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Audit: Contract audit manual

United States. Department of the Army

United States. Navy Department

United States. Department of the Air Force

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DEPARTMENT OF THE ARMY SPECIAL REGULATIONS

SR 36-70-1

DEPARTMENT OF THE NAVY

NAVSANDA PUBLICATION NO. 261

DEPARTMENT OF THE AIR FORCE MANUAL

AFM 175-3

AUDIT
CONTRACT AUDIT
MANUAL

DEPARTMENTS OF THE ARMY, THE NAVY, AND THE AIR FORCE

JUNE 1952

CONTRACT AUDIT MANUAL



DEPARTMENTS OF THE ARMY, THE NAVY,
AND THE AIR FORCE

WASHINGTON 25, D. C., 18 June 1952

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AG 461 (28 Apr 52) COMPT

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THE AIR FORCE
WASHINGTON 25, D. C., 20 October 1953

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June 1952, is changed as follows:

1. The foreword and contents are superseded by those contained herein.
2. Sections 1 and 4, Chapter IV, and Chapter V are added and should be inserted in the manual in the proper sequence. There are no changes to the chapters and appendixes. Issued 18 June 1952.

[AG 461 (18 Aug 53)]

BY ORDER OF THE SECRETARIES OF THE ARMY, THE NAVY, AND THE AIR
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Auditor General, Southern District (400); Auditor General,
Mid-Central District (600); Auditor General, Western District
(400); Auditor General, European District (50); Auditor
General, Far Eastern District (50).

CONTRACT AUDIT MANUAL

FOREWORD

The Contract Audit Manual is issued under the authority of Section 401 of the Act of 10 August, 1949 (Public Law 216, 81st Congress). This Act places the responsibility with the Comptroller of the Department of Defense for the establishment and supervision of the execution of principles, policies, and procedures of (among other things) internal audit, which includes the audit of procurement contracts.

The Contract Audit Manual prescribes auditing policies and procedures for use by the audit agencies of the Departments of the Army, Navy, and Air Force in the performance of audits of procurement contract costs and other related audit assignments. Uniformity in audit policies and procedures has been established, except where it is desirable to recognize individual procedures of a military department. Compliance with the policies, procedures, forms, and instructions for use thereof, prescribed in the Manual will become effective on the date of issuance. Certain sections of Chapter IV; Section 6, Chapter V; and certain Appendices are not published at this time. However, it is believed that the material published is of sufficient value to justify its publication in advance of the above-mentioned Sections and Appendices.

Amendments to the Manual will be made as required. In this connection, constructive recommendations should be submitted through appropriate military department channels to the Assistant Secretary of Defense (Comptroller), Attention: Deputy Comptroller for Accounting Policy. The head of the audit agency of a military department may issue, for his agency, supplementary instructions relative to any particular feature of an audit of contract costs or other audit assignment, providing such instructions are consistent with the objectives of the Manual.

To provide guidance for audits of contract costs, where unsatisfactory situations exist, the contents of the Manual are necessarily detailed; however, careful evaluation of the contractor's accounting policies and practices, and the effectiveness of the system of internal control, as provided for in the Manual, will permit a minimum of detailed audit checks and will be given every consideration in the preparation of the program of audit work to be performed.

Where mention is made in the Manual of the "district director," such title has equal reference to Regional Auditors (Army Audit Agency), Supervisory Cost Inspectors (Cost Inspection Service, Navy Department) and District Chiefs (Auditor General, USAF). Similarly, use of the title "auditor" has equal reference to the title of cost inspector. Use of the title "supervisory office" is intended to include the Regional, Area, or District offices of, respectively, the Army Audit Agency, the Navy Cost Inspection Service, and the

Revised 20 October 1953

Auditor General, USAF. The term "audit agency" includes the Army Audit Agency; the Cost Inspection Service, Department of the Navy; the Auditor General, USAF; and the audit staffs of any oversea command.

Copies of the Manual will be distributed to personnel of the Department of Defense for use in performance of official duties. Others interested in the Manual may secure copies from the Superintendent of Documents.

W. J. McNEIL
Assistant Secretary of Defense
(Comptroller)

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*To be published at a later date.

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CHAPTER I

AUDITORS'S DUTIES AND RESPONSIBILITIES

1-0.000 Scope of Chapter. This chapter prescribes the military department auditor's duties and responsibilities including his relations with persons and activities outside the audit agency by which he is employed.

1-0.001 Cooperation with Contracting Officers and Technical Inspectors. The auditor is a member of the team set up by his department to protect the interests of the Government in contractual transactions with business and other organizations. Contracting officers and technical inspectors also are members of the team and close cooperation with them is essential if maximum results are to be obtained and duplications of effort avoided. The auditor must recognize that if the contracting officer is to function in the most efficient manner in his relationships with the contractor he must have available accurate and timely information concerning contract costs. If auditing is to achieve the stature it warrants in the administration of contracts each auditor must endeavor to assist the contracting officer to the maximum extent. However, the auditor will adhere to the highest professional standards in conducting the audit and will exercise unbiased judgment in making his determinations and recommendations. As one of the initial phases of his work on a contract audit assignment, the auditor should communicate with the contracting officer (for Army and Air Force contracts) or the technical inspector (for Navy contracts) and should establish the avenues for discussions of questions of mutual interest such as approval of quantity and quality of material, questionable cost items, and public voucher certification.

1-0.002 Relations with Contractor.

1-0.002 (1) Basic Considerations. The auditor's relations with the contractor have a vital bearing on the successful completion of an audit assignment. He is expected to create and maintain the most favorable relationship as a representative of the Department of Defense and the audit agency which he represents. Contractors should be notified in advance of proposed audits or preaudit conferences to enable the contractor to make such arrangements as may be necessary to avoid delay upon the auditor's arrival at the contractor's plant. The auditor should maintain appropriate standards of personal appearance and observe the following rules: be tactful, courteous and considerate; upon request, advise the contractor on problems related to contract costs and records; expedite the audit of vouchers involving reimbursement to contractors, and the rendition of audit reports, to the greatest extent consistent with the protection of the Government's interest; use the facilities furnished by the contractor in the most advantageous and economical manner and for official purposes only. In the event of unresolved differences of opinion (other than as to allowability of costs) the auditor, having clearly presented his viewpoint to the contractor, should refer the matter to the contracting officer or to the auditor's supervisory office for advice of action to be taken.

1-0.002(2) *Gratuities and Social Contacts.* In all dealings with the contractor, the auditor is enjoined to adhere strictly to the highest standards of business and professional conduct. Any financial transaction of a personal nature between the auditor and the contractor, a subcontractor, or their employees and agents is prohibited. Acceptance of gifts, gratuities, emoluments, or services accruing to the personal benefit of the auditor is prohibited. Social relations with the contractor, a subcontractor or their employees and agents to an extent which might place the auditor under obligation to the contractor or subcontractor, or which might create the impression that he is under any such obligation, should be avoided.

1-0.002(3) *Conferences and Other Contacts.* As one of the audit phases, a conference with the contractor's representatives should be arranged primarily for the purpose of acquainting the contractor with the procedures to be followed in presenting claims and obtaining reimbursements, the requirements as to documentary evidence, and the manner in which the audit is to be conducted (by resident staff or mobile audit group). The conference also will afford the contractor's representatives an opportunity to present any questions which they may have in mind. Arrangements for working space for the audit staff should be considered. The opportunity should be taken in the initial conference to establish a basis for a cooperative and efficient working relationship. Subsequent conferences will usually be found desirable from time to time. Where important matters are involved contacts with the contractor's officials and employees normally should be conducted by the auditor in charge. Subordinate personnel should be authorized at the discretion of the auditor in charge to make such contacts as are necessary to the performance of assigned duties.

1-0.002(4) *Access to Contractor's Plant and Records.* Right of access to a contractor's plant and records for the purpose of conducting a contract audit may be provided for by statute, by the terms of the contract, or by mutual agreement. In the case of cost-type contracts and certain other contracts, the authority is conferred by statute (see Ch. VII). In the case of other types of contracts, the authority may be contained in the contract itself or be established by mutual agreement (written or oral) between the contractor and the procurement and/or audit agency concerned. When the Government has the right to audit no limitation or restriction should be placed on the auditor's inspection of the plant and of the books and records including, but not restricted to, accounts, supporting data, corporate minutes, tax returns, and operating statements, necessary to the proper determination of contract costs.

