders not yet received and actual production on orders received. The schedule is subject to disclosure, but the contractor will only certify to the actual production for orders received.

14-104.6 Reasonably Available Data

Regulations require the contractor to submit or disclose to the Government cost or pricing data that are reasonably available as of date of agreement on price or, if applicable, another date agreed upon between the parties that is close as practicable to the date of agreement on price. The concept of reasonably available data depends on the type of cost or pricing data, contractor accounting or estimating systems, and closing or cutoff dates agreed to at negotiations. The auditor must establish whether the cost or pricing data were reasonably available based on the facts and circumstances for each specific contractor and audit. FAR 15.406-2(c) deals with the time at which cost or pricing data become reasonably available to the contractor. Normally, data such as actual indirect costs and production records may not be reasonably available except on normal periodic closing dates. However, the FAR also points out that data within the contractor's or subcontractor's organization on matters significant to management and to the Government will be treated as being reasonably available on the date of agreement on price. When reporting a finding of defective pricing, in the section of the audit report addressing the second point to establish defective pricing, the auditor should discuss the date that the cost or pricing data was reasonably available to the contractor and the applicable date of price agreement.

14-104.7 Errors in Cost or Pricing Data

TINA addresses only the submission of cost or pricing data. It does not require a contractor to use such data in preparing its proposals or for there to be a relationship between the proposals and the conclusions that can be drawn from such data. Furthermore, the certification relates only to the cost or pricing data. The offeror does not certify its proposal. Therefore, under TINA, the proposal does not have to be free from mathematical errors. However, errors can result in inaccurate cost or pricing data which may result in defective pricing. The error must be an error in the cost or pricing data (i.e., factual information) submitted. Errors in estimates generally would not result in defective pricing. For example, if an error exists in an offeror’s proposal relative to a vendor quote, defective pricing would not exist if the actual quote was accurate and submitted to the Government. In contrast, if an error exists in an offeror’s proposal relative to direct labor costs due to a transposition error in the actual labor rates submitted, defective pricing may exist.

14-105 Submission or Disclosure of Cost or Pricing Data

14-105.1 TINA Requirements

Prime contractors subject to TINA must submit accurate, complete, and current cost or pricing data to the contracting officer or to the "designated representative" of the contracting officer. Subcontractors subject to TINA (at any tier) must make their submissions to the prime contractors or higher-tier subcontractors.

14-105.2 FAR Requirements

Unless an exception applies, the contracting officer must obtain cost or pricing data from the contractor before awarding any contract or modification meeting the cost or pricing data criteria of FAR 15.403-4. The contractor must actually submit the cost or pricing data in the format specified in the solicitation (for example, Table 15-2 of FAR 15.408), or specifically identify the data in writing. The requirement for submission of cost or pricing data is met when all accurate cost or pricing data reasonably available to the offeror have been submitted, either actually or by specific identifica-

tion. FAR 15.408, Table 15-2 details the procedural requirements for submitting a proposal and the required supporting cost or pricing data.

14-105.3 Submission Versus Availability of Data

The mere availability of books, records, and other documents for audit does not constitute submission of cost or pricing data. The regulations make a clear distinction between submitting cost or pricing data and merely making available books, records, and other documents without identification. The adequacy of a given submission or disclosure depends on whether the cost or pricing data is disclosed in a way that places the Government on essentially equal footing with the contractor in regard to making the pricing decisions and must be determined on a case-by-case basis.

14-105.4 Contractor Analysis and Disclosure

The contractor does not have to analyze data solely for the benefit of the Government. On the other hand, if the Government is unable to analyze the data and the contractor can do so and does, that information must be disclosed. The Government is entitled to the best cost or pricing data available to the contractor, not second best. An example of disclosing only second best would be if the contractor has prepared an analysis of cost or pricing data to better understand the raw cost or pricing data, but discloses only the raw data which the Government was unable to analyze. However, see 14-108d regarding prime contractor or higher-tier subcontractor analyses of subcontract costs. This concept can also relate to the meaningful disclosure of cost or pricing data to the Government (i.e., submission versus availability).

14-105.5 Updating Cost or Pricing Data

a. The contractor must update its cost or pricing data, not its proposal. TINA requires cost or pricing data to be submitted prior to contract award, but the data must be accurate, complete, and current as of the date of agreement on price or, if applicable, another date agreed upon between the parties that is close as practicable to the date of agreement on price. It is DoD policy to accept cost or pricing data after agreement on price but before contract award, if the data existed before agreement on price or, if applicable, another date agreed upon between the parties that is close as practicable to the date of agreement on price. See 14-120.4 on Defective Pricing "Sweeps." The contracting officer may require submission of cost or pricing data in the format indicated in Table 15-2 of FAR 15-408, specify an alternative format, or permit submission in the contractor’s format. Table 15-2, Note 1, explains that the contractor should promptly submit to the contracting officer later information as it comes into the offeror's possession. The requirement for submission of cost or pricing data continues up to the time of final agreement on price. As later information comes into the offeror’s possession, it should be promptly submitted to the contracting officer in a manner that clearly shows how the information relates to the offeror's price proposal. Future additions or revisions, up to date of agreement on price, must be annotated on a supplemental index.

b. In postaward audits, the auditor and contracting officer must assess whether the updated cost or pricing data was adequately disclosed. The auditor can provide the contracting officer with information about data which he or she believes was not adequately disclosed by the contractor. However, it is the contracting officer who must ultimately determine whether the contractor's disclosure was adequate and affected the price negotiations. For example, material is proposed at $100 a unit based on a $75 vendor quote plus escalation. The contractor provides updated cost or pricing data for a purchase order of $80 with no escalation applicable. Merely providing updated cost or pricing data without its effect on a bill of material (also cost or pricing data) doesn't appear to provide meaningful disclosure. However, if the contracting officer received the updated information and that

information was provided in an adequate way, the fact that the bill of material was not adjusted by the contractor is not a noncompliance with TINA. Moreover, adequate disclosure does not mean contractors have to give a monetary impact of updated cost or pricing data or revise a part of their proposal.

14-106 Contracting Officer's Designated Representatives for Receiving Cost or Pricing Data

a. Submission or disclosure of cost or pricing data to the contracting officer is generally easy to establish. Who a contracting officer's designated representative is and when that designation begins or ends require further analysis. The BCA has held that the contracting officer's representative is someone who is substantially involved in the proposal evaluation or contract negotiation process. Accordingly, such designation may be by specific direction or implied through field pricing support/audit support under FAR 15.404-2. During the field pricing support process, consider the timing of any Government assistance given to the contracting officer. To support price negotiations, a contracting officer can use the buying command administration staff (pricing, contract administration, technical), the contract administration staff responsible for activity at the contractor's location (pricing, contract administration, technical), and DCAA. The organizational staff that provides support to the contracting officer and the timing of that support depends on the nature of the procurement and is not the same in every situation.

b. Auditors must address this issue with the contracting officer to determine if the contractor made an appropriate submission of cost or pricing data. The active involvement of the parties supporting the contracting officer on a specific procurement generally establishes when such designation begins or ends. As a member in the procurement process, DCAA can provide audit support in evaluating a price proposal that enables it to obtain information as the contracting officer's representative. Once that audit is complete, those services may no longer be required. At this point, the auditor would not normally be a representative of the contracting officer for receiving cost or pricing data on that procurement. However, if the auditor subsequently becomes aware of additional cost or pricing data and recognizes its relationship to a specific proposal, the auditor need not perform any analysis of the data but must immediately make the contracting officer aware of the data. Additionally, if the auditor is involved in supporting negotiations after issuing the proposal audit report, he or she is a proper representative for receiving cost or pricing data. The same considerations apply for any of the contracting officer's supporting groups.

c. Case law has held that the entity responsible for establishing indirect cost rates is an appropriate recipient of cost or pricing data relating to indirect costs. Frequently DCAA is such an entity. Even though that entity may not have any active involvement in the negotiations, disclosure of such cost or pricing data to it would be to a proper representative. Because there is a Government entity responsible for establishing indirect cost rates, the ASBCA has held that the contracting officer must rely on that entity for evaluation of indirect cost rates, prior to agreeing on price, to ensure all field support data is considered.

d. When the subcontractor denies the prime contractor access to its records, the contracting officer may request that the cognizant DCAA office audit the subcontractor's proposal. The ASBCA has held that, in those cases, disclosure of cost or pricing data to the auditor satisfies the FAR 15.406-2 requirement for disclosure to the contracting officer or his representative (Motorola, ASBCA No. 41528, 94-2 BCA ¶26,596 and Martin Marietta Corp., ASBCA No. 48223, 98-1 BCA ¶29,592). The subcontractor has no obligation to either use the cost or pricing data to update its proposal or analyze it for the Government. Therefore, when the subcontractor discloses cost or pricing data to the DCAA office that performed the subcontract audit (because the subcontractor refuses to allow the prime contractor access to its books and records), the

auditor should coordinate with the subcontractor ACO to ensure that the prime ACO is provided the subcontractor cost or pricing data in a timely manner for use during the prime contract negotiations. A supplemental audit report should be issued if doing so will serve a useful purpose.

14-107 Certificate of Current Cost or Pricing Data

a. As soon as practicable after reaching agreement on price, FAR 15.403-4 requires the contractor to submit a Certificate of Current Cost or Pricing Data certifying to the accuracy, completeness, and currentness of the cost or pricing data. The Certificate of Current Cost or Pricing Data covers all cost or pricing data reasonably available to the contractor as of the date of final price agreement or, if applicable, another date agreed upon between the parties that is as close as practicable to the date of agreement on price. The allowance for a date other than the date of agreement on price was an attempt to reduce the need for proposal updates and sweeps since certain data may not be reasonably available before normal periodic closing dates, e.g., indirect costs. When performing the audit, the auditor must consider any cutoff dates and use the agreed-to date found on the certificate. Also, the contractor's responsibility is not limited to the personal knowledge of the contractor's negotiator. It extends to all information reasonably available within the contractor's organization at the time of price agreement.

b. Absence of a Certificate of Current Cost or Pricing Data does not prevent the auditor from doing a defective pricing audit, since the contractor is statutorily liable if it furnishes defective data. However, the auditor must confirm the date of price agreement with the contracting officer in order to determine if defective data exists.

c. When submitting the certificate required by FAR 15.403-4, the contractor certifies that as of the date of the price agreement or, if applicable, another date agreed upon between the parties that is as close as practicable to the date of agreement on price, the cost or pricing data are accurate, complete, and current. The Certificate addresses the concept of submitting or disclosing required cost or pricing data (facts) to the Government as of the date of price agreement or another date agreed upon between the parties. The certification itself usually does not identify the cost or pricing data by specific dollar amounts or cost elements. The auditor is the one who establishes dollars or amounts associated with the cost or pricing data in order to perform the audit.

d. Subcontract cost or pricing data must be accurate, complete, and current as of the same date specified in the prime contractor's certificate. Dates other than that of the prime contractor's certification may be relevant to the cost or pricing data provided by the subcontractor depending on the timing of subcontract award and/or the type of prime contract. (See 14-119.3 for significant dates.)

14-108 Subcontractor Cost or Pricing Data

a. Any contractor required to submit cost or pricing data and a certificate also must obtain cost or pricing data from subcontractors and prospective subcontractors. This requirement applies for any subcontract, purchase order, or modification expected to exceed the dollar thresholds for required cost or pricing data (see 14-103.2).

b. Regulations also require the prime contractor to submit subcontractor data to the Government if one of the following conditions applies:

(1) the subcontract cost estimate is $10 million or more,

(2) the estimate is more than the applicable dollar threshold for required cost or pricing data and more than 10 percent of the prime contractor's proposed price, or

(3) the contracting officer considers submission necessary for adequately pricing the prime contract.

c. Submitting cost or pricing data from more than one subcontractor, for the same subcontract item, is not usually required when:

(1) the subcontractor providing the data is the one most likely to receive the subcontract and

(2) the prospective prime contractor's subcontract cost estimate for such item is based on the data obtained.

d. A subcontractor or a prospective subcontractor must submit cost or pricing data to the prime contractor or higher-tier subcontractor. The prime contractor or higher-tier subcontractor is responsible for conducting price or cost analysis of the subcontract (see FAR 15.404-3(b)). The results of this analysis are furnished to the Government as part of its cost or pricing data submission up to the date of price agreement. Therefore, defective cost or pricing data of a subcontract cost or item may be attributable to the prime contractor or higher-tier contractor, subcontractor, or both.

e. A prime contractor granted a waiver from submitting cost or pricing data in accordance with FAR 15.403-1(b)(4) is considered as having been required to make available cost or pricing data. Therefore, although the prime contract would not be subject to TINA, any lower-tier subcontract expected to exceed the cost or pricing data threshold is required to submit cost or pricing data unless an exception at 15.403-1 applies. These subcontracts would be subject to TINA and included in the defective pricing universe for possible selection for audit. The appropriate price reduction clauses in FAR Part 52 would be included in the prime contract to allow the Government to recover for subcontract defective pricing if found. If defective pricing is found, prime contract add-ons should be applied based upon the deemed negotiated rates. For example, if the pricing action was negotiated based upon prior cost or pricing data plus updated cost or pricing data for indirect rates, the deemed negotiated rates would be the updated indirect rates, as adjusted at negotiations. The FAO should be able to verify from the PNM whether cost or pricing data was obtained from the lower-tier subcontractor. If the FAO cannot verify this from the PNM, the PCO should be contacted for this information. This should be done when the defective pricing universe is being developed to ensure the universe is as accurate as possible.

f. In establishing the Government's reliance on cost or pricing data, one of the five points for defective pricing detailed in 14-102, the auditor should give special consideration to subcontractor cost or pricing data. As stated in FAR 15.404-3(a), the contracting officer has a responsibility to determine the price reasonableness at the prime and subcontract levels. Therefore, the auditor can most readily prove reliance by looking closely at the negotiation documentation. Although the TINA is worded so as to require all subcontractors to submit cost or pricing data to the prime contractor, FAR does not require prime contractors to submit all cost or pricing data to the Government (see b. above). If a subcontractor submits cost or pricing data to a prime contractor, but the prime contractor is not required to submit the data to the Government, it may be difficult to prove reliance by the Government on the subcontractor's cost or pricing data. In this case, before the Government can get a price reduction for defective cost or pricing data, it would have to show that the prime contractor relied on the defective data in pricing the subcontract before award of the prime contract. On the other hand, if the prime contractor was required to submit the subcontractor's cost or pricing data to the Government, Government reliance on that data would be more readily established. In either case, the auditor would have to determine what was relied upon by the contracting officer to price that subcontract. The Government does not have to accept the negotiated subcontract price when determining what would be a fair and reasonable price. Instead, the Government is free to evaluate the reasonableness of subcontract price. The Government could have relied on the subcontractor cost or pricing data even if the prime contractor did not. Possible sources of this information would be the PNM, the contracting officer's contract files, and discussion with the contracting officer. Since reliance is one of the five points required to establish the existence of defective pricing, the auditor should ascertain this reliance early in the postaward audit. If reliance cannot be proven, making this determination early in the process would minimize resources spent.

14-109 Natural and Probable Consequence of Defective Data

The ASBCA (American Bosch Arma Corporation, ASBCA No. 10305, 65-2 BCA ¶5280) and the Court of Claims (Sylvania Electric Products, Inc. vs. U.S, 202 Ct. Cl. 16, 479 F.2d 1342 (1973)) have held that the presumed natural and probable consequence of defective data is an increase in the contract price of the defective amount plus related burden and profit or fee unless there is evidence that shows otherwise. The "natural and probable consequence" presumption, when unrebutted, relieves the contracting officer of the burden of reconstructing negotiations to demonstrate the effect of defective data on the contract price. However, a contractor may offer a rebuttal to this presumption and present evidence showing that the result was not a contract price increase. The contracting officer may require a DCAA analysis of the contractor's support for its rebuttal.

14-110 Government's Right of Access to Records

a. The TINA provides the Government with the right to examine contractor records to evaluate the accuracy, completeness, and currentness of the cost or pricing data required to be submitted. This right relates to the following:

(1) Proposal for the contract or subcontract,

(2) Discussions conducted on the proposal,

(3) Pricing of the contract or subcontract, or

(4) Performance of the contract or subcontract.

b. The right to examine contractor records expires 3 years after final payment under the contract or subcontract. Therefore, the auditor should plan to complete postaward audits before the right of access expires. If the auditor has not obtained the necessary records before the access rights have expired, the Government may have lost its legal entitlement to the records. If the access rights are expiring soon, consult Headquarters, PAS, to determine whether there is a legal recourse available to extend the rights.

14-111 Contracting Officer's Record of Price Negotiations

a. FAR 15.406-3 provides that after concluding each negotiation of an initial or a revised price, the contracting officer shall promptly prepare, or have prepared, a PNM (price negotiation memorandum) giving the principal elements of the price negotiation. If we provided field pricing assistance (i.e., a preaward audit report), the contracting officer shall forward one copy of the memorandum to the cognizant auditor.

b. When the contractor submitted cost or pricing data and a Certificate of Current Cost or Pricing Data was required, the PNM shall reflect the extent to which the contracting officer:

(1) Relied on the cost or pricing data submitted.

(2) Used the cost or pricing data in negotiating the final price.

(3) Recognized as inaccurate, incomplete, or noncurrent any cost or pricing data submitted by the contractor.

(4) Took action as a result of the defective data and the contractor's action on such data.

(5) Determined the effect of such defective data on the price negotiated.

c. In June 1989, the Director for Defense Procurement issued policy guidance to contracting officers for situations where contractors provide cost or pricing data after price agreement. In these situations, the contracting officer must also include in the PNM a list of all data submitted by the contractor after price agreement and the extent to which these data were relied on in order to establish a fair and reasonable price.

d. If the contractor was not required to submit cost or pricing data, the PNM will provide the exception or waiver used and the basis for claiming or granting it.

e. Subcontract auditors will obtain information on the prime contractor's certification of subcontract cost or pricing data or prime/subcontractor negotiations from the prime contract auditor.

14-112 Contract Clauses

14-112.1 Price Reduction for Defective Cost or Pricing Data

a. The contract clauses entitled Price Reduction for Defective Cost or Pricing Data are in FAR 52.215-10, 11, 12, and 13. These clauses provide for a reduction in the contract price whenever the contracting officer determines that the contract price increased by a significant amount because the contractor furnished inaccurate, incomplete, or noncurrent cost or pricing data as certified in the contractor's Certificate of Current Cost or Pricing Data. However, the TINA and regulations do not define what is a "significant amount" of increase to a contract price. (See 14-120.1 for further discussions on materiality.)

b. Absence of the price reduction clause in a contract that requires such a clause does not prevent the Government from performing a postaward audit for defective pricing. Under a well-established legal principle (the so-called "Christian doctrine") a contractor is bound by a required clause even though the clause is omitted from the contract.

14-112.2 Examination of Records

FAR 52.214-26 and 52.215-2 set forth the audit and records clauses to be inserted in prime contracts and subcontracts subject to defective pricing. 10 U.S.C. 2306a and 41 U.S.C. 254d grant audit access to contractor or subcontractor records for evaluation of cost or pricing data for three years after final payment under the contract or subcontract. (See 14-110 for the statutory language regarding the Government's right of access to contractor records.)

14-112.3 Multiple Award Schedule (MAS) Contracts

a. Federal Supply Schedule Multiple Award Schedule (MAS) contracts are issued by General Services Administration (GSA) and Veterans Affairs (VA), and include two clauses that can affect the Government's price and result in a contract price adjustment after award. Although audit procedures for the clauses may call for different audit techniques, these agencies prefer to see both clauses addressed in one audit report.

b. The Price Reduction for Defective Pricing Data clause contained in the solicitation/offer under the ""Basis for Price Negotiation" clauses covers contract prices up to the date when price negotiations are concluded. This clause addresses pricing and is not the same as the FAR clause which addresses cost or pricing data. Data supporting MAS contracts are typically based on catalog pricing; no cost data is submitted. If prices are overstated based on the contractor's failure to provide current, accurate, and complete data prior to award, the Government can obtain a refund from the contractor. This clause is normally applied to the pricing data contained in the Discount Schedule and Marketing Data (DSMD) pages of the solicitation/offer.

c. MAS contracts also contain a clause entitled ""Price Reductions". The clause is intended to ensure that throughout the term of the contract, the Government maintains its relative price/discount advantage in relation to the commercial customer or category of customers upon which the MAS contract price was based. This clause provides for repayment or price reductions to the Government for actions taken after contract award. If prices are reduced in the commercial catalog, price list, or schedule or to the commercial customer or category of customers upon which the contract award was based, the Government is entitled to similar price reductions or refunds. Such adjustments are handled in accordance with the Price Reductions Clause.

14-113 Requirements and Program Plans (Postaward Audits)

14-113.1 Requirements Plan Development

FAOs and regions develop their annual defective pricing requirements plan using the DCAA Management Information System (DMIS) and specific instructions issued by Headquarters. FAOs develop and maintain a universe of eligible actions from which they select actions for audit. The specific Headquarters instructions explain how to estimate contractor risk and determine the number of

pricing actions for postaward audit. Auditors should be familiar with these Headquarters instructions prior to starting a programmed audit.

14-113.2 Program Plan Coordination with Government and Contractor Personnel

a. To foster the exchange of useful information and achieve maximum cooperation, FAOs will provide a list of all programmed postaward audits to affected Government personnel (contracting officers and prime contract auditors) at the beginning of the program year. This type of coordination with other Government personnel establishes contact points for communications, provides information for planning and prioritizing workload, and offers the chance to obtain pertinent information that may affect the planning and performance of the postaward audits. Coordination and communication with contracting officers and prime contract auditors throughout all phases of the audit will enable the Government to achieve timely resolution of defective pricing findings. Send written notification of programmed postaward audits on prime contracts or modifications to the PCO, with a copy to the onsite FLA, if applicable (see 15-303). On subcontract audits, send written notification to the prime auditor. Identify for the PCO or prime auditor, at a minimum, such information as the PCO code, symbol and case number, the prime contract number or modification number, the contractor name, the product name, and subcontract purchase order number. The notification can complement an initial request for the price negotiation memorandum (Attachment 3 to the Postaward Audit Program).

b. At those contractors with significant programmed defective pricing activity, discuss the defective pricing program plan with contractor representatives for effective planning and audit coordination. This coordination will include discussions on the contractor risk designation and reasons for such determination, which contracts were selected and how, the timing of the audits, outstanding estimating system deficiencies, and internal control weaknesses.

14-113.3 Timing of Audit

a. Promptly audit and report on pricing actions selected for postaward audit. Each audit is part of the FAO's annual program plan for the fiscal year. To effectively accomplish the plan, phase the audits for completion throughout the fiscal year. Furthermore, Headquarters requirements planning instructions require audits on all fixed price and incentive actions over $100 million to start as soon as the office is aware of the award and to be completed no later than one program year after the year of award.

b. The Government has the right of access to records for three years from the date of final payment under the contract or subcontract. However, it is better to report on any apparent defective pricing before prime contract completion, or at the latest, before the due date of the final audit report on incurred costs under the contract.

14-114 Audit Program for Postaward Audits

a. Use the APPOST standard audit program for doing postaward audits for defective pricing. The audit program consists of six groups of audit steps: preliminary, risk assessment, analytical procedures, probe transaction testing, detailed, and concluding. Preliminary audit steps allow the auditor to compile basic information needed to conduct the audit. Risk assessment and analytical procedure steps are completed to assess the pricing action’s risk of defective pricing and to assist the auditor in planning the nature and extent of probe transaction testing for the major cost elements. Complete the preliminary audit steps, risk assessment, and analytical procedures; discuss with the supervisor the planned scope for further effort; and obtain supervisory approval of any additional effort before beginning the probe transaction testing.

b. Probe transaction testing must be completed to ensure adequate substantive testing has been done to provide a reasonable basis for an opinion. Perform probe transaction testing for the highest risk major cost elements based on the results of the risk assessment and analytical procedures. However, if there has not been an audit of

the preaward proposal and an audit of the estimating system, probe transaction testing should be performed for all major cost elements. Complete the probe transaction testing steps, discuss the results and any plans for additional detailed audit steps with the supervisor, and obtain supervisory approval before beginning any detailed audit steps.

c. Detailed audit steps in the program allow the auditor to document additional audit procedures beyond probe transaction testing applied to specific cost elements and support evidence obtained for an audit conclusion. The auditor plans the detailed steps based on the results of the probe transaction testing. Successful accomplishment of the detailed steps requires auditors to fully establish the five points detailed in 14-102b to prove defective pricing (see also the APPOST).

d. Concluding audit steps identify the administrative requirements upon completion of field work. These steps include communicating the issues and findings with the contracting officer; reporting estimating system findings, CAS findings, and potential irregularities; conducting exit conferences with the contractor; and preparing the audit report.

e. The audit program also includes sections on contract brief schedules, information request guides, schedule for chronology of events, and audit notification to the contractor.

14-115 Obtaining Price Negotiation Memorandums and Requesting Data for the Audit

a. The PNM is the most important Government document for the successful completion of any postaward audit. The auditor must review the PNM to determine what cost or pricing data the contractor provided and when, whether the Government relied on such data, what considerations the contracting officer made during negotiations, and other factual considerations that may have influenced the negotiations. FAR 15.406-3 details the minimum information included in the PNM and requires contracting officers to provide auditors with a copy of the PNM (see 14-111). Notwithstanding the FAR requirements, the auditor is still responsible for communicating or coordinating issues with the contracting officer. At the start of the audit, the auditor should confirm with the contracting officer the statement in the PNM that the Government relied on the cost or pricing data. Sole reliance on the PNM without communicating with the contracting officer is not sufficient.

b. Follow the procedures outlined below for requesting data from the contracting officer when doing postaward audits.

(1) Determine what required data is available from the DCAA FAO files, the contractor, or the ACO. Do not request data from the PCO until you determine it is not available locally.

(2) Review available data to determine if additional information is required to perform the audit. Proper planning for any postaward audit begins with the PNM. Specifically, review the PNM to establish the audit scope and determine what data may be needed to do the audit. If we do not have the PNM and cannot obtain it from the ACO, we should initially request only the PNM from the PCO. Also, the FLA can assist in obtaining required PNMs and other data.

(3) Requests for data or clarification on significant issues should be made to the PCO in writing during the audit. Requesting specific data as needed during the audit will enhance communication with the PCO and result in a better audit and a more effective report. Effective communication with the PCOs shows that we are sensitive to their resource constraints and are taking prudent steps to develop sustainable audit recommendations.

(4) Use the standard request letter (Attachment 2 to standard audit program APPOST) as a guide when writing to the PCO. Specific explanations or reasons for the data requested should be set forth. The standard request letter was designed to notify the contracting officer of the planned audit and request specific data that was not already available from DCAA FAO files, the contractor, or the ACO.

c. In rare instances the auditor may have to travel to the buying office for a personal review of the contract file before starting the audit. Also consider requesting the

contractor's negotiation log and/or record of negotiation. The lack of a PNM should not delay the start of a scheduled audit. However, it becomes increasingly difficult to support an audit baseline, disclosure of cost or pricing data, and reliance without the PNM.

d. If inadequate negotiation documentation, lack of PNMs, or chronic late receipt is jeopardizing the defective pricing program, notify the FLA at the buying office and the regional office. The regional office should work with the FLA to resolve PNM deficiencies with the buying offices.

e. For subcontracts, determine what cost or pricing data of the subcontractor the Government relied on in pricing the prime contract. The auditor at the subcontractor location will contact the auditor at the prime contractor location to obtain the prime contractor's PNM in order to identify the data relied on in pricing the prime contract. Use the FLA to assist in this internal DCAA coordination to obtain the necessary information.

14-116 Establishing the Baseline for Audit, Determining the Defective Data, and Calculating the Recommended Price Adjustment (Postaward Audits)

The auditor must (1) establish the appropriate baseline for audit, (2) determine the potential defective data, and (3) calculate the total recommended price adjustment.

14-116.1 Communicating with the Contracting Officer at the Start of the Audit

When reviewing the PNM at the beginning of the audit, the auditor should confirm with the contracting officer the statement in the PNM that the Government relied on the cost or pricing data or if there is no statement on reliance, the auditor should ask the contracting officer if there was reliance on the cost or pricing data. If the PNM has not been provided to the FAO, request the contracting officer to provide it. A copy of a pro forma memorandum to the Contracting Officer which should be tailored to each specific circumstance is available on DCAA's Intranet and APPS as Format for Announcing Postaward Audit and/or Requesting Data. After completing the risk assessment, the auditor should notify the PCO of the planned audit, as described in 4-103.

14-116.2 Baseline for Audit

a. When contractors certify cost or pricing data (facts) and execute the Certificate of Current Cost or Pricing Data, they do not specifically identify the amounts or elements of costs that are certified. Therefore, to evaluate cost or pricing data for compliance with TINA, the auditor must establish an audit baseline as a starting point in order to determine if the cost or pricing data were accurate, complete, and current. The audit baseline for determining if defective pricing exists is (1) the contractor's last proposal before price negotiations began and (2) adjustment for any additional cost or pricing data up to the time of price agreement or disclosure of sweeps data (see 14-120.4) for which the contractor addresses its significance on the proposal and submits it to the Government. Since the baseline starts with the contractor's proposal, it will include both cost or pricing data and judgments.

DEFECTIVE PRICING AUDIT BASELINE

$$$ Contractor's last proposal by cost element before price negotiations began

+ - (Plus or Minus) Additional cost or pricing data up to the time of agreement on price (or another date agreed upon between the parties), to include sweeps data, for which the contractor addresses its significance on the proposal and submits it to the Government

$$$ (Equals) Baseline for determining if defective pricing exists

b. Examine the PNM first to determine if the contractor updated its proposal or submitted additional cost or pricing data before negotiations of the contract price began. Sources of data other than the PNM include the buying office's contract file and

the contractor's PNM and contract file. Depending on the circumstances, the auditor may need to pursue one or more of these alternative data sources. Follow the procedures in 14-115 to obtain the PNM or other data needed if it is not available locally.

c. The PNM should clearly identify the cost or pricing data the contracting officer relied on to negotiate the prime contract price (FAR 15.406-3(a)(6)). If not specifically addressed in the PNM, coordinate with the contracting officer and obtain a written statement as to what data were relied on. If the contracting officer will not provide a written statement on reliance and the FAO's review of the contracting officer's file discloses no contrary evidence, assume that the Government relied on all data submitted by the contractor in negotiating the contract price.

d. Sometimes the contractor does not submit additional cost or pricing data, but the costs negotiated by the contracting officer are less than the amounts shown in the contractor's proposal. Unless the PNM discusses additional data provided at negotiations, the contractor's proposal is the baseline for audit.

14-116.3 Determining the Potential Defective Data

Once the auditor has established the baseline for audit, the next step is to compare the cost or pricing data in the audit baseline to all accurate, complete, and current cost or pricing data reasonably available to the contractor prior to agreement on price, or another date agreed upon between the parties. Differences found identify potential defective pricing. For such differences the auditor must establish the five points identified at 14-102. If the auditor cannot establish or support these points, he or she has not developed evidence to support that potential defective pricing exists.

IDENTIFICATION OF POTENTIAL DEFECTIVE PRICING

$$$ Cost or pricing data in audit baseline (14-116.2)

- (Less) Accurate, complete, and current cost or pricing data reasonably available up to the time of agreement on price (or another date agreed upon between the parties), to include sweeps data, for which the contractor addresses its significance on the proposal and submits it to the Government
- (Less) Adjustment for contracting officer nonreliance, contractor disclosures or Government's actual knowledge, and specific adjustment by the contracting officer for the effect of factual information on the negotiated price

$$$ (Equals) Potential defective pricing

14-116.4 Calculating the Recommended Price Adjustment

a. The recommended price adjustment is the total amount the contract price increased because the contractor submitted defective cost or pricing data. It includes not only the defective data, but also the associated costs and profit. Recommended price adjustments that do not meet the materiality guidelines in 14-120.1 should not be reported.

b. If the defective pricing involves a subcontract, the prime contract auditor will compute the allocable portion of prime indirect costs and profit applicable to the subcontract defective pricing and include this amount in the total recommended price adjustment for the prime contract. The prime contract auditor's report will include prime add-ons (indirect costs and profit or fee) to the subcontract defect to reflect the total amount of the subcontract defective pricing on the prime contract price.

c. The following guidance applies when calculating the recommended defective pricing adjustment:

(1) When particular cost or pricing data is not disclosed, or inaccurate or noncurrent data is used, (defective data) there is a presumption that the natural and probable consequence (see 14.109) of the defective data is an increase in the negotiated contract price in the amount of the defect, plus indirect costs and profit or fee. However, the natural and probable consequence presumption has its limits in determining the extent to which defective cost or pricing data caused an increase in the contract

price. When there is evidence of reductions obtained in negotiations, the "natural and probable consequence" is less than the full reduction attributed to the defective data. This is explained more fully in paragraphs (2) through (5) below.

(2) When there is insufficient evidence to establish the negotiated value or price of a specific defective cost element, the starting point/baseline for calculating the recommended price adjustment is the contractor's last proposal plus or minus the impact of subsequently disclosed cost or pricing data less adjustment for contracting officer nonreliance (14-116.3).

(3) The negotiated value of the defective element is the starting point/baseline for calculating the recommended price adjustment when there is evidence to show that the Government in negotiation already secured a reduction in the price of the defectively priced cost element below the contractor's last proposal, plus or minus the impact of subsequently disclosed cost or pricing data related to the defective element.

(4) Evidence to confirm the negotiated value or price of a specific defective element of cost may be included in the Government's price negotiation memorandum or other documents such as the Government's pre-negotiation clearance, target objectives, or technical analyses that were attached or referenced in the memorandum to show the breakdown of the elements of cost negotiated. Alternatively, the breakdown of the specific elements of cost in the pre-negotiation clearance or other similar documents that are not attached or referenced in the price negotiation memorandum but which the contracting officer asserts in writing is representative of the prices negotiated for those elements may also represent substantiating evidence. If there is evidence available from Government sources that confirms the specific negotiated cost element prices, this cost level should be used in the computation of the recommended price adjustment for the defective element.

(5) Computing recommended price adjustments:

(a) Starting point/baseline for computing the adjustment:

i. The value of the specific defectively priced element of cost (the level of detail at which the non-disclosed cost or pricing data relates) in the contractor's last proposal, plus or minus the impact of cost or pricing data related to the defective element submitted up to the time of agreement (or another date agreed upon between the parties) to include "sweep" data (14-120.4).

ii. However, if there is evidence available from Government sources of the negotiated value of the defectively priced element, use:

The negotiated value of the specific defectively priced cost element (the level of detail at which the non-disclosed cost or pricing data relates) based on evidence in the price negotiation memorandum or associated Government documents.

Less:

(b) The corresponding value shown by the accurate, complete, and current cost or pricing data that was reasonably available up to the time of agreement on price (or another date agreed upon between the parties) to include sweeps data.

Plus:

(c) Associated costs and profit:

i. In all cases (starting points (a)i or (a)ii above) when the negotiated values of the associated indirect rates and factors can be confirmed and are not defective, apply the negotiated rates and factors to the defectively priced cost elements. If the non-defective negotiated rates are not available, use the rates and factors in the contractor's last proposal, plus or minus the impact of related cost or pricing data submitted up to the time of agreement (or another date agreed upon between the parties) including "sweep" data.

ii. When the indirect rates are defectively priced in addition to the defective element, follow the guidance for the starting point for (a)i or (a)ii under the circumstances.

