

Master Document – Audit Program

Activity Code 17100		Termination, Fixed Inventory Basis
Version 4.1, dated May 2004		
B-1	Planning Considerations	
Purpose and Scope		
<p>1. This program is intended to provide a logical sequence to the audit effort and to reflect a mutual understanding between the auditor and the supervisor as to the scope required to meet auditing standards and DCAA objectives for the current assignment. The audit steps in the program are intended as general guidance and should be modified as considered necessary to fit the current audit.</p>		
<p>2. The objective of the termination audit is to develop information and documentation to serve as a basis for reporting to the Termination Contracting Officer (TCO) the allowable costs, settlement expenses, and profit and/or loss under the terminated contract, based on the contractor's proposal and supporting records. Applicable Government acquisition regulations will be used as criteria against which the contractor's proposal will be measured.</p>		
<p>3. A proposal submitted on the inventory basis should include only those costs allocable to the terminated effort. The proposal is limited to those residual items resulting from the termination. An allowance for profit or adjustment for loss is necessary to complete the gross settlement proposal. All unliquidated advances and progress payments, and disposal credits are then deducted. The principal audit objective in reviewing a settlement proposal on the inventory basis is to assure that the inventory assigned is allocable to the terminated effort and is the minimum reasonably on hand after the exercise of prudent business practices.</p>		
References		
<p>1. DoD CAS Working Group Guidance 77-15</p>		
<p>2. CAM Chapter 12 (Auditing Terminated Contracts)</p>		
<p>3. FAR Part 49</p>		
<p>4. FAR 31.205-42</p>		
<p>5. FAR 45.6</p>		

B-1	Preliminary Steps	
Version 4.1, dated May 2004		WP Reference
<p>1. Review request for audit and write additional audit steps necessary to satisfy specific requirements of the request.</p>		

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<p>2. Make a general review of the provisions of the terminated contract, the notice of termination, the contractor's settlement proposal, and supporting schedules to determine whether the proposal contains the information necessary to plan and perform the audit.</p>	
<p>3. Review permanent audit files and prior audits to obtain background information and identify potential audit leads to help establish audit scope.</p>	
<p>4. Understanding and Evaluating the Contractor's Internal Control Structure</p>	
<p>a. Review relevant Internal Control Audit Planning Summaries (ICAPS) (or ICQ for nonmajor contractor where ICAPS have not been completed) to obtain and document an understanding of the estimating system and any other applicable internal control systems the contractor may have (e.g., labor, MMAS). Identify any deficiencies which would impact the audit and document their potential impact on each significant cost element.</p>	
<p>b. If the contractor is classified as non-major (where ICAPS have not been completed) and if the evidential matter to be obtained during the audit is highly dependent on computerized information systems, document on working paper B-2 the audit work performed that supports reliance on the computer-based evidential matter. Specifically, document or reference one or more of the following in working paper B-2:</p>	
<p>(1) the audit assignment(s) where the reliability of the data was sufficiently established in other DCAA audits,</p>	
<p>(2) the procedures/tests that will be performed in this audit to evaluate the incurred costs that will also support reliance on the evidential matter, and/or</p>	
<p>(3) the tests that will be performed in this audit that will be specifically designed to test the reliability of the computer-based data.</p>	
<p>When sufficient work is not performed to determine reliability (i.e., reduce audit risk to an acceptable level), qualify the audit report in accordance with CAM 10-210.4a and 10-1204.4.</p>	
<p>5. Examine the settlement proposal and supporting schedules to determine if:</p>	
<p>a. Settlement proposal forms have been properly prepared.</p>	
<p>b. Certifications have been executed properly.</p>	
<p>c. Mathematical computations are correct.</p>	
<p>d. Supporting schedules covering inventories, overhead, and similar</p>	