1-0.002(5) *Records Withheld or Unavailable.* When a contractor unnecessarily delays submission of information essential to the performance of an audit, or refuses free access to the books and records, or the records are reported to have been destroyed by fire, flood or other catastrophe, the auditor will request of the contractor a written statement to be submitted with an auditor's letter report to the district director. When Army or Air Force contracts are involved, the auditor will also consult with the resident contracting officer, or if not resident, forward to him a copy of the letter report. This report will contain all relevant information including comment on absence of, or non-compliance with,

contract provision relating to the maintenance of records by the contractor and the rights of Government representatives to audit the contractor's records. When the required records are purported to have been destroyed, the auditor will attempt to verify the stated circumstances from independent sources such as police or fire departments or insurance companies and will report the information so obtained. The auditor will state what records, if any, were salvaged and will express an opinion as to the value of an audit examination of the available records. On receipt of the auditor's report, the district director will take such action as the circumstances and the directives of the military department may require.

1-0.002(6) Assistance in Preparing Claims Against the Government. Officers and employees of the Government are prohibited by law (Title 18, U.S.C. Sec. 283), from acting as agents or attorneys for prosecuting any claim against the United States or aiding or assisting in the prosecution or support of any such claim *otherwise than in the proper discharge of their official duties*. It is a part of the auditor's official duties to inform contractors of the manner in which public vouchers, termination settlement proposals, cost statements, or other financial representations in connection with Government contracts should be prepared and submitted. The auditor may advise contractors as to types of costs which are considered allowable and unallowable and on request he orally may express an opinion as to the acceptability of a specific item of cost. In case of any differences of opinion between the auditor and a contractor, the auditor should not attempt to restrict the contractor from including in claimed or stated costs any item which the contractor wishes to claim and which the auditor may consider to be of an unallowable nature.

1-0.002(7) Access to Audit Records by Contractor. Ordinarily, representatives of the contractor should not have access to the auditor's records. However, original invoices and other documentary evidence, if in the auditor's custody, and work paper schedules may be loaned to the contractor under appropriate controls by the auditor when in his judgment the contractor's request is reasonable. The cognizant district director should be consulted when there is any doubt as to the propriety of granting any request. Audit programs and confidential correspondence will not be available to the contractor.

1-0.002(8) Retention of Contract Records. Auditors will not retain contractor's records and documents longer than necessary for the audit thereof. The period of retention of contract records by the contractor is usually specified in the contract. Contractor's inquiries concerning disposition of contract records should be referred to the contracting officer for attention.

1-0.003 Audits at Other Locations. It will be the responsibility of the auditor having cognizance over the audit of the prime contract to arrange, through his district director, for necessary audits at other locations. Such audits may arise, for example, from subcontracts, from performance of part of the prime contract work by another division of the prime contractor, or in connection with home office overhead. (*Note:—*For information as to the procedure to be followed in transmitting contracts and subcontracts for audit at other locations see Appendix.)

1-0.004 Cooperation with Representatives of the General Accounting Office. Auditors of the General Accounting Office and of the Military Departments are employees of separate organizations and may not exercise administrative or technical supervision over each other. Audits will be conducted in an atmosphere of mutual respect and cooperation and the cognizant military department auditor will cooperate with and assist the General Accounting Office auditor in every reasonable way. Requests for assistance from General Accounting Office auditors in obtaining access to the contractor's plant and arranging for working space, equipment and supplies where the Army or Air Force has audit cognizance should be referred to the Army or Air Force contracting officer. Similar requests received when the Navy Cost Inspection Service has audit cognizance will be complied with by the cost inspector. The military department auditor will assist the General Accounting Office auditor in arranging for the necessary access to the contractor's books and records. Copies of public vouchers and of documentary evidence in the custody of the military department auditor will be made available to General Accounting Office auditors on request, subject only to normal office routine for obtaining and charging out files. To facilitate the General Accounting Office audit access should also be permitted to other audit records or files bearing upon the validity of reimbursements to the contractor under cost-type contracts. Access to other files or records, administrative directives and correspondence will be in accordance with audit agency instructions.

1-0.005 Respective Responsibilities of Military Department Auditors and General Accounting Office Auditors.

1-0.005(1) Military Department Auditors. Auditors of the military departments are responsible for the audit of contract costs and for approval or certification of costs based upon their audit findings. Their decisions on cost allowances will not necessarily be based on expressions of opinion by General Accounting Office representatives or decisions of the Comptroller General, but are to reflect the auditor's own judgment and the policies of the military departments. Auditors will be responsible for obtaining from the contractor documentary evidence required by the General Accounting Office and for maintaining custody of such documents until they are shipped to the General Accounting Office or disposed of as otherwise directed.

1-0.005(2) General Accounting Office Auditors. The General Accounting Office is responsible under statutory authority for accomplishing an independent audit of the collections and disbursements under military department contracts. In this connection and following established practices the General Accounting Office auditor should advise the military department auditor when discussions with contractor's supervisory or executive personnel are necessary so that the military department auditor or his representative may be present. Deviations from the established practices should be discussed with the General Accounting Office auditor and, if it appears necessary, with the auditor's supervisory office.

1-0.006 Cooperation with Auditors of Other U. S. Government Departments or Agencies. When an audit is being performed at a contractor's plant by representatives of other U. S. Government departments

or agencies, the military department auditor should consult with those representatives in the interest of making arrangements which will avoid duplication of audit effort. Such arrangements will be reported to the military department auditor's supervisory office for information and any further action which might be found appropriate.

1-0.007 Safeguarding Information.

1-0.007(1) Precautionary Measures by Audit Personnel. Military department auditors will not disclose information concerning the contractor's costs, financial matters and business affairs to unauthorized persons, or to any person who does not establish necessary military security clearance. Working papers, audit reports, unpublished financial statements, correspondence, files and other audit records may contain either information which the contractor regards as confidential or information classified for military security purposes, or both. Such information will be used only for official purposes. All necessary safeguards of such data will be provided for in accordance with military security regulations. Additional comments concerning the security of military information are contained in Section 2, Chapter VII of this Manual.

1-0.007(2) Audit of Confidential Records in Privacy. Where classified contracts are involved or where contractors indicate that records or documents are considered confidential by them, the auditor will request facilities to perform the audit in such privacy as may be warranted under the circumstances.

1-0.008 Records Not in Condition for Audit. If the auditor finds that the contractor's accounting records pertaining to a contract are inadequate, or that entries or postings are not up to date or are otherwise not in condition for audit, the deficiencies will be brought to the attention of the contractor. If corrective action is not promptly instituted, a factual report will be made to the district director for his attention and possible reference to responsible contract administration personnel. The auditor will not assist the contractor by posting transactions to the records.

1-0.009 Unsatisfactory Contract Performance. The auditor may in the course of an audit encounter situations in which he believes excessive costs are being incurred to such an extent as to indicate unsatisfactory contract performance. Such unsatisfactory contract performance may be caused by inadequate planning, inadequate supervision, surplus manpower, ineffective purchasing practices, undue extension of the life of the contract and inefficient purchasing practices. These conditions may be discussed with the contracting officer or technical inspector in an effort to have corrective action taken. If it appears the corrective measures are not being taken the auditor will report the conditions causing the unsatisfactory contract performance to the district director of the cognizant audit agency. He should indicate also the opinions of the contractor and contracting officer or technical inspector.

1-0.010 Reports of Suspected Criminal Conduct. Charges of suspected criminal conduct against any individual or firm are of a serious and lasting nature and the exercise of good judgment and sound evaluation of the facts or evidence assembled is a prerequisite to initiating such charges. When during the normal course of an audit assignment, there

come to the attention of the auditor facts which are believed to represent sufficient evidence of suspected violations of the United States Criminal Code, a detailed report thereon, classified "confidential," will be submitted to the auditor's supervisory office. The auditor will not discuss his suspicions or reveal his findings outside of official circles. Pending specific instructions from his supervisory office, the auditor will continue the audit of contractor's records in accordance with original audit requirements. If the auditor's supervisory office determines that further investigation is justified, action will be taken in accordance with pertinent regulations or directives of the military department concerned.

1-0.011 Reports of Suspected Fraud. Ordinarily the purpose of the auditor's examination of contractor's accounting records is to verify the accuracy of contractor claims, cost statements or other financial presentations. Such audit assignments do not require the auditor to test or probe into the contractor's records as protection against fraud, *unless*, during the course of normal auditing procedures, the auditor discovers or is alerted to evidential information which, upon careful evaluation, leads the auditor to suspect possible intent to defraud the Government. Upon reaching such a conclusion, the auditor will immediately discuss all the facts with the appropriate district director or submit a comprehensive report thereon, classified "confidential", and await specific instructions before proceeding with any further work of an investigative nature. Unless otherwise instructed, the auditor will continue with the audit program related to the original audit assignment. The district directors concerned, on determining that further investigation is justified, will proceed in accordance with pertinent regulations or directives of the military department concerned.