Equals:

(d) The total recommended price adjustment.

(6) If there was a total bottom-line negotiation price based on a significant reduction to the last proposal, there can be no recognition of the reduction in computing the recommended price adjustment unless there is evidence available from Govern-

ment sources to confirm the negotiated value of the specific defectively priced element. In such circumstances, the starting point for computing the recommended price adjustment would be 14-116.4c(5)(a)i.

14-117 Possible Defective Pricing Indicators

To effectively achieve the basic objectives of the DCAA defective pricing program, audit procedures must be designed to identify and explore conditions suggesting possible defective pricing. The audit procedures should also consider specific information furnished by the contracting officer when applicable. Items normally examined for indications of defective pricing are historical unit cost records, vendor quotes, purchase orders, voluntary refunds or credits from suppliers, cost trend records, sales and manufacturing volume projections, profit and loss statements, and product cost and profit analyses. The following examples are possible defective pricing indicators:

a. Significantly lower actual cost of individual items and cost elements as compared with the amounts included in the audit baseline as explained in 14-116.2. When this condition exists, perform additional tests to determine whether the lower costs reflect defective data.

b. Operations not actually performed or items of cost not incurred, although included in the contractor's proposal. (For example, changes made in the make-or-buy program, a special testing program not performed, or Government-owned equipment rental not paid.) Explore the reasons for not incurring the cost.

c. Items of direct cost included in the contract pricing proposal at prices higher than appropriate based on information available to the contractor (and not disclosed to the Government) at the time of contract price agreement. Examples are as follows:

(1) After submitting the original proposal but before price agreement, the contractor receives a firm quote from an established source which is significantly below the cost included in the original proposal.

(2) A previously used supplier not solicited this time but who normally submits a low bid. The contractor later purchases the material from this vendor at a price lower than proposed.

When detecting the above or similar situations, evaluate the circumstances involved to reach a conclusion on whether defective pricing exists. A contract price is not defective simply because subsequent market price declines allow the contractor to obtain lower material prices than the quotations obtained before award.

d. Closing or cutoff dates for recording transactions or for computing summary indirect cost rates or production cost data that did not coincide with the date negotiations concluded. For instance, the contractor's proposal included indirect or other cost data as of a prior cutoff period. In this case, the contractor is responsible for the currentness of its cost or pricing data, if a cutoff date for this information was not agreed to and identified on the Certificate of Current Cost or Pricing Data, , the Government would consider significant matters in the books or records on the date of price agreement as reasonably available to the contractor for purposes of defective pricing. This is true even if the data had not yet been summarized (see 14-104.6).

e. Less obvious defective pricing indicators may include the contractor's failure to reflect in the proposal decisions expected to lower costs on prospective contracts. This usually relates to budgets, production, automation, time and motion studies on labor, and management decisions when the decisions were made and the information was available before price agreement. Facts underlying contractor opinions, and projections are cost or pricing data; but judgments based on those facts are not (see 14-104).

14-118 Treatment of Offsets

a. The 1987 Defense Authorization Act amended the TINA to give statutory recognition to contractor offsets for defective cost or pricing data that result in understated costs. The amended TINA places the burden of proof for such offsets on the contractor and disallows using any intentional understatements to offset defective cost or pricing data that resulted in a price increase. This amend-

ment applies only to contracts or modifications to contracts entered into on or after February 15, 1987 (10 U.S.C. 2306a). As a result, the following guidelines apply to offsets.

(1) For contracts entered into before February 15, 1987, offsets are usually appropriate against defective cost or pricing data and should be considered during the normal course of audit. This includes inadvertent understatements in the contractor's cost or pricing data and intentional underproposed/negotiated prices where full disclosure of the cost or pricing data relating to the underproposed price has been made. An example of this offset is mathematical errors in the cost or pricing data. It does not include unsupported "bottom-line" management adjustments.

(2) For contracts or modifications to contracts entered into on or after February 15, 1987, offsets against defective cost or pricing data are allowable if the contractor:

(a) certifies to the contracting officer that, to the best of the contractor's knowledge and belief, the contractor is entitled to the offset in the amount requested; and

(b) proves that the cost or pricing data were available before the date of agreement on the price of the contract (or price of the modification) and that the data were not submitted before such date.

(3) However, an offset shall not be allowed if:

(a) the understated data was known by the contractor to be understated before the “as of” date specified on the Certificate of Current Cost or Pricing Data; or

(b) the Government proves that the facts demonstrate that the contract price would not have increased in the amount to be offset even if the available data had been submitted before the date of agreement on price.

(4) The first exception prohibits an offset if the contractor intentionally withheld from the Government information showing a higher cost for an item or service. To deny an offset for this reason, it is not enough that someone in the contractor's organization was aware of the true cost of the item or service. Rather, the Government must establish that someone in the contractor’s organization knew of the cost or pricing data and knew the certificate was inaccurate when submitted.

(5) The Government permits offsets among and within the various line items of the cost or pricing data, but only up to the maximum of defective overstated costs in the same pricing action. For example, the contractor may offset understated material costs against overstated labor, overhead, and G&A. However, offsets apply only within the same pricing action, e.g., for an initial pricing action or for the pricing of a change order.

b. Prior to the evaluation of any contractor offset submission (or potential offsets found during audit) for contracts entered into on or after February 15, 1987, the contractor must provide an appropriate certification in support of its claim. Although audit procedures should not be specifically designed to seek out understatements, the auditor should notify the contractor and the contracting officer in writing of potential offsets, and obtain the required certification. Until the contractor provides the required certification for its submission, DCAA should neither adjust the findings nor expend additional resources on the alleged offsets. It is important that the contractor certify to the apparent offset to ensure its allowability as stated in 14-118a.(3), (4), and (5). For example, the contractor's review of a potential offset found during the audit of a statistical sample of a bill of material may disclose that the cost or pricing data related to the higher price was known and considered by the contractor prior to agreement on price. If the contractor refuses to submit such certification, inform the contracting officer and request assistance in obtaining certified offsets prior to issuing the report to ensure timely consideration of probable offsets. If certification of the offsets cannot be obtained, state in the report that the contractor (or auditor) has identified offset amounts, but the contractor refused to provide any certification of offsets and therefore DCAA will not express an opinion on the validity of the claimed offsets. However, if the contracting officer requests evaluation of the uncertified offsets, comply with that request

and include the supplementary information in a separate appendix to the postaward report.

(1) When the contractor contends that there are understated costs for contracts entered into before February 15, 1987, but does not provide specific information, request in writing that the contractor submit specific information. Also solicit contracting officer assistance in confirming data supporting the alleged offsets and give appropriate consideration in the audit report. If the contractor does not submit this offset information within a reasonable time, normally 30 days or as agreed among the FAO, contracting officer, and contractor, issue the audit report. Present available information concerning alleged offsets in the audit report.

(2) When the contractor contends that there are understated costs for contracts entered into on or after February 15, 1987, but does not provide a certified offset submission, request in writing that the contractor submit its certified offsets so data supporting the alleged offsets can be evaluated. If the contractor does not submit this offset information within a reasonable time, normally 30 days, proceed as discussed in paragraph b.

(3) When the contractor submits offset data to the auditor after issuing the audit report, tell the contracting officer of this additional submission, furnish a copy should he or she not have one, and request his or her views on the need for auditing the additional data.

14-119 Subcontract Audit Procedures (Postaward Audits)

The "Price Reduction for Defective Cost or Pricing Data" clauses in FAR provide that when the Government finds defective pricing on a subcontract after the prime contractor and the Government have agreed on the contract price, the prime contractor is liable to the Government for the amount of the defective pricing. The subcontractor is liable to the prime contractor. Additionally, because the prime contractor is responsible under FAR 15.404-3(c) for obtaining accurate, complete, and current subcontractor cost or pricing data and for updating the data, the prime contractor is liable for subcontract price reductions even when it had no knowledge of the defective data.

14-119.1 Prime and Subcontract Auditor Responsibilities for Subcontract Costs

a. Auditors at the prime contractors, higher-tier subcontractors, and subcontractors are responsible for determining whether the certified subcontract cost or pricing data was accurate, complete, and current. Defects in subcontract cost or pricing data may be attributable to the prime contractor or higher-tier contractor, subcontractor, or both. The auditor's job is to uncover defects in subcontract costs regardless of who caused the defect. However, auditors at each level of cost (prime, higher-tier, subcontractor) have slightly different administrative responsibilities.

b. Prime contract auditors are responsible for reporting on the prime pricing action as a whole, including subcontract costs. The prime auditor evaluates cost or pricing data as of the date of price agreement with the Government. The prime auditor reports the results of the postaward audit, including any subcontract audit results, to the contracting officer. Even though the DCAA postaward selection process requires each FAO to establish pricing actions for audit, the prime auditor is still responsible for all costs under the prime contract. The prime auditor also serves as the focal point for providing subcontract auditors with the necessary information to do the subcontract audit. To properly manage the prime contract audit and its subcontract costs, the prime auditor must:

(1) Establish the subcontract cost or pricing data certified to by the prime contractor.

(2) Assess the cost or pricing data to identify leads or potential defective pricing related to specific subcontractors or subcontract parts.

(3) Request necessary assist audits based on the assessment of the cost or pricing data.

(4) Coordinate and provide relevant facts and information to the subcontract

auditor doing the subcontract postaward audit.

(5) Ensure that subcontract audit reports support defective pricing and that such defects actually affected prime contract price.

(6) Calculate the full effect of subcontract defects on the prime contract price by including prime add-ons.

(7) Report the audit results to the contracting officer. Contact the contracting officer to establish the most effective approach for issuing a prime report when the subcontract report is not complete (see10-6051.c.(1)) or when issuing completed subcontract findings when the prime report is not completed (see 10-605.1c.(2)).

c. Subcontract auditors are responsible for evaluating the subcontractor cost or pricing data submitted and/or certified to the prime contractor. The relevant dates for auditing the subcontractor's cost or pricing data vary and should be established at the beginning of the audit (see 14-119.3). The subcontract auditor obtains necessary information through the prime auditor and issues its report directly to the prime auditor, unless otherwise directed. The subcontract auditor must:

(1) Coordinate with the prime auditor to understand why the subcontract pricing action was requested for audit or to explain why the action was selected for audit.

(2) Obtain from the prime auditor, not the contracting officer, the necessary facts and information to do the subcontract postaward audit.

(3) Establish the relevant dates to determine the existence of defective pricing and confirm such with the prime auditor.

(4) Report the audit results to the prime auditor, unless directed otherwise.

14-119.2 Release of Subcontractor Data to Higher-tier Contractors

FAR 15.407-1(f) governs the release of information necessary to support a reduction in prime contract or higher-tier subcontract prices. FAR provides for contracting officer release of information, on request, to prime contractors or higher-tier subcontractors as necessary to secure a prime contract price reduction. However, if the information includes trade secrets or confidential business information, the contracting officer must protect it from improper disclosure. To assist the contracting officer, the auditor will determine if the subcontractor objects to the release of the information in the audit report to the higher-tier contractor. Present contractor objections in the audit report in accordance with 10-604.2b(2). Follow the procedures in 6-801.2 in resolving any objections to unrestricted release of information to the higher-tier contractor.

14-119.3 Subcontract Defective Pricing - Significant Dates

Depending on the circumstances, two different dates may be relevant when determining subcontract defective pricing. These dates are:

(1) the date of negotiation between the Government and the prime contractor and

(2) the date of negotiation between the prime contractor and subcontractor. Three factors determine whether one or both dates should apply:

(a) timing of the subcontract award (whether awarded before or after the prime contract),

(b) type of prime contract, and

(c) type of subcontract.

a. When a subcontract is awarded before the prime contract, subcontractor cost or pricing data must be accurate, complete, and current as of the date of final agreement on subcontract price. As a practical matter, later data would have no impact on final subcontract negotiations. Nevertheless, the prime contractor must still furnish the Government with data it becomes aware of which may have an impact on final subcontract cost to the prime contractor, e.g., a subsequent decrease in a flexibly priced subcontractor's labor rates. Such information is cost or pricing data bearing on the negotiation of the prime contract, and the failure to provide the data may lead to defective pricing.

b. If the subcontract is awarded after a firm-fixed-price prime contract, all prime and subcontractor cost or pricing data ex-

isting as of the date of the price agreement between the prime and the Government must be accurate, complete, and current. Defective subcontractor data occurring after the prime and Government price agreement cannot affect the prime contract negotiated price, since there is no right of recovery by the Government. Therefore, in this case, only the date of prime contract final price agreement is relevant for subcontractor defective pricing.

c. If a subcontract is awarded after a flexibly priced prime contract, defective subcontractor data occurring between the prime and subcontract price agreement date will affect the prime contract final price (FPI) or total cost (CPFF/CPAF/CPIF) paid by the Government. Accordingly, both dates (prime/Government and prime/subcontractor) are relevant to determine defective pricing of the subcontract. In this situation, defective pricing could occur at (1) the prime level if the prime did not provide the Government with accurate, complete, and current cost or pricing data as of prime and Government price agreement (or, if applicable, another date agreed upon between the parties that is close as practicable to the date of agreement on price,) and/or (2) the subcontractor level if the subcontractor did not provide the prime with accurate, complete, and current cost or pricing data as of prime and subcontractor price agreement.

14-119.4 Handling Subcontract Price Adjustments

Subcontract cost or pricing data may be defective regarding either the prospective subcontractor, the actual subcontractor, or both.

a. When the prospective and actual subcontractor are the same, and the subcontractor's proposal as a prospective subcontractor is defective, the recommended reduction in the prime contract price is the recommended subcontract price adjustment plus the prime contractor's additives. When a prospective subcontractor's data is defective, and the actual subcontractor for the item was an organization other than the prospective subcontractor, this limits the recommended reduction in the prime contract price to the difference between the prospective subcontractor's cost estimate and the actual subcontract price, plus the prime contractor's additives (FAR 15.407-1(f)(1)).

b. Defective pricing adjustments for subcontracts under flexibly priced prime contracts require different treatment and reporting, depending on the timing of the subcontract award.

(1) Defects in subcontract cost or pricing data negotiated with the subcontractor prior to the date of prime contract price agreement or defects in unnegotiated subcontractor cost or pricing data existing at the date of prime contract price agreement affect the prime contract price. Subcontract defects in these situations, whether caused by the subcontractor or the prime contractor, require recommended prime contract price adjustment that include the application of negotiated profit. The following guidance in (2) below regarding billed costs on subcontracts defectively priced after prime contract price agreement also applies to defects in subcontracts negotiated or existing prior to the date of prime contract price agreement.

(2) Defects found in subcontracts negotiated after the prime contract price agreement, but which did not exist as of the date of prime contract price agreement, do not affect the prime contract price agreement. Subcontractor defects in these circumstances require disallowance (for cost-type contracts) or nonrecognition (for final pricing of redeterminable and incentive-type contracts) of costs on the prime contract that will include prime contractor loadings at the rates actually applied by the prime contractor to the incurred costs. No adjustment is required to the profit on the prime contract.

(a) Payments to subcontractors under flexibly priced prime contracts that are higher than they would be had there been no defective subcontractor cost or pricing data shall be the basis for disallowance or nonrecognition of costs. Under flexibly priced prime contracts the Government has a continuing interest in such overpayments to subcontractors that is unaffected by the initial agreement on prime contract price. Accordingly, the disallowance or nonrecognition of costs will be accomplished under the contract clauses

prescribed in FAR 15.408 (also see FAR 15.407-1(f)).

(b) Until the contract closing or final pricing is completed, the disallowance or nonrecognition of costs should be effected through reductions in the prime contractor's billings. If the prime contractor has reduced its own billings for the subcontractor defects, determine if the reduction is comparable to the audit findings.

(3) Separately present findings in the prime audit report "Results of Audit" section and exhibits for (a) recommended price adjustments and (b) recommended disallowance or nonrecognition of incurred costs.

c. A firm-fixed-price contractor may obtain a refund for a defectively priced subcontract even if the subcontract cost or pricing data was not defective at the time the prime was negotiated. In this situation, the Government has no contractual right to a price adjustment. However, we should review the facts to determine if an audit report recommendation for voluntary refund is appropriate (see 4-802).

14-120 Other Audit Considerations

14-120.1 Materiality of the Defective Pricing Findings

a. The TINA and regulations do not define what is a "significant amount" by which a contract price was increased because the contractor furnished defective cost or pricing data. The Courts and the BCA have made differing decisions regarding what is a significant amount.

b. The Government expends a substantial amount of resources finding, pursuing, and settling claims of defective pricing. Accordingly, materiality should be one of the underlying factors when doing postaward audits. In determining the significance of defective pricing, consider the magnitude of the defective data including all applicable burdens (see 10-103.3j(2) and 14-116.4).

c. Any issue involving significance of a defective pricing recommendation should be resolved using the following working guideline.

Potential price adjustments of 5 percent of contract value or $50,000 whichever is less should normally be considered immaterial. When applying this standard consideration must be given to contract type. For example, on a CPFF contract with a 10 percent fee a $500,000 price adjustment is required to effect a $50,000 recovery. These materiality criteria do not apply in the following circumstances:

(1) when a contractor’s deficient estimating practices have resulted in recurring defective pricing; or

(2) the potential price adjustment is due to a systemic deficiency which affects all contracts priced during the period.

14-120.2 Defective Pricing from CAS Noncompliances

a. Generally, a CAS noncompliance found in a postaward audit does result in the certification of inaccurate cost or pricing data. However, the auditor will report CAS noncompliances revealed in postaward audits to the cognizant Federal agency official (CFAO) with the authority to make determinations of noncompliance. Regulations require that the CFAO, not the PCO, perform CAS administration for all contracts. Further, regulations require the DCAA auditor to make CAS-related recommendations to the CFAO. Therefore, do not include a price adjustment for the amount of the noncompliance in the postaward audit report, but do briefly explain in the notes to the exhibit:

(1) the noncompliance,

(2) its effect on the pricing action, and

(3) its status.

b. Issuing a CAS noncompliance report permits the CFAO to adjust all affected contracts that are both CAS noncompliant and defectively priced. Whether the violation causes a defect on multiple pricing actions or just one, the responsibility for adjustment belongs to the CFAO. Also, systemic noncompliance issues, while significant in the aggregate, may not be significant on individual pricing actions. The CFAO has a greater chance to obtain consistent recovery on all affected pricing actions through CAS than the individual PCOs do under defective pricing.

c. For subcontracts, regulations require that the CFAO of the subcontractor shall make the noncompliance determination and

advise the CFAO of the prime or next higher-tier subcontractor of such decision. The subcontractor CFAO's determination will not be reversed by the CFAO at the prime or next higher-tier subcontractor. Accordingly, the Government should receive adjustment for the subcontract noncompliance and for the prime contractor's markups applied to the subcontract.

d. If the CFAO determines the finding is not a CAS noncompliance, do not report the finding later to the PCO as defective pricing. Once the CFAO has made such a determination, the finding would be difficult to support as defective pricing.

14-120.3 Systemic Defective Pricing Issues (Non-CAS)

a. Non-CAS-related defects attributable to breakdowns in the contractor's systems may affect multiple pricing actions. The defects may be relatively small on each individual action, but significant in the aggregate. The defects may also affect many contracting officers from the various services. The best way for the Government to achieve consistent and maximum recovery of systemic defects is for one designated official to settle the issue on all affected contracts.

b. To promote consistent and maximum recovery for systemic issues the auditor must do the following:

(1) identify systemic defects, affected pricing actions, and applicable contracting officers;

(2) notify the affected contracting officers, explain the systemic defects, and suggest they designate or establish one individual to negotiate with the contractor;

(3) separate systemic findings from other specific defective pricing allegations found in the audits of the individual pricing actions;

(4) report the systemic findings in a single report that identifies all affected pricing actions and contracting officers; and

(5) address the report to each affected contracting officer. If a focal point has been designated to resolve the systemic issue, address the report to that individual with copies furnished to each affected contracting officer.

c. Set up the assignment for the systemic defect as an audit lead and include a description of the systemic defect.

14-120.4 Defective Pricing "Sweeps"

a. A defective pricing sweep is a process whereby a contractor reviews its records to determine if more current cost or pricing data exist and need to be disclosed to the Government. The sweep usually occurs after price agreement and the contractor submits this additional data to the Government with its executed Certificate of Current Cost or Pricing Data. The additional data reflect cost or pricing data that were reasonably available at the time of price agreement but not submitted or disclosed before price agreement. As a result of FASA, FAR now allows a date other than the date of price agreement on price for certification (see 14-104.3). This and the encouragement to the contracting officer to use cutoff dates, where practicable, should reduce the need for sweeps.

b. Sweep data appear defective in that the cost or pricing data were not submitted or disclosed to the Government before the price agreement. However, if the Government receives cost or pricing data with the certificate before the contract award, the contracting officer has the opportunity to adjust the contract price for such data. In addition, procurement policy issued by the DoD in June 1989 (see 14-111c) requires contracting officers to reflect such data in the PNM and the extent to which they relied on it in establishing the contract price.

c. In situations involving sweeps, contact the contracting officer to fully understand the type of data included with the Certificate, what the contracting officer did with the data, and the effect the data had on the negotiated contract price. The auditor should not recommend a price adjustment simply because the data were provided with the certificate after price agreement because this is not defective pricing.

d. The auditor must assess whether a contractor's sweep practices reflect deficiencies in estimating systems or procedures. For example, a contractor continually delays submitting cost or pricing data

until after price agreement or the cost or pricing data were available to the contractor for some time before price agreement (aging of the availability of cost or pricing data). In those cases, the auditor must take appropriate steps to report the deficiencies or irregularities.

14-120.5 Statistical Sampling Techniques in Postaward Audits

a. Agency policy supports the use of statistical sampling and professional standards recognize audit sampling as a proper audit practice to provide evidential matter. While statistical sampling provides evidential matter, can it be used to support a projection of a recommended price adjustment for defective pricing? Neither the Courts nor the BCA has ruled on the propriety of sampling evidence to support recommended price adjustments.

b. The Government has the burden of proving its case by the preponderance of the evidence. Absolute certainty is not required. The evidence need only show that the validity of the claim is more probable than not. The statistical sampling techniques which are applied within DCAA provide admissible evidence of the amount of the impact of defective data. The issue for the judge is to determine whether the sampling evidence will satisfy the standard of proof for the whole amount claimed. Therefore, the Government will be successful in litigation only if judges are persuaded that sampling has sufficient weight to comply with the "preponderance of evidence" test. The test does not require absolute certainty; it does require a weighting of the evidence and a determination of the probability of accuracy. In evaluating whether statistical sampling is a proper audit practice for determining the amount of overpricing, the Courts or the BCA will have to examine this audit technique in the context of professional standards, professional custom, and audit necessity. The weight which a judge will give to sampling evidence will depend upon the facts of the case.

c. The auditor can use sampling techniques for postaward audits to establish that defective pricing exists. However, projecting sample results for the recommended price adjustment requires satisfying the "preponderance of evidence" test. The auditor must properly develop and document the sample plan, assess the reasons for defects found, evaluate the sample, and expand the sample as necessary to reach the desired confidence level and precision. Successfully projecting sample results for defective pricing requires high confidence levels and low precision. To achieve such results, the sample may have to be expanded even more than once after evaluation.

d. Address offsets in accordance with 14-118.

(1) Offsets the auditor finds during the audit of contracts awarded before February 15, 1987 are considered as part of the normal course of audit sampling.

(2) Offsets the auditor finds during the audit of contracts awarded on or after February 15, 1987 must be certified prior to considering them in the sampling process. The auditor will make a reasonable attempt to obtain certification of possible offsets prior to evaluating and projecting sample results (see 14-118 b.).

(3) If the contractor will not certify to offsets identified during our audit of sampled items, take the following steps:

(a) Evaluate the sample, excluding the effect of any offsets the auditor discovers, to assess the confidence level and precision and expand the sample as necessary to achieve the desired confidence level and precision. If certification of offsets is likely, the auditor should also evaluate the sample including the offsets, and notify the PCO of the effect of the offsets on the sample.

(b) Project the amount excluding any uncertified offsets from the sample findings. Use this projection for the amount of the recommended price adjustment to be presented in the audit report.

(c) Use the guidance in 14-118b. to report potential offsets that the contractor would not certify.

14-120.6 Obtaining Third Party Confirmations

Obtain third party confirmations as appropriate when performing postaward audits. Confirmation of initial contract dates and

price quotes to prime or higher-tier subcontractors is a valid audit step in conducting defective pricing audits. For instance, confirming purchase orders issued within six months after certification at a price significantly lower than that certified to may disclose existence of defective pricing. Vendor confirmations will also help determine if the prime or higher-tier subcontractors were aware of reduced prices before certification. Normally, use positive (rather than negative) confirmations. Begin with informal vendor contact and follow up with a formal confirmation letter.

14-120.7 Other Administrative Audit Considerations

a. Significant defective pricing findings, direct or indirect, may affect other contracts of the contractor. The FAO will coordinate the selection of contracts for audit in addition to the current FAO program plan with the regional office if it is likely to involve a major increase in the programmed workload level for postaward audits.

b. Do not issue a DCAA Form 1 instead of an audit report for apparent defective pricing findings on a cost-type contract.

c. During a postaward audit, request any necessary technical advice and assistance from the ACO or PCO as appropriate.

d. Determine whether defective pricing findings suggest estimating system deficiencies. Unless the defective pricing was caused by a breakdown in internal controls, the problem usually relates to an estimating system deficiency. Promptly report those deficiencies using the flash reporting procedures outlined in 9-310.

14-121 Findings and Conditions Requiring Further Pursuit as Potential Cases of Fraud (Postaward Audits)

During postaward audits of cost or pricing data, be constantly alert to identify any condition which might suggest wrongdoing against the Government. Section 14-121.2 provides examples found during defective pricing audits. When finding any of these or similar conditions, refer them to the responsible investigative organization following the procedures in 4-702.

14-121.1 Statutory Provisions

a. Defective pricing may result in criminal acts under two statutory sections: 18 U.S.C. 1001 False Statements and 18 U.S.C. 287 False Claims. It may also be subject to civil penalties under 31 U.S.C. 3729, the civil False Claims Act.A false statement results when a contractor willfully makes a statement knowing that it contains false information. Certification by use of the Certificate of Current Cost or Pricing Data is an example of a statement subject to 18 U.S.C. 1001. No filing of a claim is required.

b. A violation of 18 U.S.C. 287 occurs when a contractor willfully submits a claim for money or property knowing that the claim is false, fictitious, or fraudulent. Thus, submitting an invoice on a contract that is defectively priced can be a violation.

c. A violation of the civil False Claims Act, 31 U.S.C. 3729-3733, occurs when a contractor or subcontractor knowingly presents, or causes to be presented to the Government, a false or fraudulent claim for payment or approval. “Knowingly” is defined in the statute as either:

(1) has actual knowledge,

(2) acts in deliberate ignorance of the truth or falsity of the information, or

(3) acts in reckless disregard of the truth or falsity of the information.

Unlike the criminal statutes, the civil statute provides that “...no proof of specific intent to defraud is required.” Civil penalties include damages of 2 to 3 times the amount of damages sustained by the Government, plus $5,000 to $10,000 for each voucher submitted based on the defective pricing.

14-121.2 Examples of Conditions Warranting Consideration of a Fraud Referral

The following are examples of conditions found during defective pricing audits which warrant additional evaluation to

determine if there is a reasonable basis for suspecting fraud.

a. High incidence of persistent defective pricing.

b. Repeated defective pricing involving similar patterns or conditions.

c. Continued failure to correct known system deficiencies.

d. Consistent failure to update cost or pricing data with knowledge that past activity showed that prices have decreased.

e. Undisclosed specific knowledge regarding significant cost issues that will reduce proposal cost. Two examples are a revision in the price of a major subcontract and settlement of union negotiations resulting in lower increases in labor rates.

f. Denial by responsible contractor employees of the existence of historical records that are later found.

g. Repeated use of unqualified personnel to develop cost or pricing data used in the estimating process.

h. Indications of falsification or alteration of supporting data.

i. Distortion of the overhead accounts or base information by transferring charges or accounts that have a material impact on Government contracts.

j. Continued failure to make complete disclosure to the Government of data known to responsible contractor personnel.

k. Continued prolonged delay in release of data to the Government to prevent possible price reductions.

l. Employing people known to have previously committed fraud against the Government.

14-122 Discussing Audit Findings

The auditor must coordinate and communicate with contracting officers and prime contract auditors on a regular basis to enable the Government to achieve timely and maximum resolution of defective pricing findings. The accomplishment of the DCAA defective pricing program (in terms of completing planned audits, supporting audit findings, and helping contracting officers achieve price reductions) requires a DCAA commitment to coordination and communication with Government personnel. Use the FLA to assist as necessary.

a. When apparent defective pricing is found, and the materiality threshold provided in 14-120.1 has been met, thoroughly discuss these findings with the contracting officer. Do this during the course of the audit to ensure mutual understanding of the facts (e.g., confirm reliance on and disclosure of cost or pricing data), resolve differences in method of computation, and present a unified position to the contractor. Significant factual issues should be confirmed with the PCO as early as possible to avoid wasted effort and incorrect conclusions. In addition, request the contracting officer to confirm in writing that the apparent defective data was not disclosed to either the contracting officer or his/her representative, that neither the contracting officer nor his/her representative had actual knowledge of the data, and that the contracting officer relied on the inaccurate data. A copy of a pro forma memorandum to the contracting officer which should be tailored to each specific circumstance is available on DCAA's Intranet and APPS as Format for Informing the CO of Preliminary Postaward Audit Findings and Requesting CO Reaction. At the conclusion of the audit, auditors should provide the PCO (and the ACO if the finding is related to indirect rates) with the draft report exhibit(s) and explanatory notes on the audit position, along with copies of disputed documents and other significant audit evidence, to obtain his or her comments on the factual matters involved. Coordination does not require that the auditor provide a complete draft report to the PCO or obtain PCO approval before report issuance. A copy of a pro forma memorandum to the Contracting Officer which should be tailored to each specific circumstance is available on DCAA's Intranet and APPS as Format for Providing the CO with the Draft Report Exhibits and Explanatory Notes. The auditor will also provide a copy of any draft report information provided to the PCO to the onsite FLA (refer to 15-3S1). On subcontracts, the subcontract auditor should have the prime auditor contact the PCO to determine whether the PCO wants to review the draft subcontract findings. If the PCO wants to review the draft subcontract findings, the subcontract auditor will forward the draft findings to the PCO. If the

PCO doesn't want to review the draft subcontract findings, the subcontract auditor will prepare the report and forward it to the prime auditor.

b. Discuss pertinent factual matters with the contractor throughout and at the conclusion of the audit as suggested by 4-303.1 and 4-304.3. Draft copies of the report exhibits and explanatory notes, along with copies of disputed documents and other significant audit evidence should be provided to the contractor. However, do not give the contractor any Government documents, including Price Negotiation Memorandums (PNMs) or portions of PNMs, without permission from the cognizant PCO. Refer to and comply with 4-702.4 if there is suspected fraud or unlawful activity. Generally, the contractor's responses to audit findings and the auditor's comments on those responses should be included in the audit report in order to minimize delays in resolution. The auditor should obtain the contractor's responses to audit findings as they are developed or presented at the exit conference and carefully consider the responses when calculating the final recommended price adjustment. If the contractor refuses to provide a response to the audit findings, the auditor should request the assistance of the PCO. Normally, no more than 30 days (after the exit conference) should be allowed for receipt of contractor comments.

c. If the PCO provides information which does not appear in the PNM or clarifies the PNM content regarding the cost or pricing data relied on, written confirmation should be obtained for purposes of working paper documentation. Copies of data and written confirmation should also be obtained when PCOs confirm receipt of cost or pricing data not otherwise documented in the PNM or the contractor's Certificate of Current Cost or Pricing Data. If PCOs are unwilling to provide written confirmation, the FAO should confirm its understanding of the PCO's orally provided information in writing, noting that the information will be relied on in the final audit position unless notified to the contrary in 10 days. The assistance of the FLA may also be sought if the circumstances (such as materiality, uncertainty of PCO data, and complexity) warrant it.

14-123 Reporting Results of Audit (Postaward)

a. An audit report is required for all (positive and negative) postaward audits. Prepare and distribute postaward audit reports using the guidance in 10-600. See 14-118 for a discussion of the proper treatment of offsets.

b. Each audit report with a recommended price adjustment must specifically list the five points for establishing defective pricing in the notes to the report exhibit and discuss how each point has been met (14-102b and APPOST). Highlights to be addressed in discussing the points are outlined in 10-606.5c.

c. Furnish copies to the responsible Plant Representative/ACO. Distribute additional copies as shown in 10-6S1. The working papers file will contain a summary describing audit work performed, the basis for the audit conclusion, and the rationale for any reduction in the audit scope. (For example, if reporting negative findings after auditing only a bill of materials, the summary would explain why the auditor did not audit other cost elements.) The summary will also reflect supervisory review and endorsement of the audit conclusion.

14-124 Charging Interest When Defective Pricing is Found

a. Section 952 of the 1987 Defense Authorization Act amended 10 U.S.C. 2306a to allow the Government to recover interest on overpayments to contractors resulting from defective cost or pricing data on DoD contracts or modifications dated after November 7, 1985. Interest is not applicable when there is no overpayment, for example when costs are disallowed or not recognized under cost-type or flexibly priced prime contracts (see 14-119.4). In addition, these contracts are subject to a penalty payment equal to the overpayment if prior to price agreement the contractor knew the data was defective. FAR extended the interest provision to all Government agencies for contracts or modifications entered into on or after January 22, 1991. FAR extended the penalty provision to all Government agencies for

contracts or modifications entered into on or after December 5, 1994 (FAR 15.407-1(b)(7). Reimbursements by the contractor for defective pricing must include interest computed from the date of overpayment to the date of repayment. Interest rates are the same as the taxpayer underpayment rates which are prescribed by the Secretary of the Treasury under Section 6621 of the 1986 Internal Revenue Code (see 14-125 below). A defective pricing interest calculation spreadsheet, available on DCAA's Intranet, may be found under Support/Feedback Mechanisms/File libraries/DCAA Software/Applications.

b. Overpayments occur only from payments made for supplies and services accepted by the Government, or in the case of subcontracts, accepted by the prime contractor (see paragraph c.(1) below). They do not result from "contract financing payments" as defined at FAR 32.001. Basically, contract financing payments include advance payments, interim payments on cost-type contracts, and progress payments other than those made on fixed-price, architect-engineering contracts.

c. To assist the contracting officer in carrying out the responsibility for collecting interest on overpayments resulting from defective pricing, applicable reports (see a. above) at the prime level will include the statement given at 10-606.5e as part of the "Results of Audit" portion of the report. Subcontract audit reports will include the statement given at 10-606.5f . If it is determined that interest is applicable (see a. above), the auditor should contact the contracting officer to determine if the contracting officer wants the details of the interest calculations included in the audit report. If so, an exhibit similar to Figure 14-1-1 will be added to the report. The exhibit should be prepared using the Excel spreadsheet available on the DCAA Intranet at File Libraries, DCAA/Technical Audit Services (OTS) Software/Applications under file name dpinter.zip. In any case, offer to provide assistance to the contracting officer in calculating interest during negotiation of the price adjustment when a more accurate calculation can be done. In developing the information for the exhibit, use the following method for both prime and subcontract defective pricing findings.

