Activity Code 17600		**Financial Capability Audit**
Version 5.0, dated September 2004		
B-1	**Planning Considerations**	
Purpose and Scope		
The purpose of the detailed financial condition risk assessment is to determine if there are indications of any significant financial conditions that would warrant the performance of a financial capability audit. Field audit offices will make an annual discretionary assessment of a contractor's financial condition to determine whether there is a need to perform a financial capability audit (see CAM 14-303). These assessments may be conducted during the annual planning process or in conjunction with other audits; contractor preaward and adequacy of accounting system surveys (see CAM 5-200); audits of advance payments; progress payment audits (see CAM 14-200); or other assignments. The objective of a financial capability audit is to determine if the contractor has adequate financial resources to perform on Government contracts. Financial capability audits may be performed in response to requests by the contracting officer or as determined to be necessary by the auditor or as a result of a detailed risk assessment during the annual planning process. Also, financial capability audits may be performed because the auditor became aware of events or conditions that may affect the contractor's ability to perform on Government contracts. The major objectives of the audit are to review the contractor's historical financial data and cash flow forecasts to assess (1) the contractor's current financial condition, (2) the adequacy of the contractor's near term cash flows, and (3) the contractor's near and long term capability to obtain funds outside the normal course of operations, if required, to continue as an ongoing business concern.		
This audit program contains detailed sections for performing a risk assessment of the contractor's financial condition. A separate audit program entitled APMODRAFINCAP is available for Modified Risk Assessments. FAOs will perform an annual financial condition risk assessment of the contractor's financial condition for major and non-major contractors. 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. For non-major 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. A detailed financial condition risk assessment should be performed cyclically every three years with modified financial condition risk assessments (using APMODRAFINCAP) performed in the years when a detailed risk assessment is not performed. This risk assessment is the basis for the extent (if any) of the audit procedures to be performed.		
References		

1. FAR 9.104-1, “General Standards”
2. DFARS 232.072, “Financial Responsibility of Contractors”
3. SAS 59, "The Entity's Ability to Continue as a Going Concern"
4. CAM 14-300, "Contractor Financial Capability Audits and Reporting"
5. CAM 4-803, "Unsatisfactory Conditions"
6. FASB 95, “Statement of Cash Flows”

B-1	**Preliminary Steps**	
Version 5.0, dated September 2004		**WP Reference**
1. **Research and Planning**		
a. If this is a requested audit, review the audit request for matters of particular interest to acquisition officials and prepare an acknowledgment letter. Determine if a recent risk assessment or audit has been performed that could satisfy the customer’s needs. If not, proceed with the risk assessment and/or audit tailoring this program to satisfy the customer needs.		
b. If the contractor is a subsidiary or division of a corporation, determine if obligations (including contract performance) of the subsidiary or division are legally binding on the parent organization. If a wholly owned subsidiary is legally responsible for its own contracts, the audit should be performed at the wholly owned subsidiary. If the parent is legally responsible, a risk assessment should be performed at the parent organization and the auditor should coordinate with that office. A parent corporation that owns 100 percent of a corporate subsidiary (e.g. wholly owned subsidiary) is usually not legally responsible for the obligations of its subsidiary unless a guaranty is executed. If a Corporate Guaranty (example: DLA form 619 & 621) is executed, it may still be necessary to perform a risk assessment at both the wholly owned subsidiary and the parent.		
c. Contact the requester or contract administrative office for clarification of any specific areas of concern. Request the details of any financial analyses already performed by their offices to avoid duplication (e.g., financial ratio analysis, bond rating analysis, and results of applying financial distress models).		

d. Review permanent files.	
(1) Review the results of prior accounting system surveys and results of related audits.	
(2) Obtain financial statements for the last 3 to 5 years.	
(3) Review the most recent financial capability risk assessment or audit.	
(4) Review any audit leads, including the results of any internal/external audit work in this area, and any audit leads of financial problems.	
(5) Obtain the mix of Government and commercial business.	
e. If the contractor is classified as non-major (where ICAPS have not been completed) and if the evidential matter to be obtained during the audit is highly dependent on computerized information systems, document on working paper B-2 the audit work performed that supports reliance on the computer-based evidential matter. Specifically, document or reference one or more of the following in working paper B-2:	
(1) the audit assignment(s) where the reliability of the data was sufficiently established in other DCAA audits,	
(2) the procedures/tests that will be performed in this audit to evaluate the incurred costs that will also support reliance on the evidential matter, and/or	
(3) the tests that will be performed in this audit that will be specifically designed to test the reliability of the computer-based data.	
When sufficient work is not performed to determine reliability (i.e., reduce audit risk to an acceptable level), qualify the audit report in accordance with CAM 10-210.4a and 10-1204.4.	
f. In planning and performing the examination, review the fraud risk indicators specific to the audit. The principal sources for the applicable fraud risk indicators are: • Listing of Fraud Indicators, Financial Capability Reviews (Enclosure) Document in working paper B any identified fraud risk indicators and your response/actions to the identified risks (either individually, or in combination). This should be done at the planning stage of the audit as well as during the audit if risk indicators are disclosed. If no risk indicators are identified, document this in working paper B.	