1-0.012 Violations of Regulations of Other Government Agencies. It is not the auditor's responsibility to investigate a violation of laws or regulations pertaining to Federal agencies (other than the Department of Defense) or to state agencies. However, if such a violation should be discovered by the auditor during the course of his audit, a separate written communication on the subject should be made to the district director who, with the advice and consent of the chief of the cognizant audit agency, will take such action as may be appropriate.

1-0.013 Inquiries Received from Members of Congress. Should the auditor or a member of his staff receive a communication from a Member of Congress relative to official business, the auditor should make an acknowledgment within 24 hours and forward the communication with his recommendations in respect thereof to his supervisory office. It is very important that information furnished Members of Congress be accurate and factual and that it set forth properly the position of the audit agency with respect to the matter involved. Therefore, all Congressional inquiries with suggested replies or recommended action will be forwarded to the district director for reply or transmittal to higher authority as may be required by the policy and procedures of the department concerned. Restricted or higher classified matters should not be discussed over the telephone except to state that prompt attention will be given to requests when confirmed in writing. Information given the auditor by the contractor should not be released except with the contractor's permission.

1-0.014 Visits by Government Representatives.

1-0.014(1) Inspector General. Each of the military departments has an inspection staff under an Inspector General. When an Inspector General or his representative visits an audit office, the auditor should, after satisfying himself as to the identity of the individual, cooperate fully, including the furnishing of any requested information pertaining to the audit of contracts under the auditor's cognizance. When significant matters are involved, or when requests for data or information require assignment of an auditor to prepare such data, it is preferred that communications be in writing. These may take the form of letters or informal memorandums as appropriate. The auditor should promptly advise the district director of the visit and furnish copies of correspondence and memorandums exchanged. In addition, he should report any other matters of substance which were the subject of oral discussion.

1-0.014(2) Visits by Representatives of Other Government Agencies. From time to time the auditor may be visited by a representative of the Government on a mission of official business. Such a representative should be received without hesitation. However, if the visitor does not furnish his official credentials before stating his mission, the auditor should request such identification before giving information or acting on a request for assistance. If the visitor's credentials are in order and his mission is related to the auditor's function or within the scope of the auditor's responsibility, the auditor should render such reasonable assistance as may be requested. If the visitor does not have satisfactory credentials, or the assistance requested appears unusual or unreasonable, or the information requested is classified, or if the auditor for any reason is doubtful as to the propriety of complying with the requests of the visitor, the auditor will ask that a written request be submitted through official channels. If the Government representative is unwilling to submit such a written request, he should be referred to the contracting officer or the auditor's supervisory office, as appropriate. A report should be made to the cognizant district director stating the date and time of the visit, the name, title and mission of the individual, the Government department or agency represented, and the information furnished, assistance rendered or other action taken by the auditor.

1-0.015 Temporary Duty in Regional or Headquarters Cities. An auditor assigned to temporary duty in a city where a supervisory audit office or the headquarters of his audit agency is located will report to such supervisory office, unless otherwise directed by his supervisory office, before contacting any other Government offices or performing any audit duties or other assignments.

1-0.016 Cost-Plus-a-Percentage-of-Cost System of Contracting. The auditor's attention is directed to paragraph 3-401, Armed Services Procurement Regulation, which provides in effect that under no circumstances shall the cost-plus-a-percentage-of-cost system of contracting be used by the Government for any prime contract; or allowed to be used for any subcontract under a department prime contract. If such contracts or subcontracts are encountered the entire cost, including the amount representing the percentage added, will be disapproved under cost-type contracts and recommended for non-acceptance under fixed

price contracts. This prohibition is based on the First War Powers Act and subsequent legislation.

1-0.017 Auditing Standards. The following auditing standards will be observed:

1-0.017(1) General Standards.

(a) The contract audit should be performed by a person or persons having adequate training and proficiency as an auditor.

(b) In all matters relating to the contract audit the auditor should maintain a mental attitude of unbiased judgment and objective consideration of the facts.

(c) Due care should be exercised in the performance of the audit and in the preparation of any report thereon.

1-0.017(2) Standards of Field Work.

(a) The audit program must be adequately planned, and any assistants must be properly supervised. It is the auditor's responsibility to develop an audit program which will protect the interests of the Government, and to satisfy himself by means of sound and practicable auditing procedures that the contractor's representations as to costs incurred under the contract are determined in accordance with generally accepted accounting practices, contract provisions and applicable Government regulations. The auditor should not unnecessarily extend the auditing procedures nor needlessly duplicate the work of the contractor.

(b) There should be an appropriate study and evaluation of the contractor's system of internal control (see Ch. III) to determine the extent to which reliance can be placed thereon. The information thus developed will be the basis for planning the audit procedures (see Ch. IV) and the extent of the tests of recorded transactions. Where practicable, as in the case of resident audit staffs, a study and evaluation, once made, will be kept current by periodic review and by observation of the contractor's accounting practices.

(c) A representative number of transactions should be audited to determine the extent to which reliance may be placed on the contractor's accounting policies and procedures and representations as to costs incurred under the contract. The determination as to what is a representative number (see definition in Appendix A) depends upon the auditor's judgment as to what constitutes a reasonable test of all of the recorded transactions. If necessary the audit work should be expanded or modified on the basis of the results of initial testing, but the extent thereof cannot be stated precisely and must be left largely to the auditor's judgment. A detailed audit of every significant transaction may be made when specified by the requesting authority or when authorized by the auditor's supervisory office.

(d) Sufficient competent evidence should be obtained through inspection, observation and inquiry to afford a reasonable basis for acceptance, suspension or disallowance of, or for an opinion concerning the contractor's representations as to costs incurred under the contract.

1-0.018 Correspondence. The auditor will establish routines for the control of incoming and outgoing correspondence with due regard for security regulations. When for any reason it is not possible to reply to

correspondence with reasonable promptness, the auditor should acknowledge receipt of the communication and state when a reply may be expected. Outgoing correspondence will be prepared in the form prescribed by the military department by which the auditor is employed. Army Audit Agency auditors will be governed by Department of the Army Special Regulations 340-15-1 Correspondence. Cost inspectors will be guided by the Navy Correspondence Manual (NAVEXOS P-388 (Rev)) April 1949. Air Force Auditors will be guided by Department of the Air Force Correspondence Manual, AFM 10-1.

1-0.019 Advice of Auditor's Departure from Contractor's Plant. Prior to the departure of the auditor from the contractor's plant, following completion of a contract audit assignment, he should notify the contractor's officials and the resident contracting officer or resident technical inspector. It is expected that in so doing he will express his appreciation for courtesies and cooperation extended. He should also furnish the address to which correspondence or inquiries may be sent in the event questions arise subsequent to his departure.

CHAPTER II—CONTRACT COST PRINCIPLES

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CHAPTER II

CONTRACT COST PRINCIPLES

Section 1—Introduction

2-1.000 Scope of Chapter. This chapter contains information relative to contract cost principles promulgated by the Department of Defense and the military departments (or the predecessor departments) and which have been or are presently applicable in the determination of contract costs.

2-1.001 Definition. The term "contract cost principles" as used in this chapter means those principles included in Part 4, Section VIII, Armed Services Procurement Regulation "General Principles Applicable to the Settlement of Terminated Fixed-Price Contracts" and in Section XV, Armed Services Procurement Regulation "Contract Cost Principles," and all amendments thereof. (Sec. XV, Armed Services Procurement Regulation included as appendix H to this Manual.) The term is used also in referring to similar cost principles previously published at various times by other Government departments or agencies and now used to a limited extent by the Department of Defense. The various publications set forth types and items of cost which are considered allowable and unallowable for contract-cost determination purposes.

2-1.002 Purpose and Applicability.

2-1.002(1) "General Principles Applicable to the Settlement of Terminated Fixed-Price Contracts" (Part 4, Section VIII, ASPR). These general principles are guides for contracting and auditing personnel in the development of cost data to be used as a basis for negotiating the settlement of terminated fixed-price contracts in which this Part is incorporated directly or by reference. These principles are applicable only to termination settlement proposals and are not to be employed as guides or otherwise in any other connection.