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items are in agreement with related items.	
6. Ascertain whether the cutoff was made promptly upon receipt of, or in accordance with, the termination notice.	
7. The termination contracting officer (TCO) is responsible for requesting that the contractor prepare an estimate of the cost to complete the contract. If the TCO has not done so, the auditor should request the contractor's estimate to complete through the TCO.	
8. Request that the Government technical representative review the estimate to complete and percentage of completion. Telephone requests for technical specialist assistance should be followed up in writing as required by CAM, Appendix D. If the auditor is able to use alternative measures in lieu of technical assistance to verify the accuracy of the proposed costs, the audit working papers should be documented as such and the audit report should so indicate.	
9. Subcontracts:	
a. Determine that timely termination notices were issued to all subcontractors.	
b. Determine whether a field review of a subcontractor's termination settlement proposal should be obtained (FAR 49.107). On determining and documenting the need for an assist audit, establish whether an assist audit has already been requested by the TCO. If a needed assist audit has not been appropriately requested, ask the TCO to request any necessary assist audits.	
c. If this is an audit of a terminated subcontract, determine at the start of the audit whether the subcontractor will have any restrictions or reservations on the release of the audit report to the higher-tier contractor. If so, promptly notify the TCO to determine whether the settlement proposal audit should be continued. The TCO, working with the higher-tier contractor, may be able to remove the subcontractor's restrictions or reservations. Follow the guidance in CAM 10-206.3 if the audit is completed at the request of the TCO, despite the subcontractor's restrictions or reservations.	
10. Verify the information furnished in Section I of SF 1435 for accuracy and completeness. This maybe done by comparisons with contractual documents, the termination notice, and shipping records.	
11. Make selective tests covering the mathematical accuracy of footings and extensions of inventory schedules.	
12. Ascertain that the total amount payable to the contractor for a settlement, before deducting disposal or other credits and exclusive of settlement costs, does not exceed the contract price less payments otherwise made or to be made under the contract. (FAR 49.207).	

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13. Arrange an entrance conference with the contractor personnel responsible for preparing the proposal.	
14. Review contractor's correspondence files pertaining to the terminated contract/purchase order and make excerpts of pertinent information.	
15. Review SF 1439 "Schedule of Accounting Information," and determine if accounting practices applied to the proposal deviate from disclosed or established accounting procedures. Discuss deviations, if any, with the contractor. Determine if the practices comply with FAR 31.205-42.	
16. Ascertain the availability of supporting schedules or other data prepared by the contractor in connection with the settlement proposal.	
17. Determine the extent to which the settlement proposal includes significant interorganizational or affiliated company profit. The auditor should question excess charges resulting from pricing interorganizational transactions inconsistently with the provisions of FAR 31.205-26.	
18. Review the individual charges comprising the settlement proposal for any items that appear to be out of line or unreasonable in amount. Determine whether the termination proposal contains costs already covered by an equitable adjustment proposal or claim (CAM 12-103b).	
19. Examine adjusting journal entries made just prior to effective date of termination and those subsequent thereto with a retroactive effect for the purpose of detecting manipulations or loading of termination charges.	
20. In planning and performing the examination, review the fraud risk indicators specific to the audit. The principal sources for the applicable fraud risk indicators are: a. Handbook on Fraud Indicators for Contract Auditors, Section II. (IGDH 7600.3, APO March 31, 1993) located at www.dodig.osd.mil/PUBS/index.html , and b. CAM Figure 4-7-3, CAM 6-305, and CAM 6-404.6.	
Document in working paper B any identified fraud risk indicators and your response/actions to the identified risks (either individually or in combination). This should be done at the planning stage of the audit as well as during the audit if risk indicators are disclosed. If no risk indicators are identified, document this in working paper B.	
21. Summarize the results of the risk assessment and preliminary audit steps and clearly identify the planned scope of audit for each cost element.	

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C-1	Inventory	
Version 4.1, dated May 2004		WP Reference
1. <u>Physical Inventory</u>		
a. Obtain copy of Inventory Verification Report (SF 1423) from TCO to assist in evaluating the reasonableness of the assigned termination inventory. Telephone requests to the TCO for a copy of the inventory verification report should be followed up in writing as required by CAM, Appendix D. Government technical personnel have prime responsibility for verifying inventory quantities, quality, and physical applicability. However, if adequate alternative measures in lieu of the inventory verification report are used to verify the accuracy of the proposed inventory, the audit working papers should be documented as such and the audit report so indicate.		
(1) To the extent feasible, test check inventory items for physical count and allocability to the terminated contract.		
(2) Where practicable, determine if any portion of undelivered termination inventory has been lost, destroyed, stolen, or damaged. Question the costs if the contractor cannot account for the undelivered termination inventory.		
2. <u>Pricing Termination Inventory</u>		
a. Review the method for costing the inventories.		
b. Test raw materials, purchased parts, and supplies inventory. (Use statistical sampling whenever appropriate.)		
(1) Compare inventory prices to vendor invoices and purchase orders.		
(2) Assure cash discounts or rebates have been deducted from invoice price or otherwise credited to settlement proposals on an equitable basis.		
(3) Determine that material handling charges and similar expenses are excluded from indirect expense allocations if included in material prices.		
(4) Determine if these items can be used on other work or returned to vendor.		
3. <u>Work in Process Inventory (WIP)</u>		
a. WIP based on actual costs. Trace material and labor charges to vendor invoices and payroll records on a test basis.		