g. If the company is not publicly held, request the contractor to provide written confirmation that the financial statements provided during the financial condition risk assessment disclose all off-balance sheet arrangements and related party transactions. A proforma letter requesting contractor confirmation on the financial statements is included in the Other Audit Guidance section of the APPS entitled Confirmation Letter - Financial Statements.	
h. If the company is not publicly held, and the contractor states that all off-balance sheet arrangements and related party transactions are not reflected in the financial statements and/or cash flow forecasts, request the contractor to provide a schedule separately showing (a) the maximum liability included in the financial statements and cash flow forecast and (b) the maximum liability not reflected in the financial statements and cash flow forecast, for off-balance sheet arrangements and related party transactions.	
i. Publicly held companies are required to disclose details regarding off-balance sheet arrangements under a separately captioned subsection of the “Management’s Discussion and Analysis” section of the quarterly and annual SEC filings. Review the appropriate section of the SEC filings.	
j. The contractor should be requested to provide:	
(1) Any inquiries from their certified public accounting firm related to off-balance sheet arrangements and related party transactions and their responses.	
(2) The results and reports of any internal audits, reviews or other analyses of off-balance sheet arrangements and related party transactions.	
k. When performing a detailed risk assessment, request preliminary data from the contractor. If performing an audit, prepare a list of data required for the audit and provide to the contractor when establishing the entrance conference date. Conduct an entrance conference with the contractor in accordance with CAM 4-302. Key company executives should be invited to attend the conference.	
2. <u>Risk Assessment</u>	
a. Obtain Preliminary Data and Information.	
(1) Review the previous risk assessment. The assessment should be performed/updated on an annual basis at major contractors and nonmajor contractors, if other field visits are scheduled.	
(2) At nonmajors where annual visits are not being made, the risk assessment will be performed at the first field visit during the	

contractor’s subsequent fiscal year.	
(3) Based on the circumstances, tailor the following audit steps to perform the assessment.	
(a) Gather the information needed to perform or update the risk assessment (see CAM 14-304). If not already in the permanent files obtain:	
(i) annual financial statements and/or annual reports for the last 3 to 5 years, plus year-to-date financial information for the last quarter available,	
(ii) current Form 10K and 10Q (required SEC annual and quarterly filings for publicly traded companies),	
(iii)tax returns for non-publicly traded companies, and	
(iv)external credit ratings.	
(b) Determine the contractor's primary Standard Industrial Classification (SIC) code or North American Industry Classification System (NAICS) code and verify that it accurately reflects the contractor’s primary business. The contractor’s primary business/industry segments are identified in its Form 10K. The Technical Support Branch (OTST) in Memphis can assist you in determining the appropriate SIC code. In addition, SIC and NAICS codes are available on the internet at http://www.census.gov/pub/epcd/www/naics.html.	
(c) Financial ratios for publicly traded companies and for industry averages for all companies will be requested from OTST. The requests should be submitted electronically to e-mail address 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.	
(d) Request the contractor to provide any analysis it has performed to assess its current and future financial condition. Ask the contractor to provide details on prior, current, and forecasted events that have had or are forecasted to have a favorable or unfavorable impact on its financial condition.	
b. <u>Ratio Analysis.</u> The analysis of key financial ratios, including trends, is important when performing a risk assessment. In addition, a comparison of a contractor's key ratios to other companies of comparable size in the	

