

# DCAAM 7640.1; DCAA Contract Audit Manual

## Chapter 14

### Other Contract Audit Assignments

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**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. 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 –Truth in Negotiation Compliance Audits of Contractor Certified Cost or Pricing Data \*\***

**14-101 Introduction \*\***

This section describes Truth in Negotiation compliance audits for defective pricing and provides specific audit guidelines and procedures related to this type of audit.

**14-102 Truth in Negotiation Compliance Audit \*\***

a. Defective pricing occurs when a contractor does not submit or disclose to the Government certified 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 Truth in Negotiation compliance audit by examining and analyzing the records and data available to the contractor as of the date of prime contract agreement on the price and comparing them with the submitted certified cost or pricing data.

b. The objective of a Truth in Negotiation compliance 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 certified 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 date of agreement on the 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 Truth in Negotiation compliance 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 Field Audit Office (FAO) performs Truth in Negotiation compliance 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.

## **14-103 Truth in Negotiations (TIN) \*\***

### **14-103.1 Purpose of TIN \*\***

The purpose of the Truth in Negotiation (TIN) is to put the Government on equal footing with contractors when negotiating contracts requiring certified cost or pricing data. The TIN requires contractors to submit accurate, complete, and current certified 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.

#### **14-103.2 TIN applicability \*\***

a. The TIN applies to negotiated prime contracts, modifications, and subcontracts where the Government required certified cost or pricing data. (See [FAR 15.403-1](#) and [DFARS 215.403-1](#) for exceptions to this requirement.) This includes interdivisional work, final price redeterminations, equitable adjustments, and termination settlements. TIN also applies to modifications of advertised contracts when the modification exceeds the applicable dollar threshold. Further, TIN 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. The TIN threshold for obtaining certified cost or pricing data is specific in FAR 15.403-4(a)(1), Requiring certified cost or pricing. [10 U.S.C. Chapter 271, Section 3702\(g\)](#) and 41 U.S.C. Chapter 35, Section 3502 require adjustments of the TIN threshold for inflation every 5 years, starting October 1, 1995.

The current threshold applicable to all agencies is \$2,000,000 for prime contracts awarded on or after the effective date of July 1, 2018 and for any subcontracts or modifications under those prime contracts that are expected to exceed \$2,000,000.

The adjusted threshold does not automatically apply to prime contract modifications or subcontracts (or modifications of changes to subcontracts). For prime contract modifications, new subcontracts at any tier, and subcontract modifications, the applicable TIN threshold is established at the date of agreement on prime contract price, or the date of prime contract award whichever is later. If the pre-existing prime contract is modified to incorporate adjusted threshold date, the adjusted threshold applies to the subcontracts and modifications made after the date of modification.

The adjusted threshold does not apply to undefinitized contract actions issued before the effective date, even though negotiations were completed after that date unless the prime contract was subsequently modified to incorporate the adjusted threshold. However, contracting officers may modify Basic Ordering Agreements to reflect the higher thresholds for orders issued after the effective date. Contracting officers can request certified cost or pricing data between the Simplified Acquisition Threshold of \$150,000 and the certified cost or pricing data threshold only with the approval at the Head of the Contracting Activity and provided that an exception at FAR 15.403-1(b) does not apply.

c. As provided in [FAR 15.403-1\(b\)](#), contractors may obtain exceptions from submitting certified 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, or

(5) a commercial contract is modified and meets the requirements of [FAR 15.403-1\(c\)\(3\)](#).

#### **14-104 Certified Cost or Pricing Data \*\***

##### **14-104.1 TIN Definition \*\***

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

##### **14-104.2 FAR Definition \*\***

[FAR 2.101](#) states that "certified cost or pricing data" means "cost or pricing data" that were required to be submitted in accordance with [FAR 15.403-4](#) and [15.403-5](#) and have been certified, or are required to be certified, in accordance with [15.406-2](#). This certification states that, to the best of the person's knowledge and belief, the cost or pricing data are accurate, complete, and current as of a date certain before contract award. Cost or pricing data are required to be certified in certain procurements ([10 U.S.C. Chapter 271, Section 3702](#) and [41 U.S.C. Chapter 35, Section 3502](#)).

"Cost or pricing data" mean all facts as of the date of agreement on the price or, if applicable, an earlier date agreed upon between the parties that is close as practicable to the date of agreement on price, prudent buyers and sellers would reasonably expect to affect price negotiations significantly. Cost or pricing data are factual, not judgmental, and are 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.

#### **14-105 Submission or Disclosure of Certified Cost or Pricing Data \*\***

##### **14-105.1 TIN Requirements \*\***

Prime contractors subject to TIN must submit accurate, complete, and current certified cost or pricing data to the contracting officer or to the "designated representative" of the contracting officer. Subcontractors subject to TIN (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 certified cost or pricing data from the contractor before awarding any contract or modification meeting the certified cost or pricing data criteria of [FAR 15.403-4](#). The contractor must actually submit the certified 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 certified 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 identification. [FAR 15.408](#), Table 15-2 details the procedural requirements for submitting a proposal and the required supporting certified 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 certified cost or pricing data. The regulations make a clear distinction between submitting certified 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 certified 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 certified cost or pricing data to the Government (i.e., submission versus availability).

#### **14-106 Contracting Officer's Designated Representatives for Receiving Certified Cost or Pricing Data \*\***

a. Submission or disclosure of certified 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 certified 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 certified cost or pricing data on that procurement. However, if the auditor subsequently becomes aware of additional certified 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 certified 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 certified 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 certified 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 certified 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 certified cost or pricing data to update its proposal or analyze it for the Government. Therefore, when the subcontractor discloses certified 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 certified 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. 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 agreement on the 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 agreement on the price 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 certified cost or pricing data in order to perform the audit.

d. Subcontract certified 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 certified cost or pricing data provided by the subcontractor depending on the timing of subcontract award and/or the type of prime contract. (See 14-116.3 for significant dates.)

#### **14-108 Subcontractor Certified Cost or Pricing Data \*\***

a. Any contractor required to submit cost or pricing data and a certificate also must obtain certified 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 certified 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 \$13.5 million or more,

(2) the estimate is more than the applicable dollar threshold for required certified 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 certified 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 certified cost or pricing data to the prime contractor or higher-tier subcontractor. The prime contractor or higher-tier subcontractor is responsible for conducting cost or price analyses of the



subcontract (see [FAR 15.404-3\(b\)](#)). The results of this analysis are furnished to the Government as part of its certified cost or pricing data submission up to the date of agreement on the price. Therefore, defective certified 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 certified cost or pricing data in accordance with [FAR 15.403-1\(b\)\(4\)](#) is considered as having been required to make available certified cost or pricing data. Therefore, although the prime contract would not be subject to TIN, any lower-tier subcontract expected to exceed the certified cost or pricing data threshold is required to submit certified cost or pricing data unless an exception at [15.403-1](#) applies. These subcontracts would be subject to TIN 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 certified cost or pricing data plus updated certified 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 price negotiation memorandum (PNM) whether certified 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.

f. In establishing the Government's reliance on certified cost or pricing data, one of the five points for defective pricing detailed in 14-102, the auditor should give special consideration to subcontractor certified 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 TIN is worded so as to require all subcontractors to submit certified cost or pricing data to the prime contractor, FAR does not require prime contractors to submit all certified cost or pricing data to the Government. If a subcontractor submits certified 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 certified cost or pricing data. In this case, before the Government can get a price reduction for defective certified 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 certified 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 certified 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 Truth in Negotiation compliance 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 un rebutted, 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 Record \*\***

a. The TIN provides the Government with the right to examine contractor records to evaluate the accuracy, completeness, and currentness of the certified 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 Truth in Negotiation compliance 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, Policy and Plans, Pricing and Special Projects (PSP), 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 negotiation agreement (e.g., price negotiation memorandum (PNM)) 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 certified cost or pricing data submitted.

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

(3) Recognized as inaccurate, incomplete, or noncurrent any certified 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. The PNM is the most important Government document for the successful completion of any Truth in Negotiation compliance audit. [FAR 15.406-3](#) details the minimum information included in the negotiation agreement (e.g., PNM) and requires contracting officers to provide auditors with a copy of the negotiation agreement. 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 certified cost or pricing data. Sole reliance on the PNM without communicating with the contracting officer is not sufficient.

d. In June 1989, the Director, Defense Procurement and Acquisition Policy (DPAP) issued policy guidance to contracting officers for situations where contractors provide certified 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. DFARS PGI 215.406-2(c)(i)(A) instructs contracting officers to request contractors to execute the certificate of current cost or pricing data as soon as practicable, but no later than five business days after the date of agreement on the price.

