

REVIEW AND EVALUATION OF  
CONTROL ENVIRONMENT AND OVERALL ACCOUNTING CONTROLS

CONTROL OBJECTIVES

CONTROL ACTIVITIES

AUDIT PROCEDURES

1. INTEGRITY AND ETHICAL VALUES

Management must convey the message that integrity and ethical values cannot be compromised, and employees must receive and understand that message through continuous demonstration of words, actions and commitment to high ethical standards.

Written codes of conduct address ethical business practices, conflicts of interest, and expected standards of ethical and moral behavior including dealings with customers, suppliers, employees and other parties.

Policies and procedures provide guidance on the situations and frequency of management intervention or overrides, approvals and documentation required, and the strict prohibition of manager overrides.

- a. Verify the existence of written codes of conduct/ethics. Selectively test the codes to determine if they adequately cover expected standards of conduct that affect significant internal and external business and employee relationships.
- b. Review the method used to communicate codes of conduct.
- c. Verify that written codes of conduct (i) are periodically communicated to all employees, (ii) are formally acknowledged, and (iii) cite consequences for violations.
- d. Verify that the contractor has a system to identify noncompliances with codes of conduct and pursue corrective actions.
- e. Determine whether policies and procedures address the situations and frequency of management intervention, require documentation and approval of intervention, and the strict prohibition of any management overrides.
- f. If applicable, selectively review documentation of management interventions or overrides. Assess compliance with policies and procedures.

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External influences heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may prompt management to establish specific internal control structure policies or procedures.

g. Document any external reviews that impact the internal control structure.

h. Identify access to records problems which impact on our ability to assess the internal control structure.

i. Identify possible potential internal control weaknesses inherent in any Form 2000 or ongoing investigation.

Management places emphasis on establishing and maintaining an effective system of internal controls and self-governance and does not condone signs of inappropriate practices.

j. Determine the extent to which the contractor participates in self-governance programs, such as Coordinated Audit Planning, Defense Industry Initiative, DoD Hot Lines or any procedure for reporting suspected irregularities.

2. BOARD OF DIRECTORS/AUDIT COMMITTEE

The Board of Directors and the Audit Committee should be independent enough from management so that they can constructively challenge management's decisions and act effectively on external audit communications and recommendations. The Board and Audit Committee should take an active role to ensure an appropriate upper management's commitment to ethical business practices and

The Board of Directors and/or Audit Committee are composed of independent members and are actively involved in significant decisions.

a. Obtain a list of Board of Director members. Determine their relationship to the business and assess their independence.

b. Review the minutes of the Board of Directors and all communications with the audit committee or body of similar authority to determine if the Board is taking an active role in significant management decisions.

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behavior. If auditors at contractor segments observe indications of possible weaknesses in internal controls that relate to corporate functions, they should refer them to the auditor cognizant of the corporate office. Examples include controls involving the Board of Directors and Corporate Internal Audit.

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The internal audit department is functionally and organizationally independent and is sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report their findings, opinions, and conclusions without fear of repercussion.

Management effects prompt correction of deficiencies noted in external CPA's management letter on internal controls.

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- c. Determine whether internal auditors have adopted standards for the professional practice of Internal Auditing issued by the Institute of Internal Auditors (Refer to CAM 4-1004.2.c.).
- d. Verify that the internal audit department is functionally and organizationally independent to achieve objectivity in the conduct of its audits.
- e. Determine whether the contractor has an adequate audit plan for conducting internal control and compliance reviews.
- f. Verify that there are effective follow-up procedures on internal audit recommendations.
- g. Obtain the external CPA's report of material weaknesses of internal controls and/or management letter for the most recently audited year. Determine whether corrective action has been taken in response to internal control weaknesses.
- h. Identify the services provided to the contractor by the external auditors that have an effect on the internal control environment.
- i. Determine the reason for any recent changes in

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3. BASIC STRUCTURAL ORGANIZATION

The organization structure provides the overall framework for planning, directing and controlling operations.

This structure defines the form and nature of the organization as well as the management functions and reporting relationships.

Authority and areas of responsibility should be appropriately assigned.

external auditors and review the associated SEC filing by predecessor auditors for corroborating evidence.

- a. Complete or update the contractor's basic organizational structure questionnaire.
- b. Review the current organization chart to determine whether it delineates clear lines of authority.

4. ASSIGNMENT OF AUTHORITY AND RESPONSIBILITY

Management ensures that appropriate responsibility and delegation of authority is assigned to deal with goals and objectives, operating functions, regulatory requirements, information systems and authorization for changes. The delegation of authority ensures a basis for accountability and control and sets forth individual respective roles.