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b. WIP based on standard costs. Determine that standards used are consistent with standards in costing all work and that equitable adjustment has been made for variances.	
c. WIP based on estimated costs if approved by TCO (FAR 49.206-10). Obtain technical assistance to help evaluate the reasonableness of the estimated labor hours charged to the WIP inventory.	
d. Improperly classified materials. Determine that raw materials and purchased parts have not been included in the WIP.	
4. <u>Inventory Items Generally Unallowable</u>	
Review composition of termination inventory to determine existence and allowability of the following items:	
a. Common items. Material that can be diverted to other work without loss to the contractor should be identified and questioned (CAM 12-304.5).	
b. Material acquired prior to date of contract. This item is ordinarily not allowable except under certain circumstances. Ascertain reasons for including in inventory and determine its validity. See CAM 12-304.3 for guidance.	
c. Material acquired or produced in unreasonable anticipation of delivery schedule requirements. Obtain assistance of technical personnel to help determine whether procurement or production was unreasonably accelerated (CAM 12-304.4).	
d. Material items that could be returned to suppliers. Identify and question the cost less supplier's restocking charge, transportation, and handling charges (CAM 12-304.8).	
e. Material received subsequent to termination. Examine receiving reports and question any substantial shipments by suppliers after notice of effective date of termination.	
f. Is first article inspection clause (FAR 52.209-3g) in contract? If the contract contains this clause and Government approval of the first article was not obtained, question production costs of items other than the first article.	

D-1	Proposed Special Items Of Production Costs	
	Version 4.1, dated May 2004	WP Reference
1.	Production losses (CAM 12-304.6). Determine its reasonableness and allocability to the terminated effort. Costs of the termination	

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inventory should not include costs allocable to units shipped.	
2. Rejected work (CAM 12-304.7). Ascertain reporting of rejected work. Nonreworkable rejects should not be included in the inventory schedule. Costs are recoverable, however, as part of the termination settlement if allocable to the terminated portion of the contract. Reworkable rejects should be listed on inventory schedules and costed at contract price less the estimated cost of rework.	
3. Special tooling, special machinery and equipment, special test equipment (CAM 12-304.13 and 12-304.14). Loss of useful value of these items is allowable provided the items meet the FAR definitions and specific FAR 31 criteria. Verify that items qualify under the definitions in FAR 45.101. Obtain technical assistance, if necessary. Determine if costs meet the requirements of FAR 31.205-42.	

E-1	Proposed Other Costs Fixed-Inventory Basis	
	Version 4.1, dated May 2004	WP Reference
	1. Other costs frequently include such items as initial costs, engineering costs, royalties and patent costs, mass severance pay, rental costs on unexpired leases, travel costs, and costs continuing after termination. Frequently, cost categories contain considerable variation. Therefore, detailed audit guidance provided in CAM 12-305 and should be carefully reviewed prior to developing specific audit steps. Determine whether acceptable items of other costs have been allocated to completed, terminated, and continuing portions of the contract on an equitable basis.	
	2. The audit steps listed for audits of fixed-price contract settlement proposals submitted on the inventory basis (See steps for cost elements) should be used as appropriate to audit incurred costs. The auditor should modify this pro forma audit program to incorporate these steps when auditing cost-type termination settlement proposals or fixed-price termination proposals submitted on the total cost basis.	