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

f. Subcontract auditors will obtain information on the prime contractor's certification of certified 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 Certified Cost or Pricing Data \*\***

a. The contract clauses entitled Price Reduction for Defective Certified 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 TIN and regulations do not define what is a "significant amount" of increase to a contract price. (See 14-117.1 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 Truth in Negotiation compliance 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. Chapter 271, Section 3708 grants audit access to contractor or subcontractor records for evaluation of certified 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 certified 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 Coordination with Government and Contractor Personnel \*\***

a. To foster the exchange of useful information and achieve maximum cooperation, FAOs should provide a list of all programmed Truth in Negotiation compliance audits to affected Government personnel (contracting officers and prime contract auditors) as early as possible. 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 Truth in Negotiation compliance 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 Truth in Negotiation compliance audits on prime contracts or modifications to the PCO, with a copy to the onsite FLA, if applicable (see 15-303). 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. As well, it is important to notify the contracting officer when a programmed Truth in Negotiation compliance audit is cancelled after having been announced. Accordingly, auditors are required to inform the contracting officer that the audit has been terminated/cancelled and document that communication. For subcontract audits, the auditor will inform the prime auditor that the audit has been terminated/cancelled and document that communication (see 2-306.9).

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. While the Government has the right of access to records for three years from the date of final payment under the contract or subcontract, the Contracting Officer has six years from the date the Government discovers the existence of cost or pricing data that the contractor failed to submit to issue a written decision under the disputes clause of the contract (FAR 33.206(b) bars recovery after six years). Generally, the six year period for the accrual of the statute of limitations begins when the Government first had

sufficient information to assert a claim, which in most cases occurs during the audit, but in no case later than the issuance of the audit report.

**14-114 Establishing the Baseline for Audit, Determining the Defective Data, and Calculating the Recommended Price Adjustment (Truth in Negotiation Compliance 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.

**14-114.1 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 certified cost or pricing data for compliance with TIN, the auditor must establish an audit baseline as a starting point in order to determine if the certified 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 certified cost or pricing data up to the time of price agreement or disclosure of sweeps data, if applicable (see 14-117.4) 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 certified cost or pricing data and judgments. The baseline for audit is initially developed during the risk assessment stage of the audit. At this stage of the audit, the baseline does not have to be precise. Instead, the audit team will develop an initial baseline to determine the materiality of the cost elements and perform risk assessment analysis. During the fieldwork, the audit team will prepare a more precise baseline to calculate the recommended price adjustment should the audit team determine defective pricing exists.

**DEFECTIVE PRICING AUDIT**

**BASELINE**

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

+ or - (Plus or Minus)

Additional certified cost or pricing data up to the date of agreement on the 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 certified 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.

c. Sometimes the contractor does not submit additional certified 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.

#### **14-114.2 Determining the Potential Defective Data \*\***

Once the auditor has established the baseline for audit, the next step is to compare the certified 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 date of agreement on the 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**

**\$\$\$** Certified cost or pricing data in audit baseline (14-114.1)

- (Less)

Accurate, complete, and current cost or pricing data reasonably available up to the time of date of agreement on the 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

#### **14-114.3 Calculating the Recommended Price Adjustment \*\***

a. The recommended price adjustment (RPA) is the total amount the contract price increased because the contractor submitted defective certified cost or pricing data. It includes not only the defective data, but also the associated costs and profit. In general, the noncompliance report should include a RPA. The audit team must consider materiality and pervasiveness of the noncompliance prior to reporting it in the final report.

b. Auditors may encounter instances where they find defective pricing but an external condition may prevent them from establishing the five points of defective pricing (14-102(b)). For instance, auditors may not be able to confirm that the Government relied on the defective data in negotiating with the contractor. In other instance, auditors may find that the contractor submitted an increased contract price based on defective data but the negotiated contract price offsets the increased cost resulting from the defective data. In any case, auditors should consider the significance of the noncompliance. If the noncompliance rises to the appropriate level of significance, the audit team should report the noncompliance with zero RPA. However, if the noncompliance does not rise to the appropriate level of significance, the audit team should include the noncompliance in an appendix to the audit report as a less than severe noncompliance that warrants the attention of the contracting officer.

c. 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.

d. Computing recommended price adjustments:

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

(a) 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 certified cost or pricing data related to the defective element submitted up to the date of agreement on the price (or another date agreed upon between the parties) to include "sweep" data (14-120.4).

(b) 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:

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

Plus:



(2). Associated costs and profit:

(a) 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 certified cost or pricing data submitted up to the time of agreement (or another date agreed upon between the parties) including "sweep" data.

(b) 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:

(3) The total recommended price adjustment.

e. 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 Government 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 14-114.3d(1)(a).

**14-115 Treatment of offsets \*\***

a. The TIN places the burden of proof for offsets on the contractor and disallows using any intentional understatements to offset defective certified cost or pricing data that resulted in a price increase. This applies only to contracts or modifications to contracts entered into on or after February 15, 1987 ([10 U.S.C. Chapter 271](#)). As a result, the following guidelines apply to offsets.

(1) For contracts or modifications to contracts entered into on or after February 15, 1987, offsets against defective certified 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.

(2) 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 the price.

(3) 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.

(4) The Government permits offsets among and within the various line items of the certified 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 14-115a(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 certified cost or pricing data related to the higher price was known and considered by the contractor prior to date of agreement on the 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 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.

(2) 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.

#### **14-116 Subcontract Audit Procedures (Truth in Negotiation Compliance Audits) \*\***

The "Price Reduction for Defective Certified Cost or Pricing Data" clauses in [FAR 52.215-10, 11, 12, and 13](#), 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 certified 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.

##### **14-116.1 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 certified 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 certified cost or pricing data as of the date of agreement on the price with the Government. The prime auditor reports the results of the Truth in Negotiation compliance audit, including any subcontract audit results, to the contracting officer. Even though the DCAA Truth in Negotiation compliance audit 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.

c. Subcontract auditors are responsible for evaluating the subcontractor certified cost or pricing data submitted and/or certified to the prime contractor. The relevant dates for auditing the subcontractor's certified cost or pricing data vary and should be established at the beginning of the audit (see 14-116.3). The subcontract auditor obtains necessary information through the prime auditor and issues its report directly to the prime auditor, unless otherwise directed.

#### **14-116.2 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 the audit report shell and 10-210. Follow the procedures in 6-802.6 in resolving any objections to unrestricted release of information to the higher-tier contractor.

#### **14-116.3 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 certified 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 certified cost or pricing data existing as of the date of agreement on the price 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 certified 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 the price,) and/or (2) the subcontractor level if the subcontractor did not provide the prime with accurate, complete, and current certified cost or pricing data as of prime and subcontractor price agreement.

#### **14-116.4 Handling Subcontract Price Adjustments \*\***

Subcontract certified 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 certified cost or pricing data negotiated with the subcontractor prior to the date of prime contract price agreement or defects in unnegotiated subcontractor certified 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 certified 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 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 certified 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).

d. If the prime contract is flexibly priced and the subcontract audit report recommends disallowance or nonrecognition of incurred costs (see 14-116.4b), the prime auditor will immediately advise the PCO. Timely action (1) allows the PCO to notify the prime contractor that the increased costs may be disallowed or not recognized on the prime contract and (2) enables the prime contractor to exercise the price reduction clauses it should have in its contract with the subcontractor. Delays in reporting subcontractor defective pricing may prevent the prime contractor from obtaining a subcontract price reduction, thus precluding the prime's legitimate recovery

of its costs.

## **14-117 Other Audit Considerations \*\***

### **14-117.1 Materiality of the Defective Pricing Findings \*\***

a. The TIN and regulations do not define what is a "significant amount" by which a contract price was increased because the contractor furnished defective certified 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 Truth in Negotiation compliance audits. In determining the significance of defective pricing, consider the magnitude of the defective data including all applicable burdens (see 14-114.3).

c. The audit team should exercise professional judgement to establish an initial materiality threshold in the risk assessment. The audit team should consider the quality and totality of evidence obtained and make a determination on the significance of the potential recommended price adjustment (RPA) to the procurement process, and adjust the materiality threshold as additional facts are discovered. The audit team should consider the amount of resources the Government and contractor will expend finding, pursuing, and settling claims of defective pricing.

### **14-117.2 Defective Pricing from CAS Noncompliances \*\***

a. Generally, a CAS noncompliance found in a Truth in Negotiation compliance audit does result in the certification of inaccurate cost or pricing data. However, the auditor will report CAS noncompliances revealed in Truth in Negotiation compliance 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 Truth in Negotiation compliance 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.

#### **14-117.3 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 of the contractor's business systems 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.



#### **14-117.4 Defective Pricing “Sweeps” \*\***

a. A defective pricing “sweep” is a process (see 14-120.4e) 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 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 creation designed to reduce the incidences of defective pricing found in non-compliance with the Truth in Negotiations Act (or TINA), the ideal “sweep” process is throughout the negotiation process, and before the agreement on price or shortly after price agreement. Thus, the “sweep” should not be submitted long after the price agreement. Nevertheless 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.

b. 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. Sweep data appear defective in that the cost or pricing data were not submitted or disclosed to the Government before the price agreement. The auditor should not recommend a price adjustment simply because the data were provided with the certificate after price agreement because this may not be defective pricing.