(1) Information developed for the exhibit will be based on the premise that interest on defective pricing begins to accrue whenever some part of delivery payment to a contractor under an FFP/FPI contract includes the defective-related amount (price). For cost type contracts, interest will be computed on any fee payments, made to the contractor, if the fee was overstated based on defective cost or pricing data. A public voucher payment of costs to a prime which includes prices or fees paid on a defectively priced subcontract is the triggering event for subcontract interest computation. Likewise, a progress payment of costs to a prime which includes payments for deliveries on a defectively priced subcontract is the triggering event for subcontract interest computation.

(2) Once the Excel spreadsheet, dpinter.xls, is downloaded from the DCAA Intranet, the auditor need only input data on the Summary worksheet. The auditor is required to input the contract price, recommended price adjustment, expected repayment date, and dates and amounts of each delivery payment. The model will automatically calculate the interest base (the defective portion of each delivery payment) and interest due. The spreadsheet also provides the details of the interest calculation associated with each delivery payment on a separate worksheet. The spreadsheet will compute interest for up to 15 delivery payments. If there are more than 15 delivery payments, the auditor should make additional copies of the spreadsheet, input the additional payments, and add the calculated interest together from all the summary spreadsheets to determine the total interest. If there is an unusually large number of payments, it is recommended that the payments be combined by month, quarter, or year, as appropriate. If the payments are combined, the auditor should establish a midpoint payment date, which is the date when 50 percent of the total value of the items delivered in each period is reached. The midpoint date and the total amount paid in each period are then input into the spreadsheet. Additional detailed instruc-

tions are included in the spreadsheet in the worksheet titled, "About This File."

14-125 Interest Rates – Defective Pricing

The Treasury rates in effect since July 1, 1985 are as follows:

1985	July-December	11
1986	January-June	10
	July-December	9
1987	January-March	9
	April-June	9
	July-September	9
	October-December	10
1988	January-March	11
	April-June	10
	July-September	10
	October-December	11
1989	January-March	11
	April-June	12
	July-September	12
	October-December	11
1990	January-March	11
	April-June	11
	July-September	11
	October-December	11
1991	January-March	11
	April-June	10
	July-September	10
	October-December	10
1992	January-March	9
	April-June	8
	July-September	8
	October-December	7
1993	January-March	7
	April-June	7
	July-September	7
	October-December	7
1994	January-March	7
	April-June	7
	July-September	8
	October-December	9
1995	January-March	9
	April-June	10
	July-September	9
	October-December	9
1996	January-March	9
	April-June	8
	July-September	9
	October-December	9
1997	January-March	9
	April-June	9
	July-September	9
	October-December	9
1998	January-March	9
	April-June	8
	July-September	8
	October-December	8
1999	January-March	7
	April-June	8
	July-September	8
	October-December	8
2000	January-March	8
	April-June	9
	July-September	9
	October-December	9
2001	January-March	9
	April-June	8
	July-September	7
	October-December	7
2002	January-March	6
	April-June	6
	July-September	6
	October-December	6
2003	January-March	5
	April-June	5
	July-September	5
	October-December	4
2004	January-March	4
	April-June	5

14-126 Resolution of Audit Findings

a. The auditor must continue to coordinate and communicate with the contracting officer after postaward audit re-

ports are issued in order to enable the Government to achieve a timely and favorable resolution either by negotiation or litigation of the defective pricing findings. During periodic discussions with the contracting officer, the auditor should always determine the status of open defective pricing issues. In addition, the auditor should continuously offer assistance such as commenting on data received by the contracting officer after the audit report was issued and offering to attend negotiation conferences. When assistance is requested by the contracting officer, it should be treated as a demand (nondiscretionary) assignment.

b. If the receipt of additional information or audit effort results in a revised audit position, issue a supplemental audit report (see 10-214) However, if the additional information or audit effort does not result in a change to the audit position, write a memorandum to the PCO describing the scope of additional audit effort and why there is no change in the audit position.

c. If the contracting officer informally advises the auditor of a disagreement with the audit position, every effort should be made to resolve the differences before a final determination is made. If the difference cannot be resolved, elevate the matter to management for resolution. In some cases it may also be necessary to obtain legal advice.

Figure 14-1-1 (Ref. 14-124)
Example of an Exhibit Used to Determine the Base and Simple Interest Computation on a Firm-Fixed-Price Contract Action Required Under Section 952 of the FY 1987 Authorization Act and FAR 15.407-1(b)(7)

Payment	Payment Date	Total Value of Items Delivered	Pro-Rata Base Allocation Factor	Allocated Interest Base	Interest
	(Note 1)		(Note 2)	(Note 3)	
1	10/16/95	$ 500,000	5.0%	$ 25,000	$ 5,110
2	11/20/95	1,000,000	5.0%	50,000	9,789
3	12/22/95	900,000	5.0%	45,000	8,455
4	1/23/96	700,000	5.0%	35,000	6,300
5	2/13/96	1,400,000	5.0%	70,000	12,238
6	3/8/96	500,000	5.0%	25,000	4,224
Total		$5,000,000		$250,000	$46,116
		(Note 4)			(Note 5)

Explanatory Notes:

1. Payment Date

This date represents the actual date of payment to the contractor. (Note: If payments have been combined, the note should state that this is the period midpoint date which represents the date on which 50 percent of the total value of items delivered in each period is reached.)

2. Pro-Rata Base Allocation Factor

Computation of the Pro-Rata Base Allocation Factor is as follows:

Total Contract Price	(A)	$5,000,000
Recommended Price Adjustment	(B)	$250,000
Pro-Rata Base Allocation Factor	(B/A)	5%

3. Allocated Interest Base

Simple interest shall be applied to the allocated interest base for each payment date at the applicable rates prescribed by the Secretary of the Treasury under Section 6621 of the Internal Revenue Code of 1986. Treasury rates are issued quarterly, and for convenience of computation, the quarterly interest periods may be combined if the interest rate does not change.

4. Total Value of Items Delivered

Total dollar amount will differ from contract price if performance has not been completed. (Note: for cost-type actions, the value of this column will relate to the total amount of defective fee and/or the amount of the subcontract defect.)

5. Simple Interest Calculation

The repayment date in this example is February 1, 1998; simple interest on each payment is computed up to (but not including) the repayment date. However, if the contractor and contracting officer have not agreed on a repayment date, the contracting officer may also request that the auditor recompute the interest once a repayment date has been established.

14-200 Section 2 --- Audit of Progress Payments

14-201 Introduction

a. Interim contract financing is available on certain fixed price contracts during the predelivery period as a percentage of allowable costs adjusted as discussed in this section. Financing is interest-free, but the amount is subject to limitations specified in the contract.

b. Interim financing helps stabilize the contractor's cash flow and reduces the need for outside financing. The reduced financial burden increases the number of qualified bidders and can result in a better price to the Government.

c. The risk to the Government of interim financing is the time value of money if the contractor is provided premature payments or is overpaid. The Government is also at risk if the contractor does not deliver or delivers goods and services that do not meet contractual specifications. The DCAA/CAO evaluation process must monitor and limit these risks.

d. This section provides guidance for performing audits of contractor progress payment requests based on cost. The DCAA Intranet and the APPS include a standard audit program for performing these audits (entitled APPAYCOS). Since progress payment requests based on percentage of completion are infrequently encountered, they are not addressed in this section. However, the DCAA Intranet and the APPS include APPAYPCT, a standard audit program for auditing these requests.

14-202 FAR/DFARS Provisions

14-202.1 Customary or Unusual

a. Progress payments are considered customary (see FAR 32.5/DFARS 232.5) when the contract includes the progress payment clause (FAR 52.232-16) establishing the uniform rate for calculating progress payments.

b. Effective February 23, 1999, the Director Defense Procurement issued a final rule amending the DFARS to remove references to the flexible progress payment method of contract financing. However, for those progress payment requests using flexible rates, our audit should include procedures to evaluate the flexible rates. (See 9-1400.)

c. Any other progress payments are considered unusual, and may be used only in exceptional cases when authorized in accordance with FAR 32.501-2/DFARS 232.501-2.

d. The uniform rates for customary progress payments for foreign military sales, small businesses, or small disadvantaged businesses are shown in DFARS 232.501-1. The rates for large business are based on the contract award date and are listed below.

Contract Award Date	Uniform Rate
Prior to May 1, 1985	90%
May 1, 1985 through October 17, 1986	80%
October 19, 1986 through September 30, 1988	75%
October 1, 1988 through June 30, 1991	80%
July 1, 1991 through November 10, 1993	85%
On or after November 11, 1993	75%
On or after October 1, 2001	80%

e. The contractor can request progress payments as work progresses, but not more frequently than monthly. The amount of each progress payment is computed by (i) applying the rate stipulated in the progress payment clause of the contract (DFARS 252.232-7004) to the cumulative total allowable costs under the contract as shown in the contractor's books and records (see 14-202.4); (ii) plus financing payments to subcontractors or other divisions of the contractor's corporate office (see 14-205h); (iii) less the sum of all previous progress payments. The contracting officer is responsible for approving progress payment requests.

f. The contractor is responsible for maintaining reliable accounting and billing systems with adequate internal controls for the proper administration of progress pay-

ments. If the systems or controls are deemed inadequate, the auditor should recommend that the contracting officer suspend progress payments (or suspend the portion of progress payments associated with the unacceptable portion of the contractor's systems) until the necessary corrections have been made.

g. As contract items are delivered and accepted, progress payment amounts are recovered (liquidated) by reducing payments to the contractor for completed contract items. The liquidated amount is computed by applying the liquidation rate in the progress payment clause to the contract price of items delivered and accepted (FAR 32.503-8 and 32.503-9).

(1) At the beginning of a contract, the liquidation rate is generally the same as the progress payment rate.

(2) As the contract progresses, the contracting officer may adjust the liquidation rate (FAR 32.503-9) to permit the contractor to retain the earned profit element of the contract price for completed items in the liquidation process.

14-202.2 Approval of Progress Payment Requests

The ACO will normally approve progress payment requests as a matter of course, if recent audit experience (within the last 12 months) shows that the contractor is:

(1) reliable, competent, and capable of satisfactory performance;

(2) possesses adequate accounting and billing system controls; and

(3) in sound financial condition.

As long as these favorable conditions exist, the ACO will sample progress payment requests for audit. If the contractor has poor or inadequate accounting and billing system controls, or there is reason to believe that the contract will involve a loss, the ACO may ask for more frequent audits of the contractor's progress payment requests (FAR 32.503-4). Acknowledge these requests in accordance with 4-103.

14-202.3 Contract Price and Rate Limitations

a. Contract price is a significant factor for determining the limitations on progress payments (FAR 32.501-3). The contract price for progress payment purposes is as follows:

(1) Firm fixed price contracts --- the current contract price including any unpriced modifications with obligated funds.

(2) Redeterminable or Economic Price Adjustment contracts --- the initial contract price until modified.

(3) Fixed Price Incentive --- target price plus unpriced modifications with obligated funds. However, in certain circumstances, the ACO may provisionally increase the price to the ceiling or maximum price.

b. Contract price is limited to the funds obligated under the contract, as amended. For progress payments, the contract price should exclude any part of the contract where costs are being reimbursed by other means (e.g., cost reimbursable line items).

c. Multiple Order Contracts. Generally, progress payments made under multiple order contracts should be administered under each individual order as if the order constituted a separate contract. However, if the contractor requests it and the contracting officer approves, the administration of progress payments may be based on the overall contract or agreement. Under this method, the contractor shall include a supporting schedule to identify the costs applicable to each order [FAR 32.503-5(c)].

d. Unpriced Contract Actions. The contracting officer may include unpriced contract actions as part of the contract price for purposes of computing progress payments (FAR 32.501-3). The amount for unpriced contract actions must not exceed the funds obligated for the unpriced contract action or the estimated or target prices.

e. Undefinitized Contract Actions. Effective August 24, 1987, the progress payment rate applicable to the work accomplished on undefinitized contract actions is limited to 80 percent. A higher rate is not authorized under unusual or flexible progress payments for undefinitized actions [see FAR 32.501-1(d)].

(1) Additional Limits. In an effort to encourage definitization of contract actions and to protect the Government's interests,

DFARS 217.7400 limits DoD expenditures on undefinitized contract actions to 50 percent of the not-to-exceed price without a qualifying proposal and 75 percent of the not-to-exceed price without a definitized contract. This limitation will be applied prior to the 80 percent limitation covered by FAR 32.501-1(d), or any other limitation of payment that may be imposed by the contract.

(2) Exceptions. For DoD contracts, DFARS 217.7402 exempts undefinitized actions from these limits if they represent purchases at or below the simplified acquisition threshold, or purchases involving special access programs, foreign military sales, or congressionally mandated long-lead procurement contracts. DFARS 217.7404-5 exempts purchases of initial spares.

(3) Price Ceiling Clause. This clause (DFARS 252.217-7027) establishes a not to exceed ceiling amount which the undefinitized contract action (UCA) cannot exceed upon definitization.

(4) Limitation of Government Liability Clause. This clause (FAR 52.216-24) establishes a ceiling over which the contractor is not authorized to expend or incur obligations. Generally the dollar value in this clause is a percentage of the price ceiling which was established in the Price Ceiling Clause. DFARS 216.603-4 requires this clause be included in all UCAs. Together the Limitation of Government Liability Clause and the Price Ceiling Clause establishes the dollar value of the limitation and limits the amount the contractor can bill on progress payments. If the clauses are in conflict with the DFARS, the contract provisions would take precedence, but the contracting officer should be notified. If a progress payment request includes both definitized and undefinitized work, the cost must be broken out separately. Computations of the limitation of payments must be made for each.

14-202.4 Costs to be included in Progress Payment Requests

The following costs may be included in progress payment requests, under the conditions noted:

a. Incurred Costs. Total costs incurred under the contract whether or not actually paid, plus financing payments to subcontractors.

b. Financing and Other Payments. The amount of financing and other payments for costs of supplies and services purchased by the contractor directly for the contract may be included only if the costs:

(1) are paid in accordance with the terms and conditions of the subcontract or invoice and

(2) ordinarily will be paid prior to submission of the contractor’s next payment request to the Government.

c. Direct Material. Title to materials, as defined in the progress payment clause, is vested in the Government when the material is properly chargeable to the contract. Accordingly, business concerns must have clear title before charging materials to the contract.

d. Accrued costs of contractor contributions under employee pension, profit sharing, stock ownership plans, and other post-retirement benefit (PRB) plans shall be excluded until actually paid, unless:

(1) the contractor's practice is to contribute to the plans quarterly or more frequently and

(2) the contribution does not remain unpaid 30 days after the end of the applicable quarter (any contributions remaining unpaid shall be excluded from the contractor's total costs for progress payments until paid).

e. Cost of money that would be allowable under FAR 31.205-10 shall be deemed an incurred cost for progress payment purposes.

f. Total costs for progress payment purposes shall not include any costs that are not reasonable, allocable, and allowable to the contract, or are inconsistent with generally accepted accounting principles.

14-203 Audit Responsibility - Progress Payments

a. The purpose of a progress payment audit is to:

(1) verify the amounts included on the progress payment form to the contractor's accounting books and records,

(2) evaluate the propriety of the progress payment request in accordance with the provisions of the contract, and

(3) determine whether undue financial risk to the Government will result if the request is granted.

b. Audits will usually be made upon the request of the contracting officer; however, auditors should coordinate with the contracting officer to initiate an audit whenever they have a valid reason to believe that one is necessary to protect the interest of the Government. Examples of conditions requiring coordination are:

(1) unsatisfactory financial conditions,

(2) weak or inadequate accounting and/or billing system controls,

(3) evidence of inadequate cost representations, or

(4) indications of contract losses (FAR 32.503-6(g)). To ensure adequate audit coverage, it is important to identify contractors and contracts, early in the audit planning process, where these conditions exist or where there is a high risk they will develop. The assessment of the contractor's accounting and billing system internal controls will determine areas of risk to be pursued during progress payment audits and the frequency of these audits. At major contractors this assessment is documented on the Internal Control Audit Planning Summary sheets. This assessment should be coordinated at least annually with the ACO.

14-204 Audit Scope - Progress Payments

a. The scope of a progress payment audit depends on our experience with the contractor's operations; the reliance that can be placed on the contractor's accounting and billing systems internal controls, cost representations, estimate to complete the contract, and financial condition; and whether current billing rates have been established.

b. At major contractors, accounting and billing system audits are performed on a cyclical basis and serve as the basis for determining the extent of testing needed on each individual progress payment request. The auditor should review the Internal Control Audit Planning Summary sheets for the accounting and billing systems to determine the risk associated with the systems and adjust the scope of audit accordingly. At nonmajor contractors, the preaward accounting system audit and the annual updates provide the basis for determining the scope of audit needed on each request. The auditor should review the internal control questionnaire and other related permanent file data to determine the scope of audit needed. As with any audit, the audit scope should also consider any specific concerns raised by the contracting officer.

c. In those cases where the auditor can rely on the contractor's systems and cost representations, and the contractor is in sound financial condition; then the risk would be considered low. The auditor may limit the audit to verification of billed amounts to amounts recorded on the contractor's accounting books and records, an evaluation of the contractor's compliance with contract provisions, and periodic verification of the contractor's estimated additional costs to complete. Often, an evaluation of the contractor's procedures for reconciling billing system data and records to the cost accounting records and a test of selected reconciliations will satisfy the verification objectives for claimed allowable costs.

d. In those cases where the contractor's accounting and billing system internal controls are inadequate (in total or in part) or the contractor’s financial condition is unstable, expanded testing of the progress payment request is often needed. However, our emphasis should be on the system rather than on each progress payment request. At those contractors with outstanding deficiencies, the auditor should work with the ACO and the contractor to correct the deficiencies rather than to perform expanded testing on each progress payment request. When the contractor corrects the deficiency or changes the accounting or billing systems, the auditor should give a high priority to the audit of the system change as a basis for placing reliance on the system. The next section (14-205) discusses special areas for consideration when planning an audit of a progress payment request.

14-205 Areas for Audit Consideration

During a progress payment audit, the auditor should, at a minimum, verify amounts on the contractor's certified SF 1443 to the contractor's accounting books and records. Often, an evaluation of the contractor's procedures for reconciling billing system data to the accounting records and a test of selected reconciliations will satisfy the verification objectives for claimed allowable costs. Based on assessed audit risk and prior audit experience, the auditor should consider other issues such as indications of financial distress (untimely payments to subcontractors and/or vendor demands for cash-on-delivery), ETC/EAC amounts, the loss ratio, fair value of undelivered work, and computation of liquidation amounts, as well as issues identified by the ACO or other team members. The following paragraphs address the key amounts on the SF 1443 and related considerations. A copy of the SF 1443 is available on the Acquisition Knowledge Sharing System (AKSS) web site within DCAA Document DCAAP 7641.90, Figure 5-4-1.

a. Name of Contractor (Item 1). When performing progress payment audits on contracts which require registration in the Central Contractor Registration (CCR) database (i.e., contracts that contain the clauses at FAR 52.232-33, DFARS 252.204-7004, or NASA FAR Supplement 1804.7402), auditors should verify that the contractor's CCR registration status is active/registered. If the contractor is required to register in the CCR but does not have an active registration, the auditor should note this in the audit report. To verify if a contractor is registered in CCR, the auditor should inquire through the CCR website as follows:

(1) Use Internet Explorer and navigate to the CCR website by entering the address www.ccr.gov.

(2) Once at the website, click "Search CCR" at the left portion of the screen. This will link to the search page.

(3) On the search page, input data to search for a contractor. You can use the DUNS Number, CAGE Code or Legal Business Name. You can also use a partial name to get a list of companies. Click on the Search button.

(4) A record (or list of records if you input a partial name) will appear. Click on the Info/Detail Tab to view the rest of the registration.

(5) The registration status and expiration date for the valid registration is listed at the top of the screen. The registration status will be identified as Registered/Active, Pending (registration is in the process of being validated), or Inactive (registration has been cancelled or expired).

b. Contract Price (Item 5) should be verified to the most current contract modification (14-202.3). This amount is important because it is used to establish the limitation of payments on future deliveries (Item 21.b) and to compute any applicable loss ratio. The auditor should determine if any part of the contract is being financed by other means (reimbursement on public vouchers or direct payment by the Government) and verify that these amounts are excluded. For example, award fees, incentive fees and value engineering change proposals (VECPs) are normally billed on separate invoices or public vouchers. These amounts should not be included in the contract price for progress payment purposes.

c. If the liquidation rate (Item 6.b) is less than the progress payment rate (Item 6.a), the auditor should coordinate with the ACO and determine the estimated profit used to establish the alternate liquidation rate. The auditor should verify that the current profit being realized on the contract (contract price less current EAC) is at least equal to or exceeds estimated profit used to establish the alternate liquidation rate. Otherwise, the contractor may retain excess profit on delivered and accepted contract items. The auditor in this case should recommend to the ACO that the alternate liquidation rate be changed to reflect the current profit estimate.

d. Paid Costs Eligible Under Progress Payment Clause (Item 9). Federal Acquisition Circular 97-16 dated 27 March 2000 revised the FAR regarding the eligibility of recorded purchased material and service cost which can be claimed for reimbursement on progress payment requests. All contractors, regardless of size are allowed to include in progress payment requests the purchased material and service costs which

have been incurred but not actually paid, provided the payment will be made in accordance with the terms and conditions of a subcontract or invoice and will ordinarily be paid prior to the submission of the contractor's next payment request to the Government. SF 1443 has not been revised to accommodate the revised rules regarding purchased material and service cost. Accordingly, large contractors should not complete this item and should follow the same instructions to complete SF 1443 as provided for small contractors. All contractors should complete item 10.

e. Incurred Cost Eligible Under Progress Payment Clause (Item 10). This item includes total incurred costs, less advance payments, down payments, deposits, or progress payments, performance-based payments and commercial financing payments made to subcontractors, suppliers, or others. The auditor should also verify that any subcontract costs included here are for items delivered and accepted, which resulted in the liquidation of subcontractor progress payments, performance–based payments and/or commercial financing payments at the date of the SF 1443. The auditor should verify that:

(1) All direct costs billed reconcile to the contractor's accounting books and records, as appropriate for the reliance that is placed on the contractor's systems and controls. The auditor should use the contractor's reconciliations to the extent possible to accomplish these verifications. Also, direct material costs should be evaluated to ensure that the Government has clear title in accordance with FAR 52.232-16.

(2) Indirect costs are based on approved billing rates or available forward pricing rates, or consider the need to audit the billing rates in conjunction with the progress payment audit.

(3) Obligations such as pension, profit sharing, and employee stock ownership plan contributions are paid within 30 days after the close of the quarter to which costs are assignable.

(4) Purchased material and service costs are paid in accordance with the terms and conditions of a subcontract or invoice and ordinarily paid prior to the submission of the contractor's next payment request to the Government.

f. Total Costs Incurred to Date (Item 12.a). This item includes all prime contractor incurred costs plus unliquidated subcontractor progress payments, performance-based payments and commercial financing payments (amounts paid and payable) listed on Items 14.c and 14.d. The auditor should verify any additional incurred costs on Item 12.a that were not identified on Item 10 to the contractor's accounting books and records.

g. Estimated Additional Cost to Complete (Item 12.b). Instructions on the SF 1443 require the contractor to make technical and financial estimates to complete (ETC) every six months. The auditor should verify contractor compliance with this requirement and determine that the ETC is supported with current, accurate, and complete information. If the ETC is understated, overpayment of progress payments can occur. An accurate ETC can help identify cost overrun areas which may be corrected and prevent possible default on the contract.

(1) Some contractors develop ETCs by preparing an estimate at completion (EAC) and subtracting the total costs incurred to date. EACs are best developed through rigorous methodologies such as those required under management control systems that comply with the Earned Value Management System (EVMS) guidelines specified in the Interim Defense Acquisition Guidebook (formerly DoD 5000.2-R), Part 11, Section B (see 11-200 and DCAAP 7641.47).

(a) The auditor should contact the Government contract administration office and program office officials to determine if they are aware of any cost or schedule problems that affect the EAC.

(b) The EAC should be reconciled with other required reports such as quarterly limitation on payments statements (11-100) and Cost Performance Reports (CPRs) or Cost/Schedule Status Reports (C/SSR) (see 11-203.4d(2)).

(c) Subcontractor costs included in the ETC should be limited to those amounts the prime contractor will be required to pay. This amount is the difference between the amounts that are, or are estimated to be, legal obligations to pay and the amounts already included in Item 12.a. However,

assist audits may be necessary to establish the validity of the ETC submitted by the subcontractor to the prime contractor (see 14-205i).

(d) The auditor should compare the ratio of the EAC to the contract price (indicated profit rate) with the ratio of the costs of items delivered to the contract price of those items (experienced profit rate). These ratios should be similar. The auditor should also compare the indicated profit rate with the negotiated profit rate to reveal any variance from initial estimates. Any significant variance should be coordinated with the ACO. See 14-205c.

(2) The contractor's ETC/EAC should be evaluated for reasonableness using the following methodology.

(a) When CPR or C/SSR data are available, the auditor can evaluate this data to identify forecasted or actual overruns and determine if this information is consistently reflected in the EAC. Such relationships are described in the APPAYCOS audit program. Discrepancies between CPR and C/SSR data and the EAC should be discussed with the program office and the contractor.

(b) The auditor should compare the contractor's EAC's for contract billing purposes with those used for financial reporting purposes. Contractors sometimes report different EACs because of different risk assumptions and profit expectations. The contractor should be able to reconcile any material differences. The auditor should also consider comparing the EAC with other financial and management reports which may be available and show total estimated costs to complete the contract.

(c) The auditor should evaluate the contractor's detailed ETC/EAC using the guidance in 9-300 and ensure that the contractor used appropriate rates and factors and was consistent in its estimating practices.

(d) Government technical evaluations and/or assist audits should be requested if considered necessary (see D-300). When the technical review is based on an estimate of the physical completion of the contract, there must be close coordination on the timing of the estimate or the auditor will have problems using the technical results to determine an estimate to complete. The estimate of the physical completion of the contract by the technical specialist needs to be for the same period covered by the progress payment request. The auditor should coordinate with the technical specialist and document the methodology used to evaluate the ETC or the EAC in the audit working papers.

h. The Loss Ratio Adjustment discussed in FAR 32.503-6(g) is intended to protect the Government's interest when a contract is in a loss condition, that is, when the total costs incurred to date and the ETC (Items 12.a and 12.b) exceed the contract price (Item 5).

(1) Using the Loss Ratio Factor, (Contract Price divided by Total Estimated Contract Costs), the auditor should recommend that the ACO adjust the amount on Item 11 --- Total Costs Eligible for Progress Payment to exclude the elements of loss from consideration for the instant and future progress payments.

(2) When appropriate, the auditor should coordinate with the ACO to apply a loss ratio and document the ETC/EAC supporting the decision. If the loss ratio is not applied timely, the Government will pay the contractor more than it should before delivery. This does not reduce the amount the Government will ultimately pay the contractor, but it will reduce the amount of interim financing at risk.

(3) Since the ACO is required to verify and apply the loss ratio factor, the auditor should advise the contractor to submit future invoices (SF 1443's) without adjusting their figures for the loss. However, the contractor may attach the loss ratio computation as a separate schedule.

(4) Audits of loss contracts should include steps to determine if the contractor is financially capable of completing the contract (FAR 32.503-5(b)(3)). See 14-300 for guidance on financial capability audits.

i. Subcontractor Claims. When subcontractors are entitled to progress payments, performance-based payments or commercial financing payments under FAR 32.504, the higher-tier contractor is responsible for:

- verifying subcontractor progress payment, performance-based payment and commercial financing claims and liquidations;

- approving billings for current payments; and
- ensuring that progress payments, performance-based payments, and commercial financing payments to subcontractors conform to the standards and principles prescribed in paragraph (j) of the progress payments clause (see FAR 52.232-16). The auditor should review the prime (higher-tier) contractor's audit and verification procedures to ensure the Government's interest is protected. If the contractor's analyses of subcontract progress payment, performance-based payment, and commercial financing payment requests are considered inadequate, and these costs cannot be evaluated by other techniques (other current or historical data), the auditor, after coordination with the contracting officer, should determine whether an assist audit is required.

(1) Progress Payments Paid to Subcontractors (Item 14a). Federal Acquisition Circular 97-16 dated March 27, 2000 revised the FAR and allows prime contractors that receive progress payments to be reimbursed for performance-based payments and commercial financing payments paid to their subcontractors. Accordingly, items 14a through 14e on SF 1443 should include the appropriate amounts for progress payments, performance-based payments, and commercial financing payments paid to subcontractors. The auditor should verify that:

(a) a formal written subcontract exists and that it includes either (i) progress payment terms similar to FAR 52.232-16 and the customary rate used by the Government contracting agency, (ii) performance-based payments that meet the criteria in FAR 32.1003, or (iii) commercial financing payments that meet the criteria in FAR 32.202-1;

(b) any unpaid subcontractor progress payments, performance-based payments, and/or commercial financing payments included in the prime contractor’s progress payment are paid in accordance with the terms and conditions of the subcontract or invoice and ordinarily paid prior to submission of the prime contractor’s next payment request to the Government;

(c) when subcontractor payment(s) are in the form of progress payments, the subcontractor(s) have submitted proper progress payment requests in a similar SF 1443 format;

(d) the claimed amounts are not advance payments; and

(e) title to subcontractor property will be vested to the Government.

(2) Subcontract liquidations (Item 14b) is the total progress payments, performance-based payments, and commercial financing payments liquidated from subcontractors that were made for subcontract items received, accepted, and invoiced to date.

(a) The auditor should review the higher-tier contractor's records to determine the number of subcontract items actually received, accepted, and invoiced from subcontractor(s). The auditor should verify:

(i) the price per unit and the applicable liquidation rate or amount to the subcontract terms, and

(ii) that the amount claimed was computed based on the subcontract unit price and proper liquidation rate or amount to the units received from the subcontractor.

(b) The amount of liquidated subcontractor progress payments, performance-based payments, and commercial financing payments should be included in the incurred costs eligible under progress payment clause, Item 10.

(3) Subcontract Progress Billings Approved for Current Payments (Item 14.d) represents the subcontractor progress payment, performance-based, and commercial financing requests that have been approved but not paid. The auditor should verify the amount requested to the subcontractor(s) progress payment, performance-based payment, and commercial financing payment request(s) and confirm that the contractor normally pays subcontractors in accordance with the terms and conditions of the subcontract or invoice and ordinarily makes payment prior to submission of the prime contractor’s next payment request to the Government.

(4) The amounts claimed for subcontractor progress payments, performance-based payments and commercial financing payments on Item 14.e are limited to the unliquidated progress payments, perform-

ance-based payments and commercial financing payments, plus, approved but unpaid subcontractor requests for progress payments, performance-based payments and commercial financing payments on Item 14.d.

(5) Progress payments made to subcontractors in loss positions should have been reduced by application of a loss-ratio factor (FAR 32.503-6(g)).

(6) The prime contract auditor should determine if the subcontract pricing action has had reported defective pricing. If this is the case, the auditor should determine that progress payments do not include liquidation of the defective subcontract costs.

j. Total Amount of Previous Progress Payments Requested (Item 18) should be verified to the contractor's accounts receivable records. Contractors should have adequate billing system internal control policies and procedures for monitoring and reconciling progress payment requests with progress payment receipts and liquidations on Government billings (refer to 14-205.k(3)). The auditor should coordinate Item 18 with the ACO's payment records and reconcile any differences.

k. The computations of limits for outstanding progress payments (Section III) are designed to minimize the Government's risk of overpayment by integrating paragraph (a)(5) of the Progress Payment clause in FAR 52.232-16 to restrict the amount of unliquidated progress payments on Item 24. This limitation is determined by comparing the costs of undelivered items to the price of those undelivered items as discussed below.

(1) Items 20.a through 20.e are intended to determine the amount of progress payments made on undelivered items and delivered items not invoiced and accepted, including allowable unliquidated progress payments to subcontractors. The key to this computation is Item 20.a --- Cost Included in Item 11 Applicable to Items Delivered, Accepted, and Invoiced. The auditor should verify the items delivered and their cost to the contractor's books and records (see 14-205.e).

(2) If the contract is in a loss condition, i.e., Items 12.a plus 12.b exceed the contract price in Item 5, the amount on Item 20.a should be limited to the contract price of delivered items (Item 21.a). The calculation for Item 20.b should use the adjusted costs resulting from the application of the Loss Ratio Factor (see 14-205.h).

(3) Items 21.a through 21.e are intended to determine the contract price of items NOT delivered, accepted, and invoiced. The key to this computation is Item 21.a --- Contract Price of Items Delivered, Accepted and Invoiced at the date of this SF 1443. The auditor should verify the number of contract items delivered and related contract unit prices on DD Forms 250 or similar contractor invoices to the contractor's accounting books, records, schedules of contract receivables and the contract terms (for contract unit prices). A reasonableness check between delivered items and incurred costs could highlight possible cost overruns that could impact future deliveries.

(a) Contractors should maintain contra accounts or receivables schedules to reflect the amount of progress payments requested (Item 18) and received (Item 23) as compared to contract price for delivered and invoiced items (Item 21.a). The difference between the contract price and the progress payment amounts would represent the receivable when the invoice is issued on delivered items.

(b) If the contractor does not maintain records containing the needed information, the auditor should advise the ACO/PCO of this deficiency and disclose the deficiency in the progress payment request audit report and a separate flash billing system deficiency audit report.

l. Total Amount Applied and to be Applied to Reduce Progress Payments (Item 23) is the cumulative amount of previous progress payments applied to reduce the contract price of contract items delivered and invoiced, by the cutoff date of this SF 1443.

(1) The auditor should verify the amount on Item 23 to the contractor's books and records [see 14-205k(3)(a) and (b)] as previously discussed with Item 21a through 21e.

(2) A common error in completing Item 23 is to multiply the contract price of delivered and accepted units (Item 21.a) by the liquidation rate (Item 6.b). This calculation does not consider changes in the liqui-

dation rate or other adjustments over the life of the contract. The amount on Item 23 must be verified to the contractor's books and records, otherwise the amount of unliquidated progress payments on Item 24 could be overstated.

m. The Fair Value of Undelivered Work must equal or exceed the amount of unliquidated progress payments (FAR 32.503-6(f)). The contracting officer must adjust progress payments when necessary to assure that progress payments are commensurate with the fair value of work accomplished on the contract.

(1) The fair value of undelivered work (lesser of item 20e or 21e) must equal or exceed unliquidated progress payments (Item 24). The auditor should add back the amount of the instant progress payment invoice (Item 26) to make sure that the current payment will not cause a failure.

(2) When the fair value of undelivered work is less than unliquidated progress payments, the contract is either in a loss position or has a liquidation problem and the progress payment must be adjusted to minimize the Government’s risk. On loss contracts, the application of a loss ratio (14-205h) constitutes the required adjustment to minimize the Government’s risk. (FAR 32.503-6(f)). When the contract is not in a loss position, the auditor should coordinate with the contracting officer to adjust the instant and future progress payments to minimize the Government's risk.