2-1.002(2) Contract Cost Principles. The Contract Cost Principles contained in Section XV, Armed Services Procurement Regulation, establish standards for the determination and allowance of costs in connection with performance of cost-type contracts and cost-type subcontracts thereunder. With respect to negotiated fixed-price contracts it is recognized that costs are only one of the factors to be considered in the determination of contract prices but it is believed possible eventually to develop a uniform statement of cost principles which will be applicable to such contracts as well as to cost-type contracts. However, in the absence of such cost principles and in order to provide uniformity with respect to overhead rate determinations, prenegotiation estimates and other audit matters relating to negotiation or revision of prices under fixed-price contracts and subcontracts (including those with price redetermination clauses and those of the incentive type) where cost is an important factor to be considered, the cost principles promulgated as Section XV will be used as a guide by personnel under the jurisdiction of the audit agencies in the performance of their work pertaining to such contracts except (a) where a contract has specific cost determination

provisions differing from the principles, (b) when performing audits in connection with statutory renegotiation proceedings, and (c) when performing audits of contract termination settlement proposals submitted under statutes or regulations (including Sec. VIII, ASPR) containing cost provisions differing from the principles contained in Section XV, Armed Services Procurement Regulation.

Section 2—Contract Cost Principles Previously Used

2-2.001 General. Cost principles which previously were used extensively by the military departments or their predecessors in connection with procurement contracts are discussed briefly in the following paragraphs. Presently, however, these cost principles are used only to the extent that they are incorporated or referred to in Army, Navy, or Air Force contracts executed prior to 1 March 1949 when use of the new Contract Cost Principles became mandatory for all cost-type contracts thereafter to be executed. Reference is made to these older cost principles only for information purposes.

2-2.002 Treasury Decision 5000. This Treasury Decision was signed by the Acting Commissioner of Internal Revenue in 1940 and was approved by the Secretary of the Treasury, the Secretary of War, and the Secretary of the Navy in the same year. It was promulgated for the purpose of recapturing profits in excess of those provided for by the Vinson-Trammell Act (see Ch. VII), on contracts for Navy vessels and Army and Navy aircraft, and provided in part that the regulations prescribed in Treasury Decisions 4906 and 4909 should not apply to contracts entered into after 28 June 1940 and before 1 July 1942, nor to subcontracts made with respect to such contracts. It contains in Sec. 26.9 a comprehensive definition of the cost of performing a contract or subcontract. In the absence of any other more authoritative and satisfactory publication, TD 5000 was used as a basis for cost determination in most Army cost-type contracts during World War II and thereafter until Section XV, Armed Services Procurement Regulation, became effective. It was also used on many Navy cost-type contracts executed during the years 1940, 1941, and 1942. Substantially all contracts based upon TD 5000 have been completed. The publication is now out of print and may be needed for reference by the auditor only if a question arises relative to an old contract. Several cost interpretations intended to be consistent with the provisions of TD 5000 were contained in War Department Technical Manual TM 14-1000, Administrative Audit Procedures for Cost-Plus-a-Fixed-Fee Supply Contracts, which The Contract Audit Manual superseded. Those cost interpretations are not applicable to Section VIII or Armed Services Procurement Regulation.

2-2.003 Explanation of Principles for Determination of Costs Under Government Contracts (the "Green Book"). This publication was issued in April 1942 and was thereafter used by the Navy during World War II and until Section XV, Armed Services Procurement Regulation, became effective. It was used as the basis for contract-cost determination in practically all Navy cost-type contracts, except construction contracts executed by the Bureau of Yards and Docks. At the time this manual was published, there was still a limited supply of copies of this publication

in possession of the Navy Department, Bureau of Supplies and Accounts (Cost Inspection Service), Washington, D. C. Several accounting rulings pertaining to costs allowable under the "Green Book" principles were contained in the Navy Department Revised Cost Inspection Manual which was superseded by The Contract Audit Manual. Those rulings are not applicable to Sections VIII or XV, Armed Services Procurement Regulation.

2-2.004 Explanation of Principles for Determination of Costs Under Government Research and Development Contracts with Educational Institutions (the "Blue Book"). This publication was never officially released in a printed version, but a mimeographed version, dated August 1947, was used, through incorporation by references, in certain cost-type contracts executed by the Army, Navy and Air Force. The publication sometimes was referred to as the "Blue Book" because it was expected that when printed it would be bound in a blue paper cover. The "Blue Book" has provided a formula through the use of which contract costs for research work performed by educational institutions could be determined.

2-2.005 Principles for Determination of Costs Upon Termination of Fixed-Price Supply Contracts.

2-2.005(1) Joint Termination Regulation. The Joint Contract Termination Board on 31 December 1943 approved a basic statement of cost principles to be utilized in the settlement of termination claims. This statement was made effective by the Office of War Mobilization early in 1944. Under authority of the Contract Settlement Act of 1944 (see Ch. VII), the principles, with minor changes, were later incorporated by the Office of Contract Settlement as paragraph 551, Joint Termination Regulation (JTR) and were included in the Joint Termination Accounting Manual (JTAM). That Act, including all of its implementing regulations, was applicable, when incorporated by an appropriate contract clause or amendment, to all World War II contracts executed prior to 1 November 1947 (Army and Air Force) and 19 May 1948 (Navy), and by mutual consent was also included in many subsequent contracts as the basis of settlement in event of termination. These regulations will be in use and required for reference purposes until all such contracts are finally completed or terminated and settled. Several Termination Cost Memorandums in the nature of cost interpretations were issued in connection with those cost principles but they are not applicable to Sections VIII or XV, Armed Services Procurement Regulation.

2-2.005(2) Joint Procurement Regulations. The Army Procurement Regulations, published 1 November 1947, were designated the Joint Procurement Regulations by Joint Army-Air Force Procurement Circular 1, 15 January 1948. The regulations state that they apply to the procurement by the Departments of the Army and Air Force of all supplies and services which obligate appropriated funds as to which invitations to bids or requests for proposals are issued on or after 1 November 1947. The regulations also apply to the procurement of added requirements under then existing contracts.

The Joint Procurement Regulations were superseded as related to Army procurement, by the Army Procurement Procedure, dated 15 March 1951, and as related to Air Force procurement, by the Air Force Procurement Procedures, AFM 70-6, June 1950, (which contain no statement of cost principles).

The auditor will be interested in the Joint Procurement Regulations, primarily because paragraph 5-504.9 therein prescribes certain principles for determining costs in connection with terminated fixed-price contracts which are incorporated by reference in the termination articles of many Army and Air Force fixed-price contracts. Pending issuance of Chapter VIII, Terminations, Armed Services Procurement Regulation, the Air Force (Air Matériel Command) on 12 April 1950, authorized optional use of either "contract cost principles set forth in Section XV of Armed Services Procurement Regulation" or the "principles of determining costs set forth in paragraph 5-504.9 of the Joint Procurement Regulations." Air Matériel Command Directorate Notice No. 73-3, 10 September 1950, subject, Contract Terminations, states in paragraph 11(a), "the set of principles which is applicable in an individual case is determined by the provisions of termination clause of the individual contract. It may be Section XV of Armed Services Procurement Regulation, or it may be the Joint Procurement Regulations provisions which are set out below because they are practically identical with the Joint Termination Regulations. In some instances the termination clause may not contain a reference to any principle, in which event auditing personnel will undoubtedly apply Section XV of the Armed Services Procurement Regulation." These instructions were superseded by the issuance of Section VIII, Armed Services Procurement Regulation, which makes mandatory the inclusion of contract clauses contained therein in all contracts executed on or after March 1, 1952.

Section 3—Contract Cost Principles Presently Applicable

2-3.001 Section XV, Armed Services Procurement Regulation. The use of the contract cost principles published in Section XV, Armed Services Procurement Regulation became mandatory in connection with all cost-type contracts (and all cost-type subcontracts thereunder) executed by the military departments on and after 1 March 1949. To be binding upon the Government and the contractor the cost principles outlined in Parts 2, 3, or 4 (whichever Part of Section XV is applicable must be (a) set forth in the contract or appended thereto, or (b) specifically incorporated by reference in the contract. However, any such contract may, to the extent necessary in a particular case, expressly provide for the allowance of any of the kinds of costs referred to in Part 5 of Section XV unless any of such kinds of costs are expressly excluded under Part 2, Part 3, or Part 4 (whichever is applicable). Furthermore, any such contract may exclude any item of allowable costs set forth in Part 2, Part 3, or Part 4. Because of the differences in cost allowances among these Parts and of the variations in contract provisions the auditor must be familiar with the contract and the applicable cost principles before proceeding with the audit. Section XV, Armed Services Procurement Regulation, is included as an appendix to this Manual.