- If the contracting officer reviews the data, the auditor should consider that the data was disclosed to the Government.
- If the contracting officer defers consideration of the data until after the contract award, any “sweep” data submitted may not be considered defective pricing unless it meets all five points of defective pricing.

c. The auditor should assess whether a contractor's sweep practices reflect deficiencies in estimating systems or procedures. For example, a contractor continually delays submitting certified cost or pricing data until after price agreement when the cost or pricing data were available to the contractor for some time before price agreement. In those cases, the auditor must take appropriate steps to report the deficiencies or irregularities.

d. DFARS PGI 215.406-2(c)(ii) provides flexibility to contracting officer to either (A) defer consideration of the impact of any cost or pricing data submitted by a contractor after price agreement is reached (“sweep” data) until after award of contract action or (B) reopen negotiations, establish a new price and a revised price agreement date, and obtain a new certificate. Therefore, the auditor’s approach to the “sweep” data will depend on what the contracting officer did. To obtain this information, the auditor should contact the contracting officer to understand what the contracting officer did with the “sweep” data and how it is documented in PNM.

## **14-117.5 Statistical Sampling Techniques in Truth in Negotiation Compliance 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 Truth in Negotiation compliance 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 14-115.

(1) 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 14-115 b.).

(2) 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 14-115b to report potential offsets that the contractor would not certify.

#### **14-117.6 Obtaining Third Party Confirmations \*\***

Obtain third party confirmations as appropriate when performing Truth in Negotiation compliance 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.

#### **14-117.7 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/corporate audit directorate office if it is likely to involve a major increase in the programmed workload level for Truth in Negotiation compliance 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 Truth in Negotiation compliance 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.

#### **14-118 Findings and Conditions Requiring Further Pursuit as Potential Cases of Fraud (Truth in Negotiation Compliance Audits) \*\***

During Truth in Negotiation compliance audits of certified cost or pricing data, be constantly alert to identify any condition which might suggest wrongdoing against the

Government. When finding any of these or similar conditions, refer them to the responsible investigative organization following the procedures in 4-702.

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.

#### **14-119 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, 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 certified 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. 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. The auditor will also provide a copy of any draft report information provided to the PCO to the onsite FLA (refer to the FLA Locator on the DCAA Intranet site). 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 certified 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 certified 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.

#### **14-120 Reporting Results of Audit (Truth in Negotiation) \*\***

a. An audit report is required for all (positive and negative) Truth in Negotiation compliance audits. Prepare and distribute Truth in Negotiation compliance audit reports using the guidance in Chapter 10. The prime contract auditor will incorporate positive subcontract audit report findings and made distribution of a combined report. See 14-115 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 the Truth in Negotiation compliance standard audit program). Highlights to be addressed in discussing the points:

(1) In discussing the first point, provide the relevant parts of the FAR definition of cost or pricing data along with an explanation of how the data in question fits the FAR definition. See 14-104.2.

(2) In discussing the second point, provide the date that the accurate, complete, and current data was reasonably available to the contractor and the date of agreement on the price or, if applicable, the other date agreed upon between the parties. Emphasize that the availability date was prior to the date of agreement on the price. See 14-105.2.

(3) In discussing the third point, address how the auditor was able to confirm that the contractor did not submit the data (e.g., no record of submission in contractor or Government proposal files) and that the Government had no actual knowledge of the data (e.g., PNM language and confirming memorandum). See 14-105.

(4) In addressing the fourth point, discuss how reliance was confirmed, such as the date for the PNM and the confirmation memorandum from the contracting officer. See 14-111.

(5) In addressing the fifth point, explain how the Government's reliance on the defective data caused an increase in price.

c. 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.

d. When there is reasonable basis to suspect that the contractor knowingly submitted inaccurate, incomplete, or noncurrent certified cost or pricing data, issue a referral of suspected irregular conduct using DCAA Form 2000. Following the procedures in 4-702.5, transmit a copy of the form to the contracting officer only if the responsible investigative agency does not object (see DCAAI 7640.16). Coordinate any potential notification to the procuring or administrative contracting offices regarding the fraud referral with the DCAA Justice Liaison Auditor (JLA) who will recommend a course of action. For DoD contracts or modifications awarded after November 7, 1985, include the following statement in the transmittal:

*“Notwithstanding any potential civil or criminal fraud violations, Chapter 271, as amended by Section 952(a) of the 1987 Defense Authorization Act, states that a contractor who knowingly submits inaccurate, incomplete, or noncurrent certified cost or pricing data must pay a penalty in an amount equal to the overpayment. In our opinion, there is a reasonable basis to conclude that [contractor name] made a knowing submission as contemplated under the statute and, therefore, is liable to the Government for \$ [amount].”*

e. When a pattern of deficiencies or discrepancies suggests fraud, other unlawful activity, or the existence of unsatisfactory conditions, refer or report the matter using the guidance in 4-700 or 4-800.

#### **14-121 Charging Interest When Defective Pricing is Found \*\***

a. Section 952 of the 1987 Defense Authorization Act amended [10 U.S.C. Chapter 271](#) to allow the Government to recover interest on overpayments to contractors resulting from defective certified cost or pricing data on DoD contracts or modifications dated after November 7, 1985. 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 14-122 below).

b. Interest does not accrue until delivery payments are 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). Overpayments do not result from "contract financing payments" as defined at [FAR 32.001](#). Interest does not apply to contract financing payments which include advance payments, interim payments on cost-type contracts, and progress payments other than those made on fixed-price,

architect-engineering contracts. Interest also does not apply when there is no overpayment, for example when costs are disallowed or not recognized under cost-type or flexibly priced prime contracts (see 14-116.4).

c. To assist the contracting officer in carrying out the responsibility for collecting interest on overpayments resulting from defective pricing on (1) DoD contracts or modifications awarded after November 7, 1985 or (2) other Government contracts or modifications awarded after January 22, 1991, include the following statement as part of this portion for prime contract audit reports:

*“The Government sustained a loss in the form of interest on overpayment which resulted from the contractor's failure to comply with the Truth in Negotiations Act (10 U.S.C. Chapter 271). As provided by the statute (applicable to DoD contracts) and/or FAR 15.407-1(b)(7) (applicable to contracts of all Government agencies), this interest amount is computed at the current rate prescribed by the Secretary of the Treasury under Section 6621 of the 1986 Internal Revenue Code, from the time of the overpayment to the date the Government is repaid.”*

When Truth in Negotiation compliance audits at subcontractors disclose overpayments resulting from defective pricing on subcontracts meeting the conditions in c. above, the subcontract auditor should include in this portion of the report the statement above and add the following sentence at the end of the paragraph:

*“Recommendations on interest due as a result of Government overpayments will be made by the prime contract auditor.”*

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. 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.

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 certified 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.



## 14-122 Interest Rates – Defective Pricing <sup>\*\*</sup>

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

Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1985			11%	11%
1986	10%	10%	9%	9%
1987	9%	9%	9%	10%
1988	11%	10%	10%	11%
1989	11%	12%	12%	11%
1990	11%	11%	11%	11%
1991	11%	10%	10%	10%
1992	9%	8%	8%	7%
1993	7%	7%	7%	7%
1994	7%	7%	8%	9%
1995	9%	10%	9%	9%
1996	9%	8%	9%	9%
1997	9%	9%	9%	9%
1998	9%	8%	8%	8%
1999	7%	8%	8%	8%
2000	8%	9%	9%	9%
2001	9%	8%	7%	7%
2002	6%	6%	6%	6%
2003	5%	5%	5%	4%
2004	4%	5%	4%	5%
2005	5%	6%	6%	7%
2006	7%	7%	8%	8%
2007	8%	8%	8%	8%
2008	7%	6%	5%	6%
2009	5%	4%	4%	4%
2010	4%	4%	4%	4%
2011	3%	4%	4%	3%
2012	3%	3%	3%	3%
2013	3%	3%	3%	3%
2014	3%	3%	3%	3%
2015	3%	3%	3%	3%
2016	3%	4%	4%	4%
2017	4%	4%	4%	4%
2018	4%	5%	5%	5%
2019	6%	6%	5%	5%
2020	5%	5%	3%	3%
2021	3%	3%	3%	3%
2022	3%	4%	5%	6%
2023	7%	7%	7%	8%

2024	8%	8%		
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### **14-123 Resolution of Audit Findings \*\***

a. The auditor must continue to coordinate and communicate with the contracting officer after Truth in Negotiation compliance audit reports 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 customer requested assignment.

b. If the receipt of additional information or audit effort results in a revised audit position, issue a supplemental audit report (see 10-213). 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.

### **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 CaseWare include a standard audit program for performing these audits (entitled Progress Payment, Cost). Since progress payment requests based on percentage of completion are infrequently encountered, they are not addressed in this section. However, the DCAA Intranet and CaseWare include a standard audit program for auditing these requests (entitled Progress Payment, Percentage of Completion).

**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 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](#).

c. 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%

d. 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.

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

f. 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 4-104.

#### **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 amount fixed by the contract plus the not-to-exceed amount for any unpriced modifications.

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

(3) Fixed Price Incentive - target price plus the not-to-exceed amount unpriced modifications. However, if the contractor's properly incurred costs exceed the target price, the contracting officer may provisionally increase the price up to the ceiling

or maximum price.

b. Contract price includes the total amount to be paid for complete performance of the contract, to include the not-to-exceed amounts on unpriced modifications. 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). In addition, the contracting officer shall not make progress payments or increase the contract price beyond the funds obligated under the contract, as amended.