Written policies and procedures adequately address delegations of authority and clearly delineate duties and responsibilities so that there is an adequate segregation of duties.

Written policies and procedures require evaluation of current financial conditions in order to anticipate and avoid adverse conditions.

- a. Verify that policies and procedures exist which specifically state the limitation or delegation of authority.
- b. Verify that there is a clear assignment of responsibility and delegation of authority to deal with such matters as goals, objectives, operating functions and regulatory requirements.

5. FINANCIAL CAPABILITY

Management must ensure that the contractor has adequate financial resources to perform on

The contractor conducts periodic assessments of accounts payable and accounts receivable

- a. Verify that management regularly conducts financial analysis and monitors contract cost

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government contracts.

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including analysis of accounts payable aging and the collectibility of accounts receivable.

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performance. Observe that procedures are in place and appropriate management is being informed of adverse conditions.

- b. Review notes to financial statements and SEC filings for any indication of potential adverse financial conditions and discuss these conditions with controller or other financial managers.
- c. Consider the impact of severe financial distress on the ability of the contractor to perform on government contracts.
- d. Determine that policies and procedures require the preparation of an accounts payable aging schedule and that results are elevated to appropriate levels of management.
- e. Review procedures for analyzing the collectibility of receivables.
- f. Review procedures and verify that contractor monitors loan covenants and sets up payment schedules.
- g. Verify that contractor periodically prepares and evaluates cash flow projections.

The contractor conducts periodic assessments to ensure that it is meeting debt payment schedules and is in compliance with other loan covenants.

The contractor regularly performs short and long term cash flow projections.

6. ACCOUNTING SYSTEM AND CONTROLS

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The accounting system is well-designed and is operating effectively to provide reliable accounting data and prevent misstatements that would otherwise occur.

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The contractor's accounting system consists of methods and records established to identify, assemble, analyze, classify, record and report an entity's transactions and to maintain accountability for the related assets and liabilities. The system will be designed so that the supporting documentation is complete (i.e., included purpose), accurate (e.g., includes credits where applicable), and readily available for examination.

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- a. Determine that the contractor maintains a current description of the accounting system, including books of original entry, general and subsidiary ledgers, and any statistical and/or supporting records which demonstrate the initiation of transactions, the flow of documents, and the identification of all points where correcting, adjusting or other cost transfers can be entered into the system.
- b. Determine if the contractor maintains a chart of accounts which is updated in a timely manner.
- c. Verify that adequate written policies and procedures exist for approving and documenting, correcting, adjusting, closing, credit and transfer entries.
- d. Verify that adequate procedures exist for reconciling all subsidiary cost ledgers and cost objectives to the general ledger accounts. If this function is a computerized function, the auditor should document how this is accomplished and selectively test to verify that it is occurring properly.
- e. Verify that a trial balance is prepared on regular basis and reconciles to the financial statements.
- f. Verify that adequate procedures exist for

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7. COST ALLOCATIONS

Management ensures that an item of cost or a group of items of cost are assigned to one or more cost objectives in accordance with rules, regulations, and standards for proper distribution of direct cost and allocation of indirect costs. Management ensures the proper allocation of both the direct assignment of cost and the reassignment of a share from an indirect cost pool.

The contractor maintains a current disclosure statement.

- controlling monthly accrual calculations and that an adequate approval process is used.
- g. Verify that there is adequate segregation of duties and responsibilities in such areas as access to accounting records, check-signing authority, recording disbursements in cash journal, and performance of bank reconciliations, etc.
  - h. Determine whether policies and procedures require identification of systemic problems or trends based on error reports. Verify that corrections are processed in a timely manner.
- a. Determine that the contractor's disclosure statement is current and adequately describes its accounting practices.
- b. Document, if applicable, any CAS noncompliances that may impact the internal control structure.
- c. Verify that adequate written policies and procedures exist for the identification and exclusion of unallowable costs. Determine

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that the detail and depth of records required as backup support for proposals, billings, or claims are adequate to establish and maintain visibility of identified unallowable costs (CAS 405).

Written procedures prescribe approvals required in establishing contract charge numbers.

d. Verify that adequate written procedures exist to ensure that charge numbers are based on contractual requirements and are under management control and authorizations.

Written procedures ensure that the Government receives its share of any income, rebates, refunds, allowances or other miscellaneous credits.

e. Verify that adequate written procedures exist for adjusting costs charged to the government for any income, rebates, allowances or miscellaneous credits and that appropriate approvals are required.