14-206 Reports

a. The audit report should be prepared in accordance with 10-1200 and addressed to the contracting officer who requested the audit. If the audit was initiated by the auditor, the report should be addressed to the Government representative responsible for audit of the contractor's requests for progress payments. In all cases when he or she is not the addressee, the ACO should be furnished a copy of the report. The content of the report will state the amount of progress payment that is recommended for acceptance and provide clear explanations for amounts not recommended for acceptance, including any qualifications required for such items as required technical analysis was not received or access to records problems.

b. When the unpaid balance on a contract is not sufficient to cover the anticipated cost of completion (i.e., loss contract), the report must express an opinion (positive assurance) on whether the contractor has adequate resources to complete the contract (see 14-205g(4)). If the contract is not in a loss position, and specific audit tests to evaluate the contractor's financial capability were not performed, current auditing standards do not permit us to provide negative assurance. Instead, the report may include a statement within the Results paragraph advising the contracting officer that we would have reported any additional matters which might have been disclosed by the omitted procedures.

c. When the audit discloses materially adverse findings, such as the contractor's financial deterioration, allocation of inventory to the contract substantially exceeding reasonable requirements, or delinquency in payment of contract costs, these matters will be explained in detail particularly as they relate to the Government's financial risk. To ensure that all available facts have been considered in the conclusions, the auditor should contact the ACO, discuss the findings, and invite the ACO to participate in the exit conference with the contractor (see 4-300). Further guidance on reporting instances of contractor financial jeopardy is in 14-300.

d. The contractor is responsible for maintaining reliable accounting and billing systems with adequate internal controls for the proper recording and segregation of costs. If the audit discloses weaknesses or inadequacies in the systems or controls and the contractor has not taken reasonable corrective action, the auditor should recommend that the contracting officer suspend progress payments for costs, including appropriate burden, associated with the unacceptable portion of the contractor's system until the necessary changes are made and verified. These inadequacies should be described in the audit report on the progress payment request and separate reports on accounting and billing system deficiencies.

e. When a progress payment has most likely already been paid, and we find the contractor has experienced a lower profit rate than the rate anticipated at the time the liquidation rate was established, we should recommend an immediate increase in the liquidation rate with appropriate adjustment being made to billings for delivered items [FAR 32.503-9(b)(1)]. Expediency may call for the reduction to be made on the next progress payment request unless the contractor makes an immediate refund for his prior billings on delivered items. See 14-205b.

14-207 Interest – Progress Payments

While FAR 32.614-1 provides for interest charges, interest on progress payments overpayments do not begin to run until there is a demand for repayment of the excess progress payments. Further, if the overpayment is repaid within thirty days after the demand is issued, interest is not assessed. However, the auditor should be alert to the significance of interest and, as appropriate, coordinate with the contracting officer to request a voluntary refund from the contractor for interest on overpayments or premature progress payments.

14-300 Section 3 --- Contractor Financial Capability Audits and Reporting

14-301 Introduction

a. Financial capability audits are performed to determine if the contractor is financially capable of performing on Government contracts as required by FAR 9.104-1(a) and DFARS 232.072. Contractor financial difficulties may disrupt production schedules, cause inefficient use of resources, and result in contract nonperformance. These conditions may also result in monetary loss to the Government on guaranteed loans and on progress payments.

b. Many financial capability audits are performed in response to requests by the contracting officer. Occasionally, DFAS will request financial capability audits on contractors requesting installment agreements on debts owed to the U.S. Government (see 14-308). However, in all audit situations, auditors should be alert to conditions which may indicate unfavorable or adverse financial conditions or other circumstances which could impede a contractor’s ability to perform on Government contracts. Field audit offices will make an annual assessment of a contractor's financial condition to determine whether there is a need to perform a financial capability audit (see 14-303). These assessments may be conducted during the annual planning process; contractor preaward and adequacy of accounting system surveys (see 5-200); audits of advance payments; progress payment audits (see 14-200); or separate assignments. Financial capability audits may be required because of significant events or conditions such as plant closings, major contract terminations, program cancellations, slow payment to creditors, and negative financial conditions found in financial statements and other key financial data.

c. Early detection of contractors in financial distress allows maximum flexibility for the Government to:

(1) avoid loss of critical products or services;

(2) increase or decrease interim financing;

(3) protect Government property and inventory with subordination agreement and prompt removal of completed items;

(4) increase or decrease volume of workload to the contractor;

(5) alert the contractor of Government concerns so extraordinary actions can be taken early;

(6) develop alternative sources; and

(7) avoid financial loss.

d. Early detection of contractors in financial distress allows maximum financial flexibility for the contractor to consider extraordinary management actions such as:

(1) liquidating assets by reducing excess plant and equipment;

(2) borrowing money, expanding lines of credit or restructuring debt;

(3) reducing or delaying capital expenditures;

(4) increasing ownership equity;

(5) eliminating unprofitable product lines;

(6) eliminating or subleasing of in-plant equipment and idle space; and

(7) reducing and reorganizing the workforce.

e. The financial capability audit places emphasis on evaluating the contractor's current financial condition and trends, near-term cash flows, and near and long-term ability to obtain funds outside the normal course of operations. While the evaluation of historical financial data during the financial condition risk assessment can identify unfavorable or adverse financial conditions, the audit focus is on the contractor's ability to maintain future cash flows to sustain performance on Government contracts.

f. The auditor should be familiar with DFARS 232.072, "Financial Responsibility of Contractors," and SAS 59, "The Entity's Ability to Continue as a Going Concern." These references include useful information that will greatly assist the auditor in successfully performing the financial capability audit.

g. In considering contractor financial capability, the auditor will encounter several terms (including terms with specific legal meaning) that are commonly used by financial analysts. Some of these terms, which will be used throughout this section, are listed below.

(1) Bankruptcy. A legal recognition of the state of insolvency, initiated for the benefit of creditors with unpaid and unsecured debts. Voluntary bankruptcy involves an assignment of assets by the debtor for the benefit of the creditors, while involuntary bankruptcy is initiated by an unsecured creditor.

(2) Business Failure. An entity's inability to succeed in selling its products or services, meet its obligations, and/or earn a satisfactory rate of return. A business failure may not lead to bankruptcy because the owners may choose to terminate or sell the business.

(3) Default. The failure to do something required by duty or law. The term is normally used in context of the failure to meet the conditions of a contract.

(4) Financial Capability. The prospective financial status of a contractor based on historical and forecasted financial data of the contractor.

(5) Financial Condition. The current financial status of a contractor based on historical financial data of the contractor.

(6) Financial Distress. A condition of being under financial pressure (caused by difficulty in meeting ongoing cash obligations) which may require extraordinary management actions to obtain additional funds outside the course of ordinary operations. “Extraordinary management actions” include the ability to borrow from a variety of sources, to raise equity capital, to sell and redeploy assets, and to adjust the level and the direction of operations in order to meet changing circumstances. Financial distress can be brought on by circumstances such as reduced cash flows from operations, customer payment defaults, excessive debt and related interest expense, competition in the marketplace, adverse legal actions, and changing business environment or economics.

(7) Financial Flexibility. An entity’s ability to take effective actions to control amounts and timing of cash flows so it can respond to unexpected needs and opportunities.

(8) Insolvency. Insolvency occurs when an entity cannot pay obligations as they come due. Insolvency may be a temporary condition resulting from a mismatch between cash inflows and cash outflows. Insolvency in the context of bankruptcy occurs when an entity's financial condition is such that total liabilities exceed the fair market value of assets.

(9) Liquidation. Liquidation is the process of closing a business entity, including selling assets, paying liabilities, and returning the residual to its owners. Partial liquidation would occur when an entity is involved in the piecemeal sale of a significant percentage of its assets.

(10) Long-term. Being in effect for more than one year.

(11) Near-term. Being in effect for up to one year.

(12) Off-Balance Sheet Arrangements. May involve, but are not limited to, unconsolidated, non-independent, limited purpose entities, often referred to as structured finance or special purpose entities. These entities may be in the form of corporations, partnerships, limited liability companies, trusts, structured finance entities or other types of agreements, relationships or understandings. These entities may be used to provide financing, liquidity, market risk or credit support, or involve leasing, hedging, and/or research and development services.

(13) Related Party Transactions. Related party is defined in Statement of Financial Accounting Standards No. 57. Examples of related party transactions include transactions between:

(a) a parent company and its subsidiaries;

(b) subsidiaries of a common parent;

(c) an enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise’s management;

(d) an enterprise and its principal owners, management, or members of their immediate families; and

(e) affiliates.

14-302 Responsibilities

a. DFARS 232.072 requires the contracting officer to make a determination of financial responsibility and provides suggested policies and procedures for making this evaluation. DCAA has the responsibility to provide all necessary financial advisory services to the contracting officer. An

integral part of these services is the evaluation of the contractor's financial condition. A DCAA financial capability audit may be performed in response to a specific contracting officer's request, or as a result of our self-initiated risk assessment of the contractor's financial condition. In either case, ensure coordination with the ACO on contractor issues to be considered in performing the risk assessment/audit as required in 4-103. If a financial capability audit is requested and the FAO's risk assessment does not indicate any historical financial condition problems, the FAO will thoroughly discuss the risk assessment with the contracting officer to verify the need to perform the audit (see 14-308 for exception for audits requested by DFAS related to contractor installment agreements). If agreement is reached that a financial capability audit is not required, a memorandum confirming the discussion should be sent to the contracting officer (see 14-304i).

b. The FAO cognizant of the corporate office will usually perform the financial capability audit at multidivision/segment corporations. In a CAC network, where the FAO manager cognizant of the corporate office is not the CAC, close coordination with the CAC will be needed prior to and during the audit. Each separate subsidiary or division of a contractor will not be considered as a separate entity unless obligations (including contract performance) of the subsidiary or division are not legally binding on the parent organization. A parent corporation that owns 100 percent of a corporate subsidiary is usually not legally responsible for the obligations of its subsidiary, unless a guaranty agreement is reached (see 14-302c). Subsidiary or division auditors with questions or audit leads should coordinate with the FAO cognizant of the corporate office. Any exception to this policy should be coordinated with Headquarters, PPD, in advance of performing the audit.

c. The cognizant ACO and the contractor should be contacted to ascertain if any guaranty agreements are in effect between the Government and a contractor for the performance of a partially or wholly owned subsidiary. The existence of a guaranty agreement does not relieve the auditor from determining the financial viability of the partially or wholly owned subsidiary. Where guaranty agreements exist concerning performance of Government contracts by partially or wholly owned entities, a financial capability audit of the guarantor will also be performed if the segment or subsidiary's financial condition is unfavorable or adverse.

d. The auditor should formally advise the ACO of any access to records problems encountered during the financial capability risk assessment/audit and solicit any required assistance pursuant to 1-504. All unresolved access issues should be clearly explained in the audit report, including impact on the audit scope and results.

e. Many large corporations have financial departments which perform continuous assessments of financial conditions. Auditors should fully understand the work performed by these departments in their evaluation of financial conditions. The scope of the financial capability audit should consider the degree of reliance which can be placed on the work of others including the work performed by these departments (see 4-1000).

14-303 Frequency of Performing Financial Condition Risk Assessments

a. FAOs will perform an annual financial condition risk assessment of the contractor's financial condition for major and nonmajor contractors, unless a risk assessment was performed and documented in conjunction with other audits during the year. Ideally, risk assessments should be performed soon after the issuance of the contractor's audited financial statements, thereby utilizing the most current financial information available. If audited financial statements are not available, the risk assessment should be performed using reviewed, compiled, or contractor-prepared financial statements as soon as they are available after the contractor’s fiscal year end. For nonmajor contractors, if an annual financial condition risk assessment is not performed due to audit inactivity at the contractor's location, a financial condition risk assessment will be performed at the first field visit during the contractor's subsequent fiscal year.

b. A detailed financial condition risk assessment should be performed cyclically every three years with modified financial condition risk assessments performed in the years when a detailed risk assessment is not performed.

c. FAOs will complete the risk assessment (detailed or modified) by gathering and analyzing appropriate financial data (14-304). The auditor or contracting officer may become aware of contractor financial information or events that indicate contractor financial distress. This information should be incorporated into the risk assessment. If the risk assessment so indicates, audit plans will be developed for completing the financial capability audit (APPS audit program - APFINCAP, "Audit Program for Financial Capability Audit").

d. The contracting officer may also be monitoring the contractor's financial condition. The auditor should fully understand the contracting officer's work in this area to avoid duplication.

14-304 Financial Condition Risk Assessment Procedures

a. Audit program APFINCAP contains detailed steps for performing a financial capability audit. The program also contains risk assessment steps that the auditor performs to determine the need for a complete financial capability audit. A decision to perform a financial capability audit will be made based on the results of these steps. The basis for the decision must be fully documented and discussed with the contracting officer. These risk assessment procedures should also be used to establish the scope of requested financial capability audits.

b. A detailed financial condition risk assessment should be performed cyclically every three years. A detailed financial condition risk assessment consists of performing:

(1) an analysis of the contractor's key financial ratios and trends and a comparative analysis of these ratios with applicable average industry ratios;

(2) an analysis of the contractor's financial data using one of the three Z-Score bankruptcy prediction models and a comparative analysis of the Z-Score with the average Z-Scores of companies in the related industry;

(3) an evaluation of financial statement statistics for indicators of financial distress;

(4) an evaluation of the adequacy of the contractor's internal control structure relating to financial planning and monitoring;

(5) an analysis of off-balance sheet arrangements and related party transactions (see 14-306); and

(6) a follow-up on any other indicators that raise questions about financial capability of the contractor.

c. Modified financial condition risk assessments are performed in the years when a detailed risk assessment is not performed. If indicators of financial distress are encountered, the modified financial condition risk assessment should be expanded to perform a detailed financial condition risk assessment. The steps to perform a modified financial condition risk assessment would consist of the:

(1) calculation and analysis of the trend of the contractor's key financial ratios (without a comparison to applicable average industry ratios) and

(2) analysis of any significant events that the auditor becomes aware of that would impact the contractor's financial condition.

d. Selected Key Individual Financial Ratios

(1) Financial statements provide a primary indication of a contractor's financial condition. The analysis of key individual financial ratios is an important consideration when evaluating a contractor's financial condition. However, they must be used with care. General rules of thumb regarding acceptable ratios should be avoided. Instead, the auditor should perform a trend analysis of key financial ratios and a comparative analysis of these ratios with applicable average industry ratios. Ratio analysis should cover three to five years' data, if available, and use comparable data. Obtain from the contractor the contractor's Standard Industrial Code (SIC) or North American Industry Classification Code (NAICC). The SIC/NAICC code should be verified to determine that it accurately reflects the contractor's primary business. The SIC/NAICC code is used to request indus-

try average ratios. Financial ratios for publicly traded companies and for industry averages will be requested from the Technical Support Branch (OTST). The requests should be submitted electronically to e-mail address dcaa-ratios. (If it is not in your address list, use the following: dcaa-ratios@dcaa.mil.) The request should be submitted using file S&P_REQ.zip. The file is on the Agency's Intranet under the topic "File Libraries" and then in the directory "S&P Compustat Database". The file contains instructions on submitting the request. [Note: The contractor's financial statements (Balance Sheet, Statement of Income, and Statement of Cash Flows) should be used to compute the ratios for other than publicly traded companies. The key ratios provided by OTST for publicly traded companies should be selectively verified to the contractor's financial statements.] Since these ratios are being used as one of many tools to assess risk, and not to express an audit opinion on these financial statements, the auditor can use the information from the audited financial statements to compute the ratios without testing the reliability of the external auditor's work. However, if compelling reasons exist to question the financial statements or if the statements are unaudited, then the auditor should consider whether additional audit steps are needed to verify the financial information prior to computing the ratios. The audit report should be qualified when using unaudited financial statements.

(2) At a minimum, the following key ratios should be calculated and monitored:

Ratio	Formula	Description
Current Ratio	Current Assets/ Current Liabilities	This ratio is used to measure a company's ability to pay its short-term liabilities from short-term assets.
Acid Test (Quick Ratio)	Liquid Assets/ Current Liabilities	This ratio measures a company's ability to pay off its short-term obligations from assets readily convertible to cash.
Return on Investment (ROI)	Net Income/ Total Assets	This ratio is a measure of economic performance, and is used as an indicator of management's effectiveness, a measure of a company's ability to earn a satisfactory return on investment, and a method of projecting earnings.
Debt to Equity Ratio	Total Debt/ Stockholders Equity	This ratio assists in determining the relative size of the claims of creditors compared to the claims of owners. High levels of debt can restrict management and increase risk to owners.
X1 (From Altman's bankruptcy model.)	Working Capital (Current Assets - Current Liabilities)/ Total Assets	This ratio is a measure of the net liquid assets of the contractor relative to its total capitalization. Ordinarily a firm experiencing consistent operating losses will have shrinking current assets in relation to total assets.
Cash Flow to Debt	Cash Flow (Net Income+Depreciation+ Depletion+ Amortization)/ Total Debt	This ratio is an indicator of the adequacy of available funds to satisfy debt obligations The ratio has been suggested by some studies to be the single best indicator of financial distress.
Cash Flow Return on Assets	Cash from Operations/Total Assets	This ratio measures the cash generated from assets (as opposed to income generated from assets).
Cash Flow to Sales	Cash from Operations/Sales	This ratio shows the percentage of each sales dollar realized as cash from operations.

Ratio	Formula	Description
Cash Flow Adequacy	Cash from Operations/ (Long-term Debt Paid +Purchases of Assets + Dividends Paid)	This ratio measures the contractor's ability to generate cash sufficient to cover its primary cash requirements to pay its debts, reinvest in its operations and make distributions (dividends) to owners.
Debt Coverage	Total Debt/Cash from Operations	This ratio estimates how many years it will take to retire all debt at the current level of cash from operations.

The auditor should also ask the contractor if there are other financial ratios that should be considered when evaluating the contractor's financial condition.

(3) The ratio analysis concept is that as business deteriorates, so too will the key ratios. By monitoring ratios, the auditor should be able to ascertain that the contractor may be experiencing financial distress. Comparing the contractor's ratios to the industry average ratios (also provided by OTST upon request) will provide another basis to assess the risk relating to the contractor's financial condition. Deteriorating ratios and ratios that are significantly worse than industry average ratios are strong indicators of financial problems. At contractor locations where the majority of these ratios are both experiencing a negative trend and significantly worse than industry average, the auditor normally will perform a financial capability audit.

e. Failure Prediction Models

(1) A bankruptcy prediction model is one of several tools that provide insight into a contractor's financial health. The auditor should analyze the contractor's financial data using one of the three "Z-Score" bankruptcy prediction models developed by Dr. Edward Altman. Figure 14-3-2 provides the following for each model: applicability, evaluation criteria, formulas used, variables used, and an example of the calculations.

(2) The Altman Z-Scores are useful in assessing financial condition risk and helping to identify contractors that may have financial problems. Although sole reliance should not be placed on the Z-Score, it does provide an initial indication of potential financial problems.

(3) When using the Altman Z-Scores, it is important to perform trend analysis (preferably covering the most recent completed fiscal year and the previous two to four fiscal years) of the contractor's financial distress scores and industry averages. A declining trend indicates a deteriorating financial condition. Numeric values of Z-Scores for a variety of conditions are tabulated in Fig. 14-3-2.

(4) Z-Scores showing probable future financial distress are a high risk indicator that may require a financial capability audit. The auditor should also consider Z-Score trends, ratio analyses, financial statement evaluations, and other indicators in the decision on whether to perform the audit.

(5) Z-Scores in the middle range may indicate a need to perform a financial capability audit. Any time the Z-Score is in the middle range, careful consideration should be given to Z-Score trends, ratio analyses, financial statement evaluations, and other indicators. Declining Z-Score trends combined with a Z-Score in the lower half of the middle area will require the auditor to carefully consider performing a financial capability audit. A middle range Z-Score combined with any significant unfavorable or adverse conditions in other areas will generally require an audit of the contractor's financial capability.

(6) Z-Score data will be requested from OTST for publicly traded and other than publicly traded companies (see 14-304d.(1)). OTST will provide Z-Scores for the most recently completed fiscal year and prior fiscal years using financial data obtained from Standard and Poor's Compustat database. Z-Scores will be provided for both the company under evaluation, if publicly traded, and the average of companies in the related industry, for publicly traded and other than publicly traded companies.

Company data is normally provided for a 5-year period and industry data for a 3-year period.

f. Evaluating Financial Statement Statistics for Indicators of Financial Distress

(1) The evaluation of financial statistics can provide additional insight into negative financial trends and other conditions that may result in financial distress. Such conditions may include deteriorating sales, recurring operating losses, working capital deficiencies, and negative cash flow from operations. The financial statements should be obtained for at least the five preceding fiscal years, the current fiscal year (interim), and forecasted fiscal years. The financial data from these statements should be analyzed and trend data developed for the following areas:

- Profit/loss
- Net income/loss from operations
- Cash flow from operating activities
- Cash flow from investing activities
- Cash flow from financing activities
- Sales
- Working capital (current assets minus current liabilities)
- Long-term liabilities
- Total assets

(2) The auditor should be alert to any apparent lack of operating success as evidenced by overall net losses or net losses from operations. In these circumstances, particular emphasis should be placed on evaluating the statement of cash flow and the contractor's ability to pay obligations from the cash inflows obtained in the ordinary course of business. Significant deterioration in sales or increases in liabilities should be monitored, as they have a significant influence on the contractor's ability to meet ongoing operating costs. If any of the above elements demonstrate that the contractor is or will be in financial distress, the FAO will consider scheduling a financial capability audit.

(3) Determine if there is a going concern comment (SAS 59) in the most recent financial statements. If so, this is a high risk indicator that requires further analysis and requires the performance of a financial capability audit.

g. Internal Controls

The auditor should also consider the adequacy of the contractor's internal control structure relating to financial planning and monitoring. The contractor's internal control structure should provide controls for the following:

- Written policies and procedures that require evaluation of current financial conditions in order to anticipate and avoid adverse conditions;
- Preparation of cash flow forecasts including reasonable and supported assumptions;
- Periodic assessments of accounts payable and receivable, including analysis of accounts payable aging and the collectibility of accounts receivable;
- Periodic assessments to ensure compliance with any loan covenants and debt payment schedules; and
- Periodic assessments of contract cost performance.

h. Other Indicators that Raise Questions about Financial Distress

(1) Any consideration of or actual filing for bankruptcy by a contractor requires an audit to be performed. The auditor may learn that the contractor is about to file or has filed for bankruptcy under Chapter 7 (Liquidation) or Chapter 11 (Reorganizations) of the bankruptcy laws. Filing under Chapter 11 may provide for the appointment of an independent trustee to assume control of the company for the duration of the bankruptcy proceedings. Chapter 11 proceedings cannot be considered conclusive evidence that the company will be forced to liquidate. However, any filing for bankruptcy gives rise to significant uncertainty as to the future operations of the company and the contractor's ability to perform on Government contracts.

(2) Many sources of information can provide insight into events or conditions that can significantly affect a contractor's ability to perform on Government contracts. The FAO should review financial statement notes and financial statement audit opinions and analyze this information for any unusual items or comments. Determine if there is a going concern comment in the most recently audited financial statements. If so, this should be disclosed in the audit report. The auditor should discuss any unfavorable or adverse financial conditions disclosed in the financial statements with the contractor to obtain a full

understanding of the issues. The auditor should then determine the impact on the contractor's financial capability. Further, discussions with the Contracting Officer and the contractor and review of audit leads may identify events or conditions that could be causes or indicators of financial distress. Significant events or conditions could include:

- Defaults on loan/line of credit agreements
- Denial of usual trade credit from suppliers
- Restructuring of debt where the contractor is charged a higher interest rate above the prime rate than the prior rate charged by the lending institution. The increase in the rate charged above the prime rate could be attributable to perceived contractor financial distress.
- Noncompliance with loan/line of credit covenants
- Contracts in a significant loss position
- Legal proceedings/pending claims
- Loss of principal customer/supplier
- Uninsured or underinsured catastrophes
- Labor strikes
- Unpaid state, local, and federal tax liabilities, including payroll taxes
- Contingent liabilities
- Deteriorating bond ratings
- Significant dollar amount of accounts receivable
- Significant postaward or suspected irregularity conduct audit findings and other significant unresolved questioned costs
- Contract termination for default
- Deferral of payments to suppliers
- Failure to fund pension plans
- Loans from employees or issuing stock to employees in lieu of salary
- Environmental clean-up impact
- Significant unpaid contractor debts
- Unusual progress payments or other billing concerns
- Parent company undergoing financial distress/ bankruptcy
- Physical condition of the work facilities
- Unpaid insurance liabilities

(3) Bond ratings for publicly held companies should be evaluated. Low bond ratings or declining trends may signal problems for the company in obtaining cash outside of normal operations. Debt rating data for most publicly held companies will be included in OTST's response to requests for financial ratios (14-304d.(1)).

(4) The FAO should discuss with the contractor any plans to enter into significant leases, make significant capital expenditures, liquidate assets, borrow significant cash or restructure existing debt, reduce or delay expenditures, and increase ownership equity. The auditor should verify the accuracy of the discussions to appropriate supporting data including the cash flow forecast. The auditor should also identify and analyze any unusual compensation package or outstanding loans to other company operations or company officers that would drain financial resources from an operating unit with Government contracts.

i. The auditor should perform all applicable risk assessment procedures to use as a basis for the decision to perform a financial capability audit. Only after full evaluation and consideration of the risk assessment can a decision be made to perform the audit. For self-initiated (discretionary) assignments where no risk was found, conclusions on risk assessment evaluations should be summarized in a memorandum for record and maintained as part of the FAO's permanent file. For customer requested assignments, other than those requested by DFAS on a contractor requesting an installment agreement (14-308), where no risk was found, coordinate the risk assessment results with the requestor. If the requestor agrees that further work is not necessary, confirm the coordination with the requestor in a memorandum. However, if the requestor still desires the performance of a financial capability audit, proceed with the audit. At large multi-division/segment corporations, the results should be communicated in writing to FAOs cognizant of the corporation's divisions/segments.

14-305 Audit of Contractor Financial Capability

a. The purpose of the financial capability audit is to render an opinion on the contractor's financial capability to perform on Government contracts. The audit objectives normally include the evaluation of existing and future contractor financial capabilities

to continue operations in the near-term. In some cases, contract performance may extend beyond one year and could span several years. Therefore, in some instances, circumstances require the auditor to address the long-term.

b. The audit scope will concentrate on analyzing the contractor's financial condition and cash flow projections to determine if the contractor has or will have adequate financial resources to perform on Government contracts. The audit coverage will include an evaluation of existing financial conditions, audit of cash flow projections for the near term (up to one year), and analysis of the contractor's financial flexibility to support operations. From this evaluation, the FAO will determine if the contractor will have sufficient cash flow to continue operations in the near term (up to one year). If a reasonable doubt exists that the contractor will have sufficient cash flow to sustain operations, the auditor will need to determine whether the contractor can obtain the necessary resources (e.g., loans, sale of assets, or sale of stock) to continue operations in both the near-term and in some unusual circumstances addressing the long-term. If the contractor is experiencing financial distress, the contractor may have prepared a projected cash flow statement for the CPA's SAS 59 analysis.

c. When performing an audit of the contractor's financial capability, it is the contractor's responsibility to provide appropriate financial and accounting information. Specific information that the contractor should provide is discussed in DFARS 232.072-2. If the auditor experiences difficulty in obtaining this information, the issue should be elevated to the contracting officer. If these actions are unsuccessful in obtaining the required information, the auditor should follow the guidance on access to records discussed in 1-504. Auditors should adhere to the guidance in 4-400 in preparation of their working papers. Sensitive financial capability audit working papers are likely to be used in continuing Government analysis.

14-305.1 Evaluation of Existing Financial Conditions

a. Assess Current Financial Conditions and Follow-up on Any Prior Significant Conditions

The auditor will assess the contractor's financial condition at the time of the audit. Risk assessment financial data will be updated with interim current contractor financial data and an evaluation will be made to determine whether the contractor is currently experiencing financial distress. Information and audit leads developed during the annual planning process should be reviewed and updated, if necessary. Any significant conditions or leads should be discussed with the contractor and evaluated. To analyze future cash flows, the auditor must understand the underlying cause of any current significant conditions and their potential impact on future operations.

b. Liquidation of Accounts Payable

(1) The auditor will determine if the contractor is liquidating accounts payable on a timely basis in the ordinary course of business. This will normally be performed through an evaluation of the aging of accounts payable. Contractors may have the capability to manage accounts payable through various computer software programs. To illustrate, the contractor should provide an aging schedule, similar to the following example, to demonstrate that it is adequately managing accounts payable. In order to assure that the contractor is not recording payments while actually delaying or holding checks, review canceled checks to determine the accuracy of the number of lag days between recorded payment dates and check cancellation dates. If the contractor is not liquidating its accounts payable in a timely manner, the reasons should be ascertained.

EXAMPLE --- SCHEDULE OF ACCOUNTS PAYABLE AGING

Trade Accts. - No. of Days Outstanding	Amount	Percentage
0-30 days	$ 191,300	14%
31-60	421,992	31

61-90	262,334	19
91-120	132,570	10
Over 120	347,062	26
Total Trade Accounts	$1,355,258	100%
Other	188,972	
Checks Held	117,174	
Bank Overdraft - Net	$ 187,567	
Total Accounts Payable	$1,848,971	

(2) In the circumstances where account balances are significant and the contractor does not perform an aging of accounts payable or similar analysis, the contractor should be asked to perform such analysis. If the contractor refuses, the auditor should report this absence of normal financial management and budgetary controls as a significant internal control weakness. The auditor will then consider evaluating liquidation of accounts payable by such audit procedures as statistical sampling and the use of IT retrieval software (e.g., SAS and FOCUS).

(3) For multidivision corporations with a decentralized accounts payable function, the corporate auditor may need to request assist audits of segments/divisions with significant accounts payable balances.

c. Loans/Lines of Credit

The auditor will determine whether the contractor has been unable to meet debt payment schedules or has violated any covenants of its loan agreements or lines of credit. Also, an analysis of the explanatory notes to the contractor's financial statements may help determine if any conditions on financial credit requirements exist, such as a bank line of credit that requires maintenance of certain key financial ratios. If the loan covenants or financial ratios are not being met, determine if they have been waived by the financial institution. The auditor should verify that the contractor properly classifies any lines of credit as short/long-term since the improper classification would affect the calculation of some financial ratios. Review the interest rate charged by the lending institution. An increase in the rate charged above the prime rate could be attributable to perceived contractor financial distress. Review the loan/line of credit to see if it is secured by collateral. If the contractor receives progress payments, and collateral includes inventory/work-in-process, determine if a subordination agreement is necessary.

d. Payroll Taxes.

Determine that the contractor is paying its payroll taxes timely. Obtain the Employer’s Quarterly Federal Tax Returns (Form 941) for the last two quarters. Test payroll payments to the general ledger or bank statement.

e. Chapter 11 Bankruptcy

As discussed previously (14-304h(1)), the filing of a petition with the Bankruptcy Court for reorganization under Chapter 11 gives rise to significant uncertainty as to the contractor's ability to pay debts or adequately perform on Government contracts. This event by itself requires immediate written notification to the ACO, with copies provided to the Regional Special Programs Office and Headquarters, Attention PPD. The ACO is primarily responsible for monitoring the financial condition of a contractor once an unfavorable or adverse financial condition has been reported. During Chapter 11 proceedings, a company is generally required to furnish interim financial statements and other information such as status on actions to remain a going concern or plans to reorganize. The auditor should determine what legal provisions exist and obtain the required financial information to ascertain the company's continuing financial capability.

14-305.2 Evaluation of Cash Flow Projections

a. Evaluations of cash flow projections will form the framework for the auditor's

opinion on the contractor's financial capability. The auditor needs to have a reasonable basis to assure that the contractor will be able to cover its operating costs and make appropriate payments on its liabilities in the near term (up to one year).

b. Cash flow forecasts are used for many purposes such as strategic planning, managing the contractor's day to day operations, and establishing lines of credit. At larger contractors, cash flow forecasts are generally prepared by a contractor's financial planning or treasurer's department. Since the cash flow forecast will serve as the contractor's demonstration that it has sufficient sources of cash to meet current obligations, it must be obtained and evaluated by the auditor. Similarly, projected sources of cash flow on existing Government contracts should reconcile to other internal forecasts that are contractually required to be provided to the Government (e.g., EVMS estimates-at-completion and the corollary calculations supporting progress payment requests). DFARS 232.072 provides guidance on cash flow requirements and analysis.

c. Auditors should analyze the contractor's cash flow forecasts in order to determine the contractor's ability to meet operating costs in the near term (up to one year), and any long-term liabilities coming due in the near term. There are many uncertainties surrounding a contractor's operations which may make it difficult to reasonably project cash flows beyond one year. As a result, cash flow projections beyond the current fiscal year are not usually supported by detailed estimates. For this reason, the auditor needs to concentrate the cash flow evaluations on the near term. If there is doubt about the sufficiency of the contractor's cash flow in the near term, evaluation of cash flow projections throughout the life of major contracts should be considered, if available.

d. Using the contractor-prepared schedule identifying the maximum possible liability for off-balance sheet arrangements and related party transactions (14-306.), inquire of the contractor if any of the liabilities will become due in the near term (up to one year). If any will, verify that these cash outflows are reflected in the contractor’s cash flow forecast.

e. If the contractor does not prepare a cash flow forecast as part of normal financial management, request that the contractor prepare a cash flow forecast for the audit. If the contractor fails to do so, ask the ACO to require the contractor to submit a cash flow forecast covering the duration of existing contracts (DFARS 232.072-3.) The auditor cannot give an opinion on a contractor’s financial capability without an evaluation of the contractor’s cash flow forecast (however, see exception for nonmajor contractors below). The failure to prepare cash flow forecasts will normally occur only at smaller companies. At larger companies, the auditor should report this absence of normal financial management and budgetary controls as a significant internal control weakness. Actions by a contractor to restrict or deny access should be first elevated to the ACO to require the contractor to submit a cash flow forecast covering the duration of existing contracts (DFARS 232.072). If the problem continues, it should be reported as an access to records problem (1-504). If a nonmajor contractor fails to prepare a cash flow forecast, even after requested by the auditor and the contracting officer, and if, through the audit of sufficient, competent, evidential matter it is determined that the contractor is experiencing financial distress, the auditor can issue the report giving a qualified (unfavorable) or adverse audit opinion. The scope paragraph of the audit report should be qualified due to the lack of the cash flow projection. However, the auditor cannot issue the report giving an acceptable opinion on a nonmajor contractor’s financial capability without an evaluation of the contractor’s cash flow forecast (14-307a.(4)).

f. Since a cash flow forecast is usually an internal management document, it may be presented in various formats. It may be a statement that identifies all projected sources and uses of cash, or may be presented in the same or similar format as the statement of cash flows in the annual financial statement. Forecasted cash flows in the format of the annual financial statement will normally categorize cash receipts and cash disbursements by operating, investing, and financing activities. The auditor needs to evaluate the support and reasonableness

of the contractor's cash flow forecasts --- estimates may be overly optimistic and favorable to the contractor. The auditor should, as part of the audit, perform the following procedures on major cost elements:

(1) Verify the factual data and determine the reasonableness of the underlying assumptions used to prepare the cash flow forecast;

(2) Compare previous forecasts with actual statement of cash flows to determine how reliable forecasts were in the past;

(3) Evaluate forecasts to assure they consider any significant conditions identified in the auditor's evaluation of existing financial conditions (14-304 and 14-305.1);

(4) Evaluate the logic of the cash flow forecasts --- determine if they link into any forecasted balance sheets and income statements;

(5) Determine if sales forecasts or production forecasts and related operating costs are consistent with recent financial statement trends and evaluate assumptions supporting the significant differences;

(6) Determine if the contractor's ability to achieve its cash flow forecast is dependent on the favorable outcome of one or a few key event(s). If so, the circumstances and chance of occurrence should be thoroughly explored and the impact on the cash flow projection should be considered;

(7) Determine if there are any significant events (such as a recent or potential loss of contracts) that may affect the contractor's operations. If an event is identified, the auditor should determine the impact on the analysis of cash flow projections.

g. Generally, DCAA does not confirm account balances. If the cash flow analysis is dependent on significant amounts in a particular account, the auditor will determine if reliance can be placed on contractor controls or use other analytical procedures. For example, if the cash flow analysis is heavily dependent on collection of accounts receivable, the auditor may note that independent confirmations are conducted annually by external auditors and analyze the aging schedule of the accounts receivable. If the auditor determines that confirmations are necessary, such confirmations will be coordinated with the ACO. If the ACO does not agree with the necessity for the confirmations, the confirmations will not be performed and the audit report should be qualified for these circumstances.

h. In concluding the evaluation of the cash flow projections, the auditor needs to determine whether the contractor has the financial means to meet ongoing costs of operations in the near term. This determination will be the foundation for the auditor's opinion on the contractor's ability to perform on Government contracts. When issuing the audit opinion in accordance with 14-307, the auditor should ensure the cash flow forecast represents projections for a reasonable future time period (i.e., preferably 9 months or more, however, no less than 6 months in the future from the date of the audit report). If cash flow forecasts are reasonable and show that the contractor will meet its obligations without initiating actions outside the ordinary course of operations, the contractor's financial condition will be considered adequate. A projected shortfall in meeting short-term obligations which requires obtaining cash from outside the normal course of operations (such as liquidation of assets, significant loans, or sale of stock) is considered financial distress. Financial distress is considered an unfavorable financial condition. If a shortfall is not projected but cash flows are dependent on significant conditions or events for which there is significant doubt (such as optimistic sales of a new product, anticipated contract awards, or a negative cash flow due to a pending contingent liability), the contractor's financial condition would be considered unfavorable.