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

(1) Additional Limits. In an effort to encourage finalization of contract actions and to protect the Government's interests, [DFARS 217.7400](#) limits DoD expenditures on unfinalized 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 finalized 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 unfinalized 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 unfinalized contract action (UCA) cannot exceed upon finalization.

(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 within 30 days of the contractor's 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 to this contract, and consistent with sound and generally accepted accounting principles in accordance with [FAR 52.232-16\(a\)\(4\)\(i\)](#).

#### **14-203 Audit Responsibility – Progress Payments \*\***

a. The purpose of the request for progress payment audit from the administrative contracting officer is to:

(1) verify the amounts included on the progress payment invoice ([SF 1443](#)) to the contractor's accounting books and records, and

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

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.

c. 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. This assessment should be coordinated at least annually with the ACO and documented in the permanent file.

#### **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 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 results of the

accounting and billing systems audits and other related permanent file data 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 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, including risk relating to the contractor's financial condition (see 14-301).

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 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 recommend actions to the ACO to encourage the contractor to correct the deficiencies (e.g., suspension of costs, disapproval of system). When the contractor corrects the deficiency or changes the 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 online at the [General Services Administration \(GSA\) Forms Library](#).



a. Contract Price (Item 5) should be verified to the most current contract modification to include the not-to-exceed amounts for any unpriced modifications per [FAR 32.501-3](#) (see 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.

b. 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.

c. Cost Eligible Under Progress Payment Clause (Item 11). 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 within 30 days of the contractor's payment request to the Government.

d. 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 11 to the contractor's accounting books and records.

e. 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 [DoDM 5000.04](#).

(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 Integrated Program Management Reports (IPMRs) or Cost/Schedule Status Reports (C/SSR). The IPMR is a contractually required report, prepared by the contractor, communicating program cost and schedule information to the Government. The IPMR combines and replaced the Contract Performance Report and the integrated Master Schedule (see the [Earned Value Management IPMR Guide](#)).

(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 IPMR 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 IPMR 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. 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 evaluate the adequacy of the specialists work (see Appendix B).

f. 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.

g. 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). FAR 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 within 30 days of the prime contractor's 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 11.

(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 within 30 days of the prime contractor's 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, performance-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.

h. 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.i(3)). The auditor should coordinate Item 18 with the ACO's payment records and reconcile any differences. (While the item title refers to amounts requested, Item 18 generally represents the previous amounts paid.)

i. 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.

j. Total Amount Liquidated and to be Liquidated (Item 23) is the cumulative amount of previous progress payments liquidated and those to be liquidated from billings submitted but yet paid 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 14-205i(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 liquidation 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.

k. 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 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 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).

c. The contractor is responsible for maintaining reliable accounting and billing systems for the proper recording and segregation of costs. If the audit discloses significant deficiencies in the systems 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.

d. 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 32.608-1](#) 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 – RESERVED \*\***

## **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](#) and [DFARS 245.101](#) into the following categories:

- (1) equipment,
- (2) real property,
- (3) facilities,

- (4) Government production and research property,
- (5) material,
- (6) nonseverable property,
- (7) agency-peculiar property, and
- (8) mapping, charting, and geodesy (MC&G) property.

c. Agency-peculiar property, as defined in [FAR 45.301](#) and [DFARS 245.101](#), 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 \*\***

[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, [DoDI 4161.02](#), DoD Instruction for the Accountability and Management of Government Contract Property, sets forth specific responsibilities of DoD personnel for the administration of Government property in the possession of the contractor.

##### **14-403.2 DoD Policy on Furnishing Facilities \*\***

It is DoD policy to rely on contractors to furnish, to the maximum extent possible, 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. In conjunction with its use on Government contracts, commercial use of Industrial Plant Equipment (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)).

b. 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 on 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. DoDI 4161.02 states procedures and techniques for the guidance of DoD personnel engaged in the administration of Government property in the possession of contractors. DoDI 4161.02-M also provides guidance as to specific functional areas requiring consideration and surveillance by the property administrator.

b. As stated in DoDI 4161.02, 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 Selected Areas of Cost guidebook, Chapter 9 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 Voucher Evaluation Memorandum or Incurred Cost Audit Reports \*\***

Prior to the issuance of a final voucher evaluation memorandum or development of a Cumulative Allowable Cost Worksheet 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 final voucher evaluation memorandum or Cumulative Allowable Cost Worksheet.

#### **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 auditor will evaluate property 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, Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS) 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](#) Use and Charges **\*\*****

### **14-500 Section 5 – Performance Audits **\*\*****

#### **14-501 Introduction **\*\*****

Operations audits must be conducted in accordance with the GAGAS standards established for performance audits. Operations audits must apply the GAGAS requirements and application guidance in the 2018 Yellow Book, chapters 1-5 and 8-9. Performance audit objectives range from narrow to broad and involve varying types and quality of evidence. The auditor should identify and use suitable criteria based on the audit objects to adequately plan the work necessary to address those objectives and design the methodology to obtain sufficient appropriate evidence that provides a reasonable basis for the findings and conclusions based on the audit objectives.

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 (3-204) 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. The audit program must be planned to reduce audit risk to an acceptably low level. In planning the audit, auditors should assess significance and audit risk and apply these assessments to establish the scope and methodology for addressing the audit objectives.

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.

c. Auditors should identify and use suitable criteria based on the audit objectives. Suitable criteria are relevant, reliable, objective, and understandable and do not result in the omission of significant information, as applicable, within the context of the audit objectives. The relative importance of each of these characteristics to a particular engagement is a matter of professional judgment. In instances where laws, regulations, or policies prescribe the criteria to be used for the engagement, such criteria are presumed to be suitable in the absence of indications to the contrary. See the 2018 GAGAS 8.18 for examples of criteria.

#### **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, and 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 3-204 and 4-103).

#### **14-504 Cost Avoidance Recommendation Resulting From Operations Audits \*\***

a. The report should include cost avoidance recommendations, regardless of whether the contractor is in agreement with the audit results. When the auditor identifies opportunities for the contractor to reduce costs, the cost impact of any recommendation is reportable if it is measureable using a realistic estimate. The cost avoidance amount is a conservative estimate of the savings achievable for a period of at least 12 months and no more than six years, after implementation of the recommendations. Compute the cost avoidance in a reasonable manner considering all offset costs. Offset costs include all direct or indirect costs required to implement the action that would result in the cost avoidance. Audit recommendations may result in a one-time savings, savings over the life of a particular program or piece of equipment, or a savings that would recur annually for an indefinite period of time.

b. The value of cost avoidance recommendations represents the difference between the cost of current procedures or expenditures and the cost of recommended practices, procedures, or expenditures. The starting point would be current year costs and any future periods where the auditor can determine a reasonable basis to estimate for the future cost avoidance up to a total of six years. Compute the gross savings amount based on the contractor's total operations and then prorate based on the percentage of total Government sales (this includes fixed price and flexibly priced contracts as well as subcontracts). Deduct implementation and installation costs from the total contractor savings prior to prorating savings to all Government contracts/subcontracts and clearly show them in the audit report.

c. Some audit recommendations produce only a one-time savings. For example, if a contractor were going to demolish a building at a cost of \$2 million and instead an operations audit recommended selling the property, then the \$2 million not spent on demolition would represent a one-time savings. There are also instances when a one-time management action would result in savings affecting several identifiable fiscal years, such as canceling plans to acquire major items of equipment over a number of years, leasing rather than purchasing equipment, or recommendations associated with a specific program that has a clearly defined end date. For example, if a labor utilization audit was performed on a specific program that was going to end in three years, then it is logical to recognize cost avoidance over those three years. However, it would be incumbent upon the auditor to determine that labor will remain constant over those three years. If, as the program comes to a close, labor were projected to decline, then projected cost avoidance would also decline in the same proportion.

d. Certain recommendations result in recurring annual savings that continue for an indefinite period of time such as utility audits. For example, if an operations audit recommended changes in the heating and air conditioning controls at a contractor facility that would result in energy savings of \$1 million annually, then those savings could be recognized over six years since they will be realized continuously once corrective actions have been implemented. In these situations, it would also be incumbent on the auditor to consider whether over the next six years the business base (government share) will remain constant. If changes in the workload are significant over the six-year period, then utility consumption may deviate significantly and the cost savings should consider the changes. Any projection of cost avoidance must consider future workload as it relates to that cost savings. A simplistic example of this is as follows:

(1) We performed a utility operations audit at a contractor. The auditor has reviewed the forward pricing rate information and budgetary data and has determined that the business base including government participation will remain constant over the next six years. The operations audit determined that implementation of certain changes in the heating and air controls would realize an annual savings of \$2 million. The cost of implementation is \$1 million. Therefore, the report should include \$11 million as the cost avoidance calculated as follows:

Year	Savings
1	\$1 million
2	\$2 million
3	\$2 million
4	\$2 million
5	\$2 million
6	\$2 million
Total	\$11 million

(2) The first year savings is the annual \$2 million of savings less the \$1 million offset for implementation costs. The audit report would show cost avoidance of \$11 million as well as in DMIS. In six months to a year, perform a follow-up audit to verify implementation of the contractor's corrective actions, actual savings realized, and the expected continuation of a stable business base. Based on the follow-up, the auditor will disposition in DMIS the original audit's reported net savings over the full six-year period. In this case, the follow-up audit validated the cost avoidance as calculated in the initial audit.

