

DCAAM 7640.1; DCAA CONTRACT AUDIT MANUAL

Chapter 11

Audit of Contractor Compliance with Contract Financial Management Requirements

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11-000 Audit Of Contractor Compliance with Contract Financial Management Requirements **

11-001 Scope of Chapter **

This chapter provides guidance that is peculiar or special to the accomplishment of the audit of contractor compliance with contract financial management requirements. To the extent appropriate under the circumstances, Chapters 3, 4, 5, and 6 of this manual are equally applicable to the audit assignments discussed in this chapter.

11-100 Section 1 - Audit of Contractor Compliance with "Limitation of Cost," "Limitation of Funds," and "Limitation on Payments" Clauses **

11-101 Introduction **

This section provides guidance for auditing contractual limitations on costs, funds, and payments.

11-102 General **

Contract limitation of cost clauses ([FAR 52.232-20](#)) and limitation of funds clause ([FAR 52.232-22](#)) contain financial reporting requirements for cost-type contracts. The contract limitation on payments clauses ([FAR 52.216-5](#), [6](#), [16](#), and [17](#)) contain financial reporting requirements for contracts with price redetermination provisions and fixed-price incentive contracts. The limitation of cost and funds clauses in cost-type contracts require the contractor to advise the contracting officer in writing whenever the contractor has reason to believe that costs expected to be incurred under the contract in the next 60 days (may vary between 30 and 90 days) when added to all costs previously incurred, will exceed 75 percent (may vary between 75 and 85 percent) of the estimated total contract costs or funds allotted to the contract, respectively. The limitation of cost clause also requires the contractor to notify the contracting officer when there are indications that the total cost for the performance of a contract will be substantially greater or less than the estimated total contract cost. Under FAR 52.232-20 and 52.232-22, the Government is not obligated to reimburse the contractor for costs incurred in excess of cost or funding limitations. Similarly, the contractor is not obligated to continue performance under the contract or otherwise incur costs in excess of the limitation or, if the contract is cost sharing, the amount then allotted by the Government to the contract plus the contractor's corresponding share. However, if the Government notifies the contractor in writing that the amount allotted to the contract has been increased and specifies the amount, the Government is then obligated to the total revised amount allotted to the contract. The limitation on payments clause in contracts with price redetermination provisions and fixed-price incentive contracts requires the contractor to report to the contracting officer the costs in relation to billing prices on items for which final prices have not been established. The objective of Limitation on Payments Statement quarterly submissions is to keep billing rates during contract

performance in line with expected final prices; indicated overpayments can be recouped and excessive billing rates adjusted on a timely basis. This is a minimum requirement. The contract or the procuring agency may require additional reporting, or the contractor may prepare other internal reports in addition to those required by the Government.

11-103 Scope of Audit **

Knowing the management tools available to a contractor in controlling, projecting and monitoring contract costs is of utmost importance. Obtaining this knowledge is an integral part of system audits aimed at determining the adequacy of contractor financial management systems. It is important for the auditor to ascertain that the contractor has the financial management tools necessary to adequately identify potential contract overruns or underruns. The auditor should promptly notify the contractor and the ACO of any deficiencies. In evaluating the contractor's financial management policies and procedures, the auditor should ascertain:

a. The nature and adequacy of controls which govern the establishment of budgets; the procedures for accumulating incurred costs by budget element; the actual cost compared to budgeted costs; the means provided for comparing incurred costs to the percentage of contract completion; and development of estimates to complete (ETC).

b. Whether the contractor's organization effectively utilizes its financial management tools to promptly report potential cost overruns and underruns to contractor management and subsequently to the Government.

c. The methods by which the overall contract financial controls relate to the day-to-day supervisory controls maintained at the operational level.

11-104 Audit Procedures **

The audit procedures suggested in this section are not intended to be all-inclusive; the auditor, after considering these guidelines, must develop an audit program based on individual circumstances. At the beginning of the audit the auditor should coordinate with the cognizant contracting officer as discussed in [4-104](#).

11-104.1 Determination of Reporting Requirements **

When appropriate, the auditor should:

a. Determine, from contract briefing files or other available sources, those contracts which require limitation of cost reports, limitation of funds reports, or limitation on payments statements.

b. Ascertain whether the contractor is required to meet additional reporting requirements not specifically required by the contract.

c. Ascertain whether internal reports, in addition to those required by the contract, are prepared to increase internal financial management controls. If so, they should be compared with the reports submitted under the contract to determine whether significant differences exist.

d. Compare the reporting requirements among various contracts and determine whether there is duplication in the reports required and in the information assembled. The auditor should consider the possibility of the contractor using reports required by one military department, command, or Service to satisfy the needs of all contracting officers.

11-104.2 Evaluation of Reporting Controls **

When appropriate, the auditor should:

a. Evaluate the contractor's procedures applicable to the budgetary controls of individual contracts and compare the estimated cost of individual tasks and departments in the cost estimate with the budgeted funds.

b. Ascertain and evaluate for each division (or plant) the internal procedures for controlling the financial status of Government contracts and determine the source of the reported incurred costs and the basis for ETC. The auditor also should determine the extent and frequency of supervisory reviews of the status reports and whether explanations are required when there are significant deviations from the budget.

c. Ascertain and evaluate the manner in which revised ETC, in terms of engineering and production man hours, relate to the production control schedules and engineering manpower schedules at specific work centers.

d. Evaluate the documentation flow of the financial status reports from the various sources to the finance manager responsible for preparing the overall financial report for the assigned project.

e. Evaluate the controls exercised by the finance manager, including:

(1) the manner in which the source data are reviewed for reliability,

(2) the basis for changes to the source data, and

(3) a determination of the extent to which requests for explanations from operations responsible for the source data are made relative to causes of potential cost overruns or underruns.