14-305.3 Analysis of Financial Flexibility

a. The auditor needs to consider the contractor's financial flexibility to perform on Government contracts in the near and long term. Consideration should be given to existing assets (net of liabilities), current bond ratings, bank lines of credit, long-term plans for liquidating assets, restructuring/increasing debt (the near term should be considered in the cash flow analysis), and plans for increasing ownership equity. Where near-term financial distress is indicated, a determination should be made as to

the contractor's ability to obtain the additional resources to continue operations through extraordinary management actions.

b. Future plans to add or sell resources should be discussed with the contractor and verified. These audit procedures are critical if the contractor is in financial distress and needs additional cash to continue operations. The auditor should discuss with the contractor any planned extraordinary management actions to obtain or conserve cash and verify the supporting data, such as the following:

(1) Plans to liquidate assets. Determine possible direct or indirect effects on Government contracts of any planned disposal of assets.

(2) Plans to borrow money or restructure debt. Evaluate the availability of debt financing, including existing committed credit arrangements such as lines of credit and arrangements for factoring of receivables or sale-leaseback of assets.

(3) Plans to reduce or delay expenditures. Determine possible direct and indirect effects on Government contracts of any plans to reduce or delay capital or maintenance expenditures.

(4) Plans to increase ownership equity. Review existing or committed arrangements to raise additional capital, to reduce current dividend requirements, or to accelerate cash distributions from affiliates or other investors.

c. On completion of this part of the audit, the auditor will have better insight on the contractor's capability to obtain cash resources outside of normal operations through extraordinary management actions. When a contractor is in financial distress, analysis of the contractor's capability to obtain cash resources and repay those resources will give the auditor a reasonable basis for determining whether or not the contractor will be able to perform on Government contracts (near and long term).

14-306 Review of Off-Balance Sheet Arrangements and Related Party Transactions

a. The performance of financial condition risk assessments and financial capability audits depend heavily on the accuracy of a contractor's financial statements. Financial statements that accurately reflect the contractor's financial condition should incorporate the effects of off-balance sheet arrangements and related party transactions. During the financial condition risk assessment, and any subsequent financial capability audits, the auditor's determination that these effects have been incorporated into the contractor's financial statements will be based on whether the contractor is publicly held or not.

(1) Publicly held companies are required, as a result of Securities and Exchange Commission (SEC) final rulings implementing the Sarbanes-Oxley Act of 2002, to disclose all material off-balance sheet transactions, arrangements, and obligations (including contingent obligations) that are "reasonably likely" to have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses in each annual and quarterly financial report required to be filed with the Commission. The details regarding these off-balance sheet arrangements are to be disclosed under a separately captioned subsection of the "Management's Discussion and Analysis" (MD&A) section of the quarterly and annual SEC filings. Furthermore, corporate executive officers, the principal financial officer or officers, or persons performing similar functions of a company filing periodic reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 must certify in each quarterly and annual report that, based on their knowledge, the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of the operations of the company as of, and for, the periods presented in the report. As a result of the MD&A disclosure requirements and corporate certifications, audit effort required to assure that the financial statements include consideration of off-balance sheet arrangements and related party transactions should be limited to management inquiries that the company has complied with the new SEC final rulings in its SEC filings (effective for fiscal year ending on or after June 15, 2003), confirmed by a cursory review of the SEC

filings themselves. Further explanatory or cost detail from the company to better understand the maximum liability connected with any disclosed off-balance sheet arrangement or contractual obligation should be obtained as necessary.

(2) For non-publicly held companies, auditors should request the contractor to provide written confirmation that the financial statements provided during the financial condition risk assessment include disclosure of all off-balance sheet arrangements and related party transactions. The request for confirmation should be sent to, and the contractor's response should be signed by, a contractor official no lower than a vice president, chief financial officer, or chief executive officer. A shell letter requesting contractor confirmation on the financial statements is included in the Other Audit Guidance section of the APPS entitled Confirmation Letter – Financial Statements. The contractor should also provide a schedule separately showing the maximum liability included in the financial statements and cash flow forecast, and the maximum liability not reflected in the financial statements and cash flow forecast, when the contractor states that the maximum liability for off-balance sheet arrangements and related party transactions is not reflected in the financial statements and/or cash flow forecast. In addition to a written confirmation and schedule, the contractor should also be requested to provide:

(i) any inquiries from their public accounting firm related to off-balance sheet arrangements and related party transactions and their responses. Some contractors may not have engaged a CPA firm to audit their financial statements. In this instance, auditors may accept a response from the contractor stating that they did not engage a CPA firm to audit their financial statements; and

(ii) the results and reports of any internal audits, reviews, or other analyses of off-balance sheet arrangements and related party transactions.

(a) The auditor should obtain an understanding of the information provided by the contractor, along with the written confirmation from the contractor that the financial statements include disclosure of the maximum liability of off-balance sheet arrangements and related party transactions. A list of potential related party indicators is included in the Other Audit Guidance section of the APPS entitled Potential Related Party Indicators, and should be used to assist in identifying situations that would indicate related party arrangements.

(b) Evaluate for audit leads any inquiries from the contractor's public accounting firm related to off-balance sheet arrangements and related party transactions, and the contractor's response to these inquiries.

(c) Compare for consistency the contractor's response to its public accounting firm's inquiries concerning off-balance sheet arrangements and related party transactions to the contractor's disclosures in the confirmation letter. Follow up on any inconsistencies with the contractor.

(d) Evaluate for any audit leads, the results and reports of any internal audits, reviews or other analyses of off-balance sheet arrangements, and related party transactions.

(e) Verify that the contractor-prepared schedule, identifying the maximum possible liability for each disclosed off-balance sheet arrangement and related party transaction, is based on sufficient, competent, evidential matter and is reconcilable to the contractor's supporting documentation for each liability.

b. At the completion of the detailed financial condition risk assessment, if the non-publicly held contractor has not provided the written confirmation letter, begin performance of a financial capability audit.

c. During the performance of a financial capability audit, request the contractor (if not publicly held), to provide written confirmation that the cash flow forecast provided during the financial capability audit includes liabilities associated with off-balance sheet arrangements and related party transactions. The request for confirmation should be sent to, and the contractor's response should be signed by, a contractor official no lower than a vice president, chief financial officer, or chief executive officer. A shell letter requesting contractor confirmation on the cash flow forecast is included in the Other Audit Guidance section of the APPS entitled Confirmation Letter – Cash Flow Forecast.

Unless provided during the financial condition risk assessment (14-306a(2)), the contractor should also provide a schedule separately showing the maximum liability included in the financial statements and cash flow forecast, and the maximum liability not reflected in the financial statements and cash flow forecast, when the contractor states that the maximum liability for off-balance sheet arrangements and related party transactions is not reflected in the financial statements and/or cash flow forecast. In addition to the written confirmation and schedule, the contractor should be requested to provide:

(1) Any inquiries from their public accounting firm related to off-balance sheet arrangements and related party transactions and their responses to these inquiries. Some contractors may not have engaged a CPA firm to audit their financial statements. In this instance, auditors may accept a response from the contractor stating that they did not engage a CPA firm to audit their financial statements.

(2) The results and reports of any internal audits, reviews or other analyses of off-balance sheet arrangements and related party transactions.

d. When a contractor that is not publicly held refuses to provide a confirmation letter and/or results of inquiries from its public accounting firm and/or results of internal audits, reviews, and other analyses, the financial capability audit report should contain one of the following opinions:

(1) When the auditor has sufficient evidence, even without the confirmation letter, that the contractor's financial capability is adverse, the auditor should issue the audit report with an adverse opinion (14-307a.(3)) and include a qualification for the non-receipt of the contractor's confirmation letter. The purpose of the qualification is to notify the contracting officer that the financial capability could be even worse than presented in the audit report had the contractor provided the confirmation of the off-balance sheet arrangements and related party transactions. In this instance, the auditor has sufficient information without the confirmation letter to express the opinion on the adverse financial capability.

(2) If the contractor refuses to provide the confirmation letter and/or any of the related data, the auditor must disclaim an opinion, except when the auditor has sufficient evidence of an adverse financial condition. In the absence of sufficient evidence of an adverse financial condition, the lack of the confirmation letter and/or the related requested data limits the scope of audit. A significant scope limitation must result in a disclaimer of opinion. The confirmation letter and/or the related requested information is of such importance to the formation of the auditor's opinion that its absence is sufficient to warrant disclaiming an opinion. The Results of Audit section of the report would be worded as follows:

"(Contractor's name) refused to confirm whether the financial statements and cash flow forecast provided during the examination included the disclosure of the maximum liability of off-balance sheet arrangements and related party transactions (insert any related information the contractor refused to provide). We consider the contractor's failure to provide this confirmation to be a significant restriction on the scope of the examination. Because of the restriction on the scope of our examination, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on whether (contractor's name) has adequate financial resources to perform Government contracts in the current and near-term (up to one year)."

14-307 Opinion Criteria in Reporting on Contractor Financial Capability

a. In reporting on financial capability, the auditor will express an opinion (in the results of audit) on the contractor's financial capability to perform on Government contracts. Figure 14-3-1 is a flowchart depicting the appropriate opinion to use when issuing a financial capability report. See 14-308 for modifications to the opinions for audits performed at the request of DFAS related to a contractor requesting an installment agreement. When a contractor is expected to be in financial distress, but has sufficient resources to operate in the near term, the report will specifically address this condition and address any long-

term implications. An assertion of substantial doubt about the contractor's financial capability to perform on Government contracts will be based on near-term (up to one year) expectations that the contractor will be under severe financial distress and have significant difficulty obtaining outside funding to continue performing on Government contracts. The determination that a financial distress situation exists should be based on professional judgment supported by a sufficient degree of audit evidence. Based on the conditions identified during the audit, the auditor will select and use verbatim, one of the following opinions. Following the opinion, it is appropriate to include additional detail supporting the opinion that addresses the specific contractor situation. However, the additional detail should not contradict the opinion (e.g., giving an acceptable opinion and then disclosing that the contractor has substantial debt that is not paid timely, indicating an unfavorable financial condition).

(1) When the audit discloses no financial distress (or relatively insignificant financial distress) and no indications of significant long-term problems, the contractor's financial capability is considered adequate (however, see paragraph (4) below where nonmajor contractors do not prepare a cash flow forecast for our evaluation). In this case, the audit opinion would be worded “In our opinion, the contractor’s financial condition is acceptable for performing government contracts. Our examination of (contractor’s name) financial capability disclosed that it will be capable of performing on its Government contracts in the near-term.”

(2) When the contractor is experiencing financial distress (near-term) but management can, through extraordinary action (such as loans, liquidation of assets, or sale of stock), provide adequate funds to continue performing on Government contracts, the audit opinion must state that the contractor's financial capability is considered unfavorable for the near-term. The opinion would be worded “In our opinion, the contractor is in an unfavorable financial condition. Our examination of (contractor's name) financial capability disclosed that it may have difficulty meeting its near-term financial obligations and may not be capable of performing on its Government contracts without extraordinary management actions.” This condition is reported because the contractor's financial distress in the near-term could affect the contractor's ability to continue receiving external funding. The results of audit will summarize the unfavorable conditions and management's plans to mitigate these conditions. Specific details on audit findings and recommendations will be included in the report appendixes. The auditor will also include the appropriate paragraphs discussed in 14-307b.

(3) When the contractor is experiencing financial distress and there is reasonable doubt that the contractor will be able to obtain necessary funds to continue performance on Government contracts, the auditor’s opinion on the contractor's financial capability is adverse. The opinion in this case is worded “In our opinion, the contractor’s financial condition is adverse. Our examination of (contractor’s name) financial capability disclosed that there is a substantial doubt that the contractor will be financially capable of continuing to perform on Government contracts.” The results of audit paragraph will summarize the adverse conditions and management actions taken to mitigate these conditions. Specific details on audit findings and recommendations will be provided in the report appendixes

(4) A financial capability report with an acceptable opinion cannot be issued for nonmajor contractors that do not provide a cash flow forecast for our evaluation, even though the performance of detailed audit steps did not show signs of financial distress in the near term. In this case, a financial capability report disclaiming an opinion should be issued in accordance with the guidance in 10-200.

b. The following paragraphs provide the auditor with recommendations for the ACO to consider, given the seriousness of conditions discussed in 14-307a.(2) and (3). In addition to these recommendations, the auditor should advise the ACO to selectively scrutinize future progress payments requested by the contractor to ensure that they are computed in accordance with contract terms. The auditor should also report any known weaknesses in the contractor's

billing procedures which would necessitate a restriction of contract financing through progress payments (see 14-200). The existence of financial jeopardy greatly increases the Government's risk regarding billings. Consequently, the scheduling of a billing system audit should be considered.

(1) If the contractor will be unable to meet its ongoing obligations without extraordinary management actions, the auditor should recommend to the ACO that the contractor be required to submit periodic status reports (e.g., monthly, quarterly, or semi-annually depending on the severity of the situation) covering the contractor's plans for mitigating the unfavorable financial conditions. The status report should include such relevant information as cash flow projections, efforts to obtain financing, status of compliance with existing loan/line of credit covenants, efforts to reduce cost, sale of assets, sale of stock, updates of significant contract estimates at completion, and status of sensitive litigation.

(2) If there is substantial doubt that the contractor will be financially capable of performing on Government contracts in the near term, the auditor should recommend that the ACO take action to protect the Government's interests. The auditor should also recommend to the ACO that the contractor be required to submit a status report monthly (until the adverse conditions are corrected) which covers the contractor's plans for and progress towards mitigating the adverse condition.

(3) Financial capability audit reports issued on a corporate subsidiary that is majority owned by a parent corporation should include a recommendation that the ACO obtain a guaranty agreement from the parent corporation for the performance of all Government contracts awarded to the corporate subsidiary.

14-308 Financial Capability Audits Requested by DFAS for Contractor Installment Agreements

a. In accordance with DoD Financial Management Regulation, Volume 10, Chapter 18, when a debtor to the U.S. Government can establish sufficient justification, a series of installment payments may be approved by DFAS which will ensure liquidation of debt within a reasonable time frame. When contractors anticipate having financial difficulty repaying the debt, the contractor may approach DFAS for a repayment installment plan. Prior to approving the installment agreement, DFAS will likely request DCAA to perform a financial capability audit taking into consideration the proposed installment payments to ensure that the contractor has the financial capability to repay the installments.

b. DCAA and DFAS have coordinated and developed a procedure where DCAA will provide assistance to DFAS on the analysis of contractor financial capability for installment agreements totaling $50,000 or more. The procedure is as follows:

(1) The contractor submits a request to DFAS for an installment agreement on debt owed of $50,000 or more.

(2) DFAS provides the contractor with a proposed monthly payment amount. DFAS informs the contractor of the pending DCAA audit and requests the contractor to provide its financial statements for the past three years and a 12-month cash flow forecast reflecting the proposed monthly installment amount.

(3) The DCAA Financial Advisor at DFAS Columbus will advise DFAS which DCAA FAO is cognizant of the subject contractor.

(4) DFAS submits a request for a financial capability audit to the cognizant DCAA FAO. The audit request will include the contractor financial statements for the past three years and the 12-month cash flow forecast reflecting the proposed installment amounts.

(5) The cognizant FAO will perform a financial capability audit on the contractor, address the report to the requestor at DFAS, and include on the distribution the ACO and the DCAA FLA at DFAS Columbus.

(6) DFAS uses the information in the DCAA audit report to make a determination if the proposed installment agreement amount is acceptable.

(7) DFAS coordinates their decision on the installment agreement with the contractor.

c. When requested by DFAS to perform a financial capability audit on a con-

tractor requesting an installment agreement, as background information, the auditor should check the contractor permanent files to determine the results of any recently completed financial condition risk assessment. Even if a risk assessment was completed in the past 12 months, a financial condition risk assessment should be performed. Moreover, after performing a risk assessment where no risk was found, continue the performance of a financial capability audit. The rationale for performing the financial capability audit is that the contractor has disclosed that it is experiencing financial difficulties to DFAS by its inability to repay in lump sum the debt owed the Government. The purpose of the audit is to determine whether the contractor has the financial capability to repay the proposed installment amounts. The audit will also determine what the contractor did with any overpayment on the subject contract and why it is currently not available to return the overpayment to the Government.

d. The financial capability audit will consist of performing a detailed financial condition risk assessment and audit as discussed in 14-304, 14-305, and 14-306. The contractor financial statements and cash flow projection used in the audit will be those provided by DFAS in its request for audit. The DCAA shell audit report for financial capability audits, tailored to reflect the request from DFAS and using the opinion paragraphs discussed below, should be used to report the audit results. A summary of reporting considerations for financial capability reports for DFAS installment agreements is shown in Figure 14-3-3.

(1) When the audit discloses no financial distress (or relatively insignificant financial distress) and no indications of significant long-term problems, the contractor's financial capability is considered adequate. The audit opinion that the contractor's financial condition is acceptable (see 14-307a.(1)) should be followed by the statement "…and should have the financial resources to make the proposed installment payments." In addition, if, while examining the contractor's financial statements and cash flow forecast, in the auditor's judgment, the contractor has other financial means of making the total lump sum payment to DFAS, these financial means should be disclosed in the report (for example: "Our examination of the contractor's financial statements as of (date) disclosed that the contractor has a cash balance of (insert amount), accounts receivable of (insert amount), and an available line of credit of (insert amount). We recommend DFAS discuss with the contractor the possibility of making the total lump sum payment of (insert amount) with these funds as an alternative to obtaining an installment agreement with DFAS. In our opinion, making a total lump sum payment will not place the contractor in an unfavorable financial condition.")

(2) When the contractor is experiencing financial distress (near-term) but management can, through extraordinary action, provide adequate funds to continue performing on Government contracts, the audit opinion must be qualified to state that the contractor's financial capability is considered unfavorable for the long term. The audit opinion would include the unfavorable opinion from 14-307a.(2) followed by the sentence "Through these extraordinary management actions, (contractor's name) should be able to repay the proposed installment amounts."

(3) When the contractor is experiencing financial distress and there is reasonable doubt that the contractor will be able to obtain necessary funds to continue performance on Government contracts, the auditor's opinion on the contractor's financial capability is adverse. The audit opinion would include the adverse opinion from 14-307a.(3) followed by the sentence "Consequently, there is substantial doubt that (contractor's name) will be financially capable of repaying the proposed installment amounts."

(4) Since the contractor has requested an installment agreement with DFAS, the audit report should recommend that the contractor be required to submit future annual financial statements and cash flow forecasts covering the life of the installment agreement to DFAS and the contracting officer.

14-309 Financial Capability Reporting Requirements

a. Audit reports will be issued on all completed financial capability audits. The financial capability audit report should be prepared in accordance with 10-1200. A financial capability audit report shell is included on the APPS under the filename 17600RPT.DOC. If the contractor provided a cash flow forecast for our evaluation and our audit discloses no financial distress, the audit opinion should be worded as described in 14-307a.(1) and detailed exhibits or schedules are not required. The auditor needs to ensure the cash flow forecast used as a basis for supporting the audit opinion represents projections for a reasonable future time period (i.e., preferably 9 months or more, however, no less than 6 months in the future from the date of the audit report).

b. If reliance is placed on the work of others to reduce planned audit scope, the guidance in 4-1000 should be followed.

c. Coordination of and responsiveness to requested due dates is always important. However, greater emphasis and attention should be given to the issues whenever there is an indication of potential financial distress.

d. To ensure that all available facts have been considered, the auditor will discuss findings with the cognizant ACO and the contractor throughout the audit, especially as issues are identified. Other interested parties should be similarly kept abreast of audit progress, and special emphasis should be made to discuss any exception identified during verification of contractor data. The auditor will normally provide the draft report to the contractor at the exit conference, and a reasonable time will be provided for the contractor's written response. Top-level contractor management should be involved in important interim and exit conferences, especially when sensitive audit issues are presented.

e. The auditor will respond timely to customer requests to evaluate contractor submissions showing actions taken to improve financial condition. The auditor should communicate the results of these evaluations timely, in writing, to the customer. Depending on the circumstances, the written communication could be a follow-up report or a memorandum.

f. Financial capability audit reports will normally be addressed to the ACO. However, those financial capability audits requested by DFAS will normally be addressed to DFAS with a copy sent to the DCAA Financial Advisor at DFAS Columbus and the ACO. Audit reports on major contractors that indicate financial distress (14-307a.(2) and (3)), should be forwarded to the requestor with two copies provided through the regional office to Headquarters, ATTN: PPD.

g. Audit reports issued at the corporate office will be provided to FAOs cognizant of the divisions and segments. When the report is distributed to the responsible division or segment FAO, a transmittal letter should advise that the report contains sensitive information and should not be released outside of DCAA to other Government agencies unless approval is provided by the corporate auditor.

h. When financial distress conditions are disclosed at a contractor location which is part of a multidivision corporation, this information should be forwarded in writing to the cognizant contract audit coordinator (CAC), corporate home office auditor (CHOA), or group audit coordinator (GAC), as applicable. Under these circumstances, only the CAC, CHOA, or GAC is in a position to determine if the conditions adversely affect the contractor's company-wide financial position. If financial jeopardy conditions are disclosed at a subsidiary or affiliate for which the parent company does not have liability for Government contracts, separate financial capability audits will be conducted at the parent and at the applicable subsidiary or affiliate.

i. Identify and mark all financial capability reports "FOR OFFICIAL USE ONLY" in accordance with 10-203.13.

Figure 14-3-1
Financial Capability Reporting Decision Flowchart

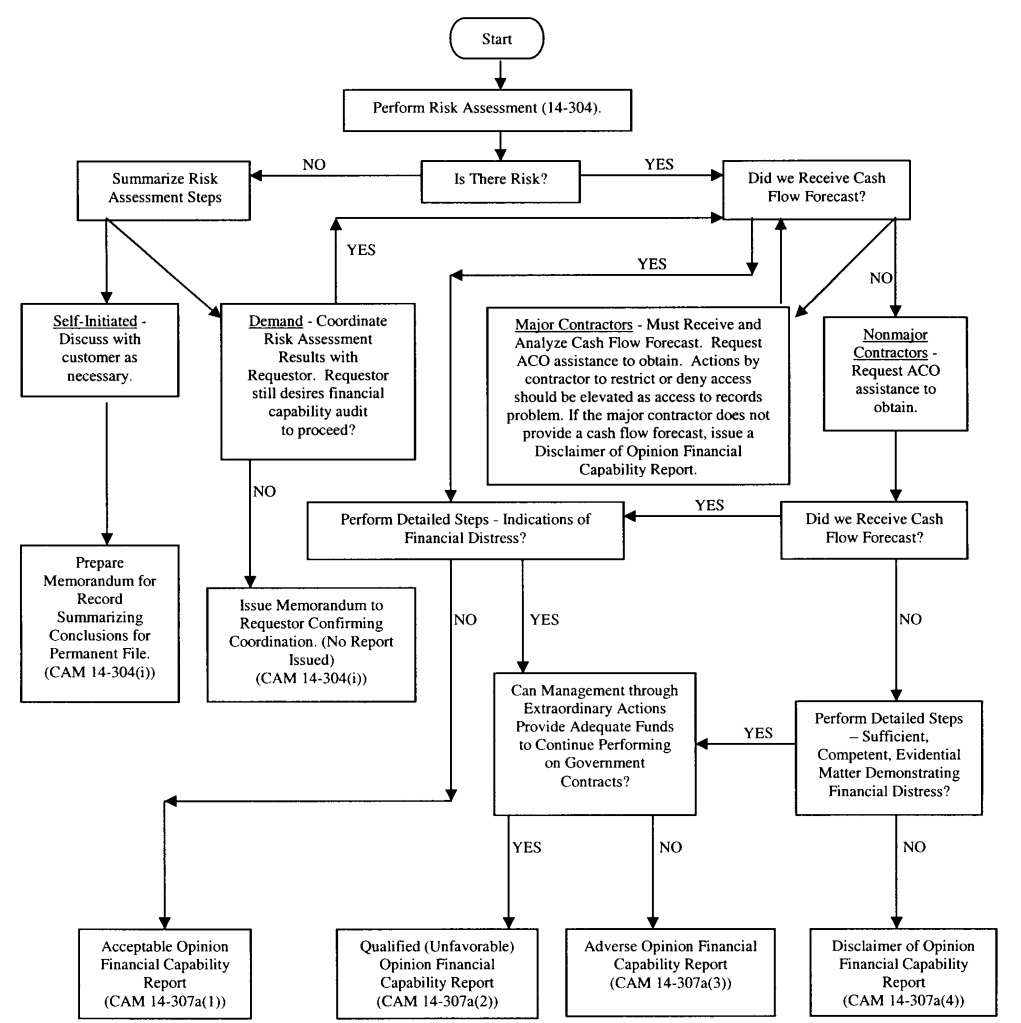

Figure 14-3-2
The Altman Z-Score Formulas

a. Provided here for each model is the model's applicability, evaluation criteria, formulas, and an example. The models use multiple discriminant analysis to calculate a single Z-Score for a company. The Z-Score is useful in predicting bankruptcy potential. Although the models alone should not be relied upon to support a financial condition assessment, they do indicate to the auditor whether further analysis is needed.

b. Each of the three models uses its respective financial ratios, considered simultaneously, to calculate the Z-Score. Pertinent financial data necessary to calculate the Z-Score can normally be derived from the contractor's financial statements. For this analysis, use information from the contractor's most recently completed fiscal years to calculate the Z-Scores. For ease of reference, the Z-Score models are referred to as Model I, II, and III.

c. The applicability, evaluation criteria, formulas, and formula weights are provided below:

MODEL I	Publicly traded (NYSE, AMEX, NASDAQ, etc.) manufacturing (primary SIC codes 2000 through 3999) companies only. This is the original Altman model.
MODEL II	Other than publicly traded manufacturing (primary SIC codes 2000 through 3999) companies only. This model is Altman's 1983A bankruptcy prediction model for private companies.
MODEL III	All remaining companies excluded by I and II. This model is Altman's 1983B bankruptcy prediction model with asset turnover correction.

Interpretation of Model Results (Note b)			
MODEL I	MODEL II	MODEL III	Indication
< 1.81	< 1.23	< 1.10	Probable future financial distress
1.81 to 2.99	1.23 to 2.90	1.10 to 2.60	Possible future financial distress
> 2.99	> 2.90	> 2.60	Little or no chance of financial distress

Z-Score Model Formulas	
Variable	Formula
X1 (Note c)	Working Capital/Total Assets
X2 (Note d)	Retained Earnings/Total Assets
X3 (Note e)	Earnings Before Interest and Taxes (EBIT)/Total Assets
X4 (Note f)	Stockholder Equity/Total Liabilities (Current + Long-Term)
X5 (Note g)	Sales/Total Assets

ALTMAN Z-Score MODEL VARIABLE WEIGHTS			
	MODEL VARIABLE WEIGHTS		
MODEL VARIABLES	MODEL I	MODEL II	MODEL III
X1	1.2	.717	6.56
X2	1.4	.847	3.26
X3	3.3	3.107	6.72
X4	.6	.420	1.05
X5 (Note h)	1.0	1.000	N/A

(a) Altman Z Models. Comparable industry data (including ratios) is available (all models) from OTST whether or not your company is publicly traded. However, individual company data (including ratios) is available (through OTST) on publicly traded companies only. Therefore, the auditor will be responsible for calculating individual company ratios on other than publicly traded companies.

(b) Data is from Corporate Financial Distress and Bankruptcy, Chapter 8, by Edward I. Altman, 1993.

(c) Working Capital/Total Assets. This ratio is a measure of the net liquid assets of the firm relative to the total capitalization. Working capital is defined as the difference between current assets and current liabilities. Ordinarily, a firm experiencing consistent operating losses will experience a reduction in current assets in relation to total assets.

(d) Retained Earnings/Total Assets. The incidence of failure is much higher in a firm's early years. Therefore, the age of a firm is implicitly considered in this ratio. For example, a relatively young firm will probably show a low RE/TA ratio because it has not had time to build up its cumulative profits.

(e) Earnings Before Interest and Taxes/Total Assets. This ratio is a measure of the true productivity of the firm's assets, aside from any tax or leverage factors. Since a firm's ultimate existence is based on the earning power of its assets, this ratio is particularly appropriate for analysis of corporate failure. For the computation of earnings before interest and taxes, the auditor should exclude extraordinary items and gains or losses such as disposal of a segment of a business.

(f) Stockholder Equity/Total Liabilities (Current + Long-Term). For Model I, stockholder equity is measured by the combined market value of all shares of stock, preferred and common. Use the book value of stockholder equity for Models II and III. Total liabilities includes both current and long-term obligations.

(g) Sales/Total Assets. This is the financial ratio that illustrates the firm's assets' ability to generate sales. It is one measure of management's capability in dealing with competitive conditions. This ratio is applicable to Models I and II only.

(h) X5 Application. Based on ease of application and common usage, the weight assigned to the X5 variable has been rounded from .99 to 1.0.

Figure 14-3-2

CALCULATING THE Z-SCORE

- Determine which model is appropriate for the company under evaluation.
- Calculate each of the applicable model variables ("X" ratios) via reference to notes (c) through (g).
- Multiply each "X" ratio by the applicable weight for model selected.
- Add the products together to obtain the Z-Score for the company.

COMPANY DATA:	THOUSANDS
WORKING CAPITAL	$1,534
TOTAL ASSETS	12,486
TOTAL LIABILITIES	9,125
SALES	14,696
EBIT	923
RETAINED EARNINGS	2,900
STOCKHOLDER EQUITY - MARKET VALUE	2,235
STOCKHOLDER EQUITY - BOOK VALUE	3,361

VARIABLE	VARIABLE CALCULATION			RESULT
X1	$1,534	/	$12,486	.123
X2	2,900	/	12,486	.232
X3	923	/	12,486	.074
X4 [MARKET VALUE]	2,235	/	9,125	.245
X4 [BOOK VALUE]	3,361	/	9,125	.368
X5	14,696	/	12,486	1.177

EXAMPLE OF A MODEL III - Z SCORE CALCULATION					
X1	6.56	X	.123	=	.81
X2	3.26	X	.232	=	.76
X3	6.72	X	.074	=	.50
X4 [BOOK VALUE]	1.05	X	.368	=	.39
X5 N/A					
Z-SCORE					2.46

Figure 14-3-3
Summary of Reporting Considerations for Financial Capability Reports for DFAS Installment Agreements

Financial Condition	Ability to Make Payment	Report Comments
Acceptable	Can make lump sum payment without adversely affecting acceptable financial condition	Recommend DFAS discuss with the contractor the possibility of making the total lump sum payment with available funds as an alternative to obtaining an installment agreement with DFAS.
Acceptable	Can make installment payments without adversely affecting acceptable financial condition	Contractor should have the financial resources to make the proposed installment payments. The report should recommend that the contractor be required to submit future annual financial statements and 12 month cash flow forecasts covering the life of the installment agreement to DFAS and the contracting officer.
Unfavorable	Can make installment payments without further adversely affecting unfavorable financial condition, as long as extraordinary actions are taken	Contractor may have difficulty making the proposed installment payments, but should be able to make repayment if extraordinary management actions are taken. The report should recommend that the contractor be required to submit future annual financial statements and 12 month cash flow forecasts covering the life of the installment agreement to DFAS and the contracting officer. The report should recommend that the contractor be required to submit periodic status reports covering the contractor's plans for mitigating the unfavorable financial conditions (CAM 14-307b.(1)).

Figure 14-3-3

Financial Condition	Ability to Make Payment	Report Comments
Adverse	Substantial doubt that contractor can make installment payments	Contractor does not have the financial resources to make the proposed installment payments. (In these instances, DFAS will normally request immediate full payment of the debt amount.) The auditor should recommend that action be taken to protect the Government's interests. The auditor should also recommend that the contractor be required to submit a status report monthly (until the adverse conditions are corrected) which covers the contractor's plans for and progress towards mitigating the adverse conditions (CAM 14-307b.(2)).

14-400 Section 4 --- Contract Audits of Government Property Including Government Furnished Property (GFP)

14-401 Introduction

This section covers contract audit responsibilities in connection with Government-owned property in the possession of contractors and subcontractors. It describes the various types of Government-furnished and contractor-acquired Government property, key contract regulations on such property, and the responsibilities of the Government property administrator. Related contract audit interests are divided into:

(1) considerations regarding Government property that fall within the ongoing audits of incurred costs and price proposals, and

(2) certain audits of Government property matters that are undertaken on specific request.

14-402 Types of Government Property

a. Government property in the possession of contractors may consist of:

(1) property provided or leased to the contractor by the Government, and

(2) property acquired by the contractor from other sources where upon acquisition title passes to the Government under terms of the contract.

b. Government property is further classified by FAR 45.101, 45.301, and DFARS 245.301 into the following categories:

(1) plant equipment,
(2) real property,
(3) special test equipment,
(4) special tooling,
(5) facilities,
(6) Government production and research property,
(7) material,
(8) nonseverable property,
(9) agency-peculiar property,
(10) industrial plant equipment (IPE),
(11) mapping, charting, and geodesy (MC&G) property, and
(12) other plant equipment (OPE).

c. Agency-peculiar property, as defined in FAR 45.301 and DFARS 245.301, may be furnished to contractors under a facilities contract, a supply or service contract containing the appropriate Government Property clause, or a special bailment agreement.

14-403 Contract Regulations on Gov't Property

14-403.1 Basic FAR/DFARS References

a. FAR Part 45/DFARS Part 245 contains the basic regulations regarding Government property in the possession of contractors. Both government and contractor responsibilities are set forth in this part. In addition, DoD 4161.2-M, DoD Manual for the Performance of Contract Property Administration, sets forth specific responsibilities of DoD personnel for the administration of Government property in the possession of the contractor.

b. By memorandum dated June 30, 1998, the Director of Defense Procurement extended authorization for all military departments and defense agencies to deviate from certain requirements in FAR Part 45. The class deviation reduces property record keeping activity and periodic physical inventory requirements for low value Government property. Under the deviation, the contractor's property control records provide the basic information needed, and the contractor is not required to update changes in location after the establishment of the official Government property record. "Low Value Property" means Government property with an acquisition cost of $1,500 or less in the classes of special tooling, special test equipment, and plant equipment. Specifically excluded from this definition are agency-peculiar property, material, real property, and sensitive property. The class deviation is in effect through July 14, 1999, or until FAR Part 45 is revised to include these provisions, whichever event occurs first.