same or similar industries will yield important audit leads on the financial health of the company.	
(1) Use the contractor's financial statements to compute the ratios for the most recently completed fiscal year and the previous 2 to 4 fiscal years. An electronic workbook that calculates financial ratios is available on the Eastern Region website (Financial Capability Ratios Workbook). The workbook calculates the financial ratios and Z-Score. Use of that workbook is not required, but its use should improve the efficiency and effectiveness of the risk assessment. Since these ratios are used as one of many tools to assess risk, and not to express an audit opinion, the auditor can use the information from the audited financial statements to compute the ratios without testing the reliability of the external auditors work. However, if compelling reasons exist to question the financial statements, or the statements are unaudited, then the auditor should consider what additional audit steps are needed to verify the financial information prior to computing the ratios. If performing an audit, the audit report should be qualified accordingly.	
(a) For publicly traded companies, obtain company specific financial data from OTST. Publicly traded financial information will be provided for the most current 5 years of data available from the S&P Compustat database.	
(b) For privately held companies, compute the key ratios in CAM 14-304 over a 3 to 5 year period.	
(2) Request from the contractor any additional ratios that the contractor believes may be a better indicator of its financial condition. Consider using such ratios. Industry averages for other ratios may be available from OTST on a special request basis.	
(3) If the contractor has audited financial statements or a statement of cash flows is available, the auditor should also calculate and evaluate certain cash flow ratios such as: Cash Flow Return on Assets, Cash Flow to Sales, Cash Flow Adequacy, and Debt Coverage which may indicate the contractor's efficiency in generating cash from operations, its ability to satisfy primary cash requirements, and the adequacy of its cash flow to repay debt. For publicly traded companies, the cash flow ratios can be obtained from OTST. Cash from operations (as used in these ratios) is provided in the contractor's statement of cash flows. If a contractor does not have a historical statement of cash flows, we would not calculate and evaluate the cash flow ratios.	

(4) Obtain industry average financial data for publicly traded and privately held companies from OTST. Use the data as a benchmarking tool in the risk assessment phase. Industry average information will be provided for the most current 3 years of data available from the S&P Compustat database.	
(5) When requested, OTST will provide: (a) key financial ratios (see CAM 14-304), (b) cash flow ratios (see CAM 14-304), and (c) Altman Z-Score computations (see CAM 14-304 e and CAM Figure 14-3-2).	
(6) Review the trends of the contractor's key ratios. If a consistent unfavorable or adverse trend is noted for the most recent 3-year period, obtain from the contractor an explanation for the trend.	
(7) Compare the contractor's key ratios to industry averages for the most recent completed fiscal year (obtained from OTST). Any ratios that significantly differ from the industry average should be evaluated in further detail. Determine what financial statement items caused the differences. Obtain an explanation from the contractor for the unfavorable or adverse trends and any actions being taken to improve the conditions. Sometimes a change in accounting practice, or unusual accounting method such as an inventory valuation method, will explain the variance.	
c. <u>Failure Prediction Model.</u> The Z-Score is a bankruptcy prediction model used during the risk assessment that can provide additional insight into a contractor’s financial condition. It should be used only as one of the many tools discussed in CAM 14-304 to assess the need for a financial capability audit. The Z-Score should be interpreted in accordance with CAM Figure 14-3-2. Because customers may place undue reliance on Z-scores, they are not normally included in the audit report.	
(1) Evaluate the trend of a company’s Z-Score over the most recently completed fiscal year and the previous 2 to 4 fiscal years using the Z-Score model. CAM Figure 14-3-2 describes three Z-Score models: (a) Model I: manufacturing companies that are publicly traded (primary SIC codes 2000 through 3999) (b) Model II: manufacturing companies that are privately held (primary SIC codes 2000 through 3999), and (c) Model III: all remaining companies excluded by Models I	

and II. Different weights are applied to the components of each model depending on the type of company being reviewed.	
(2) Compare the company's Z-score to the interpretation of model results, CAM Figure 14-3-2. Compare the company's Z-Score to the industry average over its most recently completed fiscal year. The industry averages are provided by OTST along with the key ratios. A negative trend, indications of financial distress, or a score significantly below industry average may warrant the need for further evaluation.	
d. <u>Financial Statement Analysis.</u> Financial statement analysis can provide insight into unfavorable financial trends and other conditions that may result in financial distress. Certain financial statement line items should be evaluated to identify any unfavorable or adverse trends or other conditions. Specific attention should be paid to the following areas:	
(1) Profit/Loss - Continued overall net losses will usually deteriorate a company's cash position.	
(2) Cash Flow – Historical cash flow from operating, investing and financing activities should be evaluated to monitor the contractor's ability to pay obligations from cash inflows obtained in the ordinary course of business. Nonperformance on Government contracts will usually result from insufficient sources of cash to meet current demands for cash. If a company has to make substantial borrowings to meet ordinary business expenses, it probably has financial problems.	
(3) Sales - Significant deterioration of sales should be monitored since it may directly influence the contractor's ability to meet ongoing operating costs. Declines in sales or increases in sales (high start-up costs/initial material costs) may increase or decrease profit and affect cash flow.	
(4) Working Capital - An analysis of a company's ability to liquidate current liabilities with current assets may disclose cash flow difficulties. Consideration should be given to the liquidity and market value (especially accounts receivable) of the current assets.	
(5) Net Worth - A company with little or no net worth (Total Assets - Total Liabilities), combined with current operating losses, presents a significant risk of nonperformance on Government contracts. Little or no net worth makes it difficult to attract equity investment or credit facilities.	