#### **14-505 Conferences and Reports on Operations Audits \*\***

- a. See 4-300 for guidance on entrance, interim, and exit conferences with the contractor.
- b. Promptly after completing each operations audit, prepare and distribute a report in accordance with 10-400, regardless of findings. Shell reports are available for all operations audit assignment codes except follow-up audits.
- c. Issue a follow-up report when the contractor agreed to take corrective action on reported 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.

#### **14-506 Sharing of Operations Audit Results, Research and Training using OASIS \*\***

a. The performance of operations audits is significantly enhanced by effective communication among FAOs and regional audit staff (e.g., exchanging various audit approaches and findings, and sharing research and training).

(1) The Operations Audits Summary Information System (OASIS) provides an effective and immediate way of sharing and disseminating operations audit programs, findings, research, and new training via the DCAA Intranet.

(2) DCAA Headquarters' OTS oversees the OASIS system with the assistance of OTST personnel. OTST reviews and approves materials submitted for OASIS and sends them to the webmaster for uploading to OASIS. OTST will coordinate with the submitting office if the material is deemed unsuitable for posting or clarification is needed.

(3) DCAA personnel may request access to OASIS through their RS, who will forward the request to OTST at the e-mail address DCAA-TSC-OA@dcaa.mil. HQ personnel may request access directly through this same email address.

b. DCAA auditors should review OASIS before starting a new operations audit assignment, developing OA training materials or conducting OA research.



c. DCAA auditors will e-mail the audit program, audit report, and a synopsis of the audit to the DCAA-TSC-OA mailbox for all operations audit reports with positive findings (unique negative audit reports may be provided). The synopsis of the major audit areas covered in the audit should be prepared using the format in Figure 14-5-1. An example is shown in Figure 14-5-2.

d. Additionally, DCAA auditors will e-mail relevant new research material and training presentations to the DCAA-TSC-OA mailbox as soon as possible. Research information includes consultant studies, consultant reports, implementation guides, pamphlets, vendor presentations (if not restricted by copyright), etc., as well as helpful World Wide Web addresses.

### **Figure 14-5-1 Synopsis Format \*\***

Synopsis of Operations Audit Findings (describe each finding separately)

Industry: Identify the type of industry such as shipbuilding, aircraft, electronics, space and missile systems, etc.

Major Audit Area: Identify the functional area of the contractor's operation in which the audit was performed. The subtitle identified the type of findings or specific condition disclosed.

Indicator: Identify the initial data evaluated, tests performed, or observations made that alerted the auditor to the problem. Multiple items should be written in a list format.

Audit Approach: Identify the detailed steps, methods, techniques, comparisons, and criteria used to fully develop and support the audit findings. Multiple items should be written in a list format.

Conclusion and Recommendation: Identify the auditor's conclusion, the cost impact on the contractor's operations, and the recommended corrective action. Multiple items should be written in a list format.

Contractor's Reaction: Identify the contractor's response to the audit recommendations. Multiple items should be written in a list format.

## **Figure 14-5-2 Example of Synopsis \*\***

### **SYNOPSIS OF OPERATIONS AUDIT FINDINGS**

INDUSTRY: Electronics

MAJOR AUDIT AREAS: Direct Production Labor and Related Supervision Overtime Controls

INDICATOR: The contractor consistently incurred high levels of overtime as a percent of straight-time hours. The internal control is weak in that no written procedures exist to preclude employees from working prolonged and uninterrupted periods of overtime.

AUDIT APPROACH: The audit approach included:

1. Random sampling of employees over an eight-week period to obtain a representative pattern of incurred overtime.
2. Comparing the sampled incurred overtime to a study on the productivity of overtime labor. The study was performed by Don Fuller and published by the Industrial Education Institute.

CONCLUSION AND RECOMMENDATION: The audit concluded that 48.8 percent of the sampled workers' overtime hours were nonproductive. The nonproductive overtime cost is estimated to be \$1.34 million annually.

CONTRACTOR'S REACTION: The contractor concurred with the DCAA recommendation.

## **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-pay-back 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, 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 ( $\$100 + (\$100 \times .06)$ ). 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. Although 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 bottlenecks 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 – Reserved**

## **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 years' 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 State 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 Final Voucher Evaluation Memorandums \*\***

a. Upon request, a final voucher evaluation memorandum will be issued to the USP&FO as of the agreement completion date. The Contractor's Release of Claims and Assignment of Refunds, Rebates, Credits, etc. is not required. Therefore, issuance of the final voucher evaluation memorandum should not be delayed for this reason. It should be noted, however, that the agreements prescribe the cost sharing 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 final voucher evaluation memorandum.

### **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 – Advanced 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 10-210).

#### **14-905 Contract Audit Services for Nonappropriated Funds \*\***

##### **14-905.1 Background and Authority \*\***

a. [DoD Instruction 7600.06](#) establishes policies and procedures for audits of non-appropriated 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 7600.06.

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 certified 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 Evaluation of Data Other Than Certified Cost or Pricing Data in Support of Requests for Exception From Certified 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 certified cost or pricing data at [FAR 15.403-1](#). FASA also added two new commercial item exceptions from submitting certified cost or pricing data. The Clinger-Cohen Act of 1996 [also known as the 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., certified 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 "data other than certified 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 data other than certified 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 certified cost or pricing data in the format indicated in [FAR 15.408](#), Table 15-2—Instructions for Submitting Cost/Price Proposals When Certified 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 Objectives 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 9-207, auditors may either perform examinations or applications of agreed-upon procedures on proposals supported by data other than certified 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 \*\***

[FAR 15.403-1\(b\)\(1\)](#) discusses the requirements for granting an exception based on adequate price competition. Price competition is adequate when:

(1) Two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement;

(2) Award will be made to the offeror whose proposal represents the best value where price is a substantial factor in source selection; and

(3) 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 facts and approved at a level above the contracting officer.

#### **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 paragraph (3)(i) or (ii) of the commercial item definition 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, or
- (5) 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 certified 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 nongovernmental 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 certified 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 certified cost or pricing data. Only the HCA may grant a waiver, and this authority is non-delegable. For DoD contracts, the Director, Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS), 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 DPAPSS 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 certified cost or pricing data. Consequently, award of any lower-tier subcontract expected to exceed the certified cost or pricing data threshold requires the submission of certified 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 certified 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 certified 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 data other than certified 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 when an examination is performed. The support the auditors provide on data other than certified 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 [10-1000](#)). Since the auditor is not performing an examination, no opinion of any type should be given, including a qualified or adverse opinion.

b. Certified cost or pricing data are not required when an exception from certified cost or pricing data applies or a waiver is being contemplated. Therefore, there should be no reference in the report to certified cost or pricing data. However, contracting officers can obtain data other than certified cost or pricing data, which includes cost data, if required to determine the price reasonableness.

c. There should rarely be a need for technical assistance on these types of audits. 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 (see [10-1008](#)).

d. The auditor should not express an opinion on whether an item qualifies for an exception from certified 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 Audit 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 under the Foreign Military Financing (FMF) Program. These terms and conditions are presented in the Contractor’s Certification and Agreement.

### **14-908.2 Types of Foreign Military Financing [\\*\\*](#)**

a. DSCA’s basic responsibilities are explained in its Security Assistance Management Manual ([SAMM](#)). 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. Foreign Military Sales. FMS encompasses Government-to-Government transactions as defined by the SAMM. 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 Selected Areas of Cost guidebook, [Chapter 65](#)).

c. Direct Commercial Contracts. A DCC is the sale of articles and services between a foreign government and a U.S. company, rather than through the U.S. Government. A DCC is a general term for a legally binding agreement in which the parties are obligated to do or refrain from doing something. The terminology should not be confused with FAR Part 12 related to the acquisition of commercial items. Since a DCC is not a U.S. Government acquisition, DCCs are not directly covered the FAR or Cost Accounting Standards (CAS). However, FAR and CAS may be incorporated by reference by the governing laws and guidelines. DCCs are governed by the Arms Export Control Act (AECA), the SAMM, and the DSCA Guidelines for Foreign Military Financing of Direct Commercial Contracts. The AECA provides the authority to provide FMF funding to DCCs. DCCs financed by a U.S. loan or grant administered by DSCA are subject to DSCA Guidelines for Foreign Military Financing of DCCs. 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”. While the entire FAR is not applicable to financed DCCs, some portions of FAR are incorporated by reference by the DSCA DCC guidelines. The DSCA Guidelines Enclosure 2 Pricing Reviews provide reference to the offeror’s cost/price submissions being in accordance with FAR, DFARS, other contract cost principles and procedures, generally accepted accounting principles, and the requirements and procedures of the CAS, as applicable.