14-403.2 DoD Policy on Furnishing Facilities

It is DoD policy to rely on contractors to furnish, to the maximum extent possi-

ble, the facilities necessary to perform a Government contract. Facilities includes Government property used for production, maintenance, research, development, or testing. It does not include material, special test equipment, special tooling or agency-peculiar property. Facilities having an acquisition cost of less than $10,000 shall not be provided to contractors unless:

(1) the contractor is operating a Government-owned plant on a cost-plus-fee basis,

(2) the contractor is performing onsite at Government installations,

(3) the contractor is a nonprofit institution of higher education or other nonprofit organization whose primary purpose is the conduct of scientific research,

(4) the contractor is performing under a contract specifying that it may acquire or fabricate special tooling, special test equipment, and components thereof subsequent to obtaining the approval of the contracting officer, or

(5) facilities are unavailable from other-than-Government sources. Facilities, as well as IPE and automatic data processing equipment, may be furnished to contractors as prescribed by FAR 45.302 and DFARS 245-302.

14-403.3 Use of IPE on Commercial Work

a. IPE is defined and identified by noun name in DFARS 245.301.

b. In conjunction with its use on Government contracts, commercial use of IPE may be authorized by the contracting officer or contract provisions for no more than 25 percent of the total time available for both commercial and Government use during the contractor's normal work schedule. Commercial use in excess of 25 percent must have the prior approval of an Assistant Secretary of the Military Service or, where applicable, the Defense Logistics Agency Director. In addition, the approval authority may also be delegated to the head of a contracting activity, provided the redelegation is approved by the Office of the Assistant Secretary of Defense, Production and Logistics, Production Resources (OASD (P&L)(PR)).

c. When IPE items are no longer required for Government contracts, they will not be made available to the contractor solely for commercial use.

14-404 Government Roles in Audit of Government Property

14-404.1 Functions of the Gov't Property Administrator

a. A single property administrator is designated for all contracts involving Government property at each contractor location. He or she is the Government representative primarily responsible for property administration, including the surveillance of the contractor's control of Government property. DoD 4161.2-M states procedures and techniques for the guidance of DoD personnel engaged in the administration of Government property in the possession of contractors. DoD 4161.2-M also provides guidance as to specific functional areas requiring consideration and surveillance by the property administrator.

b. As stated in DoD 4161.2-M, the property administrator is responsible for approving the contractor's property control system and for examining its actual application. In accomplishing his or her duties, however, the property administrator is to recognize the responsibilities of other Government personnel and obtain their assistance when required.

14-404.2 Related Contract Audit Functions

a. The contract auditor and the property administrator have certain related responsibilities for Government property in the possession of contractors. As a generalization, the contract auditor is primarily concerned with contractors' financial records and controls of Government property related to claimed or proposed contract costs and prices. The property administrator, on the other hand, is primarily concerned with contractors' property records and controls related to the physical existence, custody, maintenance, safeguard, usage, rental, and disposition of Government property.

b. Since the auditor and the property administrator have a substantial common interest in the contractor's Government property records, discussions and close liaison are required to avoid unnecessary duplication and obtain optimum deployment of available Government personnel. The contract auditor will accept and make full use of the property administrator's review data and evaluation reports. Consistent with this use, the auditor will develop a program of nonduplicative audit steps designed to accomplish DCAA areas of responsibility.

c. The auditor will be responsive to requests for assistance and advice to responsible Government activities on matters involving analyses of the contractor's financial books and records pertaining to Government property.

d. Contractor operations are audited on a comprehensive basis by purpose. The auditor will not perform a separate or special audit of property under an individual contract solely to permit the retirement of the contract files and records by procurement or contract administration offices. There is no requirement for an audit of the contractor's Government property records by the contract auditor as a prerequisite to the retirement of the property administrator's contract files and records.

14-404.3 Internal Audit Functions

The DoD internal audit organizations are responsible for auditing the property administrator's activities and for evaluating the system of Government property administration. Policies governing relationships with these organizations, including those concerning requests to assist them in these kinds of reviews, are stated in 1-400.

14-405 Contract Audit Objectives and Procedures

The following audit objectives and procedures regarding Government property apply at contractor locations where audits of incurred costs are performed on a recurring basis.

14-405.1 Preliminary Planning Steps

The DCAA auditor should ascertain whether the contractor's Government property accounting and control system has the current approval of the property administrator. Review the property administrator's approval report and obtain copies of

(1) the contractor's property accounting procedures manual,

(2) reports of the property administrator's surveillance of the property, and

(3) the internal audit reports issued by Government and contractor personnel.

This information should be used by the auditor in making an initial assessment of the extent of reliance to be placed on existing property controls and procedures and the extent of transaction testing to be undertaken.

14-405.2 Audit Programs for Material Costs

Contractors normally use the same procurement practices and material control systems for both Government-owned and contractor-owned materials. The audit functions for Government materials will, therefore, be integrated to the maximum extent with the overall audit of incurred material costs. The audit programs developed in accordance with the guidance contained in Chapter 6 will be used for the evaluation of those aspects of Government property activities which are the responsibility of DCAA.

14-405.3 Testing of Purchase Costs

The auditor will determine whether recorded purchase costs are properly claimed for reimbursement by the contractor by testing purchases of contractor-acquired Government property (facilities, materials, special tooling, and special test equipment) to see if the property was:

(1) required for contract performance,

(2) properly classified and acquired with the proper contractual authority,

(3) bought in reasonable quantities at prudent prices, and

(4) received, inspected, and entered accurately in the contractor's accounting records.

Consider the guidance in 14-600 relative to the evaluation of the contractor's capital asset acquisition program and 7-2106 on capital items as contract costs.

14-405.4 Evaluation of Material Handling and Usage

The evaluation of the contractor's stockage, issuance, and usage of Government material is the primary responsibility of the property administrator. The evaluation of these same functions for contractor-owned material used in performing Government contracts is the primary responsibility of the contract auditor. In those cases where the contractor uses the same system, procedures, and personnel for contractor-owned and Government-owned material, the auditor may test the effectiveness of each of these functions on a comprehensive basis by selecting transactions without distinction as to material ownership (see 6-300). The results of these tests may be applied to the functions as a whole.

14-405.5 Final Audit Reports

Prior to the issuance of a closing statement or final report on each cost-reimbursement type contract or subcontract, the auditor will review the contract to determine if potential credits may result from the disposition of Government property. If necessary, coordinate with the property administrator as to whether there are any credits relating to the quantity, condition, use and/or disposition of Government property that are to be applied to the total cost of contract performance. The auditor will use the information in preparing the contract audit closing statement.

14-405.6 Evaluation of Residual Materials and Intercontract Transfers

a. Transfers of Government materials between contracts and the disposition of residual inventories should be carefully evaluated. The contract auditor should assure that intercontract transfers of inventory and related costs comply with FAR 31.205-26 for inventory and costing purposes.

b. Audit recommendations for adjustments to contract cost, price, or fee should be considered:

(1) when residual materials from completed cost-reimbursement type contracts are transferred to follow-on incentive type contracts on a no-cost basis and such use was not anticipated, or

(2) when amounts of Government material authorized for use under the contract are changed significantly without any related contract price or fee adjustment.

14-405.7 Evaluation of Physical Controls

The evaluation of physical control of recorded Government property, both Government-furnished and contractor- acquired, is primarily the responsibility of the property administrator. The auditor will, however, be alert to any unauthorized or improper use of these items or to the existence of idle equipment. Such disclosures may arise from labor floor checks, physical inventory observations, plant perambulations, or other normally performed contract audit procedures. Where extensive repairs or maintenance activities are observed, the auditor will coordinate with technical personnel, as required, to determine whether such practices are necessary and result in reasonable costs to the Government.

14-405.8 Allocation of Depreciation and Rental Charges

a. Contractor-owned and Government-owned facilities and equipment may be used in a single cost center which performs Government and commercial work. In these cases, the contract auditor should carefully review the allocation of depreciation costs to Government and commercial work to ensure that it is equitable. If, for example, the Government-owned equipment is used wholly on Government work on a no-charge basis, and other similar items of contractor-owned equipment are used for commercial work, it may be proper to charge all the depreciation costs on such equipment to the commercial work.

b. Rental expense for use of Government-owned equipment and facilities on

commercial work as authorized in the contract should normally be charged to such commercial work rather than be included as part of overhead allocated to both government and commercial work.

14-405.9 Use of Gov't Property on FMS

Prior to February 1, 1991, when authorized in the contract, rental expense for use of Government-owned equipment and facilities on foreign military sales (FMS) contracts were normally charged to such work. On February 1, 1991, DFARS 245.4 was changed to permit rent-free use of U.S. Government property on FMS contracts. In accordance with Public Law 101-165, the change was made retroactive to November 21, 1989. Because of the retroactive application of the policy, FMS contracts issued between November 21, 1989 and February 1, 1991 may have been overcharged. However, reimbursements for such overcharges are limited to the amount of rental use charge contained in the affected "Letter of Agreements" and must be approved by the contracting officer.

14-406 Government Property Audits Upon Specific Request

14-406.1 Audit of Contractor Reports on Gov't Property

The contractor is required by FAR 45.505/DFARS 245.505, to prepare and submit financial reports on the amount of Government-owned facilities and Government material in its possession. The auditor will evaluate these reports if specifically requested to by the contracting officer or property administrator.

14-406.2 Audit of Rental Charges for Use of Gov't Property

The Director of Defense Procurement (DDP) issued a DoD Class Deviation on Use and Charges Clause. The class deviation is effective from September 6, 1996 through September 30, 1999, or until FAR Part 45 is revised to include these provisions, whichever occurs first. The detailed guidance can be found at 14-4S1. The deviation clause, guidance, and prescribed language is to be used in lieu of the clause at FAR 52.245-9 and its guidance and prescribed language at 45.202-1, 45.205(c), 45.302-6(c), and 45.403(a) and (b).

The clause makes the time property is actually used for commercial purposes the rental basis. This permits contractors to:

(1) obtain property appraisals from independent appraisers, and

(2) use appraisal-based rentals for all property.

This allows contracting officers to consider alternate bases for determining rentals. The rental policy changes are intended to encourage dual use of Government property. The guidance noted should be substituted where applicable below.

a. The monthly percentage rental rates for the facilities and equipment (including IPE) furnished a contractor are set forth in the Use and Charges Clause (FAR 52.245-9) in the contract. The rates apply to the acquisition costs of the facilities and equipment, plus the cost of transportation to and installation in the contractor's plant, if such costs are borne by the Government. The contractor may, however, be authorized by the contract or by the contracting officer, in writing, to use the facilities and equipment on a no-fee basis for specific contracts, subcontracts, or other work. If any item is used during a rental period without authorization, the contractor is liable for the full period rental for such item without any credit for no-fee use. The Secretary concerned, however, may waive, in writing, the contractor's liability for such unauthorized use if he or she determines that circumstances would justify the waiver.

b. After the close of each rental period, the contractor submits to the contracting officer a written statement of use made of the facilities and equipment and the rental due the Government. The rental amount is reduced by a credit for no-fee usage during the rental period. The credit is computed by multiplying the full rental rate by a fraction in which the numerator is the amount of no-charge usage and the denominator is the total amount of usage during the rental period. The unit used in determining usage will be direct labor hours, sales, hours of

use or any other equitable basis approved by the contracting officer.

c. The DCAA auditor will be responsive to specific requests from the contracting officer for the audit of contractor's rental statements. Generally, such requests will relate to the verification of:

- the basis of the rental computation, and
- the propriety of the procedures for controlling, recording, and reporting usage in accordance with contract provisions.

In accomplishing the requested audit, the results of facilities utilization reviews made by the property administrator will be appropriately used.

(1) A determination of proper rental amounts requires audit consideration of a variety of factors incorporated in facility agreements, including the proper base. The rates applied to base costs are set forth in the contract clause set forth in FAR 52.245-9. The auditor should determine that all facilities acquisition costs are in the base including leasehold improvements for which the Government holds title.

(2) The auditor should assure that the unit used to determine facilities utilization is equitable. The unit used should be representative of the actual facilities utilization, regardless of whether the usage is rent-free. Rent-free facilities should not be excluded from the base and included in computing the credit for rent-free usage.

14-406.3 Gov't Property Audits at Other Locations

At contractor locations where incurred costs are not performed on a recurring basis, the DCAA auditor will audit Government property only upon the specific request received from the contracting officer or the internal auditor. Such audit assistance would relate to Government property areas similar to those outlined in 14-405 above. Where a large number of such requests are received and performance would have an impact upon accomplishing other audit workload, guidance will be requested from Headquarters.

14-407 Audit Discussions

Deficiencies or unsatisfactory conditions disclosed by the auditor should be discussed with the contractor to the extent necessary to assure the validity of the findings. Further, any adverse conclusions or recommendations for changes in the contractor's property procedures and controls will be discussed with the property administrator and included in the report to the administrative contracting officer.

14-408 Audit Reports on Gov't Property

a. Findings and recommendations relating to Government property will be reported as appropriate in system survey reports, audit reports on individual contracts, and in reports on significant functional areas.

b. Deficiencies requiring immediate attention and findings on significant functional areas involving Government property should be reported promptly in a separate report to the administrative contracting officer, with a copy to the property administrator.

c. Audit reports in response to specific requests from the administrative contracting officer or internal auditors will be addressed to the requesting office.

d. Where the property administrator requests DCAA assistance on a specific matter or problem, the response will be addressed to the property administrator, with a copy to the administrative contracting officer.

14-4S1 Supplement --- FAR 52.245-9

52.245-9 Use and Charges (Deviation)
Use the following clause when Government property and real property is to be used for commercial purposes:

USE AND CHARGES (APR 1984) (DEVIATION)

(a) Definitions.
As used in this clause-

Acquisition cost means the acquisition cost recorded in the Contractor's property control system or, in the absence of such record, the value attributed by the Government to a Government property item for purposes of determining a reasonable rental charge.

Government property means property owned or leased by the Government.

Real property means land and rights in land, ground improvements, utility distribution systems, and buildings and other structures. It does not include foundations and other work necessary for installing special tooling, special test equipment, or equipment.

Rental period means the calendar period during which Government property is made available for commercial purposes.

Rental time means the number of hours, to the nearest whole hour, rented property is actually used for commercial purposes. It includes time to set up the property for such purposes, perform required maintenance, and restore the property to its condition prior to rental (less normal wear and tear).

(b) General.

(1) Rental requests must be submitted to the administrative Contracting Officer, identify the property for which rental is requested, propose a rental period, and calculate an estimated rental charge by using the Contractor's best estimate of rental time in the formulae described in paragraph (c) of this clause.

(2) The Contractor shall not use Government property for commercial purposes, including Independent Research and Development, until a rental charge for real property, or estimated rental charge for other property, is agreed upon. Rented property shall be used only on a non-interference basis.
(c) Rental charge.

(1) Real property and associated fixtures.

(i) The Contractor shall obtain, at its expense, a property appraisal from an independent licensed, accredited, or certified appraiser that computes a monthly, daily, or hourly rental rate for comparable commercial property. The appraisal may be used to

compute rentals under this clause throughout its effective period or, if an effective period is not stated in the appraisal, for one year following the date the appraisal was performed. The Contractor shall submit the appraisal to the administrative Contracting Officer at least 30 days prior to the date the property is needed for commercial use. Except as provided in paragraph (c)(1)(iii) of this clause, the administrative Contracting Officer shall use the appraisal rental rate to determine a reasonable rental charge.

(ii) Rental charges shall be determined by multiplying the rental time by the appraisal rental rate expressed as a rate per hour. Monthly or daily appraisal rental rates shall be divided by 720 or 24, respectively, to determine an hourly rental rate.

(iii) When the administrative Contracting Officer has reason to believe the appraisal rental rate is not reasonable, he or she shall promptly notify the Contractor and provide his or her rationale. The parties may agree on an alternate means for computing a reasonable rental charge.

(2) Other Government property. The Contractor may elect to calculate the final rental charge using the appraisal method described in paragraph (c)(1)of this clause subject to the constraints therein or the following formula in which rental time shall be expressed in increments of not less than one hour with portions of hours rounded to the next higher hour-

$$\text{Rental charge} = \frac{(\text{Rental Time in hours})(.02 \text{ per hour})(\text{Acquisition Cost})}{720 \text{ hours per month}}$$

(3) Alternate methodology. The Contractor may request consideration of an alternate basis for computing the rental charge if it considers the monthly rental rate or a time-based rental unreasonable or impractical.

(d) Rental payments.

(1) Rent is due at the time and place specified by the Contracting Officer. If a time is not specified, the rental is due 60 days following completion of the rental period. The Contractor shall calculate the rental due, and furnish records or other supporting data in sufficient detail to permit the administrative Contracting Officer to verify the rental time and computation. Unless otherwise permitted by law, payment shall be made by check payable to the Treasurer of the United States and sent to the contract administration office identified in this contract or by electronic funds transfer to that office.

(2) Interest will be charged if payment is not made by the specified payment date or, in the absence of a specified date, the 61st day following completion of the rental period. Interest will accrue at the "Renegotiation Board Interest Rate" (published in the Federal Register semiannually on or about January lst and July lst) for the period in which the rent is due.

(3) The Government's acceptance of any rental payment under this clause, in whole or in part, shall not be construed as a waiver or relinquishment of any rights it may have

against the Contractor stemming from the Contractor's unauthorized use of Government property or any other failure to perform this contract according-to its terms.

(e) Use revocation. At any time during the rental period, the Government may revoke commercial use authorization and require the Contractor, at the Contractor's expense, to return the property to the Government, restore the property to its pre-rental condition (less normal wear and tear), or both.

(f) Unauthorized Use. The unauthorized use of Government property can subject a person to fines, imprisonment, or both, under 18 U.S.C. 641.

(End of clause)

14-500 Section 5 --- Operations Audits

14-501 Introduction

This section provides guidance on the audit of operations of major contractors. Additional assistance may be obtained from the Special Programs Branch of the Technical Audit Services Division (OTS). OTS maintains a database of positive operations audit findings titled Operations Audit Summary Information System (OASIS). A synopsis of the reported audit findings in a selected area may be obtained from OTS.

14-502 Audit of Operations of Major Contractors

14-502.1 Audit Plan

When evaluation of the factors influencing the extent and scope of the audit effort (3-104) discloses that the Government has a significant interest in a contractor's operation at any major organizational level, the audit plan should provide for continuous auditing of related areas of the contractor's management system. The audit plan should be developed in a manner to permit the timely accumulation and reporting of information in areas of cost that have managerial significance and will contribute to a more economical and efficient operation. It should be sufficiently comprehensive to accord broad coverage of the contractor's complete operations as they affect performance of Government contracts.

14-502.2 Audit Approach

a. That portion of a contractor's cost representations which indicate actual experience, generally is taken from the contractor's books of accounts which are the end product of the accounting system element of its internal control structure. The cost so recorded reflects the results of management policies and decisions and the degree of control exercised over operations and expenditures. On the principle that the whole equals the sum of its parts, it follows that data taken from books of account and other records may be accepted based on minimum or reduced verification and testing if costs and financial data are based on:

(1) prudent management policies and decisions,

(2) an efficient organization reflecting effective management control over operations, and

(3) a sound and reliable system of accumulating accounting and financial data.

b. Predicated on this principle, the total audit concept places major emphasis on the degree of prudence exercised by management in establishing policies and making management decisions, methods of controlling costs, and the extent of reliance that can be placed on the accounting information and other financial data.

14-502.3 Audit Program (Operations Audit)

a. A basic requirement in the development of the audit program is an evaluation of the contractor's overall organization chart, the management policies, procedures, and controls developed for operations, and the accounting system and other records designed to control, record, and measure the results of operations. Typical areas of coverage are presented in Chapters 6 and 9, e.g. purchasing and subcontracting, bid estimating procedures, employee utilization, and indirect cost audits. From knowledge and understanding obtained from the evaluations, auditing procedures should be developed in such manner to provide a basis for repeated evaluations of the operations related to the overall plan and operations of the organization.

b. The audit program should be sectionalized to cover specific functions or areas of the contractor's operations and the various phases of the system as they relate to the accumulation and recording of accounting, financial, and other management data. The auditing procedures to be applied under each of the sectionalized portions of the audit program should be logically arranged to enable an evaluation and reporting of the conditions found for each of the areas programmed.

14-503 Planning Considerations

a. The audit plan for major contractor operations is primarily designed to seek out and identify those areas where the contractor's practices are wasteful, careless, inefficient and result or may result in unreasonable costs and unsatisfactory conditions in performing Government contracts; and to report such matters to those responsible for taking action to correct or improve the condition.

b. FAR 31.201-3 defines ""reasonable" as it applies to the cost of performance of Government contracts. The responsibility placed upon the auditor to disclose unreasonable costs requires serious consideration and a clear understanding of the internal operations of the business, and the practices of the industry as a whole. The auditor should keep in mind that the interest of the contractor may not be compatible with the interest of the Government. For example, from the contractor's viewpoint it may be more prudent for the contractor to rent rather than purchase an item of equipment even if the action results in greater contract cost.

c. The auditing procedures need to be designed and applied in such a way as to provide the auditor with full knowledge of the methods by which the contractor controls its production and research; the bases for the contractor's make-or-buy decisions, including decisions relating to the specific components entering into the end item, and the acquisition of facilities and production equipment; the manner in which employees are recruited and in which materials are acquired; whether or not the employees and materials and facilities are effectively utilized; and what constitutes a reasonable level of expense. In short, the auditor should be in a position to know that expenses are necessary, that business practices are sound, and that actions are prudent and in line with established practices. Therefore, the auditor should be completely familiar with the basis upon which the management decisions are made by the contractor.

d. In terms of an audit technique, this approach must be geared to inquire into those management and operational decisions which affect the nature and level of costs being proposed and incurred under Government contracts. The knowledge gained forms the basis for constructive recommendations to improve the contractor's internal control structure and the economy and efficiency of contractor operations.

e. A procurement agency's special interest in certain areas of the contractor's operations should be considered in audit planning (see 3-104 and 4-103).

14-504 Conferences and Reports on Operations and Internal Control Audits

a. See 4-300 for guidance on entrance, interim, and exit conferences with the contractor.

b. Promptly after completing each operations or internal control audit, prepare and distribute a report in accordance with 10-400, regardless of findings. Shell reports are available for all system audit assignment codes.

c. Issue a follow-up report when the contractor agreed to take corrective action on reported deficiencies or cost avoidance but has taken an unusually long time (six months or more) without any effective action. The follow-up report should recommend that the ACO make further efforts to obtain the needed contractor corrective action(s). If there is a pattern of contractor failure to take corrective action in such cases, emphasize this fact in the report.

d. Also include the impact of cost avoidance recommendations as questioned costs in reports on audits of price proposals in accordance with the criteria in 9-308.

14-600 Section 6 --- Audit of Contractor Capital Investment Projects

14-601 Introduction

This section provides guidance for auditing the planning, budgeting, implementation and benefits evaluation of contractor capital investment projects.

14-602 General

a. Contractors have a responsibility to maintain their competitiveness and increase productivity through the efficient management of capital investment.

b. The capital budgeting process often involves long-term planning decisions for capital investments. The auditor, in conjunction with other members of the procurement team, has an excellent opportunity to assess these management decisions. In performing an operations audit of the contractor's capital investment program, the auditor should identify capital utilization and investment opportunities which may ultimately benefit the Government. Recommendations to contractor representatives and administrative contracting officers (ACOs) should emphasize the cost avoidance aspects of capital investments and look for fast-payback opportunities (capital investments which produce cost benefits equal to the original cash outlay over the shortest time frame); however, non-financial benefits such as improved quality, mobilization capability, and enhanced competitiveness should not be overlooked. For purposes of this section, a contractor's capital investment program includes areas such as make-or-buy decisions, ADPE acquisitions/leasing, plant equipment and building acquisitions/leasing, relocations, plant reorganizations and high cost research and test equipment, etc. Recommendations resulting from an operations audit of the contractor's capital investment program may be of particular value in the performance of special procurement studies, such as Should Cost Audits, since they often require audit of the contractor's capital investment program to insure that alternate manufacturing methods, equipment and procedures have been adequately considered for the specific procurement under consideration.

c. Contractor capital expenditures involve resource commitments which, in many instances, are irreversible. Therefore, it is essential that the contractor's capital investment policies and procedures provide management with prompt and comprehensive information on investment decisions. A reliable, logical and documented method of evaluation should be established by the contractor to ensure that broad company objectives are being considered and the proposed capital expenditures are prioritized. Contractor decisions in this regard are affected by a myriad of factors, some of which may not result in the most equitable treatment of Government work. For example, due to limitations on funds available for capital investments, the contractor might be required to choose between purchasing a piece of equipment for a commercial division or for a division working primarily on Government cost reimbursement type contracts. The contractor will undoubtedly attempt to produce increased profits and cash flow. Since the contractor will continue to recover its incurred costs in the Government division, it may be less inclined to increase the efficiency of that division. Thus, priorities should be audited carefully to ensure that the Government is afforded the benefit of the most economical and efficient capital investment options available to the contractor.

d. The contractor's written procedures for a capital investment program should provide for the following:

(1) A well-defined organization with established decision authority and responsibility for aggressively pursuing capital investment opportunities which will improve the efficiency of operations, affect long-term economies, and make timely identification and replacement of deteriorated and obsolete items.

(2) A systematic approach for auditing processes, organizations and methods, affecting improvements and detecting deteriorated, obsolete, and underutilized items.

(3) A standard procedure for identification of potential capital budgeting projects, estimation of project benefits and costs, evaluation of proposed projects, and development of the capital expenditure budget based on project acceptance criteria.

(4) A documented review and approval process which assures that the assumptions are correct, all relevant factors have been considered, and proposals are consistent with organization objectives.

(5) A systematic follow-up to insure that project implementation is prompt and within estimated costs.

(6) A system for tracking and comparing planned to actual benefits.

14-603 Methods for Evaluating Capital Investment Proposals

a. A capital investment evaluation system is necessary to ensure proposals are evaluated in light of organizational goals so that the most desirable investments are undertaken. The financial attractiveness of capital investment proposals must be judged by comparing the cost (investment) required with the benefit (increased revenues) expected.

b. The methods commonly used to evaluate capital investment proposals are presented below. Depending on circumstances, some methods are preferred over others. Auditors should refer to managerial accounting and financial text books for detailed descriptions as to how these methods are applied and ensure that the method selected by the contractor is appropriate to the circumstances.

14-603.1 Payback Method

The payback method is the most widely used approach to capital investment. It measures the length of time required for the flow of cash benefits produced by the investment to equal the original cash outlay, and is calculated by dividing the original cost by the annual cash savings. The resultant calculated payback period is usually compared to a predetermined payback period which is preferred by the company. This method is easy to use since it measures the project's desirability in terms of quick cash. However, it does not consider the time value of money or cash flows after the payback period.

14-603.2 Accounting Rate of Return Method (ARR)

The ARR method is frequently used. It evaluates a project by computing a rate of return on the investment using accounting measures of net income rather than cash flow, as used in all other evaluation methods. Annual project expenses are subtracted from annual revenues of the project; the resultant amount is divided by the project investment. The project investment (investment base) may be the initial cost or the average investment for the life of the project. Since depreciation is used in determining income, it is considered in this method. The ARR method is criticized because it totally ignores the timing of cash flows, the duration of cash flows and the time value of money.

14-603.3 Payback Reciprocal

This method is a simple way of estimating the internal rate of return. It is determined by dividing 1 by the payback period. It should be used only if cash flows are expected to be uniform and the life of the project is at least twice the payback period; otherwise the estimated internal rate of return is very poor.

14-603.4 Discounted Cash Flow Methods

a. All discounted cash flow methods are based on the time value of money, meaning that an amount of money received now is worth more than an equal amount of money received in the future. For example, if money can be invested at 6 percent and $100 dollars is invested now, it will accumulate to $106 dollars by the end of one year ($100 + ($100 X .06)). Thus $100 dollars received today is worth more than $100 dollars received one year from today. The time value of money is a very important concept involving compound interest.

b. To simplify the process of evaluating proposals using discounted cash flows, the assumption is often made that any cash flows or cost savings from a project occur at the end of an accounting period. Al-

though the assumption is sometimes unrealistic, because a project may offer cash flows or cost savings throughout the year over its lifetime, the assumption simplifies calculations and allows the use of present value tables. The results obtained are usually close enough to those that might be obtained by more realistic estimates of the precise timing of cash flows.

c. Some technique for comparing present values is necessary. Accordingly, one of the discounted cash flow methods described below is preferred. However, the methods described above are acceptable provided substantially the same results are achieved.

(1) Net Present Value Method (NPV). Under the NPV method, all cash inflows and outflows are discounted at a minimum acceptable rate of return, which is usually the firm's cost of capital. The NPV is the difference between the present value of the project cash inflows and outflows discounted at the cost of capital. If the present value of cash inflows is greater than the present value of cash outflows, the project is acceptable. This method is simple to use and especially convenient for non-uniform cash flows since they are all discounted at the firm's cost of capital.

(2) Internal Rate of Return (IRR). The IRR is the interest rate that discounts an investment's future cash flows to the present so that the present value of those cash flows exactly equals the cost of the investment. It is not given; it must be computed. Once found, management can decide whether the rate is high enough to warrant acceptance of the project. Management must have a minimum acceptable rate of return in mind, below which projects are not acceptable. The IRR can be compared to the cost of capital which is typically expressed as an interest rate; an IRR greater than the cost of capital should be considered favorably by the contractor. The IRR method specifically addresses the time value of money and the timing of cash flows. Depreciation plays no role in the evaluation of projects.

(3) Profitability Index (PI). Other things being equal, larger investment proposals yield larger net present values. The PI is the ratio of the present value of the cash inflows to the present value of the cash outflows (present value of cash inflows divided by the present value of cash outflows) thereby providing a basis for comparison between projects of different sizes. The higher the profitability index, the more desirable the project in terms of return per dollar of investment.

14-604 Audit Objectives

The primary objectives of the audit are:

(1) to ascertain that the contractor has a reliable, efficient and cost-effective capital asset acquisition/leasing program;

(2) to report any significant deficiencies in the program or practices to responsible contractor and Government procurement representatives; and

(3) recommend improvements.

14-605 Audit Procedures

The audit procedures below are not intended to be all inclusive. They are designed to help identify those contractor capital investment areas where improvements are needed. These procedures include steps to determine whether the contractor has the necessary policies and procedures to identify and implement capital investments on a timely and cost-effective basis.

a. Review Board of Directors or other management level minutes for discussions on proposed and/or considered capital investments and ascertain rationale for acceptance or disapprovals. Be alert to circumstances where management may be so engrossed in improving the economy and efficiency of commercial segments that Government segments are not accorded adequate attention.

b. Examine contractor budgets and forecasts for information on capital investment planning.

c. Review budget committee minutes for proposed capital investments; ascertain company rationale for selection, alternatives, or rejection of acquisitions.

d. Scrutinize capital expenditures for equipment to be used primarily on Government contracts. Be alert for instances where capital equipment acquired for use on Government contracts is later transferred to a commercial division after the

costs have been substantially recovered over a relatively short period of time.

e. Ascertain if the contractor's organization is staffed with personnel who have capital investment decision authority and responsibility.

f. Evaluate the contractor's capital investment program to determine that it provides for a continuing input regarding existing asset utilization and new investment opportunities.

g. Verify that there are established procedures for the preparation and documentation of economic analysis for all proposed capital investment projects.

h. Evaluate the economic analysis of selected investment proposals using the methods described in 14-603.

i. Determine if the contractor has performed studies to ascertain plant capability and whether consideration is given to making rather than buying, at less cost, if the contractor acquired additional equipment.

j. Determine whether the contractor is reviewing selected items of machinery and equipment for excessive down time which may indicate a need for overhaul or replacement.

k. Assure that the contractor is reviewing circumstances leading to production bottle-necks from an obsolete equipment perspective.

l. Ascertain if the contractor is reviewing large backlogs to assure that they do not result from insufficient capital equipment to meet the current level of business activity.

m. Determine whether the contractor is reviewing plant and equipment ledgers to establish the age of existing equipment and the frequency of its replacement.

n. Determine if the contractor is examining maintenance and repair costs for selected items of equipment and ascertain whether decisions are being made regarding the economy of continued repair as opposed to the long run economy of replacement.

o. Determine if the contractor's procedures for identifying deteriorated or obsolete equipment are effective and that recommendations for replacement are appropriately carried out.

p. Ascertain whether the contractor reviews usage records in order to determine if equipment is being fully utilized. Should extensive idleness exist, make certain the condition is noted for follow-up with the ACO/plant representative. A technical review should be requested to determine whether the equipment is excess to the contractor's needs.

q. Review the contractor's system for evaluating scrap and rework accounts to assure that such costs are not a result of improper or inadequate capital equipment.

r. Determine if the contractor is regularly reviewing procedures for controlling the handling of material, tools, and equipment to establish whether excessive losses may be averted by investment in an improved materials control system, e.g., counting devices, measuring devices, and material handling equipment.

s. Consult with contractor cost accountants and industrial engineers to determine if, they have submitted sound investment ideas which were not approved by management. Evaluate management's reasons for rejecting these ideas. Ideas with merit should be pursued with contractor management and the ACO.

t. Be alert for capital investment opportunities during perambulation.

14-606 Coordination with ACO

In view of the technical aspects involved in most capital investment reviews it is essential that audit plans be coordinated with the ACO (see 14-400 for Government property). Also, recommendations should be coordinated with the/ACO for technical feasibility as well as cost savings and increased productivity. A joint recommendation by the ACO's representative and the auditor will probably receive more favorable consideration by both the contractor and the ACO.

14-700 Section 7 --- Audit of Production Scheduling and Control

14-701 Introduction

This section contains audit guidance for the audit of the contractor's production scheduling and control, which comprise the basic system and management procedures for planning, scheduling, and control of the day-to-day operations and for the coordination of the material, labor, and facilities required. The contractor's system of production scheduling and control has a substantial impact on the cost incurred and therefore requires some attention. Evaluations of this kind must be closely coordinated with other Government personnel having responsibilities in this phase of the contractor's operations.

14-702 General

Production scheduling and control comprise the contractor's basic system and management procedures for planning, scheduling, and the control of the day-to-day operations and for the coordination of the material, labor, and facilities required. The contractor's system of production scheduling and control should provide for the continuous management control and appraisal of the work performed. The objective in the evaluation of the system is to determine whether the controls effectively enable the contractor to obtain and use material, labor, and facilities so that production goals and contract delivery schedules are met efficiently and economically. Duplication of the efforts of others should be avoided where possible, and full use should be made of the results of reviews performed by production specialists or other contract administration personnel. Where appropriate, the auditor's evaluation should be coordinated with other Government personnel having responsibilities in this phase of the contractor's operations.

14-703 Audit Objective

The objective in the evaluation of the system is to determine whether the controls effectively enable the contractor to obtain and use material, labor, and facilities so that production goals and contract delivery schedules are met efficiently and economically.