(6) Long-term Liabilities – An analysis of a contractor's long-term liabilities should be performed. Significant increases in long-term liabilities may indicate financial distress.	
(7) The notes to the financial statements and the SEC filings (10K and 10Q) should be reviewed to determine if conditions such as those described in CAM 14-304(f) exist. Determine if there is a going concern comment (AU 341.13) in the most recent financial statements. If so, this is a high risk indicator that requires further analysis. Depending on the year of the going concern comment, this could cause the risk assessment to be expanded into an audit. (For example, if the going concern comment is in the earliest of the three years, an expansion into an audit may not be necessary. If the going concern comment is in the most recent year, then the risk assessment should be expanded to an audit since this would be a significant negative indicator.) This information along with any other questions raised by newspaper articles, rumors, or review of board of director minutes should be discussed with the contractor in order to obtain a full understanding of the issues and any contractor actions being taken to remedy the situation. Auditors at corporate offices with multiple divisions/segments should survey auditors at all Government locations to identify any unfavorable or adverse events.	
(8) The auditor should review the notes to the financial statements for any indication that the contractor has additional off-balance sheet arrangements and related party transactions not previously disclosed. Any lead should be followed-up with the contractor.	
e. Internal Controls. The auditor should obtain an understanding of the contractor's internal control structure relating to financial planning and monitoring as summarized in the Internal Control Audit Planning Summary or the ICQ for non-majors. Some of the key controls are:	
(a) The contractor has written policies and procedures that require evaluation of current financial conditions in order to anticipate and avoid unfavorable or adverse conditions.	
(b) The contractor conducts periodic assessments of accounts payable and accounts receivable including analysis of accounts payable aging and the collectibility of accounts receivable.	
(c) The contractor conducts periodic assessments to ensure that it is meeting debt payment schedules and is in compliance with other loan covenants.	

(d) The contractor regularly performs short and long-term cash flow projections.	
(e) The contractor performs periodic assessments of contract cost performance.	
f. Off-Balance Sheet Arrangements and Related Party Transactions	
The auditor should review the information provided by the contractor, as well as information contained in the quarterly and annual SEC filings (if a publicly traded company) to determine if the financial statements disclose the maximum liability of off-balance sheet arrangements and related party transactions. A list of indicators that identifies the existence of related parties, entitled Potential Related Party Indicators, is included in the Other Audit Guidance section of the APPS and should be used to assist in identifying situations that would indicate related party arrangements.	
(1) Review for audit leads any inquiries from the contractor's certified public accounting firm (CPA) related to off-balance sheet arrangements and related party transactions and the contractor's response to these inquiries.	
(2) Compare for consistency the contractor's response to CPA inquiries concerning off-balance sheet arrangements and related party transactions to the contractor's disclosures in the confirmation letter. Follow-up any inconsistencies with the contractor.	
(3) Review 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.	
(4) Verify that the contractor-prepared schedule (for nonpublicly held companies)identifying the maximum possible liability for each disclosure of off-balance sheet arrangements and related party transactions is based on sufficient, competent, evidential matter, which should be reconciled to the contractor's supporting documentation for each liability.	
g. Other Indicators	
(1) Bond and Debt ratings for publicly held companies should be reviewed. Low bond/debt ratings or declining trends may signal problems for the company in obtaining cash outside of normal operations. Where a conflict exists between external bond/debt ratings (especially high bond/debt ratings) and other risk assessments, the auditor should ascertain and evaluate the reason for the conflict. Bond/debt ratings may not be indicative of a company's ability to perform on contracts, and may not	