2-3.002 Subjects Affecting Cost which May Require Special Consideration. Part 5 of Section XV, Armed Services Procurement Regulation, enumerates examples of items of cost which may require special consideration by the contracting officer in connection with the negotiation of a cost-type contract for the purpose of (a) determining which items, if any, should be expressly provided for in the particular contract and

(b) incorporating appropriate clauses in the contract. However, in the absence of a specific contract provision in respect of any of these items of cost, the general bases for determination of costs as set forth in Paragraphs 201, 301, and 402 of Contract Cost Principles and in an applicable Cost Interpretation will govern allowability.

2-3.003 General Bases for Cost Determination. The bases for determining cost under cost-type contracts are set forth briefly below:

(a) The total cost of a contract is the sum of the allowable direct costs incident to the performance of the contract plus the properly applicable portion of allowable indirect costs, less applicable income and other credits.

(b) Costs must be reasonable; judgment must be exercised in determining reasonableness.

(c) Cost must be determined by the application of generally accepted accounting principles and practices.

(d) The costs of a contract are subject to the limitations as to types and amounts of cost items set forth in Section XV (as implemented by Cost Interpretations) or as especially provided in the contract.

2-3.004 Contract Cost Principles in Relation to Generally Accepted Accounting Principles and Practices. Generally accepted accounting principles are those which are described in professional accounting literature, and in official pronouncements of recognized associations of accountants such as the American Institute of Accountants. Generally accepted accounting practices are those which are in common use by business organizations and indorsed by recognized associations of accountants and leading practitioners. There are also disagreements among practitioners on particular points. The nature of these pronouncements, indorsements and disagreements makes it impossible to find an over-all statement relating to all phases of a comprehensive and integrated body of accepted accounting principles and practices. Instead, the principles and practices followed by a particular contractor must be measured against the aggregate body of generally accepted accounting principles and practices followed or indorsed. Accounting methods, and cost principles, thus established, are those to which reference is made in Section XV, Armed Services Procurement Regulation. Within these broad limits there are alternative and optional accounting and cost methods. For example, there are several acceptable methods of depreciation accounting and of inventory pricing. Some methods are better suited for particular types of business than for other types. Accounting practices which depart from generally accepted accounting practices must yield results which are equitable to the Government.

2-3.005 Contract Cost Principles in Relation to Internal Revenue Code. The contract cost principles are directed to the validity and reasonableness of items of cost as components of the aggregate cost of a contract based upon generally accepted principles and practices. Their status as allowable deductions from taxable income for the purpose of computing Federal income taxes is not the criterion of allowability as costs under Government contracts.

2-3.006 Cost Interpretations in Relation to Contract Cost Principles. Because of their wide applicability the contract cost principles are written

in broad language establishing uniform policies. Cost Interpretations of contract cost principles provide upon issuance a more detailed uniform basis for the determination of the allowability of items of cost. The items of allowable cost referred to in cost interpretations are subject to the basic tests of reasonableness, conformity with generally accepted accounting principles and practices, and the limitations set forth in Section XV, Armed Services Procurement Regulation, or otherwise especially incorporated in a contract. The interpretations are contained in Part 6, Section XV, Armed Services Procurement Regulation and are included in Section XV which is an appendix to this Manual.

2-3.007 Part 4, Section VIII, Armed Services Procurement Regulation, "General Principles Applicable to the Settlement of Terminated Fixed-Price Contracts." Paragraph 8-402 thereof states:

"Statement of Principles for Consideration of Costs. In considering cost data as a basis for negotiation, the Statement of Principles set forth in this Part shall be used as a guide. The cost principles reflect certain policy determinations regarding the types of costs which should ordinarily be taken into account in determining fair compensation in the settlement of a fixed-price contract terminated for the convenience of the Government. Costs contemplated by this Statement of Principles are intended to include the direct costs incurred which are reasonably necessary for the performance of the contract and which are properly allocable to the terminated portion thereof, and the indirect costs incurred which are properly allocable to such terminated portion. In applying this Statement of Principles to any particular case, the following factors will govern: (i) reasonableness, (ii) generally accepted accounting principles and practices, (iii) any limitations or special provisions as to types or amounts of cost items as set forth in the contract or in the written records of the contract negotiations, and (iv) allocability. Failure to mention any item of cost herein is not intended to imply either that it may or may not be considered."

The remainder of the Part sets forth:

- (a) General policy for treatment of cost as relates to specific areas,
- (b) Specific examples of costs which may be included,
- (c) Specific examples of costs which may not be included, and
- (d) Certain considerations governing the determination of profit on terminated fixed-price contracts.

**CHAPTER III—SURVEY OF CONTRACTOR'S
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CHAPTER III

SURVEY OF CONTRACTOR'S INTERNAL CONTROLS AND ACCOUNTING PRACTICES

3-0.000 Scope of Chapter. A survey of contractor's internal controls and accounting practices should be performed as the initial phase of an audit assignment. The survey develops information which forms the basis for the development of the audit program by indicating the extent to which reliance can be placed on the contractor's internal controls and accounting practices. When used to maximum advantage the survey, together with acceptance by the contractor of auditor's recommendations for improvement, should permit a reduction in the detailed audit work to be performed. The material contained in this chapter is applicable to a contractor with existing or proposed contracts. Also, it is applicable to fixed price and cost-type contracts. The general nature and characteristics of internal control are presented in Section 1. Because much information on this subject has been published, Section 1 is not intended to be all-inclusive but is designed to present a résumé of some of the basic principles. Section 2 contains information concerning the importance and scope of the auditor's survey, and the evaluation of the contractor's internal control as related to the audit of contract costs. Section 3 presents a guide to the survey of internal controls and accounting practices.

Section 1—Nature of Internal Control

3-1.001 Definition and Characteristics of Internal Control. Internal control is defined as the plan of organization and all of the coordinate methods and measures adopted within an entity to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

3-1.002 Elements of Internal Control.

3-1.002(1) Plan of Organization. The organization plan of any business should be as simple as the nature of its activities will permit, and sufficiently flexible to meet changing conditions. Its general structure should depend largely upon the type and size of the business; products manufactured, services rendered, or work performed; and the segregation of operations by geographical areas, subsidiaries, plants, divisions, products, etc. The plan should provide appropriate separation of functional responsibilities, such as purchasing, production, sales, finance and comptrollership. This separation need not result in rigid departmentalization or require excessive personnel. In larger organizations departmentalization will logically occur primarily because such specialization permits the more efficient utilization of personnel. In smaller organizations formal departmentalization may not be warranted. However, in such organizations it is possible to assign the functional responsibilities in such a manner as to achieve the objectives of internal control without burdening the organization with an organizational structure which is too complex for its needs. The adequacy and effectiveness of internal controls are dependent upon the degree of independence existing among operating,

custodial, accounting and internal audit functions. Authority and responsibilities assigned to the functional areas should be clearly defined, preferably in writing.

3-1.002(2) Financial Procedures. Financial procedures include those procedures for the authorizing and recording of all actions concerning assets, liabilities, revenues, expenses and equities. Such procedures are most effective when clearly understood throughout the organization. They should be incorporated in a "procedures manual" which should also include a chart of accounts and sample forms with instructions for their use. The degree of refinement of such procedures is greatly influenced by the size of the organization. Formal budgetary controls, material controls, production schedules, periodic summaries and reports and analyses, and related instructions or manuals may be used to maximum advantage by larger contractors. Smaller contractors can achieve the objectives of such controls and reports through the use of less formal methods.

3-1.002(3) Sound Practices.

(a) Internal check is an element of internal control arising from the division of employee's duties in such a manner that automatic checks and balances are maintained in the handling and recording of transactions and in the care and protection of assets. This is usually accomplished by such division of duties and responsibilities that no one person will handle all phases of a transaction completely from beginning to end, nor will the same person have control over both an asset and the record of it. Internal check is a logical complement to the plan of organization. It takes advantage of the normal division of labor which is inherent in an efficient enterprise. Any organization of two or more people can so assign its functional responsibilities as to provide a significant degree of internal check. As the number of employees increases, with a resulting refinement in the division of duties, a greater number of such checks can be developed.

(b) Physical verifications are an integral part of internal control. Illustrative of such verifications are: inventories of materials, supplies, equipment and tools; the checking of materials actually used with the quantities charged to the work performed; observations of employees at work for the purpose of verifying the accuracy of time and cost records; payment of employees, or observation of the payment, by independent persons.