#### **14-908.3 General Oversight Requirements <sup>\*\*</sup>**

a. The DSCA Guidelines for Foreign Military Financing of Direct Commercial Contracts states that sole-source procurements that exceed \$2,500,000 require a pricing review. DCMA, with DCAA’s assistance as required, will provide the field pricing support. Requests for field pricing support on direct commercial contracts from foreign governments are processed by DCMA Headquarters, International and Federal Business Division. DCMA requests for field pricing support and interim oversight effort should be treated as reimbursable assignments.

b. In addition, the DSCA Guidelines for Foreign Military Financing of Direct Commercial Contracts states that awards (sole source, Defined Basic Ordering Agreements (DBOAs), or competitive awards) valued at \$1,000,000 or more, the foreign government is required to contract with DCMA for contract audit services. DCMA will arrange with DCAA to perform audits on the prime contractor’s compliance with its Certification and Agreement throughout the life of the DCC. In addition to receiving foreign government requests via the DCMA Headquarters, DSCA may directly request DCAA to evaluate and report on contractor compliance with its Certification and Agreement. These requests are processed through DCAA’s Financial Liaison Advisor assigned to DCMA Headquarters, and will include as an enclosure 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 2 and 6) 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 audit, the auditor should plan to complete the examination before the right to access expires.

#### **14-908.4 Audit for Contractor Compliance with Certification and Agreement**

<sup>\*\*</sup>

a. A memorandum issued by the DoD Comptroller on November 4, 1991 outlines the responsibilities of DSCA and DCAA regarding evaluations of direct commercial contracts. Only certain elements of the Certification and Agreement are subject to DCAA audit. Those elements are noted in the Agency’s standard audit program for evaluating contractor compliance with its Certification and Agreement.

b. For contracts receiving DSCA financing, 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.

#### **14-908.5 Reporting Results of Audit (DSCA) \*\***

a. Prepare the report using DCAA's audit report shell developed specifically for the DSCA compliance evaluation and the guidance in 10-200. The report shell is available on the DCAA Intranet and in CaseWare.

b. 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 if there are findings, include DSCA Headquarters on distribution.

#### **14-909 Evaluations of Other Transaction Agreements (OTAs) \*\***

##### **14-909.1 Background \*\***

a. OTAs are legal contracts other than Federal Acquisition Regulation (FAR) based procurement contracts, grants, and cooperative agreements used to stimulate, support, or acquire research or prototype projects. OTAs were authorized to encourage commercial firms to join with the Department of Defense (DoD) to advance dual-use technology and to broaden the technology and industrial base available to DoD. Unless otherwise provided for, OTAs are not required to comply with the FAR, its supplements (e.g., Defense Federal Acquisition Regulation Supplement (DFARS)), or laws limited in applicability to procurement contracts, such as the Truth in Negotiation and Cost Accounting Standards (CAS).

b. The law has authorized OTAs under the 10 United States Code (U.S.C), Section 2371 Research OTAs and Section 2371b Prototype OTAs. There are three types of OTAs. The Section 2371 authority addresses awarding Research OTAs and the Section 2371b authority addresses awarding Prototype OTAs and Production OTAs.

(1) [Section 2371 Research OTAs](#). In 1989, Congress enacted [10 U.S.C. 2371](#), "Research Projects: Transactions Other Than Contracts and Grants," which authorized the use of OTAs for basic, applied, and advanced research projects. OTAs for research may be used when it is not feasible to use a standard contract, grant, or cooperative agreement. Most of the OTAs awarded under Section 2371 by DoD are Technology Investment Agreements (TIAs). TIAs are assistance instruments used to stimulate or support research. The regulations governing the award and administration of TIAs are covered under 10 U.S.C. 2371 and the DoD Grant and Agreement Regulations (DoDGARs) under [32 CFR Part 37](#). 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).

(2) Section 2371b Prototype and Production OTAs. Prior to the National Defense Authorization Act (NDAA) for Fiscal Year (FY) 2016, Public Law 114-92, the use of OTAs for prototyping and follow-on production was authorized through NDAA for FY 1994, Section 845 (as amended), and 10 U.S.C. 2371. The NDAA FY 2016 permanently codified the authority to use OTAs for prototype projects and transitioning successes into follow-on production in [10 U.S.C. 2371b](#).

- (a) Prototype OTAs must be directly relevant to enhancing the mission effectiveness of military personnel and the supporting platforms, systems, components, or materials proposed to be acquired or developed by the DoD, or to improvement of platforms, systems, components, or materials in use by the armed forces. This instrument may be used only when at least one of the following conditions is met:
  - (i) There is at least one nontraditional defense contractor participating to a significant extent in the prototype project;
  - (ii) All significant participants in the transaction other than the Federal Government are small businesses or nontraditional defense contractors;
  - (iii) At least one third of the total cost of the prototype project is to be paid out of funds provided by parties to the transaction other than the Federal Government; or
  - (iv) The senior procurement executive for the agency determines in writing that exceptional circumstances justify the use of a transaction that provides for innovative business arrangements or structures that would not be feasible or appropriate under a contract or would provide an opportunity to expand the defense supply base in a manner that would not be practical or feasible under a contract.
- (b) Production OTAs must meet the following criteria under 10 USC 2371b(f):
  - (i) A prototype OTA must have been awarded;
  - (ii) The prototype OTA must have provided for a follow-on production award;
  - (iii) Competitive procedures had to be used to select participants in the prototype OTA;
  - (iv) Participants must have successfully completed the prototype projects; and

(v) The participants are willing and able to complete a production of the prototype.

c. The research and prototype OTAs are typically further described as expenditure-based or fixed-price depending on how payments under the agreement are made.

(1) Expenditure-Based OTA. Agreements where payments are exclusively or primarily based on amounts generated from the awardee's financial or cost records.

(2) Fixed-Price OTA. Agreements where the primary method of payment is not based on amounts generated from the awardee's financial or cost records, including agreements where the price is fixed against established milestones and/or estimated level-of-effort. Since fixed-price OTAs are not based on the contractor's financial and cost records, these OTAs are less likely to include clauses in the agreements related to financial management system, record access, or audit requirements.

d. OTAs can be awarded to a single company, joint venture, partnership, prime contractor with subcontract relationships or consortium (through its members or authorized agent).

#### **14-909.2 Audit Responsibilities \*\***

An agreements officer (AO) may request a DCAA audit or advisory assistance in determining the reasonableness of the OTA prior to award or to determine if the costs or accounting system comply with the terms of the OTA after the award. DCAA may be able to provide audit or advisory services to assist AOs in assessing the reasonableness of the costs or compliance with the agreement terms.

#### **14-909.3 Special Considerations \*\***

a. Solicitation Process. There is a wide range of methods by which to solicit OTAs and the Government team is not confined to using a Request for Proposals (RFP) process. Agencies awarding OTAs from a solicitation are free to create their own process to solicit and assess potential solutions provided it is a fair and transparent process, provides for competitive procedures to be used to the maximum extent practicable (or merit-based competitive procedures for TIAs), and documents the rationale for making the Government investment decision. Each OTA must be independently evaluated based on its solicitation process and terms when considering what advisory or audit services can be performed on OTAs.

b. Agreement Terms. The terms included in an OTA can vary depending on the specific requirements of each project. Agencies awarding OTAs are afforded flexibility in the terms included in an agreement which are often influenced through the negotiation process with the contractor. When assessing the ability to perform an advisory or audit service in support of an OTA, the audit team needs to develop an understanding of the agreement terms of each OTA.

c. Record Access and Audit Clauses. The inclusion of record access and audit clauses is negotiable in OTAs. If the audit clause does not provide sufficient access/records for the auditor to perform an advisory or audit service, the audit team should communicate their concerns with the customer in a timely manner. The audit team should also notify DCAA Headquarters, Pricings and Special Projects Division, of any access limitations encountered.

d. Cost Principles. OTAs typically allow and encourage contractors to use their existing systems, permitting they comply with Generally Accepted Accounting Principles (GAAP) and that they maintain adequate records to account for federal funds received under the agreement. OTAs are generally not subject to FAR/DFARS and any cost principles applicable must be included in the agreement terms. However, the expenditure-based TIAs (a common type of Research OTA) commonly require a contractor to use the cost principles established in [FAR Part 31](#) or [2 CFR Part 200](#). An expenditure-based TIA with a for-profit contractor that has existing FAR/DFARS covered contracts should include terms which require the contractor to use the same regulations for identifying allowable costs (FAR Part 31) for the TIA, unless an exception is obtained ([DoDGARs 37.625](#)). Similarly, an expenditure-based TIA with a non-profit contractor that has existing FAR/DFARS covered contracts should include terms which require the contractor to use the same regulations ([2 CFR Part 200.400](#)) for identifying allowable costs for the TIA ([DoDGARs 37.635](#)).

e. Cost/Resource Sharing. Cost sharing includes both cash and/or in-kind contributions, which 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 include pre-agreement costs, indirect costs, prior IR&D costs, and in-kind valuation/usage.