consider all information available to the auditor. Current bond/debt ratings will be provided along with company ratios for public companies by OTST.	
(2) Discuss any plans the contractor may have 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. Verify accuracy of decisions to supporting data.	
(3) Identify and analyze any unusual compensation packages used to retain employees or outstanding loans to other company operations or company officers that would drain financial resources from an operating unit with Government contracts.	
(4) Be alert to any other potential considerations that may warrant more analysis in the risk assessment or expansion to any audit. These items may be identified by the customer, company employees, other auditor or other sources. These may include: • Borrowing from or under-funding pension plans, • Non-payment of insurance premiums or under-insurance, and • Under-maintained infrastructure (e.g., facilities, accounting software, etc.).	
h. Summarize the results of the detailed risk assessment. The summary should be maintained as part of the permanent file. Discuss the results with the ACO. For risk assessments performed at the corporate office, communicate the results to the auditors cognizant of the divisions/segments. If a financial capability audit is needed, proceed to the detailed audit steps in this audit program.	
i. For discretionary assignments where no risk was found, conclusions on the risk assessment evaluation should be summarized in a memorandum for record. For nondiscretionary assignments where no risk was found, coordinate the results with the requester and the ACO. If the requester agrees that further audit work is not necessary, confirm the coordination with the requester in a memorandum. If the customer desires an audit, proceed to the detailed audit steps of this audit program. At the completion of the detailed financial condition risk assessment, if the contractor has not provided the written confirmation letter, begin performance of a financial capability audit.	

C-1	**Cash Flow Projections**

Version 5.0, dated September 2004	**WP Reference**
1. Obtain Data and Other Information.	
a. This section of the audit program focuses on financial capability and includes an evaluation of the forecasted cash flows and related information. Obtain the following information to proceed with the audit:	
b. A cash flow forecast with supporting rationale for up to 12 months.	
c. The current fiscal year operating budget, including each contractor division.	
d. The capital acquisitions budget for the next 5 years.	
e. Accounts payable aging schedules for more than one period.	
f. Accounts receivable aging schedules for more than one period.	
g. Copies of any loan covenants/agreements.	
h. Status of any outstanding lines of credit.	
i. Debt/Bond payment schedules.	
j. Pending/potential claims and the status of any legal proceedings, investigations or any potential recoveries of losses.	
k. Current Board of Directors Minutes.	
l. Current sales backlog and new contract awards.	
m. Corporate guarantees, if applicable.	
n. Subordination agreement, if applicable.	
o. Any updates to status of any unfavorable or adverse conditions noted during the risk assessment.	
p. Employee Payroll Quarterly Federal Tax Returns (IRS Form 941) for the last two quarters.	
q. Obtain Written Confirmation Letter and Other Information. Request the contractor 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. A proforma 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. In addition to the written confirmation, the contractor should also be requested to provide:	
(1) A schedule separately showing (i) the maximum liability included in the financial statements and cash flow forecast and	

(ii) 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.	
(2) Any inquiries from their certified public accounting firm related to off-balance sheet arrangements and related party transactions and their responses to these inquiries.	
(3) The results and reports of any internal audits, reviews or other analyses of off-balance sheet arrangements and related party transactions.	
2. <u>Update the Risk Assessment.</u> Update the risk assessment data with year end or interim current year-to-date financial data or other considerations if there has been a significant lapse of time since the assessment was performed.	
3. <u>Review of Cash Flow Projections.</u> The cash flow forecast should be evaluated by the auditor for reasonableness. The contractor's certified public accountants may have performed a cash flow projection review during their annual audit. Determine if this occurred and if it is possible to review their audit efforts. The evaluation of the cash flow forecast will form the basic 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 have sufficient sources of cash to perform on Government contracts.	
a. 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. It may be necessary to explain in detail what we need in this regard and provide an example at some contractor locations. If the contractor fails to do so, ask the ACO for assistance in obtaining a cash flow forecast and in determining the appropriate period for the cash flow (DFARS 232.072-3).	
b. An audit opinion cannot be rendered for a major contractor without a cash flow forecast. The auditor should report this absence of normal financial management and budgetary controls as a significant internal control weakness. Actions to deny access should be elevated to the ACO for assistance. If the problem continues, it should be reported as an access to records problem (see CAM 1-504).	
c. If a non-major contractor fails to prepare a cash flow forecast, and detailed audit steps indicate the contractor is experiencing financial distress, the auditor can issue an unfavorable or adverse	