(c) An internal audit is an unbiased examination made by management's employees of one or more phases of an organization's activities to determine the accuracy of accounting data, the extent of the care and protection of assets, and the degree of compliance with management's prescribed policies and rules. Such examinations should be performed by internal auditors who have no assigned operational responsibilities. In order that the examinations will be unbiased and that the results thereof may receive appropriate attention, the internal audit staff should report directly to the comptroller or a higher executive.

3-1.002(4) Competent Personnel. The effectiveness of every aspect of internal control is dependent upon employment of personnel having required qualifications and appreciation of their responsibilities. Effec-

tive internal control requires that such personnel be given a clear understanding of their responsibilities and be trained in their duties.

Section 2—Auditor's Survey

3-2.001 Importance of Survey. The importance of a carefully planned survey, performed with the active assistance of contractor personnel, and an intelligent evaluation by the survey auditor of the information obtained, cannot be overemphasized. The extent to which reliance can be placed upon the contractor's internal controls and accounting practices is the principal factor to be considered when preparing the audit program, particularly with respect to minimum requirements for test checks of recorded transactions. The extent of such reliance will govern the amount of the auditor's work unless the test checking process discloses deficiencies or weaknesses which justify expansion of the scope of the audit.

3-2.002 Scope of Survey.

(a) The scope of each survey should be sufficiently comprehensive to permit the auditor to form an opinion as to the adequacy of the contractor's accounting practices and internal controls and the reliance that may be placed on the contractor's contract cost determinations. The factors to be considered in determining the scope of the survey includes: target date of the survey report, if one is to be written; the availability of audit personnel; the type, dollar value and number of the contractor's existing and prospective contracts; the anticipated period of contract performance; the purpose and scope of prospective audits; and the complexity of the contractor's operations and accounting and cost systems. The overall audit effort should be intelligently apportioned between the survey and the verification of claimed cost or other audit work to be performed.

(b) The scope of each initial survey will be relatively complete when one of the following exists:

- (1) a substantial portion of the production of a contractor's plant is for Government contracts.
- (2) an audit residency exists or is to be established,
- (3) a non-recurring audit is sufficiently important to the Government,
- (4) the amount of the contract is proportionately large.

(c) Where smaller and less important cost type or fixed-price audits are to be performed on either a "mobile" or a "one time" basis, the scope of the initial survey should ordinarily be governed by existing conditions. In some instances the advantages to be gained from a survey may be so limited as to justify only a minimum survey consisting of an observation of the contractor's facilities and a discussion with contractor's key personnel of the contractor's accounting practices. Where there are indications that the contractor may receive additional contracts which will require audit, the value of a survey of broader scope, or more intensive as to detail, should be considered.

(d) Subsequent to an initial survey of a contractor's accounting practices and internal controls at plants where an audit residency has been established, so long as auditors are resident at the contractor's plant, the survey file will be kept current by continuing reviews and recordings of

changes that occur. At plants where a survey was made for the purpose of a one time audit, the auditor, on each succeeding assignment, will review changes in internal controls and accounting practices or make an entirely new survey, as may be justified by the passage of time and importance of the audit then to be performed.

3-2.003 Planning and Making the Survey.

(a) Preliminary planning of a survey should include a study of the requirements of the contract or contracts to be audited, pertinent information obtained through preliminary discussion with contractor's officials, review of procedures manuals and an objective inspection of plant operations. The auditor should utilize all of the information available from the contractor and should attempt to obtain the active assistance of the contractor's internal audit and accounting staff. The contractor's accounting and cost practices and internal controls should be reviewed. The auditor should study the plan of organization, requirements for authorizations and approvals, delegations of authority, and the records and forms in use. The routines followed by employees in the performance of their duties should be reviewed to evaluate the dependability of the contractor's accounting practices and internal controls.

(b) The survey should include an observation of the contractor's plant so that the auditor may gain a basic knowledge of the contractor's products and production processes. Special attention should be given to that portion of the plant which is engaged or is expected to be engaged in work on military department contracts.

(c) The auditor's discussions with the contractor's officials and employees, observations, verification tests and evaluation of effectiveness of the internal controls and accounting practices should be recorded on working papers. When organization charts and production and document flow charts of plant and accounting operations are available the auditor should utilize such charts to the fullest extent possible and prepare only such supplemental information and working papers as appear necessary. If such charts do not exist, the potential value of such charts to the contractor's organization, and to the auditor, may be discussed with the contractor's representatives with a view to their preparation by the contractor. Otherwise, it may be advantageous for the auditor to prepare pencil draft charts for his own files; however, certain skills and the time element are often important factors in this connection, and satisfactory results may be obtained by concise notations which, if prepared in sequence of the various phases of operations, will ordinarily provide adequate data for review and evaluation purposes.

(d) Where independent public accountants or contractor's internal auditors have surveyed the accounting practices and internal controls, possibly as a part of a broader audit assignment, the survey auditor should endeavor to obtain copies of reports or working papers for review.

(e) Weaknesses in the contractor's accounting or cost practices or internal controls should be discussed with the contractor's officials. Such discussions should be recorded in the survey working papers. Until satisfactory remedial action is taken by the contractor the audit program will include provision for adequate audit coverage of the contractor's operations where weaknesses have been revealed.

(f) When the auditor's survey indicates that the reliability of the

contractor's internal controls is jeopardized by inefficiency or lack of cooperation on the part of any of the contractor's employees, such matters will be brought to the attention of the auditor's immediate supervisor. The supervisory auditor will advise the auditor as to the action deemed appropriate in the particular circumstance and the comment, if any, to be included in the survey report, if a report is to be made. In appropriate cases the supervisory auditor may authorize the survey auditor to discuss the matter directly with the contractor. The prevailing circumstances and subsequent action taken should be noted in the survey working papers. The audit program should provide for adequate review of costs or cost records which are affected by the work performance of an inefficient or uncooperative contractor employee until remedial action is effected.

3-2.004 Considerations Governing Recommendations to Contractor.

(a) The procedures used by the contractor may be the result of years of experience in the conduct of a particular enterprise, and may produce results which, in the final analysis, are equally as satisfactory as those which would be accomplished by other theoretically preferable standards and procedures. For this reason the auditor should not expect or demand system perfection. When it is found that contractor's internal control procedures and accounting practices may be relied upon to produce equitable and reasonably accurate recorded costs, the auditor should not suggest or require changes merely to meet his own personal preferences or to effect conformance with any predetermined standards.

(b) Recommendations for changes should be made only after weighing the costs involved against the benefits to be derived. Suggested improvements may be discussed but the contractor should not be urged to change the established procedures in order to improve the internal controls unless one of the following conditions exists:

- (1) the procedures for accurate cost determination are inadequate,
- (2) the work under Government contracts will extend over a long period,
- (3) internal control can be improved appreciably,
- (4) continuance of the present routine would require the expenditure of audit effort substantially disproportionate to the audit effort otherwise required.

One of the basic objectives of the contractor's cost accounting procedure, and the most important from the auditor's standpoint, is the accurate accumulation of costs applicable to each contract. The contractor should be interested in any change in his procedures which will make possible a reduction in the volume of detailed audit work to be performed or will improve existing internal controls. Good judgment is expected from the auditor in deciding what suggestions should be made to the contractor in order to reduce the auditor's workload to the extent practicable under all the circumstances. If the contractor is not receptive to the auditor's suggestions for improving the system of internal controls, and the lack of such controls or the condition of the records otherwise are conducive to the inflation of costs and/or amounts to be billed under Government contracts, the matter should be brought to the attention of the district director.

3-2.005 Guide to Survey of Internal Controls and Accounting Practices.

(a) Section 3 of this chapter constitutes a guide to the survey of internal controls and accounting practices. This guide is intended to cover the survey of operations of an average contractor with emphasis placed upon the accounting practices and internal controls that are directly related to contract performance and costs. The internal control standards indicated by the questions in the guide are not intended to be, and will not be, applicable in their entirety to every contractor, nor will they be adequate in every instance, due to differences among business entities in organizational structure and character and type of business. The auditor is not expected to restrict the scope of his survey to questions listed but is expected to use initiative and judgment in following them. When conditions are encountered which are not covered by the list he will be expected to expand his survey to the extent required.