f. OTA Billings. Government financing on an OTA may be based on actual expenditure reimbursement, advanced payment, or milestone payments. OTA financing based on payable milestones may be structured in a manner that milestones need not be adjusted for actual expenditures (fixed amount). Alternatively, the OTA may require that milestones reasonably track actual cost incurred (expenditure-based). Under payable milestones, the organization is entitled to bill for the milestone payment identified in the Schedule of Payments and Payable Milestones when it accomplishes an identified milestone. In the event that incurred costs differ significantly from the milestone payment amount, the Agreement Administrator may adjust future milestone payment amounts. The milestone should be accomplished and accepted by the Government prior to the milestone being billed.

g. Consortium-Lead Costs. These costs are usually considered an indirect expense. The consortium lead should not be separately charging its administrative costs to the OTA, unless specifically provided for. If the inclusion of the OTA 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 for Government contracts.

h. Interest. If advance payments are authorized, the OTA 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.

i. Recovery of Funds. OTAs under the authority of 10 U.S.C. 2371 and 2371b provide that an OTA project may include terms and conditions that allow for recoupment of Government investment funding from the performer in certain situations. Any recoverable funds should be remitted to the Government and placed in the agency's designated Treasury account to be available for the agency to use on subsequent programs.

j. Accounting Treatment. The contractor should account for all costs incurred in support of the OTA, including the contractor and Government cost share, consistently. The contractor should account for the OTA either as an IR&D project or as direct effort (similar to a contract). [FAR 31.205-18\(e\)](#) states that costs incurred by a contractor, pursuant to cooperative arrangements (e.g., joint ventures, limited partnerships, teaming arrangements, and collaboration and consortium arrangements) 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. The contractor should account for the Government payments as a credit to the IR&D account and should only allocate allowable unreimbursed IR&D costs to Government contracts.

k. Advance Agreements. Contractor requests for an advance agreement should be coordinated with the cognizant regional office/corporate audit directorate and then through DCAA Headquarters, Pricing and Special Projects Division. When requested to comment on OTA advance agreements where the contractor plans to account for the OTA 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 OTA costs.

#### **14-909.4 Reporting [\\*\\*](#)**

Prepare audit reports in accordance with the applicable Agency guidance associated with the type of GAGAS engagement.



## **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/dpap/Docs/PBPGuideNov2001.pdf>.

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](#)).

## **14-1000 Section 10 – Application of Agreed-Upon Procedures \*\***

### **14-1001 Introduction \*\***

a. This section contains guidance on performing agreed-upon procedures engagements. An agreed-upon procedures engagement is one in which an auditor is requested to issue a report of findings based on specific procedures, agreed-upon by the auditor and requestor, performed on an assertion (e.g., 316 contractor submission) or a subject matter. An agreed-upon procedures engagement is appropriate for situations where the requestor wants information on a subject matter or assertion, generally relative to specific criteria, but does not require an opinion, recommendations or negative assurance. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusion based on the auditor's work.

b. Under [Generally Accepted Government Auditing Standards](#) (GAGAS), DCAA may perform an agreed-upon procedures engagement for any assignment if (1) the subject matter or assertion to which the procedures are to be applied is subject to reasonably consistent measurement, (2) the requestor and DCAA agree on the nature, timing, and extent of the procedures to be applied, including the criteria to be used and (3) the requestor assumes responsibility for the sufficiency of the procedures. GAGAS incorporate the Statements on [Standards for Attestation Engagements \(SSAE\) AT-C Section 201](#) as amended by [SSAE 19](#) covering fieldwork and reporting on applications of agreed-upon procedures and the general attestation standard on criteria.

### **14-1002 Agreed-Upon Procedures \*\***

In an agreed-upon procedures engagement the requestor assumes responsibility for the sufficiency of the agreed-upon procedures since the requestor determines, based on their specific needs, what procedures should be performed. Regions, CADs, and Field Detachment should modify their quality control and AUP monitoring processes to require RAM/CAM and FAO manager approval of the proposed procedures prior to agreement with the requestor and for review of draft AUP reports before issuance. Such approvals must be documented in the working papers. The auditor is responsible for carrying out those procedures. In planning an agreed-upon procedures engagement the auditor should:

- Understand the requestor's objectives,
- Understand the difference between appropriate and inappropriate agreed-upon procedures, and
- Establish an agreement with the requestor on the terms of the engagement.

### **14-1002.1 Understanding the Requestor's Objectives \*\***

a. Requests for DCAA services vary, depending on specific circumstances and customer needs. The auditor should inquire about the requestor's objectives and then discuss with the requestor the procedures which will accomplish those objectives. The auditor should clarify exactly what the requestor needs and structure the assignment appropriately. Other types of audit services may be more appropriate to satisfy the requestor's objectives. Requests for procedures that require the auditor to make determinations based on auditor judgment (e.g., reasonableness), or provide recommendations or opinions should not be performed as an agreed-upon procedures engagement. Agreed-upon procedures acknowledgement letters delivered through CaseWare include a list of sample questions the auditor may use to assist in determining the appropriate engagement.

b. If applicable, the auditor and requestor should also explicitly discuss the use of a technical specialist. The auditor should document the discussion.

### **14-1002.2 Appropriate Agreed-Upon Procedures \*\***

Auditing standards limit the type of work that can be performed as agreed-upon procedures. In determining the procedures to be performed, the auditor and requestor must only agree to procedures that do not require the auditor to form an opinion or make recommendations. Auditors should not agree to perform procedures that are overly subjective and open to varying interpretations. Terms of uncertain meaning are not acceptable for use when performing an AUP because they are not sufficiently precise or have an uncertain meaning. However, if the uncertain term is defined to indicate the nature, timing, and extent of the procedures associated with these actions then it is acceptable. Some examples include the terms Note, Review, General review, Limited review, Evaluate Analyze, Check, Test, Interpret, Verify or Examine. There are terms that can be used to clarify for a better understanding of what is to be performed; these would include words such as Inspect, Confirm, Compare, Agree, Trace, Inquire, Recalculate, Observe, Mathematically check. The procedures to be applied to the subject matter are expected to result in consistent findings using the established criteria.

### **14-1002.3 Establishing an Agreement on the Terms of the Engagement \*\***

a. GAGAS require auditors to establish a clear understanding regarding the terms of the engagement. DCAA auditors should accomplish this through an acknowledgement letter that clearly defines the specific procedures agreed-upon for the assignment, including the definition of materiality, if materiality limits are agreed to by the auditor and requestor. The acknowledgement letter should not be issued until after DCAA and the requestor have discussed the requirements and reached an agreement on the procedures to be applied. The auditor should not perform an agreed-upon procedures engagement when the auditor and requestor do not agree upon the procedures to be performed or when the requestor does not take responsibility for the sufficiency of the procedures. The acknowledgement letter should be prepared in accordance with the applicable guidance in [4-104f](#). In some circumstances, the

procedures initially agreed-upon may be modified over the course of the engagement. In such cases, the requestor's acknowledgement of responsibility for the revised procedures should be documented in the working papers. A revised acknowledgement letter should be prepared if the modifications to the procedures are significant.

b. The auditor should inform the requestor of any previously reported CAS violations, FAR violations, or DFARS business system deficiencies/material weaknesses that might significantly affect the objective of the agreed-upon procedures. However, the auditor is not required to perform procedures beyond those agreed to. Such discussions should be documented in the working paper file, reiterated in the acknowledgment letter, if known at the time, and included in the audit report as "Report on Other Matters".

c. When circumstances impose restrictions on the performance of the agreed-upon procedures, the auditor should attempt to obtain agreement from the requestor for modification of the agreed-upon procedures. If an agreement cannot be reached, the auditor should describe the restrictions in the report or, if the restrictions significantly impact the extent of the procedures, withdraw from the engagement.

d. Before an auditor agrees to convert an examination to an application of agreed-upon procedures, the auditor should consider the guidance on disclaimer of opinion in [2-102.2](#). An examination cannot be converted to an application of agreed-upon procedures merely to avoid disclosing a scope limitation encountered during the course of the examination.

### **14-1003 Agreed-Upon Procedures Report [\\*\\*](#)**

This section provides guidance for preparing application of agreed-upon procedures reports in accordance with GAGAS.

#### **14-1003.1 Nature of Agreed-Upon Procedures Reports [\\*\\*](#)**

a. In an agreed-upon procedures engagement, an auditor is requested to issue a written report covering findings from applying clearly defined procedures that are agreed to by the requestor and auditor and applied to the contractor's subject matter or assertion, such as a price proposal or other submission (see 14-1001). The auditor should report only on procedures agreed-to and where the requestor has acknowledged that the procedures are appropriate for the intended purpose of the engagement.

b. Application of agreed-upon procedures does not constitute an examination, review or advisory service. Our report assists the requestor in evaluating a subject matter or assertion. An agreed-upon procedures report provides findings based on the comparison of the specified subject matter or assertion against agreed-upon criteria. The requestor selects the procedures and criteria to achieve an intended purpose.