audit opinion on the contractor's financial capability which should be qualified due to the lack of the cash flow projection. If a non-major contractor fails to provide a cash flow forecast and detailed audit steps did not indicate financial distress, a report disclaiming an opinion should be issued. Refer to CAM 14-305.2e and 14.307a(4).	
(1) If the forecast is presented in the form of a statement of cash flows, verify the key amounts to the forecasted income statement and balance sheet.	
(2) Compare significant cash flow line items to actual historical balances. Determine if sales or production forecasts and related operating costs are consistent with recent financial statement trends and evaluate supporting assumptions.	
(3) Verify that projected sales agree with the contractor's annual financial plan and indirect rate forecasts. A list of projected sales or sources of cash, by contract, should be reviewed by the auditor and verified to contract data on a sample basis. Any contracts in a loss position should be carefully reviewed to determine the extent to which any additional billings might be made. Assist audits may be required at multidivisional organizations.	
(4) Other significant sources of cash should be identified by the contractor and verified by the auditor. Any projected collection of outstanding claims or unliquidated contract balances should be verified with the appropriate agency. If a significant projected source of cash is due to a planned liquidation of accounts receivable, confirmations may be required to the extent they were not audited by independent auditors. Contact the ACO prior to confirming accounts receivable balances outside the Government. If the ACO requests that receivables not be confirmed, qualify the report accordingly. Only the difference between the beginning and ending balance represents a source of cash.	
(5) 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 reviewed.	
(6) Verify projected uses of cash to the contractor's annual financial plan and forecasted indirect rate submission. Review the contractor's production schedule to determine if the variable uses of cash such as material purchases and payroll (headcount) are adequate to support performance assumptions.	
(7) Verify that all interest and principal payments on any debt,	

loans, or lines of credit are considered in the forecast.	
(8) Determine if the cash flow forecast considers any unfavorable or adverse conditions that have already been identified in the auditor's review of existing financial conditions.	
(9) Compare previous cash flow forecasts with actual statements of cash flows to determine the reliability of past forecasts.	
(10) Determine whether the contractor has the financial means to meet ongoing costs of operations in the near term. If the cash flow forecast is reasonable and shows that the contractor will meet its obligations without initiating actions outside the ordinary course of business, the contractor's financial condition will be considered adequate. Routine borrowings against a line of credit that do not consume most of the line of credit are not a condition that should be considered financial distress. However, a projected shortfall in meeting short term obligations may require obtaining cash from outside the normal course of operations by means of extraordinary management actions (such as liquidation of assets, significant loans, or sale of stock) which is considered financial distress. If a significant 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 would also be considered to be in a condition of financial distress.	
(11) Using the contractor-prepared schedule identifying the maximum possible liability for off-balance sheet arrangements and related party transactions, inquire of the contractor if any of the liabilities will become due in the near term (one year or less). If any are, verify that these cash outflows are reflected in the contractor's cash flow forecast.	

D-1	**Liquidation Of Accounts Payable**	
Version 5.0, dated September 2004		**WP Reference**
The auditor should determine if the contractor is liquidating accounts payable on a timely basis by reviewing the contractor's accounts payable		

aging schedule. Obtain a copy of the contractor's policy regarding liquidating accounts payable. For a multidivisional corporation with a decentralized accounts payable function, the auditor may need to request assist audits of segments/divisions with significant accounts payable balances.	
1. Verify the accounts payable aging schedule for more than one period to supporting accounting records (e.g., general ledger). Contractors may have the ability to manage accounts payable through various computer sort programs. When account balances are significant and the contractor does not prepare an aging schedule 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 use of the IT retrieval software (e.g., SAS and FOCUS).	
2. Compare debt cancellation dates with cancelled checks on a sample basis to determine if any checks are being held.	
3. Evaluate the number of days outstanding. Any significant deviation from the contractor's policy should be explained. Significant payables over 90 days should also be explained by the contractor. Determine if the reason for slow liquidation of payables is due to inadequate available cash.	

E-1	**Financial Flexibility**	
Version 5.0, dated September 2004		**WP Reference**
The auditor needs to consider the contractor’s financial flexibility to perform on Government contracts in the near and long-term. 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 (AU 341.07 – 341.09).		
1. Determine if the contractor has any plans to minimize the effects of a forecasted insufficient cash flow. Such extraordinary management actions may involve any or all of the following: a. Company reorganization/downsizing b. Restructuring of debt c. Liquidation of assets		