14-704 Audit Procedures

a. Evaluation of Organization. The auditor should obtain, where available, or prepare independently, organizational charts reflecting the contractor's operating elements engaged in production control activities. Based on evaluation, personal observations, and discussions with contractor personnel the auditor should determine whether:

(1) responsibilities for the various aspects of the production control have been assigned to organizational elements and specific individuals, and

(2) the various aspects of production control have been organized to promote efficient performance of these functions.

b. Evaluation of Procedures. The auditor should evaluate the production control activities for overall adequacy of coverage in the areas listed below:

(1) Preparation of master production schedules. These schedules should reflect the production period starting and completion dates for each manufactured component, subassembly, and final assembly so that plant delivery requirements can be established for raw materials and subcontract components. Master production schedules are also used for production control activities related to engineering labor, manufacturing labor, and facility requirements and utilization.

(2) Preparation and distribution of periodic production reports to management during contract performance. These reports should disclose the status of operations and areas of difficulty if established production goals are not being met.

(3) Revision of production and operational plans and schedules for contract changes and modifications processed during the period of contract performance. The prompt processing of revisions to production plans and schedules on the basis of such contract changes is an important factor in minimizing resulting additional costs.

14-705 Testing the Procedures

Guidance with respect to the evaluation of material and labor is in 6-300 and 6-400. The following paragraphs contain additional guidelines for testing procedures relating to production scheduling and control.

14-705.1 Material

The auditor should consider the audit steps listed below as the basis for developing an audit program:

a. Evaluate the procedures used for the preparation of detailed bills of material and other media which show the individual raw materials, common items, and purchased parts required for the end item; and evaluate the time schedules which indicate when these items are required at the production line.

b. Evaluate the reliability and timeliness of the procedures for the preparation of work orders, job orders, and other production authorizations. These authorizations are issued to production supervisory personnel as authority for work performance and usually contain a listing of materials to be used in the manufacture and assembly processes; any discrepancies between material requirements and the quantities actually received should be apparent.

c. Review the procedures for the coordination of procurement, engineering, manufacturing, and other functions within the contractor's plant to ascertain whether all problem areas with respect to delinquent deliveries by suppliers and subcontractors, substandard items, production breakdowns, quantity cutbacks, and specification changes are properly coordinated for management's attention and solution. Changes in decisions involving materials from in-house manufacture (make) to subcontract procurement (buy) without proper coordination may result in both the manufacture and procurement of the same item to meet a single requirement.

d. Review the production control reports prepared for management for the status and effectiveness of material operations. Those items which appear to deviate from the established norm should receive further emphasis.

14-705.2 Production Control Activities

The steps listed below should be considered for inclusion in the audit program:

a. Verify the effectiveness of the contractor's production control activities for material by selectively testing the application of these procedures to particular contracts and associated component parts.

b. Review the documentation of a number of selected items to ascertain whether requirements were properly determined and scheduled for either receipt or manufacture in accordance with the master production plan for the overall contract.

c. Trace the sequence of the selected items in b. above with the applicable documentation through production control and, for those items purchased, through procurement, receiving and inspection, storage, issue, and the manufacturing process. Ascertain whether the production cycle was accomplished in accordance with the established schedules and whether the schedules were properly developed. When the scheduled sequence of material was not timely, determine whether the delays were reported to management and whether action taken corrected the problem or whether the production schedule was revised.

d. When contract changes have occurred, evaluate the production control activities to determine whether timely and appropriate action was taken to revise the production control schedules and plans to accommodate the contract changes. Also determine whether the revised plans were furnished to all interested company activities as soon as possible so that the cost of contract changes could be kept to a minimum.

14-705.3 Progress Planning

This subparagraph makes reference to such terms as ""master release schedules," ""master plan," and ""engineering parts list." When these terms are used, the auditor should be aware that the specific terms may not be applicable to a particular contractor, but similar controls should be in effect, and the audit procedures will be equally applicable. The following audit steps should be considered as a minimum

during the evaluation of the progress planning activity:

a. Evaluate the method used to transcribe or convert the data from the engineering package to the production planning report. Examine the controls and procedures for developing the data in the engineering package from which make-or-buy decisions are made.

b. Select a number of master release schedules related to the contract end item and compare with the corresponding engineering parts lists. When deviations exist, determine the reasons for the deviations and the effect on production, and ascertain the reasonableness of added costs required to make the changes.

c. Schedule the time phasing between the date the engineering package was received from the engineering section and the date the master release schedule was reproduced and distributed. Inordinate time lags should be evaluated, and further audit effort should be accorded those situations where significant differences exist between the planned time and the actual time experienced.

d. Determine whether all excess parts applicable to canceled assemblies are removed promptly from the engineering parts list.

e. Determine whether the production planning report is maintained on a current basis and contains additions and deletions resulting from engineering changes.

14-705.4 Release of Shop Orders

The procedures listed below should be considered for inclusion in the audit program:

a. Evaluate the contractor's procedures for:

(1) analyzing the data on the master release schedule (are the controls and methods used adequate for the preparation of shop orders),

(2) determining quantities to be produced on each shop order to provide lot costs on a timely basis, and

(3) coordinating the release of shop orders to ensure contract end items unit costs on a timely basis.

b. Select a number of completed shop orders and:

(1) Determine the propriety of the cost codes by comparing them with the master cost code.

(2) Schedule and compare the actual operation time with the standard time and investigate significant variances for shop overloading, production delays, and the effect of such delays or other failures to meet planned schedules.

(3) Determine causes and reasonableness of variations in actual production from scheduled production, such as :

(a) failure to receive materials on time,

(b) machine breakdowns,

(c) improper dispatching,

(d) nonavailability of special tools, or

(e) employee absenteeism.

(4) Review shop orders reflecting small unit quantity releases, emphasizing those units in which the relationship of setup time to actual production time appears disproportionate, and review the contractor's efforts to determine economical lot size releases and the manner in which small lot sizes are consolidated for more economical runs.

(5) Determine that rework of defective materials received from vendors is properly authorized and approved.

14-705.5 Shop Forecasting and Loading

The procedures which follow should be considered for inclusion in the audit program:

a. Evaluate the procedures and methods used to determine production capacity, machine output, and shop loading. Determine whether the information made available for forecasting shop production is realistic. Review all reports, charts, and records used to compare the actual production loading with the forecast and determine whether the data used for the contracts under audit are current and reliable.

b. Compare the production load forecast charts with actuals for selected departments to determine the extent that peaks and valleys occur for the operation over an extended period of time. When production peaks and valleys persist, determine the action taken, if any, particularly if the situation is the result of loading factors.

c. Evaluate the loading factor used for machine utilization and compare with

actual utilization records to determine the extent of machine idleness. Emphasis should be accorded idle time resulting from improper loading practices involving the more expensive machines. Further, consideration should be accorded idle machine time caused by factors such as repairs, employee absenteeism, nonavailability of tools or fixtures, or delays occasioned by untimely material deliveries.

14-800 Section 8 --- Advanced Cost Management Systems (ACMS)

14-801 Introduction

a. This section provides guidance concerning the effect of technological advancements in manufacturing on cost accounting systems and contractor's efforts to implement an Advanced Cost Management System (ACMS). As auditors evaluate costs incurred on contracts and evaluate estimates of costs supporting price proposals, they should be aware of the implications of technological modernization and ACMS.

b. ACMS can affect audits of costs incurred on contracts and estimates of costs supporting price proposals. Specific guidance related to these areas appears in Chapters 5, 6, and 9 with appropriate notations referencing ACMS. It is important to develop a better understanding of the contractor's manufacturing processes and monitor the trends in manufacturing practices and processes. Therefore, auditors should tour contractor manufacturing facilities periodically.

14-802 Description of Technological Modernization

Technological modernization involves the introduction or expanded use of automation in manufacturing processes. Technological modernization is not just a humanless, robotic, lights-out factory. It can be a gradual process toward a machine orientation of the factory floor. Examples are the use of common numeric control machines and machine cells and the evolution of technical processes that can reduce labor hours and equipment hours in developing a better product.

14-803 Indicators of Technological Modernization

Auditors should be aware of the following factors which may indicate the presence of technological modernization:

a. Changing cost patterns (e.g., a shift from direct to indirect costs).

b. Introduction of major new products and program requirements.

c. Increased competition.

d. Increased capital expenditures.

e. Introduction of new high-efficiency machines.

f. Introduction of islands of automation (i.e., computer-controlled sections of the manufacturing process with little or no human involvement).

g. Introduction of new technologies.

h. Introduction of new, more sophisticated information systems.

i. Increased expenditures for manufacturing and production engineering.

14-804 Effect of Technological Modernization

a. Some contractors are accomplishing substantial technological advancements on the factory floor. These advancements (in machinery, processes, and practices) can change how products are made and can cause changes to the flow of costs. Technological advancements should reduce the amount of direct labor. In addition, large expenditures are often required to purchase advanced equipment which can increase the amount of depreciation and consequently the overhead pool expense. Thus, if direct labor comprises the allocation base for the manufacturing overhead pool, a declining labor base combined with an increasing overhead pool will cause a significantly higher overhead rate.

b. As technology has evolved, cost accounting systems have not always kept pace. Technological advancements can highlight accounting system weaknesses that result in inconsistent and inequitable cost accounting representations and allocations. Accordingly, the effect of technological modernization on contract costs must be carefully evaluated.

c. If the cost accounting system does not keep pace, the following potential problems may increase costs to the Government:

(1) Products are not costed accurately.

(2) Costs are not allocated accurately.

(3) Existing products support the cost associated with developing future product technology.

(4) Improved manufacturing operations and technological advancements are not

reflected in the cost estimating systems on a timely basis.

(5) The current accounting system does not support equipment/technological investment justification, i.e., savings beyond time and material, such as reduced cycle time, scrap, rework, and quality.

14-805 Definition of an ACMS

a. The main objective of an ACMS is to achieve better information to determine product cost so that management can make business decisions based upon more accurate information.

b. A fully developed ACMS is an integrated system which operates from one database and is capable of supporting cost management functions such as product cost reporting, performance measurement, investment justification, and life-cycle reporting (see below for additional discussion of terms). In most cases, ACMS initiatives are not a revolution; i.e., they are not developed and implemented overnight. ACMS initiatives, for the most part, are an evolution. Contractors will continue to evolve their accounting systems in various stages of progress during the journey to an ACMS. ACMS initiatives also encompass various accounting concepts, such as activity based costing (ABC), which focuses the assignment of costs to the activities of a business. The first stages of ACMS implementation can be as simple as a reexamination of cost pools and allocation bases.

c. Some points which are critical to understanding ACMS are identified as follows:

(1) Activities are those actions needed to achieve the goal and objectives of the function.

(2) Product cost reporting can be viewed as identifying the cost of performing significant activities of the business.

(3) The goal of performance measurement is to determine the efficiency and effectiveness of activities.

(4) The purpose of investment management is to identify, evaluate, and implement new activities, or alternatives for performing existing ones, to improve the future performance of the firm.

(5) Life-cycle costing is the accumulation of costs for activities that occur over the entire life cycle of a product, from inception to abandonment by the manufacturer and consumer.

14-806 Role of the Auditor

a. The auditor, in his or her advisory accounting capacity, should evaluate the adequacy and compliance of the proposed accounting change to implement an ACMS in accordance with current regulations using materiality and risk criteria. In fact, auditors should encourage contractor consideration of Government needs beyond minimum adequacy. Contractors, making changes for their own needs, are often receptive to considering customer needs that they could readily accommodate and which they might otherwise ignore.

b. The establishment of an early and effective dialogue between the contractor and the Government about the planned ACMS is essential to successful implementation. This dialogue should begin after the feasibility study but before the system design. At a minimum, contractors with CAS-covered contracts must notify the Government at least 60 days prior to a voluntary change to an accounting practice (or on a mutually agreeable date) as required by FAR 52.230-6(a)(2). In the beginning, the contractor will typically brief the Government representatives about reasons for the change, description of the new system, the implementation plan, and the timetable for implementation. If the auditor hears about the proposed transition through alternative sources (for example, the company newspaper), the auditor should raise the question with the contractor as soon as possible.

c. Auditors should monitor the contractor's progress as the change evolves. Monitoring the transition progress entails meeting with the contractor for periodic briefings which focus on the system requirements and capabilities, implementation plans, and proposed timetable; fact-finding potential issues; discussing audit concerns; and recommending improvements on a timely basis. Auditors should be proactive and take the initiative to make the contractor aware that auditors are available for periodic progress briefings. In addition,

if the internal auditors are not acting as members of the implementation team, DCAA auditors should take the initiative to consult with them on system auditability. When auditors discuss audit concerns and issues, they should address the ability of the system to operate in the Government contracting realm; for example, audit trails and system controls. Auditors should provide timely input as they foresee possible ramifications that could arise from the change.

d. It is the contractor's responsibility to design and develop the system. Monitoring the transition progress should not include the auditor becoming part of the creation and development process of the system. At no time should the auditor take on any specific responsibility for the system or give up future audit rights when the system starts to function.

14-807 ACMS IT Audit Approach

a. The best and most logical approach to auditing the sophisticated computer systems which underlie an ACMS is the establishment of a team comprised of cognizant FAO auditors (including the IT specialist), and, whenever appropriate, the regional IT auditor (with OTS serving as technical consultants). This team can then interface, under the overall leadership of the FAO manager, with the contractor's own implementation team. If support of the regional IT auditor is needed, that support should be brought into the process at the earliest possible time; i.e., when the contractor first notifies the Government of the approved plan for a new system. In this way, the IT auditor will be in a position to monitor significant contractor activities in this area throughout the change process. It is important for both the FAO auditors and the regional IT auditor to understand the fundamental concepts upon which the accounting system is based.

b. When a new cost accounting system is installed, the contractor must validate that the system is operating as designed and developed. The auditor should verify that the system is operating in an auditable and controllable environment. The most effective audit approach is to monitor the contractor's validation process and to coordinate with the contractor's implementation team and internal auditors, thereby avoiding unnecessary duplication of effort and maximizing resource utilization.

c. During periodic contractor briefings, auditors should discuss the design of the audit trail, discuss potential issues, and recommend improvements for the audit trail when appropriate. IT auditors can assist the FAO auditors in evaluating the reliability of system output by assessing the transaction processing and the controls over it. In addition, FAO auditors should also coordinate efforts with the contractor's auditors who will also be interested in the reliability of the audit trail.

14-808 Consistent Charging of Cost

a. The introduction of advanced manufacturing technology may make it possible for the contractor to directly identify machine-related costs normally charged as overhead expense (such as depreciation and machine maintenance costs) to the products using the services of the machinery. Consequently, similar costs may result in both indirect and direct charges to final cost objectives which is a potential CAS 402 noncompliance. 48 CFR 9903.202 requires contractors to disclose/describe their accounting practices, including cost pool composition, associated allocation bases, and the charging of costs direct and indirect. The Disclosure Statement should also describe specific criteria and circumstances when costs are sometimes charged directly and sometimes indirectly. The Disclosure Statement then becomes determinative as to whether or not costs are incurred for the same purpose (see CAS 402-50(b)).

b. One objective of CAS 402 is to preclude overcharging of some cost objectives as may occur when similar costs are charged both directly and indirectly to final cost objectives. This can be accomplished by tracking the flow of parts through the manufacturing floor as a basis for determining what costs are being charged to those parts. In addition, the contractor can purify the affected cost pools to avoid double counting. Auditors should closely scrutinize the applicable section of the Disclosure Statement that deals with the contractor's criteria for

defining the circumstances under which costs may be charged sometimes directly and sometimes indirectly. Auditors should verify that the disclosed practices are in compliance with CAS 402.

14-809 ACMS Pilot Tests

a. If the contractor determines to run the new ACMS simultaneously with the existing system as a test, it is important from both the Government and contractor perspectives that the contractor disclose the plan for dual systems as soon as top management makes the decision. As part of the disclosure the company can and should explain that the pilot system is a test, subject to change, and that the output is uncertain.

b. Output from the new system being run simultaneously as a pilot test meets the definition of cost or pricing data, even if the contractor does not plan to install the new system as part of its official accounting system but intends to use it only as a management tool. Compliance with the Truth In Negotiations Act (TINA) requires contractors to provide accurate, complete, and current cost or pricing data concerning a covered procurement. FAR 2.101 provides that ""cost or pricing data are more than historical accounting data; they are all the facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred." It includes all data that have a bearing on price whether or not the data are used to construct the cost estimate or are thought to be important. Official estimating, accumulating, and reporting of costs will continue under the old, existing system while the new system is simultaneously used as a management tool. Timely contractor disclosure of the dual systems to the ACO/PCO will be the key to avoiding problems with the Truth in Negotiations Act.

c. For a contractor planning to install the new system as part of its official accounting system, CAS rules (FAR 52.230-2 and 52.230-5) would govern the change process and ensure that the Government is adequately protected during the transition process. Contractors will continue to estimate and report based upon the old system while simultaneously testing the new system. Subsequent to the change, the cost impact proposal will be used to adjust any contracts that were priced using the old system.

d. The auditor should be meeting periodically with the contractor to discuss the pilot system's implementation and progress. During those meetings one of the topics for discussion should be the new system's output. Disclosure by the contractor of the output in the format provided by the system should be sufficient. The auditor should then analyze the system output (i.e., evaluate system data, reports, and report format) with the contractor. Potential audit issues and recommendations should be discussed, including comments on the form system output should take to be useful for Government needs.

e. The contractor should reconcile the dual systems on an overall basis. The auditor should evaluate the contractor's reconciliation to determine if both systems are allocating the same total costs to contracts (costs per contract, cost structure, and allocation process may differ, but total costs should not). If the two systems are not reconcilable on an overall basis, auditors should inform the contractor, so that corrective action can be taken.

14-900 Section 9 --- Other Special Purpose Audits

14-901 Introduction

This section provides procedures and audit guidelines for certain special purpose audits which are infrequently encountered by the DCAA auditor. General audit procedures that are equally applicable to these audits are in other chapters of this manual.

14-902 Contract Audit Services for TRICARE

14-902.1 TRICARE Program Background

a. The Dependents' Medical Care Act (PL 84-569) provides in part for the establishment of a uniform program of medical and dental care for eligible dependents of members of the uniformed services. The act was amended by PL 89-614 to authorize an improved health benefits program and to extend health care benefits to retired members of the uniformed services and to eligible dependents of deceased, retired, and active duty personnel. Section 613 of PL 93-82, Veterans Health Expansion Act of 1973, expanded coverage to dependents of totally disabled veterans, living or deceased. In the 1980's, the search for ways to improve access to top-quality medical care, while keeping costs under control, led to several Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) "demonstration" projects in various parts of the United States. Foremost among these was the "CHAMPUS Reform Initiative" (CRI). Beginning in 1988, CRI offered Service families a choice of ways in which they might use their military health care benefits. Five years of successful operation and high levels of patient satisfaction convinced DoD officials that they should extend and improve the concepts of CRI, as a uniform program nationwide. The new program is known as TRICARE.

b. TRICARE is a regionally managed health care program for active duty and retired members of the uniformed services, their families, and survivors. TRICARE brings together the health care resources of the Army, Navy, and Air Force and supplements them with networks of civilian health care contractors.

c. Under TRICARE, seven managed care support contracts covering DoD's 12 health care regions were awarded to civilian health care contractors. Contracts are awarded for 5 years (1 year plus 4 option years). The Office of the Assistant Secretary of Defense (Health Affairs) sets TRICARE policy and has overall responsibility for the program. The civilian health care contractors are overseen by the TRICARE Management Activity (TMA), a part of Health Affairs. TMA has the responsibility for administering the TRICARE contracts.

14-902.2 Contract Audit Procedures

a. Contract audit services will be provided, upon contracting officer request, in accordance with applicable RFP or contract clauses and audit procedures contained in the applicable chapters of CAM.

b. Specific consideration will be given to the following areas when applicable to the contract audit:

(1) Administrative costs claimed by the contractor in its proposal should be evaluated and tested for allowability, reasonableness, and allocability to the program. A large part of the contractor's total administrative costs claimed will consist of allocated salary costs. The bases for allocation of the salary expenses and other elements of administrative costs claimed should be evaluated for propriety. The proposed administrative rate should be evaluated for overall reasonableness (compare it with the provisional amount authorized, the prior year's experience, etc.). Significant rate changes should be analyzed and their causes commented on in the audit report.

(2) Health care costs claimed by the contractor in its proposal should be evaluated for allowability, reasonableness, and allocability based on the auditor's knowledge of the contractor's basis of the estimate.

14-902.3 Audit Reports

Prepare audit reports in accordance with the applicable section(s) of Chapter 10,

including any supplementary financial information required by the contracting officer.

14-903 National Guard Bureau Agreements with the States and Possessions

14-903.1 Background

a. The National Guard Bureau enters into training site agreements (TSA) between the Federal Government and the States and Possessions (including political subdivisions thereof) of the United States for the maintenance and operation of National Guard training facilities. Such agreements are awarded under the provisions of 10 U.S.C. Chapter 133 which provides for the acquisition, use, and maintenance of facilities needed for reserve component training. The agreements are usually cost-sharing arrangements which provide partial reimbursement of the costs incurred. The agreements are funding devices and are not written as contracts. They lack FAR clauses, including disputes and allowable cost provisions. The United States Property and Fiscal Officer (USP&FO) is the administrator for the Federal Government; the Adjutant General or equivalent official generally serves as the representative of the State or Possession.

b. In addition to the usual cost-sharing agreements, there are a limited number of facility construction or operation agreements which provide for direct payment by the Federal Government of the allowable costs. Under these agreements, no reimbursements are involved since the State does not disburse its own funds for costs incurred in performance. Certifying officers appointed by the States send approved payroll data and original copies of vendors' invoices through the administrator to the designated Air Force Accounting and Finance Center or Army Finance Center where payment checks are issued directly to the employees and vendors.

c. All State National Guard activities, including the Air National Guard Bureau activities, are under the jurisdiction of the National Guard Bureau, run jointly by the Departments of the Army and the Air Force.

14-903.2 Basic Audit Responsibilities

a. The use of DCAA audit services is at the option of the USP&FO. Audits will be made only when requested.

b. The DCAA auditor should coordinate visits to State National Guard units with the State audit office.

c. Audits will be performed in accordance with arrangements mutually agreed upon between DCAA and the USP&FO. Since the agreements are issued on an annual basis and are of relatively small dollar value, audits of the records at completion (end of fiscal year) will ordinarily suffice.

14-903.3 Audit Procedures

a. Prior to starting the audit, arrange with the USP&FO and/or the State National Guard representatives for access to the necessary records, vouchers, and supporting documentation.

b. Audit procedures in Chapter 6 will be used as a guide in the audit. The procedures may be modified to fit particular circumstances, however, the objectives of the audit are the same as in cost-reimbursement type contracts. If a concurrent audit of transactions is not made, appropriate emphasis will be placed on the evaluation of the effectiveness of the contractor’s internal controls.

14-903.4 Allowability of Costs

The allowability of costs will be determined on the basis of the terms and conditions included in the agreement.

14-903.5 Audit Reports

a. Upon request, a contract audit closing statement will be issued to the USP&FO as of the agreement completion date in accordance with 10-900. The Contractor's Release of Claims and Assignment of Refunds, Rebates, Credits, etc. is not required. Therefore, issuance of the contract audit closing statement should not be delayed for this reason. It should be noted, however, that the agreements prescribe the cost shar-

ing of common-use space, and provide for disposition of net income derived from leasing facilities or from other arrangements.

b. Unallowable costs not previously reported will be set forth on DCAA Form 1, letter or audit report, as appropriate, and furnished with the contract audit closing statement.

14-903.6 Correspondence

Correspondence pertaining to agreements intended for either the State or the administrator may be mailed to the Adjutant General or equivalent official of the State concerned. When appropriate, the correspondence should be marked for the attention of the administrator (USP& FO). To expedite delivery in those instances where the respective offices are in different parts of the State, such correspondence may be addressed directly to the administrator and a copy forwarded to the Adjutant General or equivalent State official.

14-904 Contract Audits of Advance Payments

14-904.1 Background

Advance payments may be authorized by the Government. Funds authorized must be deposited in a special bank account and withdrawals must be closely supervised by the Government. The contractor is usually required by contract terms to furnish a periodic accounting of all funds disbursed from the special bank account.

14-904.2 Audit Responsibility – Advance Funds

Audits of advance funds will be made only when requested by the contracting officer.

14-904.3 Audit Procedures

The scope of the audit will be in accordance with generally accepted auditing procedures appropriate under the circumstances. Audit procedures to be considered include:

(1) Direct confirmation of the special bank account fund balance.

(2) Reconciliation of the confirmed bank balance with contractor's records and most recent statement of accountability of funds furnished the Government.

(3) Proof of the disbursement and deposit transactions reflected on bank statements with disbursement and deposit transactions shown in the contractor's records.

(4) Evaluation of the use of the funds withdrawn from the advance fund bank account to insure propriety thereof. Funds improperly used, including payments of unallowable costs, should be redeposited by the contractor.

(5) Determining whether Government payments are properly deposited within a reasonable time.

(6) Determining whether advances made to subcontractors are in accordance with basic agreements and are properly authorized and approved.

(7) Determining whether the amount of the fund is excessive considering the needs of the contractor to finance performance of the contract.

14-904.4 Audit Reports

Audit reports on advance funds will be prepared and distributed in the same manner as for progress payments (see 14-200 and 10-200).

14-905 Contract Audit Services for Nonappropriated Funds

14-905.1 Background and Authority

a. DoD Instruction 7600.6 establishes policies and procedures for audits of nonappropriated funds and related activities. Under this Instruction, DCAA is authorized to furnish appropriate audit services in connection with nonappropriated funds contracts.

b. The matter of reimbursement for such audit services will be based on the criteria set forth in DoD Instruction 7600.6.

c. The types of audit service that DCAA will render include

(1) the evaluation of price proposals where negotiated contracts, estimated to amount to $500,000 or more, are to be awarded on the basis of cost or pricing data submitted by the offerors,

(2) the audit of costs incurred under cost reimbursement or incentive type contracts, where the amount to be paid is, except for fee or profit, to be determined by cost incurred by the contractor, and

(3) on a limited basis, the evaluation of contracts that include clauses guaranteeing that prices will not exceed those offered other customers.

14-905.2 Audit Responsibility – Nonappropriated Funds

a. Price proposal evaluations and incurred cost audits in connection with nonappropriated fund contracts will be made only upon the specific request of the cognizant DoD component, for example, Office of the Secretary of Defense, Organization of the Joint Chiefs of Staff, a Military Department, or a Defense Agency.

b. Requests for audit service are to be sent directly to the cognizant DCAA regional office, except in overseas areas, where requests may be sent directly to the cognizant DCAA branch office.

14-905.3 Audit Procedures

The nature of the audit effort authorized for proposed awards and contracts financed by nonappropriated funds is similar to the service normally provided by DCAA with respect to contracts financed from appropriated funds. Consequently, audits involving nonappropriated fund contracts and proposed awards will be performed in accordance with the appropriate sections of this manual.

14-905.4 Audit Reports

Prepare reports for nonappropriated fund activities in accordance with the applicable section of Chapter 10. Generally the requesting official would be the appropriate addressee.

14-906 Special Audits Related to Government Rights in Inventions

14-906.1 Background

a. FAR 27.3/DFARS 227.3, Patent Rights Under Government Contracts, emphasize the necessity for the Government to be in a position to know and exercise its rights under the Patents Rights-Retention by the Contract Clause. The contracting officer or designated representative has the primary responsibility for maintaining the proper controls to assure timely reporting by contractors.

b. The patent rights clause entitles the Government to certain rights in inventions which are either conceived or first reduced to practice during the performance of a Government contract containing the clause. However, the Government may find itself in disagreement with a contractor on the question of whether an invention was actually conceived or reduced to practice under a Government contract. Resolution of these questions may depend on the ability to demonstrate that contract funds were applied to the development of the invention.

14-906.2 Contract Audit Responsibility

a. Field audit offices will be responsive to requests for contract audit services under the patent rights clause.

b. The audit request should provide the contractor's statement as to:

(1) the specific individuals involved in the conception of the invention,

(2) the time period during which the work was performed, and

(3) the reason the Government was not given license-free use of the invention.

14-906.3 Audit Procedures

a. The auditor should determine how the salaries of the individuals responsible for the invention were charged during the period involved.

b. An evaluation should also be made of the contractor technical reports issued in connection with the invention to determine if any individuals, other than those disclosed by the contractor, were instrumental in the invention development. The time

charges of the additional individuals revealed should also be analyzed to determine the accounts or contracts to which their time was charged during this time period.

c. During the normal audit of the contractor's operations, the auditor should be alert to instances where the Government may not have received proper rights to contractor inventions. The auditor should advise the administrative contracting officer of the contractor's apparent failure to comply with the patent rights contract clause.

14-906.4 Audit Reports

Follow the guidance in 10-1200 in preparing the audit report.

14-907 Evaluations of Information Other Than Cost or Pricing Data in Support of Requests for Exception From Cost or Pricing Data Requirements

14-907.1 Background

a. The Federal Acquisition Streamlining Act of 1994 (FASA) changed the traditional exceptions (called exemptions prior to FASA) from the requirements of submitting cost or pricing data at FAR 15.403-1. FASA also added two new commercial item exceptions from submitting cost or pricing data. The Clinger-Cohen Act of 1996 [also know as Federal Acquisition Reform Act of 1996 (FARA)] also changed the exceptions by combining the catalog or market price exception with the commercial item exception. In the past, exceptions were discretionary, now they are mandatory, i.e., cost or pricing data shall not be obtained if an exception applies. Any information requested from an offeror to support an exception is now categorized as "information other than cost or pricing data." Contracting officers, although still tasked with the responsibility of purchasing supplies and services at a fair and reasonable price, are instructed not to obtain more information than is necessary. A hierarchical preference for obtaining information is provided at FAR 15.402.

b. FASA eliminated the SF 1412, Request for Exemption from the Submission of Cost or Pricing Data, and provided an SF 1448, Proposal Cover Sheet, Cost or Pricing Data Not Required. As of January 1, 1998, as a result of the FAR Part 15 Rewrite, the SF 1448 was eliminated. FAR 15.403-5(b)(2) now provides that information other than cost or pricing data may be submitted in the offeror's own format unless the contracting officer requests a specific format and describes it in the solicitation. The SF 1411, Proposal Cover Sheet, Cost or Pricing Data Required, was also eliminated and the contracting officer may now require submission of cost or pricing data in the format indicated in FAR 15.408, Table 15-2—Instructions for Submitting Cost/Price Proposals When Cost or Pricing Data are Required; specify an alternate format; or permit submission in the contractor's own format. When using Table 15-2, the offeror is still required to summarize specific information on the first page of the proposal, some of which was previously provided on the SF 1411.

14-907.2 Audit Objective and Procedures.

This section addresses all of the exceptions provided at FAR 15.403-1. FASA and Clinger-Cohen have provided the contracting officer maximum flexibility to determine that the price is fair and reasonable. Therefore, much of the standardization previously found in requests for exceptions, e.g., catalog or market price, is gone. The auditor's participation, and the amount of support provided, will be at the discretion of the contracting officer. However, the auditor has a responsibility to communicate to the contracting officer any information he or she has that may render granting an exception inappropriate. In accordance with 9-206, auditors may either perform examinations or applications of agreed-upon procedures on proposals supported by cost information other than cost or pricing data. Auditors may only perform applications of agreed-upon procedures on proposals supported only by price or sales data. The auditor must communicate with the requestor prior to starting the evaluation to ensure a clear understanding of the requested services. An acknowledgement letter is used to confirm agreement on the

services to be provided (see 4-103d). Since the audit effort will vary from procurement to procurement, CAM does not provide detailed audit steps to be followed. However, sections 14-907.3 through 14-907.6 discuss the exceptions at FAR 15.403-1 to identify the requirements that must be met for each.

14-907.3 Adequate Price Competition

a. FAR 15.403-1(b)(1) discusses the requirements for granting an exception based on adequate price competition. Price competition is adequate if at least two responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement and if:

(1) award will be made to the offeror whose proposal represents the best value where price is a substantial factor in source selection; and

(2) there is no finding that the price of the otherwise successful offeror is unreasonable.

Any finding that the price is unreasonable must be supported by a statement of the facts and approved at a level above the contracting officer.

b. Price competition will also be considered adequate even though only one offer has been received when certain criteria are met. The contracting officer must be able to reasonably conclude that the offer was submitted with the expectation of competition, for example, the offeror believed that at least one other offeror was capable of submitting a meaningful offer and that the offeror had no reason to believe that other potential offerors did not intend to submit an offer. The determination that the proposed price is based upon adequate price competition and is reasonable requires approval at a level above the contracting officer.

c. Price competition will also be considered adequate if price analysis clearly demonstrates the proposed price is reasonable in comparison with current or recent prices for the same or similar items, adjusted to reflect changes in market conditions, economic conditions, quantities, or terms and conditions under contracts that resulted from adequate price competition.

14-907.4 Prices Set By Law or Regulation

FAR 15.403-1(b)(2) discusses prices set by law or regulation. This includes pronouncements in the form of periodic rulings, reviews, or similar actions of a governmental body; or embodied in the laws that are sufficient to set a price. The contracting officer ordinarily does not require DCAA assistance to make a determination on this claim for exception.

14-907.5 Commercial Items

a. This exception is granted for an item that meets the commercial item definition in FAR 2.101, or any modification as defined in FAR 2.101(c)(1) or (2) that does not change the item from a commercial item to a noncommercial item. This exception also includes catalog or market price items. FAR previously defined commercial items as supplies and services regularly used for other than Government purposes and sold or traded to the general public in the course of normal business operations. The definition, now provided at FAR 2.101, has been significantly expanded. A commercial item means any item, other than real property, that is of a type customarily used for nongovernmental purposes and that:

(1) has been sold, leased, or licensed to the general public;

(2) has been offered for sale, lease, or license to the general public;

(3) has evolved from a commercial item that is sold or offered for sale as a result of technological advancement (even if it is not yet available);

(4) requires either modifications of a type that is customarily available in the commercial marketplace or minor modifications for unique Government purposes;

(5) or any combination of the above.

The definition now includes items with the potential to be offered for sale to the public, e.g., an item in the development stage, if the item evolved from a commercial item and if it will be available in the commercial marketplace in time to satisfy Government delivery requirements. The definition also encompasses modifications if they are minor or customary in the marketplace; and

ancillary services, like installation, training, or technical support and updates. The item could still meet the definition of a commercial item if a modification that is unique to the Government is made to a commercial item, if the modification is minor.

b. If an item meets the definition of a commercial item at FAR 2.101, it is excepted from the requirement to obtain cost or pricing data. A contract for a commercial item must be awarded as firm-fixed-price or fixed-price with economic price adjustment and is exempt from Cost Accounting Standards (CAS) coverage.

c. The determination of whether an item meets the definition of a commercial item is generally done in the presolicitation stage, through market research as detailed in FAR Part 10, which traditionally was prior to DCAA's involvement. However, the auditor sometimes is asked to assist the contracting officer in making this determination. Furthermore, after the commerciality determination has been made, the contracting officer may request our assistance in his/her determination of the reasonableness of the price. Various types of support the auditor can and has provided the contracting officer in the presolicitation and price analysis stages are:

(1) Verification of sales history to source documents,

(2) Identification of special terms and conditions for the commercial item,

(3) Identification of customarily offered discounts for the item,

(4) Verification of the item to an existing catalog or price list, and

(5) Verification of historical data for an item previously not determined commercial that the offeror is now trying to qualify as a commercial item.

d. If requested, our role is to support the contracting officer in granting a commercial item exception by verifying the information to the contractor's books and records or other sources of financial data such as surveys, financial studies, or audit history of the same or similar items produced by other suppliers. Sometimes there are many factors that go into this decision to which the auditor does not have access, for example, price history on the same or similar items produced by other offerors or other information obtained through market research. As previously stated, an item can be "of a type" customarily used for non-governmental purposes. The commerciality does not have to be determined on the basis of the specific item being offered, rather whether the requirements can be met by an item "of a type" available in the marketplace. This gives the contracting officer considerable latitude in determining an item to be commercial. Therefore, the auditor is not in a position to state whether an item does or does not meet the requirements in the definition. In addition, the auditor should not state whether the price of the item is fair and reasonable. This is the contracting officer's responsibility as well. What the auditor can do is apply certain agreed-upon procedures to sales, price, or cost information, and report the results of those procedures to the contracting officer to assist in his or her decision-making.