(b) District directors are authorized to reproduce the guide as presented herein as a check list; or, preserving the basic format, delete or add items to adapt the guide to surveys of the very large or the very small contractor, or to surveys of specialized types of contract operations, such as: research and development, construction, national guard, stevedoring, or time and material. The survey of contractor's records of Government furnished property ordinarily will be covered in the general survey of the contractor's operations; however, for use when general surveys have not been made, a special guide limited to the records of Government furnished property is authorized. In a particular case, auditors should add or delete questions to the extent considered appropriate to each survey.

(c) The system of numbering the questions of the guide departs from that utilized throughout the text material of the manual. This is necessary in order to provide a simple, flexible numbering device which will permit the addition or deletion of questions while permitting those questions retained to be identified with the numbers originally assigned. The various parts of the guide are identified through the use of capital letters in alphabetical sequence. Individual questions are numbered in sequence within each part. Where questions are subdivided, such subdivisions are identified by small letters. When additional questions are considered necessary they should be included in the appropriate part following the highest numbered question in that part, and be assigned the arabic numerals in the same series already employed in that part.

3-2.006 Completing the Guide. The questions in the guide are presented in a manner whereby, under normal conditions, an affirmative check will indicate the existence of a good internal control situation, and a negative check will indicate either, (i) an unsatisfactory situation, (ii) unsatisfactory pending further verification of underlying factors, or (iii) that the standards cannot be fully met due to the nature of the contractor's operations or a relatively small administrative and accounting staff which preclude use of certain of the prescribed standards. Working paper references should be indicated in the guide in all pertinent instances where an affirmative checkmark is shown and in all instances where a negative checkmark is shown. The letters NA (not applicable) should be inserted

against any question which does not apply to the particular survey. No questions should be left blank in all columns. Upon completion of the survey the in-charge auditor will include on the first page of the guide a brief summary on the results of the survey and his appraisal thereof including comment as to weaknesses in internal control. Names of military department auditors participating in the survey and the number of hours spent thereon will also be shown. Where effective assistance has been received from members of the contractor's staff, their names should also be shown.

3-2.007 Working Papers. The auditor should prepare working papers in sufficient detail to record clearly the extent of the review of the contractor's internal controls, accounting practices and operating procedures. The auditor must appreciate that the guide is but a "memory-bracer" to assure adequate coverage and to facilitate review. Since "yes" or "no" answers to questions in the guide will not be sufficient in most instances the auditor must use working papers to indicate:

- (a) the source of information,
- (b) contractor's prescribed procedures,
- (c) contractor's actual practices,
- (d) auditor's conclusions as to adequacy of procedures and practices.

The auditor should keep the following standards in mind in the development of working papers:

(a) Can a reviewer intelligently evaluate the contractor's internal control procedures and practices through a review of the guide and the working papers without recourse to numerous discussions with the auditor?

(b) If it becomes necessary to reassign the survey auditor, can his replacement continue the survey without significant loss of time through a review of the guide and working papers?

Working papers should be kept neat, orderly and legible and should be appropriately cross-indexed in themselves and with the guide. They should not be cluttered with miscellaneous or scratch paper memorandums or unidentified notations or comments. Copies of forms, charts, and manuals (when readily available) should be included whenever such information is necessary to a complete presentation. Care should be exercised to avoid the inclusion of routine forms, charts and manuals which are not necessary in the evaluation of the system. Illustrations of such items to be included in the working papers are: brief history of the business; lists of divisions or plants and of important properties; lists of products; organization and flow charts; chart of accounts; statements of sales policies and of production and distribution methods; financial and operating statements; accounting manuals or excerpts therefrom; statements of accounting policy; pension plan matters; and description of contractor's cost system.

3-2.008 Survey Reports. A formal survey report will be prepared only when requested by the contracting officer or upon instruction from the auditor's supervisory office.

3-2.009 Permanent File. The completed guide and related working papers will constitute a permanent file. Ordinarily, only one permanent file will be maintained for each contractor. Permanent files will be kept

at audit residency offices, or where no residency has been established, in the supervisory office having jurisdiction over the audit. Permanent files will be reviewed and brought up to date as often as conditions may warrant but, in any event, at least once each year as long as the contractor has active contracts subject to audit. Mobile auditors will carry the permanent file on each recurring audit assignment and add any pertinent information developed during succeeding audits or surveys. The permanent file should be kept neat, orderly and legible. Additions should be filed in their proper sequence, or if that is impracticable, they should be properly cross-referenced.

Section 3—Guide to Survey of Internal Controls and Accounting Practices

Contractor _____

Address _____

Auditor's Comment on Results of Survey (Include specific comment as to weaknesses in internal control).

Survey Made By:

<i>Names of Military Department Auditors</i>	<i>Number of Hours</i>
In charge _____	_____
Assisting _____	_____
Assisting _____	_____
Assisting _____	_____

<i>Names of Contractor's Personnel who actively cooperated in the survey:</i>	<i>Title</i>
_____	_____
_____	_____
_____	_____

Date Survey Started: _____

Date Survey Completed: _____

Formal Survey Report Requested: () Yes () No

Part A—Basic Information

1. () Corporation () Partnership () Proprietorship
 - a. () Close () Family
 - b. () Family () Limited
 - c. () Publicly held () Regular
 - d. () Listed on _____ Stock Exchange
2. Incorporated in State of _____
3. Date of Incorporation _____
4. Divisions or Plants () None (W/P _____)
5. Subsidiaries, Parent or Affiliated Companies () None (W/P _____)

- 6. Names and Titles of Principal Executives (including Organization Chart, if available). (Show percent of time devoted to business and salaries paid.) (W/P _____)
- 7. Names of Partners, Partnership Interest. (Show percent of time devoted to business and salaries paid.) (W/P _____)
- 8. Type of Operation: () Manufacturing () Service
() Construction () Other (Specify) _____
- 9. Products Manufactured or Type of Service:
Commercial: _____
Government Contracts: _____

- 10. Contractor's Fiscal Year Ends: _____
- 11. Name of Outside Auditors _____
- 12. Type of Audit Service Rendered: () Balance Sheet Audit
() Balance Sheet and Operations () Tax Service () Other
(Specify) _____
- 13. Form of Contractor's Accounting Policies: () Accounting Manual
() Accounting Letters () Other (Specify) _____

- 14. Cost Accounting System: () Job Costs () Process Costs
() Standard Costs () Other (Specify) _____

- 15. Approximate Number of Hourly Employees: _____
- 16. Approximate Number of Salaried Employees: _____
- 17. Annual Volume of Commercial Sales: \$ _____
- 18. Government Contracts: (W/P _____) \$ _____
- 19. Any indication of financial instability? () None (W/P _____)

Part B—Accounting System—General

	Yes	No	W/P Ref
1. Are the general and subsidiary books of account adequate for and suited to the contractor's business? _____			
2. Are the cost records controlled by or periodically reconciled with the general books of account? _____			
3. Does cost accounting system provide for reliable cost determination? _____			
4. Are the cost accounting system and cost records conducive to ready determination of contract costs? _____			
5. Where cost-type contracts exist, are unallowable costs: (a) segregated and charged to separate accounts in the recording process? _____			
(b) not segregated in the recording process but subsequently reclassified? _____			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
6. If standard costs are used, can actual costs be determined through use of variance accounts or otherwise? _____			
7. Are separate cost accounts maintained for each cost type contract? _____			
8. Are separate cost accounts maintained for each fixed-price contract with price re-determination clause? _____			
9. Are separate cost accounts maintained for each fixed-price contract without redeter-mination clause? _____			
10. Are separate cost accounts maintained to record starting load costs (rearrangement, tooling, training, abnormal rejects and spoilage, etc.) for each:			
(a) Cost type of contract? _____			
(b) Fixed-price with price redeter-mination? _____			
(c) Other fixed-price contracts? _____			
11. Are work orders a part of the accounting and cost system? _____			
12. Are work orders used for the following classes of work:			
(a) Preproduction costs? _____			
(b) Tooling costs? _____			
(c) Experimental research and de-velopment costs? _____			
(d) Designing and engineering project costs? _____			
(e) Costs of reworking vendor's ma-terial? _____			
(f) Costs of reworking defective work in process? _____			
(g) Major plant repairs, rearrange-ments, or installation of new equipment? _____			
13. Where work orders are not used, explain in work papers how such costs are recorded and charged to contracts _____	NA	NA	
14. If overhead is added to direct costs on work orders, is such charge equitable and offset by credit to overhead pool? _____			
15. Are work order costs distributed:			
(a) Monthly? _____			
(b) Other? (Specify) _____			
16. Will the method of accruing costs and writing off deferred charges result in a reasonably correct application of cost to the contract period? _____			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
17. Do accounting procedures provide for segregation of normal expense accruals from accruals for contingencies?			
18. Are journal vouchers or equivalent records:			
(a) approved by an authorized official?			
(b) supported by adequate substantiating data?			
(c) complete with adequate explanation?			
19. Is any portion of the records maintained at other locations so as to make assist audits necessary?			
20. If it is anticipated that future costs must be estimated (new contract negotiations, price redeterminations, conversion of cost-type to fixed-price contracts), are accounting and production data reliable and sufficient to provide reasonably dependable cost projections for:			
(a) material costs?			
(b) labor costs?			
(c) indirect costs?			
(d) other contract costs?			
21. Are internal audits performed by designated employees?			
22. Do such employees function independently of personnel responsible for accounting and finance?			