d. Additional borrowings e. Reduced or delayed expenditures f. Increased ownership equity g. Reduced dividends h. Sale of a portion of the company	
2. Review the following indicators in order to determine the extent of the contractor's ability to obtain additional cash:	
a. <u>Net worth (Assets - Liabilities)</u> Companies with no or little net worth have a difficult time attracting additional investment. Lines of credit or additional borrowings are often guaranteed by officers' and/or shareholders' personal assets.	
b. <u>Current Outside Ratings</u> Companies with high debt/bond/stock ratings may be able to raise additional cash through the issuance of additional debt, bonds, or stock. However, it should be noted that such ratings are only for existing debt, bonds, and stock. The company's ability to meet new interest, principal and/or dividends must be evaluated.	
c. <u>Liquidation of Assets</u> In order to raise cash, a company may sell existing assets. It is important to determine that such assets are not secured and are not pertinent to the continued operations of the company. Determine any direct or indirect effects of any planned disposition on Government contracts. The sale of assets that are secured often does not provide additional cash. However, it may favorably impact the debt to equity ratio, the cash flow to debt ratio and reduce debt service costs.	
d. <u>Bank Line of Credit</u> Loan covenants should be reviewed to determine if the contractor is in compliance with the terms of the agreement, including maintenance of established minimum account balances and ratios. Determine if credit line is guaranteed by another individual or corporation. If operating losses continue, such guarantees may be withdrawn, thereby eliminating existing lines of credit. Also, determine the amount of credit currently outstanding, amounts available, and terms of repayment on current balances.	

F-1	**Loan Covenants**
Version 5.0, dated September 2004	**WP Reference**
Review the contractor's loan agreements and covenants to determine if the contractor is complying with all of the conditions of the loan such as	

maintaining established ratios.	
1. Request the contractor to provide a historical analysis of the established ratios. Verify calculations. If the ratios are not being monitored by the contractor, the auditor should report this as a material internal control weakness.	
2. If the loan covenants or financial ratios are not being met, determine if they have been waived by the financial institution.	
3. Review the debt payments schedules. Verify that historical payments have been made on a timely basis. Note future payment requirements for verification during the contractor's cash flow forecast.	
4. 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.	
5. Review the interest rate charged by the lending institution. An increase in the rate charged significantly above the prime rate could be attributable to perceived contractor financial distress.	
6. Review loan/line of credit to determine if they are secured by collateral. If the contractor receives progress payments, and collateral includes inventory/work-in-process, determine if a subordination agreement is necessary.	

G-1	**Bankruptcy**	
Version 5.0, dated September 2004		**WP Reference**
Determine if the contractor has filed a petition for reorganization with the Bankruptcy Court or if any legal proceedings have been initiated by vendors for payment. [This condition gives rise to significant uncertainty as to the contractor's ability to adequately perform on Government contracts.] If the contractor has filed for bankruptcy:		
1. Determine if the ACO has been notified of any petition for bankruptcy. If not, provide written notification to the ACO immediately, and provide copies to the Regional Special Programs Office and Headquarters, Attention PPD.		
2. Determine what legal provisions exist and obtain the required financial information to ascertain the company's continuing financial capability.		
3. Consider qualifying the audit report regarding the bankruptcy proceedings.		

H-1	Payroll Taxes	
Version 5.0, dated September 2004		**WP Reference**
Determine if the contractor is paying its payroll taxes on a timely basis. Obtain the Employer's Quarterly Federal Tax Returns (form 941) for the last two quarters. The payment should be traced to cancelled checks, receipts from the bank or receipts from electronic fund transfer. If the contractor uses an external payroll company to process payroll, obtain copies of the statements for the last two quarters and verify accordingly. If the contractor owes the IRS for unpaid payroll taxes, try to obtain a copy of the agreement from the contractor and determine if the contractor is timely on payment. Failure to make timely payment of payroll taxes is a high risk indicator. The IRS acts promptly in such cases, and the IRS claim to contractor assets in satisfaction of payroll tax liability is superior to the contracting agency's claim to any unearned contract funds in the contractor's possession.		

I-1	Other Potential Conditions	
Version 5.0, dated September 2004		**WP Reference**
Other potential conditions that must be considered include:		
• Litigation		
• Unusual agreements with the Internal Revenue Service		
• Vendor requirements for Cash or Delivery payments		
• Production delays		
• Contract overruns		
• Labor disputes, etc.		

A-1	Concluding Steps	
Version 5.0, dated September 2004		**WP Reference**
1. Summarize the results.		
a. Select and use an opinion paragraph verbatim from CAM 14-307a. Following the opinion, it may be appropriate to include additional detail that addresses the specific contractor situation. For example, there may be improving or worsening conditions. There also may be mitigating circumstances such as lack of progress payments or		