F-1	Proposed Costs Continuing After Termination	
	Version 4.1, dated May 2004	WP Reference
	Generally, only costs associated with termination activities are allowable after the effective date of termination. FAR 31.205-42(b) allows the contractor to recover post-termination costs (assuming costs meet other allowability criteria) if the costs cannot reasonably be discontinued	

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immediately after notice of termination.	
1. Obtain contractor rationale for incurring costs after termination date.	
2. Review circumstances and necessity for incurring costs and determine if there was reasonable effort to discontinue their incurrence.	
3. Obtain technical advice in reviewing the reasons for contractor failing to immediately terminate production or subcontractor effort.	

G-1	Proposed Indirect Costs	
	Version 4.1, dated May 2004	WP Reference
	Techniques for auditing indirect cost pools and indirect cost allocations are discussed in CAM, Chapter 6, Section 6.	
	1. Determine the reasonableness of the method and base period for the allocation of indirect expenses.	
	2. Assure that any functions normally charged indirect and reclassified direct for this termination are excluded from indirect allocations. Items charged consistently indirect according to a contractor established or disclosed practice may be properly charged consistently as direct costs in settlement proposals.	
	3. Ascertain that terminated inventory excludes indirect costs not properly allocable because of the completion stage of the terminated inventory (for example, packing, shipping, and inspection).	
	4. Determine that indirect cost rates are based on a full cost accounting period (CAS 406).	

H-1	Proposed G&A Expenses	
	Version 4.1, dated May 2004	WP Reference
	Established audit procedures for review of G&A expenses are applicable to termination claims. See CAM Chapter 6, Section 7, and FAR Part 31.203.	
	1. Assure that costs of an indirect nature proposed as direct termination costs have been excluded from the GA expense pool. See the Review of Proposed Indirect Costs Section, Step 2.	
	2. Ascertain that proposed post termination costs do not include unabsorbed costs - CAM 12-305.7b (e.g., occupancy costs that would have been allocated to the contract if not terminated are not allowable	

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<p>as costs continuing after termination). The Armed Services Board of Contract Appeals has held that unabsorbed overhead is related to the contractor's existence as an ongoing organization and is not a continuing cost of a terminated contract; further the Government is not a guarantor of the contractor's continuing overhead nor is such intended by the language in the termination clause.</p>	
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I-1	Profit Or Loss Computation	
	Version 4.1, dated May 2004	WP Reference
	The auditor's responsibility is to provide as much information as possible to assist the TCO in negotiating a fair profit or a fair loss adjustment. The following financial factors should be developed and included when possible in the audit report.	
	1. Using the estimated percentage of completion and estimate to complete obtained in W/P section B-1 Step 7, compute the profit and/or loss which would have been experienced had the contract not been terminated.	
	2. Profit is not allowable if the contract would have resulted in a loss at completion (FAR 49-203). If a loss contract is indicated, compute the adjustment for loss as required (CAM 12-308).	
	3. If all attempts to evaluate profit or loss on the terminated contract are unsuccessful, set out the following considerations for the TCO:	
	a. Rate of profit contemplated at time contract was negotiated.	
	b. Rate of profit realized on completed items.	
	c. Average rate of profit on similar products or similar lines.	

J-1	Proposed Settlement Expenses	
	Version 4.1, dated May 2004	WP Reference
	1. Analyze the items proposed for settlement expenses and test check to supporting data.	
	2. Consider the possibility of duplication through indirect cost and/or G&A allocations.	
	3. Settlement expenses are incurred after termination, and profit is not applicable.	
	4. For settlement proposals on the total cost basis and for settlement	

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proposals for cost reimbursement contracts ascertain that no settlement expense activity is claimed in items 1-4 of SF 1436 and 1437. Indirect cost allocated to settlement expense effort is limited to that defined in FAR 31.205-42(g).	
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K-1	Proposed Settlement With Subcontractors	
	Version 4.1, dated May 2004	WP Reference
	1. Ascertain whether the Contracting Officer has approved or ratified the amounts of the settlements with subcontractors.	
	2. Ascertain that indirect expenses allocated to subcontract proposals are limited to those specified in FAR 31.205-42(h).	