14-907.6 Modifications to Contracts for Commercial Items

The exception at FAR 15.403-1(b)(5) applies when modifying a contract for commercial items. The standards for granting a commercial item exception at FAR 15.403-1(c)(3) also apply for modifications.

14-907.7 Waivers

a. FAR 15.403-1(b)(4) authorizes the head of a contracting activity (HCA) to waive the requirement for submission of cost or pricing data in exceptional cases. The FAR provides that the HCA may consider granting a waiver if another exception does not apply, but the contracting officer can determine that the price is fair and reasonable without submission of cost or pricing data. Only the HCA may grant a waiver, and this authority is non-delegable. For DoD contracts, the Director, Defense Procurement and Acquisition Policy (DPAP), issued guidance in February 2003, incorporating provisions contained in Section 817 of the National Defense Authorization Act for Fiscal Year (FY) 2003, regarding the granting of exceptional case waivers. The DPAP guidance requires that the granting of an exceptional case waiver

shall be made only upon a determination that:

(1) the property or services cannot reasonably be obtained under the contract, subcontract, or modification, without the grant of the waiver;

(2) the price can be determined to be fair and reasonable without the submission of certified cost or pricing data; and

(3) there are demonstrated benefits to granting the waiver.

b. For purposes of subcontract pricing, a contractor or higher-tier subcontractor granted a waiver shall be considered as having been required to make available cost or pricing data. Consequently, award of any lower-tier subcontract expected to exceed the cost or pricing data threshold requires the submission of cost or pricing data unless an exception otherwise applies to the subcontract. The appropriate price reduction clauses at FAR Part 52 would be included in the prime contract for the purpose of flow down to the subcontract.

c. If the contracting officer is considering granting a waiver from cost or pricing data requirements, there are various types of support that the auditor can provide during the price and cost analysis stages, such as:

(1) verification of submitted data to source records,

(2) actual and negotiated contract unit price trends,

(3) unit price trends from other programs,

(4) trends of company profits,

(5) effects of accounting changes on historical cost comparisons,

(6) effects of contractor cost reduction initiatives on future costs,

(7) effects of significant inefficiencies or problems, and

(8) if parametric techniques were used, verification of inputs, outputs, and major cost drivers.

d. Auditor assistance to the contracting officer on waivers can be critical to ensure the Government obtains a fair and reasonable price absent cost or pricing data. In those cases where the auditor is aware of problems or issues that would significantly impact future procurements, he/she should be alert to future buys by maintaining contact with the Procuring Contracting Officer (PCO), and meeting with the PCO prior to issuance of the solicitation to offer DCAA's financial and advisory services.

14-907.8 Reports

a. Auditors may perform either examinations or applications of agreed-upon procedures on cost information other than cost or pricing data (see 9-207). Guidance in 9-210 and 10-304.6 should be used to prepare an appropriate opinion or to disclaim an opinion. The support the auditors provide on information other than cost or pricing data, which is price or sales data, is an application of agreed-upon procedures. The application of agreed-upon procedures report will be issued with a disclaimer of opinion (see 9-207 or 10-1000 for the format of a report disclaiming an opinion in an application of agreed-upon procedures engagement). Since the auditor is not performing an examination, no opinion of any type should be given, including a qualified or adverse opinion.

b. Cost or pricing data shall not be obtained when an exception from cost or pricing data applies. Furthermore, if a waiver is being contemplated, cost or pricing data shall not be obtained. Therefore, there should be no reference in the report to cost or pricing data. Any information obtained would meet the definition at FAR 2.101 for information other than cost or pricing data.

c. There should rarely be a need for technical assistance on these types of audits. However, when performing an examination, the auditor should evaluate the need for technical assistance and proceed in accordance with guidance in Appendix D. Usually if a contracting officer believes that technical input is necessary to support the determination of a fair and reasonable price, the contracting officer can request that input directly from the technical specialist and provide the results to the auditor. When performing applications of agreed-upon procedures, rather than become involved in obtaining technical assistance, the usual course of action for the auditor would be to suggest modifying the agreed upon procedures. If the requestor will not modify the procedures, any restrictions or unavailability of technical assistance should be described in the report.

However when performing applications of agreed-upon procedures, lack of a technical review will never result in a qualified opinion since we do not issue an opinion on these types of evaluations.

d. The auditor should not express an opinion on whether an item qualifies for an exception from cost or pricing data requirements. For example, if requested to verify catalog or market price items, the auditor should only verify the information provided, not express an opinion as to whether the item meets the definition of a commercial item or qualifies for an exception. When catalog or market prices are used, the regulations no longer provide percentage guidelines nor define "substantial quantities." Therefore, the contracting officer will take the information the auditor has verified and the results of the market research and make the determination.

14-908 Compliance Evaluations for the Defense Security Cooperation Agency [DSCA]

14-908.1 Introduction

This section explains (i) the role of the Defense Security Cooperation Agency (DSCA) in foreign military financing and (ii) the auditor's role in evaluating contractor compliance with DSCA's financing terms and conditions. These terms and conditions are presented in the "Contractor's Certification and Agreement" document signed by both the contractor and DSCA.

14-908.2 Types of Foreign Military Financing

a. DSCA's basic responsibilities are explained in its Security Assistance Management Manual, DoD 5105.38-M. They include directing, administrating and supervising the Security Assistance Program. Included within the Security Assistance Program is the Foreign Military Financing (FMF) Program, which provides loans and financing for Foreign Military Sales (FMS) and Direct Commercial Contracts (DCC).

b. Under the security assistance financing umbrella, foreign governments may acquire U.S. defense articles and services under either of two arrangements:

(1) Government to Government, (Foreign Military Sales) and

(2) contractor-to-Government (Direct Commercial Contracts).

c. Foreign Military Sales (FMS). FMS is defined at 7-1307.2. FMS encompasses Government-to-Government transactions as defined by the Security Assistance Management Manual. The U.S. Government acts as the agent for the purchasing foreign government. DoD policy provides that procurements made for FMS will comply with Federal acquisition regulations and procedures, including audit oversight (see 7-1307).

d. Direct Commercial Contracts (DCC). Under a DCC, the sale of articles and services is between a U.S. firm and a foreign government. A foreign government may request approval to use foreign military financing to fund direct commercial contracts. DCCs which are approved for financing by DSCA, are financed with loans issued under the Arms Export Control Act. In consideration of receiving DSCA administered financing, the contractor agrees to comply with specific elements contained in a signed document titled "Contractor's Certification and Agreement with Defense Security Cooperation Agency (Certification and Agreement)." A DCC and Certification and Agreement are not subject to the FAR or Cost Accounting Standards. However, those contracts financed by a U.S. loan or grant administered by DSCA are subject to DSCA oversight. DSCA, or alternatively, the Defense Contract Management Agency representing a foreign government, will request that DCAA apply agreed-upon procedures to determine if a contractor is in contractual compliance with the elements of the Certification and Agreement.

14-908.3 Contractor's Certification and Agreement with DSCA

a. The Certification and Agreement, has been revised over time. The most recent edition is dated August 2001. The auditor should carefully review the contractor's Certification and Agreement to ensure that the appropriate version is being evaluated for compliance.

b. A memorandum issued by the DoD Comptroller on November 4, 1991 outlines the responsibilities of DSCA and DCAA regarding evaluations of direct commercial contracts, and makes it clear that only certain elements of the Certification and Agreement are subject to DCAA oversight. Those elements are noted in the Agency's standard program for DSCA compliance evaluations, AUPDSCA.

c. DSCA's "Guidelines for Foreign Military Financing of Direct Commercial Contracts" provides additional policy and procedures for the use of foreign military financing to fund direct commercial contracts between U.S. industry and foreign governments.

d. Copies of the pro forma "Certification and Agreement," DSCA "Guidelines for Foreign Military Financing Direct Commercial Contracts," and the November 1991 Comptroller memorandum are available from DCAA Headquarters, Policy Programs Division.

14-908.4 General Oversight Requirements

a. The DSCA Guidelines state that on all contracts of $750,000 or more, the foreign government is required to contract with DCMA for contract administration. DCMA, with DCAA's assistance, will provide field pricing support, and monitor contractor performance to ensure compliance with the DSCA Certification and Agreement. Requests for field pricing support on direct commercial contracts from foreign governments are processed by DCMA Headquarters International and Federal Business Team. DCMA Headquarters arranges for field pricing support through the local DCMA field office. DCMA requests for field pricing support and interim oversight effort should be treated as reimbursable assignments.

b. In addition to receiving foreign government requests via the DCMA Headquarters, DSCA may directly request DCAA to apply agreed-upon procedures and report on contractor compliance with its Certification and Agreement. These requests are processed through DCAA's financial liaison advisor assigned to DCMA Headquarters. Included as an enclosure to DSCA's request is a file folder including the contractor's Certification and Agreement, relevant correspondence and audit leads. DSCA requests for DoD oversight services should be handled as nonreimbursable assignments.

c. The Certification and Agreement (element numbers 1 and 5) provides the U.S. Government the right to examine any of the contractor's directly pertinent books and records involving transactions related to the DCC. The right to examine contractor records expires three years after final payment under the contract. Therefore if requested to perform a DSCA compliance agreed-upon procedures evaluation, the auditor should plan to complete the evaluation before the right to access expires.

14-908.5 Application of Agreed-Upon Procedures for Contractor Compliance with Certification and Agreement

a. Use the AUPDSCA standard audit program for evaluating contractor compliance with its Certification and Agreement. This program is based on the application of agreed-upon procedures (see 9-108 and 9-209) and has been coordinated with the DSCA Headquarters. The AUPDSCA program provides detailed steps corresponding to the relevant elements in the Certification and Agreement.

b. Contracts receiving DSCA financing and the applicable Certification and Agreements are not subject to the FAR including its provisions on cost allowability. The allowability of costs will be determined on the basis of the terms and conditions included in the Certification and Agreement.

c. During the normal audit of the contractor's operations, the auditor should be alert to the risk of inappropriate shifting of costs between DoD contracts and direct commercial contracts financed through DSCA.

14-908.6 Reporting Results of Agreed-Upon Procedures

a. Prepare the report using DCAA's pro forma "agreed-upon procedures" report developed specifically for the DSCA compliance evaluation and the guidance in 10-

1000. The pro forma report is available on the DCAA Intranet and the APPS.

b. The purpose and scope of the report should cite the procedures applied and state that auditing procedures performed did not constitute an examination made in accordance with GAGAS. In an application of agreed-upon procedures, the auditor does not perform an audit and does not provide an opinion or negative assurance. Instead, the report on agreed-upon procedures should be limited to the procedures performed and results of the procedures.

c. Distribution of reports in response to specific requests from DSCA will be limited to DSCA. Reports issued in response to requests from DCMA should be addressed to DCMA and include DSCA Headquarters on distribution.

14-909 Evaluations of Other Transaction (OT) Agreements

14-909.1 Background

a. OTs are instruments other than contracts, grants, and cooperative agreements that are used to stimulate, support, or acquire research or prototype projects. OTs were authorized to encourage commercial firms to join with the DoD to advance dual-use technology and to broaden the technology and industrial base available to DoD. Unless otherwise provided for, OTs are not subject to the requirements of the acquisition laws and regulations established for contracts, including FAR, DFARS, and CAS.

b. Congress has authorized the following two types of OTs: Section 2371 Research OTs and Section 845 Prototype OTs.

(1) Section 2371 Research OTs. In 1989, Congress enacted 10 U.S.C. 2371, "Research Projects: Transactions Other Than Contracts and Grants," which authorized the use of OTs for basic, applied, and advanced research projects. It was enacted as a 2-year pilot program for the Defense Advanced Research Projects Agency (DARPA). The National Defense Authorization Act for Fiscal Year (FY) 1991 broadened the authority to include military departments and made the authority permanent. 10 U.S.C. 2371 prescribes that DoD funding should not exceed that provided by non-Government parties to the maximum extent practical (i.e., contractors should provide at least 50 percent of the costs for the research project). Section 2371 OTs may be referred to as "Consortium Agreements" (those issued by DARPA), "Cooperative Agreements Under 10 U.S.C. 2371" (used by the Military Departments), Technology Reinvestment Projects (TRPs) (issued between 1993 and 1995), and most recently, Technology Investment Agreements (TIAs). TIAs were originated by the Directorate of Defense Research and Engineering (DDR&E) and are intended to replace the consortium agreements and cooperative agreements under 10 U.S.C. 2371. There is no significant difference in the types of agreements. OTs for research may be used when it is not feasible to use a standard contract, grant, or cooperative agreement. Section 2371 OTs are usually issued to a consortium consisting of commercial companies (including traditional DoD contractors), not-for-profit companies, and universities. When an OT is awarded to a consortium, one contractor is designated as the lead to coordinate on behalf of the consortium and takes on the primary administrative responsibility. The lead consortium member will normally serve as the Consortium Program Manager and the Consortium Administrator and performs such functions as preparing the consolidated consortium billings to the Government based on the individual billings prepared by the consortium members.

(2) Section 845 Prototype OTs. The National Defense Authorization Act for FY 1994, Section 845, augmented the OT authority to allow DARPA, under a 3-year pilot program, to use the OT authority for prototype projects directly relevant to weapons or weapon systems. The National Defense Authorization Act for FY 1997, Section 804, further broadened the authority to include the military departments and other officials designated by the Secretary of Defense. Section 803 of the National Defense Authorization Act for FY 2001 (P.L. 106-398) extended the authority to use OTs for prototypes until September 30, 2004 and provided clarification on the appropriate use of OTs for prototype projects. Section 803 states that any new OT entered

into for prototype effort must have at least one nontraditional defense contractor participating to a significant extent, or at least one-third of the cost of the OT must be provided by the contractor, unless a waiver is granted by the senior procurement executive. Section 803 defines a nontraditional contractor as an entity that is neither subject to full Cost Accounting Standards (CAS) coverage, nor has entered into or performed on a contract in excess of $500,000 for prototype effort or basic, applied, or advanced research, within the past twelve months. Section 845 OTs are typically not performed by a consortium of contractors.

14-909.2 Audit Responsibilities

The primary purpose of an OT evaluation is to apply agreed-upon procedures to determine compliance with the financial aspects of the agreement. In the event the requested scope is significant enough to warrant performing an audit, an opinion may be rendered. Specific objectives of the evaluation typically are to determine whether the contractor's (or consortium of contractors'):

- incurred costs follow the terms of the OT;
- billed costs comply with the terms of the OT; and
- cost share (contribution) amounts are being provided in accordance with the terms of the OT.

14-909.3 OT Documentation

a. Documentation in an OT differs from that found in a contract. Key documents often included in Section 2371 OTs, and to a limited extent in Section 845 OTs, are as follows:

(1) Schedule of Payments and Payable Milestones – generally includes a description of the payable milestones and dates, the consortium contribution amount by milestone, and the Government contribution amount;

(2) Funding Schedule – identifies the consortium members and their respective cost sharing amounts by the type of contribution (i.e., cash, IR&D, in-kind); and

(3) Business Status Report – includes status of contributions by consortium members and identifies incurred costs compared to forecasted expenditures identified in the program plan.

b. Other documents/information considered useful during the evaluation of a Section 2371 or Section 845 OT may include:

(1) Payable Events/Milestones Report – identifies accomplishment of the payable events/milestones; and

(2) Annual Program Plan Document – includes a description of the forecasted expenditures and describes the payable events/milestones.

c. Information contained in paragraphs a. and b. should be available at the individual consortium member location. However, if the information is not available at the consortium member company, contact the auditor at the lead contractor.

d. Other information considered useful during the evaluation of both Section 2371 and Section 845 OTs is as follows:

(1) Audit Access clause – This clause identifies the auditor (i.e., Government auditor or independent public accountant (IPA)) that has primary responsibility for evaluating compliance with the OT and the time period in which an evaluation can be performed. However, if the OT is cost type with anticipated payments in excess of $5 million and was entered into on or after June 19, 2003, see 14-909.4. If the OT identifies that an IPA will perform an evaluation, and has done so, the auditor should review 4-1000, "Relying on the Work of Others." The evaluation procedures should be adjusted as necessary to preclude duplication by building upon the work performed by the IPA. If the audit clause does not provide sufficient access for the auditor to perform the agreed-upon procedures, the auditor should work with the requestor to ensure adequate access is granted. Auditors are also requested to notify DCAA Headquarters, Special Projects Division, of any access limitations encountered.

(2) Financial Management clauses – These clauses identify the accounting and billing requirements. OTs typically require that the contractor's accounting system comply with generally accepted accounting principles (GAAP) and that the contractor

maintain adequate records to account for federal funds received under the agreement. The American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide titled "Audit of Federal Government Contractors," Section 2.46, Applicability of GAAP, states that GAAP provides little guidance for cost accounting purposes in the Government contracting industry. GAAP contains some guidance on cost measurement and assignment; however, it provides no guidance for cost allocations. Auditors should perform sufficient procedures on the contractor's cost accounting system to assure themselves that the accounting treatment for the OT results in a fair and equitable allocation of costs (see 14-909.5d.).

(3) Cost Principles clause – This clause, if included, will identify the cost principles that are applicable to the OT.

(4) Pre-Award Costs clause – This clause, if included, will identify a dollar value and time period under which costs may be incurred to support the OT prior to the actual signing of the OT.

14-909.4 Applicability of Dollar Thresholds

a. 32 C.F.R. Section 3.8 gives DoD audit access to awardees' and subawardees' records on cost type OT agreements for prototype projects (Section 845 OTs).

b. DCAA or an IPA (as identified in the agreement) shall have audit access for cost type OTs that provide for total Government payments in excess of $5 million (including options). The Agreements Officer has the discretion to include DoD access to records below this threshold. The dollar threshold applies to new solicitations issued on or after June 19, 2003 and may be applied to new prototype awards resulting from solicitations issued prior to that date. Cost type OTs include agreements where:

(1) payments are based on amounts generated from the awardee's financial or cost records;

(2) at least one third of the total cost is to be provided by non Federal parties; or

(3) financial or cost records/reports are required to be submitted to determine whether additional effort can be accomplished for the fixed amount.

c. DCAA will perform the audit if, at the time of the OT award, the awardee or subawardee is not subject to the Single Audit Act (see 13-207), and is performing a procurement contract that is subject to the FAR cost principles and/or to CAS.

d. If the awardee or subawardee is not performing a contract subject to the FAR cost principles and/or to CAS, either DCAA or a qualified IPA may perform the audit, as stated in the audit clause of the individual OT agreement.

e. In the event of a termination, DCAA will have access to fixed priced OT agreements in excess of $5 million if the agreement states that the potential termination settlement amounts may be based on amounts generated from cost or financial records.

f. Audit access deviations, both above and below the threshold, may occur. These will be documented in the agreement.

14-909.5 Audit Procedures

a. Accounting Treatment. Section 2371 OTs require that the contractor contribute at least 50 percent of the costs for the OT (contractor cost share). Although not mandatory, Section 845 OTs may also require a contractor cost share. All costs incurred in support of the OT, including both the contractor and Government cost share, should be accounted for consistently. OTs should be accounted for either solely as an IR&D project, or solely as direct effort (accounted for similar to a contract). FAR 31.205-18(e) states that costs incurred by a contractor, pursuant to cooperative arrangements that are entered into under Section 2371, should be considered allowable as IR&D if the work performed would have been allowed as contractor IR&D had there been no cooperative arrangement. While OTs are generally not subject to CAS, CAS-covered contracts receiving an allocation of IR&D costs would be affected if a portion of the OT were accounted for as an IR&D project. CAS 402, Consistency in Allocating Costs Incurred for the Same Purpose, requires that all costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to the final cost objective. The purpose of CAS 402 is to ensure that

each type of cost is allocated only once, and on only one basis, to any contract or other cost objective. If the contractor accounts for the costs incurred under the OT partially as direct effort (final cost objective accounted for as a contract) and partially as indirect effort (IR&D project), then the contractor is in noncompliance with CAS 402. Auditors should follow 8-302.7 when deciding whether to report the noncompliance.

b. Cost Share. Cost share includes both cash and/or in-kind contributions. DoD Grant and Agreement Regulations (DoDGARs) 34.2 require that in-kind contributions may be in the form of real property, equipment, supplies and other expendable property, and the value of goods and purchased services directly benefiting and specifically identifiable to the project or program. Issues to consider when evaluating any claimed cost share include pre-agreement costs, indirect costs, prior IR&D cost, and in-kind valuation/usage.

(1) Pre-Agreement Costs – The auditor should verify that the amount claimed as cost share, whether it is cash or in-kind contributions, includes only cost incurred after the date of the OT, unless pre-agreement costs were authorized under the agreement. Costs incurred prior to entering into an OT are unacceptable for satisfying the contractor's required cost share. Costs incurred under current Government-funded research and development contracts, grants, or cooperative agreements, such as awards made by NASA, are also unacceptable for satisfying the contractor's cost share. This position is supported by the DoDGARs Section 34.13(a), which states that claimed cost share is unacceptable if it was either (1) included as a contribution under any other federally-assisted project or program, or (2) paid by the Federal Government under another award.

(2) Indirect Expense – The contractor may not claim, as a direct cost to the OT, an indirect expense that is more appropriately allocable to other cost objectives, for example, claiming depreciation expense on a current asset being used on the OT as a direct cost to the OT or claiming manufacturing product support as a direct cost, typically an indirect expense allocable to the programs using that specific production line. In both cases, a contractor's claim of an indirect expense as its cost share, separate and distinct from any appropriate indirect expense allocation to that OT, will represent unacceptable cost share. This practice may also result in a CAS 402 noncompliance and have an impact on the contractor's CAS covered contracts. A final cost objective must have charged to it (a) all of its direct costs, and (b) its allocable share of indirect costs. While the contractor may not claim as cost share any costs appropriately assignable to another cost objective as a direct or indirect expense, such as depreciation expense on a current asset, the contractor may claim a usage fee on fully depreciated equipment (see FAR 31.205-11(l), Depreciation).

(3) Prior IR&D Costs – IR&D costs incurred prior to the contractor being awarded the OT are unacceptable. On May 13, 1996, the Senate Armed Services Committee specifically addressed this issue in the U.S. Senate Report No. 104-267 addressing Research Projects: Transactions Other Than Contracts and Grants under the National Defense Authorization Act for Fiscal Year 1997. The report stated that the committee had intended that the sunk cost of prior research efforts not count as cost-share on the part of the private sector firms. Only the additional resources provided by the private sector needed to carry out the specific project should be counted. This position is consistent with policy issued by the DDR&E in its December 2, 1998 guidance, as well as guidance included in the Guide for Section 845 OTs for prototype projects.

(4) In-Kind Valuation / Usage – The auditor should apply procedures to evaluate the valuation of the in-kind contributions and determine if they are reasonable and/or allowable. This may require the assistance of technical personnel. The auditor also needs to verify that these in-kind costs are not being claimed (either directly or indirectly) on any other DoD contracts, grants, or cooperative agreements. Furthermore, the auditor should verify that any in-kind contributions were used on the OT. This may also require that technical assistance be requested.

c. FAR / DFARS. OTs are generally not subject to FAR or DFARS. However, if the

contractor accounts for the OT as an IR&D project and allocates those costs to Government contracts, the costs must comply with applicable FAR and DFARS provisions. Therefore, as part of the incurred cost audit of IR&D/B&P, auditors should ensure that any unallowable OT costs that are included in the IR&D pool have been properly excluded and have not been reimbursed under Government contracts. In addition, as part of the evaluation of a specific OT, auditors should ensure that the contractor equitably accounts for the Government payments as a credit to the IR&D account and should verify that only allowable unreimbursed IR&D costs are allocated to Government contracts.

d. Accounting Practices. OTs are sometimes awarded to contractors that already do substantial business with DoD. While it is expected that the contractor will use the same accounting system for Government contracts and the OT, the evaluation procedures should determine if the same system was used. The auditor should perform the necessary steps to determine if incurred costs (i.e., direct labor, material, other direct costs, and indirect rates) were accounted for using the same accounting practices used to account for DoD contracts. Limited steps should be performed to determine the potential cost impact on other Government contracts if the contractor did not use its normal accounting practices (i.e., contractor did not use DoD approved indirect rates for the OT).

e. OT Billings. Government financing on an OT may be based on milestone payments or actual cost incurred. OT financing based on payable milestones may be structured in a manner that milestones need not be adjusted for actual expenditures (fixed price). Alternatively, the OT may require that milestones reasonably track with actual cost incurred (cost type). Under payable milestones, the consortium is entitled to bill for the milestone payment identified in the Schedule of Payments and Payable Milestones when it accomplishes an identified milestone. If the milestone payment schedule is subject to adjustment based on actual cost incurred, the auditor should compare billed costs by milestone to incurred costs by milestone, if possible, to determine if any significant differences exist. The auditor should also compare total billed costs to total incurred costs to determine if there is any significant difference in total. In the event that incurred costs differ significantly from the milestone payment amount, the Agreement Administrator may adjust future milestone payment amounts. Regardless of whether the milestone payment is subject to adjustment, the auditor should confirm, on a selective basis, that the milestone was accomplished and accepted by the Government prior to the milestone being billed. When evaluating a Section 2371 or Section 845 OT, the auditor should verify that the contractor used its DoD provisionally approved overhead rates, and when available, final negotiated overhead rates to report/record indirect costs. If the DoD approved rates were not used, auditors should determine, to the extent possible, the cost impact to the Government.

f. Preaward Evaluations. In the event the auditor is requested to perform a preaward evaluation of an OT proposal, the evaluation of the overhead rates should include an analysis of the contractor's anticipated workload. Depending on the significance of the proposed OT, the auditor should verify that the contractor has included the impact of the OT on its proposed overhead rates. The auditor should also comment on the proposed accounting treatment for the OT and identify whether the contractor estimated the OT costs in accordance with its procedures used to estimate costs on its DoD contracts. When the contractor estimates an OT as both an IR&D project and a contract, the guidance at 8-302.7 for citing a CAS 402 noncompliance should be followed.

g. Advance Agreements. FAR 31.109 encourages participants to negotiate advance agreements regarding cost treatment prior to the execution of certain financial instruments that include special or unusual costs. Various contractors may attempt to enter into advance agreements regarding their accounting treatment of the OT as it relates to CAS 402 requirements. Contractor requests for an advance agreement should be coordinated with the cognizant regional office. When requested to comment on OT advance agreements where the contractor plans to account for the OT costs as IR&D, the auditor should recommend

that the advance agreement include a requirement for the use of the contractor's existing Government contract accounting system for accumulating the OT costs. Since the OT costs would be classified as IR&D, they would already be part of the contractor's government contract accounting system. Thus, the use of any other system to account for the OT costs would only increase the amount of contractor and Government resources needed to audit the costs being allocated to the other Government contracts.

h. Order of Precedence. In the event of a conflict between the terms of the OT agreement and other governing documents, the auditor should analyze the OT to determine if an order of precedence has been established. Precedence may be established for the DoDGARs, the articles of the OT, the attachments to the OT, or the consortium's articles of collaboration.

i. Additional Areas for Evaluation. In addition to the detailed discussion of OT evaluation areas identified above, auditors may be requested to perform any of the following steps. This list is not all-inclusive and evaluation procedures may be requested that are not identified here. The auditor should also analyze the OT to identify any discretionary clauses and suggest the requestor include procedures to evaluate compliance.

(1) Accounting Changes. When the contractor has reclassified OT costs (i.e., direct to indirect), possibly as a result of an inconsistent accounting treatment, determine the cost impact on DoD contracts.

(2) Compliance with Other Regulations. Verify that the contractor's treatment of the OT is in accordance with OMB Circular A-110 or A-133, and DoD Directive 3210.6-R, DoDGARs.

(3) Consortium-Lead Costs. Verify that the consortium lead is not separately charging its administrative costs to the OT, unless specifically provided for. These costs are usually considered to be an indirect expense. In addition, the lead should not be allocating these costs to the lower level consortium members. If the inclusion of the OT administrative costs in the indirect cost pool results in a disproportionate allocation of indirect costs, then a special allocation in accordance with CAS 418, Allocation of Direct and Indirect Costs, may be appropriate.

(4) Cost Savings or Other Benefits Achieved. Inquire of the contractor whether any cost savings or other benefits were achieved as a result of being granted statutory/regulatory relief under the OT.

(5) Facilities Capital Cost of Money (FCCOM). Verify that the contractor is not inappropriately claiming FCCOM when it was not included in its preaward proposal.

(6) General & Administrative (G&A) Costs. Compare the proposed accounting treatment for the OT to the actual treatment being used. The contractor may have proposed all or a portion of the OT as IR&D effort. The contractor would not have applied G&A expenses to those costs. However, the contractor may be accounting for the OT costs as a contract and applying G&A.

(7) Government Property. Verify the existence of Government property.

(8) Interest. If advance payments are authorized, the OT may require that a separate interest bearing bank account be established to account for the Government funds. Any interest earned should be remitted annually to the Government. Identify whether the lead consortium member has earned interest on the Government funds for the specific OT, and if so, whether it was subsequently credited to the Government. This could result from the Government paying out funds to the lead consortium member, who in turn does not pay out the funds to the consortium members on a timely basis.

(9) Profit. Verify whether the contractor is inappropriately applying profit to the Section 2371 OT. Profit is normally not provided for under a Section 2371 OT for basic, applied, and advanced research.

(10) Program Income. Verify that income from such sources as royalties on patents and copyrights is being credited to the agreement.

(11) Special Clauses. Analyze the OT for any special clauses.

(12) Termination. Perform an evaluation on a terminated OT.

14-909.6 Evaluation Program

A standard program, 17900 Other Transactions (OT), for performing applications of agreed-upon procedures to both Section 2371 and Section 845 OTs is available on the APPS and DCAA's Intranet. Regardless of the type of OT being evaluated, the program should be tailored to meet the specific objectives of the evaluation to be performed. Additional tailoring will be required if it is determined that an examination will be performed.

14-909.7 Reporting

A report "shell" is available for reporting the results of the application of the agreed-upon procedures, for both Section 2371 and Section 845 OTs. This report shell should be modified, as appropriate, to reflect the scope and results of the evaluation being performed. The report shell, 17900 Other Transactions (OT), is available on the APPS and DCAA's Intranet. Auditors should also consider the guidance contained in 10-1000.

14-910 Performance-Based Payments (PBPs)

14-910.1 Introduction

a. FAR 32.1001(a) provides that PBPs are the preferred financing method when the contracting officer finds them practical, and the contractor agrees to their use. PBPs are not authorized for use in conjunction with other methods of contract financing except advance payments and guaranteed loans (FAR 32.1003(c)). PBPs may be based on:

(1) performance measured by objective, quantifiable methods;

(2) accomplishment of defined events; or

(3) other quantifiable measures of results (FAR 32.1002).

b. The procedure for establishing PBPs is a two-part process comprised of establishing the performance bases (events or criteria) and establishing the performance-based finance payment amount. A PBP amount may be established on any rational basis including (but not limited to):

(1) engineering estimates of stages of completion;

(2) engineering estimates of hours or other measures of effort to be expended in the performance of the event or achievement of a performance criterion; and

(3) the estimated projected cost of performance of particular events (FAR 32.1004(b)(4)).

14-910.2 Administration and Payment of Performance-Based Payments

FAR 32.1007(c) states that the contracting officer is responsible for determining what reviews are required for protection of the Government's interests when using PBPs. The contracting officer should consider the contractor's experience, performance record, reliability, financial strength, and the adequacy of controls established by the contractor for the administration of PBPs. Based upon the risk to the Government, post-payment reviews and verifications should normally be arranged as considered appropriate by the contracting officer. If considered necessary by the contracting officer, pre-payment reviews may be required. The contracting officer may also reduce PBPs when the contractor fails to comply with a material requirement of the contract, fails to progress on the contract, is in unsatisfactory financial condition, or is delinquent in payment of any subcontractor under the contract (FAR-32.1008).

14-910.3 Role of the Auditor

a. A user's guide has been developed to facilitate the establishment of performance-based events and PBP amounts. The guide instructs contracting officers to use DCAA and DCMA when establishing PBP events and values. The guide notes that representatives of DCAA and DCMA will have special familiarity with the program as well as with the contractor's operations and organization. This experience and familiarity can be a valuable asset for the contracting officer and the program office when selecting and defining appropriate PBP events. Contracting officers are encouraged

to seek the input of DCAA and DCMA representatives and to build in their continuing involvement when negotiating and structuring performance-based events and PBP amounts. Finally, the guide notes that using all of the experience and specialized expertise of DCAA and DCMA can often make a substantial difference in the practicality and success of a performance-based financing approach in a major contract activity. A copy of the PBP User's Guide in PDF format can be obtained at http://www.acq.osd.mil/ar/resources.htm.

b. Auditors and financial liaison advisors (FLAs) can provide valuable financial advice to those contracting officers and buying commands considering the use of PBPs. Since FAR 32.1007(c) makes the contracting officer responsible for determining what reviews are required when using PBPs, auditors should be fully responsive to requests from contracting officers for audit assistance in both pre-payment and post-payment PBP reviews. Auditors should acknowledge contracting officer requests in accordance with 4-103.

c. Pre-payment auditor assistance may be sought in establishing and valuing PBP events. PBP events should be established to allow the contractor a reasonably consistent cash flow during the period of performance. Enough PBP events should occur during contract performance to avoid long periods of no or insufficient cash flow for the contractor when the rate of expenditures is significant. PBPs cannot, in total, exceed 90% of the price of the contract or delivery item to which they apply (FAR 32.1004(b)(2)(ii)). Because the use of PBPs is limited to definitized fixed-price type contracts, the final payment (which will liquidate all prior PBPs) will occur only after the Government has accepted the contractor's performance.

d. Post-payment reviews may include verification of incurred costs on performance-based contracts. Although post-payment reviews of incurred costs will not impact previously negotiated PBP amounts, post-payment reviews can provide invaluable documentation and support to both the Government and the contractor in establishing PBPs on follow-on and/or future contracts. The objective of such reviews is to provide expenditure profile information required to ensure that PBPs established on future contracts are commensurate with the value of the performance-based event or performance criteria and do not result in an unreasonably low or negative level of contractor investment in the contract (FAR 32.1004(b)(3)(ii)).

14-910.4 Reporting

Audit reports will be issued on all completed PBP audits. The PBP audit report should be prepared in accordance with 10-1200 and addressed to the contracting officer who requested the audit. When the audit discloses materially adverse findings, these matters will be explained in detail. To ensure that all available facts have been considered in the conclusions, the auditor should contact the contracting officer, discuss the findings, and invite the contracting officer to the exit conference with the contractor (see 4-300).