#### **14-1003.2 Agreed-Upon Procedures Report Format, and Contents [\\*\\*](#)**

a. Prepare reports following the standard aspects of report preparation (see [10-200](#)) and the professional standards for reporting (see 2-307.4). The report should contain all necessary and pertinent information to be fully responsive to the needs of the recipient. Reports should be prepared using the following format:

- Report Cover Sheet (14-1003.3)\*
- Table of Contents (14-1003.4)\*
- Executive Summary (14-1003.5)\*
  - About [Contractor's Name]\*
  - About this Agreed-Upon Procedures Engagement\*
  - What We Found\*
- Report on [Brief Description of the Agreed-Upon Procedures] (14-1003.6)\*
  - Management's Responsibility\*
  - Auditor's Responsibility\*
  - Scope of Application of Agreed Upon Procedures\*
  - Results of Application of Agreed-upon Procedures\*
- DCAA Personnel and Report Authorization (14-1003.7)\*
- Report Distribution and Restrictions (14-1003.8 and .9)\*
- Exhibits (14-1003.6g)
- Appendixes (14-1003.10)

\* Required in every report regardless of type.

b. The report shells for Activity Codes 28000, Application of Agreed-Upon Procedures; 17800, NASA Property Agreed-Upon Procedures; and 17900, Agreed-Upon Procedures, Other Than Price Proposals, include the appropriate release restriction language.

c. DCAA limits the word "audit" to reports on examinations. Therefore, the word "audit" is not included in the report number, the report title, the section headings, or the report header. Instead, the words "Application of Agreed-Upon Procedures" are included in the section headings. The use of the term "engagement" rather than "audit," "examination," or "review," is more appropriate to describe the work performed by DCAA in an agreed-upon procedures engagement.

d. Example report language is included in the report shells and the working papers A and A-01 depending on the agreed-upon procedures assignment. The body of the report will contain the following captioned paragraphs, as applicable.

### **14-1003.3 Report Cover Sheet [\\*\\*](#)**

Follow general guidelines at [10-205](#) and the specific language requirements (i.e., excluding audit) guidance above.

#### **14-1003.4 Table of Contents [\\*\\*](#)**

Follow general guidelines at [10-206](#) and the report format guidance above.

#### **14-1003.5 Executive Summary (Agreed-Upon Procedures) [\\*\\*](#)**

Follow general guidelines at [10-207](#) and the specific guidance below.

a. About this Agreed-Upon Procedure Engagement. This section should describe why the agreed-upon procedure engagement was performed. It should identify the requestor(s); the contractor's assertion or subject matter, including the date; and reference numbers (solicitation number or ACO field pricing case number).

b. What We Found. This section should provide a high level summary of our findings and other information that came to our attention when performing the procedures. Due to the nature of agreed-upon procedures, this section may be limited to a brief statement and refer the reader to the results of agreed-upon procedures. It should not include restrictions on performing the agreed-upon procedures.

#### **14-1003.6 Report Narrative – Reporting on the Agreed-Upon Procedures and Responsibilities [\\*\\*](#)**

The proforma reports included with the standard AUP package contain additional instructions and report language that is specific to the agreed-upon procedures being performed.

Report on Agreed-Upon Procedures applied to [contractor name and subject matter]

The agreed-upon procedures report provides the requestor with our findings resulting from applying the procedures. The "Report on" section will describe the subject matter (e.g., Elements of a proposal) or assertion that the procedures were applied, state we performed the agreed-upon procedures and the date (with any revisions) the procedures were agreed to.

##### **Management's Responsibility**

This section states that it is the contractor's responsibility to comply with the specified criteria (e.g., contract terms). It also states that the contractor is responsible for its internal control that prevents, detects, and corrects noncompliances due to error or fraud. The AUP assignment packages contain language specific to the agreed-upon procedures being performed.

##### **a. Auditor's Responsibility**

This section summarizes our responsibility in conducting the agreed-upon procedures, and the paragraph routinely includes the following statements:

- We performed the agreed-upon procedures solely to assist the requestor in evaluating the subject matter.
- Our responsibility is to perform the agreed-upon procedure engagement in accordance with GAGAS.
- That the requestor has acknowledged that the procedures are appropriate for the intended purpose of the engagement.

The assignment packages include additional instruction and language specific to the agreed-upon procedures being performed.

#### b. Scope of Application of Agreed-Upon Procedures

If applicable, provide a description of the nature of the assistance provided by a technical specialist.

#### c. Restrictions on Agreed-Upon Procedures

Restrictions on procedures refer to circumstances that restrict the auditor's ability to perform the procedures agreed-upon with the requestor (see 14-1002.3). The Restrictions on Procedures section is similar to the scope qualification in audit reports when a qualified opinion is provided. However, a qualification section is not used in application of agreed-upon procedures reports because the auditor is not providing an opinion. Generally, instances of non-compliance with FAR or CAS do not restrict the auditor's ability to apply the agreed-upon procedures; therefore, such circumstances are generally not appropriate restrictions on the application of the procedures. Relevant instances of non-compliance with FAR or CAS may, in some cases, may be included in an appendix to the report as "Report on Other Matters" (see 14-1003.10).

#### d. Results of Application of Agreed-Upon Procedures

In accordance with GAGAS, the auditor does not express an opinion on the subject matter when issuing an agreed-upon procedures report. Therefore, all agreed-upon procedures reports include the following statements:

- We have performed the mutually agreed-upon procedures solely to assist you in evaluating the assertion or subject matter.
- We were not, and did not, perform an examination engagement, the objective of which would be to express an opinion on the subject matter of the report.
- The requestor has acknowledged that the agreed-upon procedures are appropriate for the purpose intended in the engagement.
- A disclaimer of responsibility for the appropriateness of those procedures.



- Had we performed additional procedures, other matters may have come to our attention that would have been reported.

In addition, the results section includes the following elements which are discussed in detail below:

- Exhibits and schedules detailing the agreed-upon procedures applied and the related findings, and
- Additional remarks applicable under the circumstances.

The results of applying agreed-upon procedures should be expressed in the report as findings (as defined in the SSAEs), rather than adjustments, recommendations or questioned cost. The report should exclude opinion-like language and language that implies any level of assurance. For example, the report should not include statements such as “in our opinion,” “the costs are reasonable,” “nothing came to our attention,” or “costs are understated.”

e. Exhibits and Schedules – Procedures Performed and Findings

Follow general guidelines at [10-211](#) and the guidance below. The next part of the results section should identify each agreed-upon procedure applied, followed by the resulting findings and explanatory notes. While exhibits and explanatory notes in agreed-upon procedures reports are usually less extensive than those in audit reports, they should be sufficiently detailed to clearly and concisely explain the findings to the requestor. The following subheadings should be included in the structured note, as applicable, for each agreed-upon procedure:

a. Agreed-Upon Procedure. Briefly describe the agreed-upon procedure, including any agreed upon materiality for threshold limits for reporting. The agreed-upon procedures listed in the report should be the ones detailed in the acknowledgment memorandum. If the procedures were modified during the course of the engagement, but were not significant enough to warrant a revised acknowledgment memorandum, the modification should be clearly explained in the working papers.

b. Summary of Findings. This will generally be a table summarizing the findings, including explanatory notes if needed to adequately explain the procedures applied and the resulting findings. A narrative description of the findings, rather than a table, may be used if more appropriate in the circumstances. Report all findings, even if immaterial, unless the definition of materiality was agreed to by the auditor and requestor.

c. Contractor’s Reaction. If appropriate, provide a statement that the contractor either agrees or disagrees with the findings and the basis for any disagreement.

d. Auditor’s Response. Provide any appropriate comments if the contractor

disagrees with the findings.

e. Additional Remarks

(1) Indicate the date an exit conference was held and the name and title of the contractor's designated representative with whom the exit conference was conducted (see [4-304](#)). Also, briefly describe the contractor's reaction in this section. Detailed comments on the contractor's reaction to the report findings will be included in the explanatory notes, where appropriate. When the contractor provides a formal, written response, it should be referenced within the Results of Application of Agreed-Upon Procedures section and included as an appendix to the report.

(2) Further remarks should be included when appropriate to the circumstances. For example, include remarks if information in the report was provided to the contracting officer in advance of issuing the report.

**14-1003.7 DCAA Personnel and Report Authorization (Agreed-Upon Procedures) \*\***

Follow the guidelines at [10-209](#) for report distribution.

**14-1003.8 Report Distribution (Agreed-Upon Procedures) \*\***

Follow the guidelines at [10-210.1](#) for report distribution.

**14-1003.9 Report Restriction and Narrative (Agreed-Upon Procedures) \*\***

Follow the guidelines at [10-210.2](#) for report restrictions; however, restrictions paragraph 4 should be revised to limit use of the report to certain parties. The CaseWare report shells for Activity Codes 28000, Application of Agreed-Upon Procedures; 17800, NASA Property Agreed-Upon Procedures; and 17900, Agreed-Upon Procedures, Other Than Price Proposals, include the appropriate restriction language.

**14-1003.10 Appendices (Agreed-Upon Procedures) \*\***

Follow general guidelines at [10-212](#) and the specific guidance below.

Report on Other Matters. This appendix should be used to communicate matters, unrelated to the specific agreed-upon procedures that come to the auditor's attention that may significantly impact or contradict the subject matter or assertion being reported on (see 14-1002.3). The appendix should clearly communicate that opinions are based on previous engagements when providing information on CAS violations, FAR violations, or DFARS business significant deficiencies/material weaknesses that were previously reported.