nature of product or service. Prepare and submit a draft audit report for review, based upon the format in CAM 10-1200.	
b. When an audit is not performed based on the results of the risk assessment, prepare a memorandum for the record in accordance with CAM 14-304i.	
2. Obtain as necessary regional approval of draft report.	
3. Report separately, in flash report format, any internal control deficiency found during the audit.	
4. Coordinate preliminary results with the ACO and or requestor. If the issues warrant, invite the ACO to attend the exit conference.	
5. Hold exit conference with contractor and provide a draft copy of the audit results for contractor written comment. Significant issues should have already been discussed with the contractor during the audit. Allow a reasonable time for the contractor's written response. Top level contractor management should be involved in the exit conference if sensitive issues are going to be discussed or the draft report states there is some doubt regarding the contractor's ability to perform on Government contracts.	
6. Prepare final report incorporating the contractor's response.	
7. If the audit is performed at a corporate office, distribute a copy of the audit report to all FAOs in the CAC network. Also provide copies of the reports to PLAs and FAs as appropriate. Include a transmittal letter advising that the report contains sensitive information and should not be released outside of DCAA.	
8. Update permanent files and Internal Control Audit Planning Summary.	
9. Closing actions should be performed in accordance with FAO procedures. These procedures may require either auditors or administrative personnel to perform various closing steps. Completion of these closing actions should be documented (e.g., by initials and date on the CD or working paper folder, etc.) and should include:	
a. The title, author, and keywords fields of the file properties in the audit report must be completed (for the audit report only) prior to final filing.	
b. Review the APPS exe file for size. APPS-generated executable files that are over 10 megabytes in size should be reviewed to ensure that the format and content justify the size. Supervisors are responsible for reviewing or designating someone to review these files for content and format.	
c. Review the APPS exe file for temporary files. These files can be recognized by the “~$” or “~WRL” at the beginning of the file name. Once the APPS exe file is complete and there is NO	

	ACTIVITY to be completed on any of the files contained within the exe file, any temporary files should be deleted so there are no unintentional versions of working papers and/or reports. NOTE: This should be done prior to invoking the Export/Archive Option in APPS.	
d.	Once an audit report is signed, the electronic document should immediately be modified to indicate who signed it, and it should be password protected. The electronic file should then be renamed according to the convention “01 DCAA Report [RORG-ASSIGNMENT NO.] – Final.doc” and changed to a read-only file. Only this file should be stored, transmitted, or otherwise used for official purposes. For Memorandums the word “Report” would be replaced by “MFF” or “MFR” in the naming convention as appropriate.	
e.	When the audit report is transmitted electronically to the requestor, the transmission email should be saved as a txt file (this will ensure the attachments are not saved again). Saving delivery or read receipts is optional. If saved, the naming convention should distinguish them from transmittal emails.	
f.	Once the report is signed, the signature page of the audit report must be scanned in accordance with Agency standard scanning instructions. For audit packages, the scanned signature page file should be named the same as the audit report (see above) with “-sig” added (i.e., 01 DCAA Report 01101-2002X10100389-Final-sig.pdf). There is no requirement to make the file a part of the APPS generated executable file and it must be included separately in the iRIMS folder. There is no need to scan the signature page of a Memorandum unless it is distributed outside of DCAA.	
g.	Ensure an electronic copy of the final draft audit report containing the supervisory auditor’s initials and date, cross-referenced to the working papers, is included in the working paper package. The final draft report should include all substantive changes made to the original draft, with cross-referencing updated as necessary. It should differ from the final report only due to minor administrative changes (spelling, format, etc.) made during final processing.	
h.	Ensure all working paper files are "read only" and, if necessary, compressed for final storage. Generally, current Agency software should be used to automatically modify all electronic files for storage.	
i.	Two complete sets of electronic working papers should be filed. One set (official) will be filed in iRIMS. A second set (backup) will be stored on removable media in the hard copy working paper folder. The new APPS naming convention (ex: 01701_2003A10100001_Archive_093003.exe) will be used for	

both. If there will be a short-term need to access the working papers, a third, or "working" set should be stored so as to be available for reference, generally on the LAN. This set should be deleted when no longer needed.	
j. Verify using a separate machine, that electronic files stored on removable media are not corrupted and can be unarchived. Indicate the test was successful by placing tester initials and date prominently on the CD label.	
k. Verify using a separate machine, that electronic files stored on removable media are not corrupted and can be unarchived. Indicate the test was successful by placing tester initials and date prominently on the CD label.	
l. File the “official” set of electronic files in iRIMS (see iRIMS User Guide).	
m. **Do Not File Sensitive Audits in iRIMS**: Sensitive audits include but are not limited to classified work, suspected irregular conduct, hotline or DCAA Form 2000 related files. These audits should not be filed in iRIMS at this time. See CAM 4-407f for filing instructions.	