A-1	Concluding Steps	
	Version 4.1, dated May 2004	WP Reference
	1. Summarize the audit findings and comment on the acceptability of the contractor's internal controls and the degree to which they were relied on.	
	2. Hold an exit conference. Discuss all audit conclusions with the contractors designated official. If there are exceptions to be reported, obtain the contractors official reaction for inclusion in the audit report.	
	3. Write draft audit report and complete indexing and cross referencing of working papers. If a technical evaluation or inventory valuation was not obtained, qualify report accordingly.	
	4. Provisions in 10 U.S.C. 2306a, known as the "Truth in Negotiations Act" and FAR 15-804 Cost or Pricing Data have applicability to termination actions. If applicable, prepare a defective pricing lead sheet when the proposal was based largely on estimated costs, as opposed to incurred costs, and the associated risks are considered high.	
	5. Update permanent files as necessary.	
	6. Closing actions should be performed in accordance with FAO procedures. These procedures may require either auditors or administrative personnel to perform various closing steps. Completion of these closing actions should be documented (e.g., by initials and date on the CD or working paper folder, etc.) and should include:	
	a. The title, author, and keywords fields of the file properties in the	

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<p>audit report must be completed (for the audit report only) prior to final filing.</p>	
<p>b. Review the APPS exe file for size. APPS-generated executable files that are over 10 megabytes in size should be reviewed to ensure that the format and content justify the size. Supervisors are responsible for reviewing or designating someone to review these files for content and format.</p>	
<p>c. Review the APPS exe file for temporary files. These files can be recognized by the “~\$” or “~WRL” at the beginning of the file name. Once the APPS exe file is complete and there is NO ACTIVITY to be completed on any of the files contained within the exe file, any temporary files should be deleted so there are no unintentional versions of working papers and/or reports. NOTE: This should be done prior to invoking the Export/Archive Option in APPS.</p>	
<p>d. Once an audit report is signed, the electronic document should immediately be modified to indicate who signed it, and it should be password protected. The electronic file should then be renamed according to the convention “01 DCAA Report [RORG-ASSIGNMENT NO.] – Final.doc” and changed to a read-only file. Only this file should be stored, transmitted, or otherwise used for official purposes. For Memorandums the word “Report” would be replaced by “MFF” or “MFR” in the naming convention as appropriate.</p>	
<p>e. When the audit report is transmitted electronically to the requestor, the transmission email should be saved as a txt file (this will ensure the attachments are not saved again). Saving delivery or read receipts is optional. If saved, the naming convention should distinguish them from transmittal emails.</p>	
<p>f. Once the report is signed, the signature page of the audit report must be scanned in accordance with Agency standard scanning instructions. For audit packages, the scanned signature page file should be named the same as the audit report (see above) with “-sig” added (i.e., 01 DCAA Report 01101-2002X10100389-Final-sig.pdf). There is no requirement to make the file a part of the APPS generated executable file and it must be included separately in the iRIMS folder. There is no need to scan the signature page of a Memorandum unless it is distributed outside of DCAA.</p>	
<p>g. Ensure an electronic copy of the final draft audit report containing the supervisory auditor’s initials and date, cross-referenced to the working papers, is included in the working paper package. The final draft report should include all substantive changes made to the original draft, with cross-referencing updated as necessary. It should differ from the final report only due to minor administrative changes</p>	

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(spelling, format, etc.) made during final processing.	
h. Ensure all working paper files are "read only" and, if necessary, compressed for final storage. Generally, current Agency software should be used to automatically modify all electronic files for storage.	
i. Two complete sets of electronic working papers should be filed. One set (official) will be filed in iRIMS. A second set (backup) will be stored on removable media in the hard copy working paper folder. The new APPS naming convention (ex: 01701_2003A10100001_Archive_093003.exe) will be used for both. If there will be a short-term need to access the working papers, a third, or "working" set should be stored so as to be available for reference, generally on the LAN. This set should be deleted when no longer needed.	
j. Verify using a separate machine, that electronic files stored on removable media are not corrupted and can be unarchived. Indicate the test was successful by placing tester initials and date prominently on the CD label.	
k. Securely enclose the "backup" set of electronic files (CD) and any "official" set of hard copy in the hard copy folder.	
l. File the "official" set of electronic files in iRIMS (see iRIMS User Guide).	
m. <u>Do Not File Sensitive Audits in iRIMS</u> : Sensitive audits include but are not limited to classified work, suspected irregular conduct, hotline or DCAA Form 2000 related files. These audits should not be filed in iRIMS at this time. See CAM 4-407f for filing instructions.	