11-104.3 Audit Objectives **

The audit objectives are:

(1) to determine whether the contractor has complied with the reporting requirements contained in the contract clause, and

(2) whether the financial data contained in the contractor's reports and statements are reasonable and consistent with the data presented in other required Government reports and/or claims.

11-104.4 Audit Guidelines **

The audit guidelines which are applicable to the minimum reporting requirements in 11-102 are as follows:

a. Ascertain whether the contractor is submitting reports required by its contracts. Compare these reports with the contractor's internal financial reports for consistency.

b. Evaluate limitation of cost reports. The limitation of cost clause requires the contractor to provide the contracting officer advance notice whenever the total cost incurred on the contract will exceed a specified percentage of, or will be greater or substantially less than, the estimated cost specified in the contract. The contractor must submit a revised estimate of the total cost of performing the contract as part of the notification. Limitation of cost reports should be evaluated using the following guidance:

(1) Evaluate the contractor's revised EAC using the guidance in 14-205f.

(2) Ascertain whether the limitation of cost reports in successive periods reflect significant cost underruns or overruns.

(3) Ascertain whether the contracting officer has obtained contractor explanations for overruns when continuous overruns have occurred over an extended period.

(4) When continuous underruns are projected over an extended period, and when the overall estimated contract price has not been reduced, the auditor should ask the contracting officer why.

(5) When individual contracts indicate continuous significant cost overruns or underruns, the auditor should evaluate this condition in relation to the price established at the time of award. If it is determined that consistent overruns or underruns resulted from defective initial pricing, the contracting officer should be so advised.

c. Evaluate limitation of funds reports. The limitation of funds clause requires the contractor to provide the contracting officer advance notice whenever the total cost incurred on the contract will exceed a specified percentage of the funds currently allotted or, for cost sharing contracts, this amount plus the contractor's corresponding share. This notice must include an estimate of the amount of additional funds required to continue performance for the period specified in the contract. Limitation of funds reports should be evaluated using the guidance in 11-104.4b above.

d. Evaluate quarterly limitation on payments statements. Quarterly limitation on payments (QLOP) statements must be submitted quarterly, in accordance with the provisions of ([FAR 52.216-5](#), [6](#), [16](#), and [17](#)). The primary objectives of QLOP statements are to provide for recoupment of overpayments and to indicate a need for a reduction in billing prices. These conditions become apparent when the contractor is underrunning targets used to establish billing prices. Overruns are caused by incurred and allocated costs exceeding the contract target costs. The general objective is to keep billing prices in line with expected final prices during contract performance. Progress payments (SF 1443) and Material Inspection and Receiving Reports (DD Form 250) provide corroborating evidence for quantities delivered and amounts billed. Thus, these documents should be evaluated along with the QLOP statements. Even though a request for audit may specify a particular document, auditors should try to identify each submission with comparable cutoff dates for direct comparison and reconciliation. When evaluating QLOP statements and reconciling them to progress payment requests and material inspection and receiving reports, consider the following:

(1) The auditor must first review the contract terms to determine which of the FAR clauses (FAR 52.216-6, 6, 16, or 17) is applicable and examine the contractor's compliance with these reporting requirements.

(2) It is the ACO's responsibility to ensure that the contractor submits the QLOP statements within 45 days after the end of each quarter of the contractor's fiscal year in which a delivery is first made and accepted by the Government under the contract. The auditor will only undertake an examination or other advisory services of a QLOP statement when requested by the ACO.

(3) The auditor should determine that costs related to delivered items are the same as the amounts excluded from costs shown as a basis for unliquidated progress payments (Item 20a of the progress payment request).

(4) The total amount of all invoices or vouchers for supplies delivered (or services performed) should be the same as Item 21a on the most recent progress payment request.

(5) The auditor should assure the comparability of contract items used in computations required by the various subsections of the QLOP statement. In all instances, cost data should relate to supplies and services delivered and accepted.

(6) The auditor should determine the methods used by the contractor to identify actual costs of delivered and invoiced items. Understatement of this amount usually results in an overpayment of progress payments by overstating the costs eligible for progress payments applicable to undelivered and uninvoiced items.

(7) The auditor should ascertain whether the contractor makes prompt refunds or adjustments when cost underruns are indicated in the performance of fixed-price redeterminable contracts.

11-104.5 CAS Compliance **

The auditor should determine if reporting practices comply with [CAS 401](#), "Consistency in Estimating, Accumulating, and Reporting" (See [Chapter 8](#)).

11-105 Reports **

Reports will be furnished in response to specific requests for evaluations in this area. Audit reports will be prepared in accordance with [10-100 and 10-200](#). When there is reason to recommend correction of a substantial deficiency, a special report will promptly be initiated by the auditor even if there is no request from a contracting officer.

11-200 Reserved

11-300 Reserved

11-400 Reserved