Part C—Purchasing Procedures

Purchases generally should be made on the basis of competitive bids wherever the size or nature thereof warrants such procedure. Purchase procedures should permit but not require purchases to be negotiated without competitive bids in such instances as the following: emergencies; when small amounts are involved; when the item needed is non-competitive; personal and professional services; perishable subsistence supplies; experimental, developmental and research work; when the character, ingredients or components of the supplies or services are such that public disclosure should be avoided.

Purchase orders should be definite as to specifications and quantities of material, descriptions of services, Government contract number, price, discounts, tax exemptions, transportation terms, f.o.b. points, delivery schedules, basis of purchase (oral bid, written bid, catalog price, or other), and terms of payment. Where trade practice permits variation between quantity ordered and quantity shipped, the purchase order should specify the variation permitted. Transportation matters involved should be considered by personnel best qualified to determine the most economical means in the circumstances.

Purchase orders should instruct vendors to indicate the purchase order

number on all shipping documents, invoices and correspondence relating thereto.

When a purchase is made on a cost basis the agreement should state the basis for cost determination, and provide that the vendor will maintain adequate cost records which will be available for audit by contractor and/or Government auditors.

Procedures should be in effect to avoid purchases, under Government contracts, in contravention of statutes and regulations forbidding the use of the cost-plus-a-percentage-of-cost system of contracting.

Agreements covering "hourly rate" purchases or "time and material" purchases should state: the hourly rates; the categories of employees to which such rates are applicable; the basis for determining the allowability of charges for materials, travel, tooling (if separately reimbursable), overtime work and other services; conditions governing subcontracting; and over-all price limitations. They should provide for maintenance of adequate records which will be available for audit by contractor and/or Government auditors.

The terms "materials" and "supplies" as used in parts C, D, E, F, G, H, and I are intended to include, where appropriate, direct and indirect materials and supplies, small tools, work in process, and finished goods.

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are purchasing functions segregated from plant and accounting operations?.....			
2. Is there effective coordination between engineering, material control and purchasing departments with respect to contract material requirements, purchase requisitions, engineering changes and stop orders?			
3. Are purchase orders prenumbered and accounted for by numbers?.....			
4. Are requisitions for purchases, change and stop orders authorized by an official independent of the purchasing department?.....			
5. Are purchase orders properly prepared and signed by an authorized person?.....			
6. Are purchase orders to result in direct charges to Government contracts readily identifiable?			
7. Are changes in purchase orders accomplished through the use of change orders which justify the change?.....			
8. Are purchase orders reviewed for correctness of specifications and terms?.....			
9. Does contractor follow a prescribed policy in requesting competitive bids?.....			
10. When purchase orders provide for billing on a "cost" or "hourly rate" basis, does purchase order include provision for:			
(a) basis of cost determination?.....			
(b) audit of invoiced costs?.....			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
11. Are safeguards in effect to prevent purchase of excessive quantities?.....			
12. Does contractor prohibit use of cost-plus-a-percentage-of-cost purchase orders on Government contracts?.....			
13. Does contractor formalize all change and stop order instructions to vendors?.....			
14. Is the process of purchasing for employees segregated from the regular purchasing mechanism?.....			
15. What are the bases of pricing inter-company material transactions and those with subsidiaries and affiliates?.....			

Part D—Material Receiving and Inspection

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are the receiving department operations physically segregated from other operations?.....			
2. Are receiving points established and is all incoming material required to clear such points?.....			
3. Is the receiving department advised of purchases as commitments are made?.....			
4. Are receiving reports serially numbered and accounted for?.....			
5. Are receiving reports prepared for all materials received?.....			
6. Are receiving reports signed to evidence receipt of material?.....			
7. Are copies of receiving reports forwarded to accounting department?.....			
8. Does contractor verify by count or by weight the material quantities received?.....			
9. If not weighed or counted, does contractor's method of verification protect the interest of the Government?.....			
10. Is quality inspection adequate to protect the interests of the Government?.....			
11. Is quality inspection evidenced by inspection reports or notations on the receiving report?.....			
12. Are procedures established for the physical and accounting control of:			
(a) defective or damaged materials received?.....			
(b) materials received but not ordered?.....			
(c) substituted materials received?.....			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
13. Are claims against carriers for material lost or damaged in transit filed promptly?			
14. Are rejected purchases returned to vendors through the shipping department?			
15. Do the procedures followed by the contractor assure a minimum delay in handling and recording materials received, return of rejected materials, reporting of shortages and forwarding of documents to the accounting department?			

Part E—Material Handling, Storage and Control

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Is responsibility for protection and custody of all materials definitely placed?			
2. Are contractor materials segregated from Government-owned material:			
(a) physically?			
(b) in the records?			
3. Are material transfers to stock rooms verified as to quantities when received by stock room personnel?			
4. Are materials delivered by the receiving department to storerooms or other controlled areas rather than to production locations?			
5. Are materials stored so as to guard against deterioration?			
6. Are materials stored in a systematic manner?			
7. Do adequate physical safeguards exist to prevent the unauthorized removal of material?			
8. Are adequate stock or perpetual inventory records maintained?			
9. Are stock or perpetual inventory records maintained independent of stock room personnel?			
10. Are slow moving, obsolete and over stocked items periodically reported for consideration of a contractor executive?			
11. Is prompt action taken thereon?			

Part F—Material Withdrawals

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are material withdrawals made only by use of authorized requisition?			
2. Are requisition forms prenumbered?			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
3. Do requisitions provide for accounting distribution of cost?.....			
4. Are requisitions priced on a basis which will yield equitable results?.....			
5. Are requisition forms, used to withdraw Government-owned materials, of a different color or otherwise readily identifiable?.....			
6. Are receipts taken for materials withdrawn from stock?.....			
7. Are unused materials returned to stock room for credit?.....			
8. Is the issuance of small tools controlled through a charge-out system?.....			

Part G—Physical Inventories

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are materials, supplies, small tools, work in process, and finished goods physically inventoried at least annually?.....			
2. Are written instructions in effect for taking of physical inventories?.....			
3. Are physical inventories taken under direction of the Comptroller or other independent person?.....			
4. Are inventory "cut-off" procedures for shipping, receiving and stores departments clearly defined and followed?.....			
5. Are physical inventory counts checked by independent personnel?.....			
6. Are "in transit" and consigned materials verified?.....			
7. Are inventories consistently priced through a method which is in accord with generally accepted accounting principles?.....			
8. Are all transportation costs uniformly charged:			
(a) as a material cost?.....			
(b) as an item of overhead?.....			
9. Is the accuracy of physical inventory recapitulation verified:			
(a) as to quantities with inventory sheets or tags?.....			
(b) as to unit conversion?.....			
(c) as to prices?.....			
(d) as to extensions, sheet totals and summary totals?.....			
(e) for material withdrawal or movement during the taking of physical inventory?.....			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
10. Are differences between physical inventory count and perpetual inventory balances investigated?			
11. Are perpetual inventory records adjusted to physical count?			
12. Do the inventory control accounts reflect the amounts of physical inventory adjustments?			
13. Is the approval of a responsible executive required on all adjustments made to inventory records as a result of physical inventory taking?			
14. Does the contractor take physical inventory of materials and work in process:			
(a) at the point of price redetermination in contracts containing price redetermination provisions?			
(b) at the completion of cost-type contracts?			
(c) at the completion of contracts in which Government furnished material was used?			
15. If physical inventories are not taken at the completion of cost-type contracts, are records which are adequate to enable the contractor to make an accurate presentation of the cost of production maintained?			
16. If physical inventories are not taken at price redetermination points, are records maintained which are adequate to enable the contractor to make:			
(a) an accurate presentation of the cost of production to that point?			
(b) a reliable projection of costs to complete the contract?			

Part H—Materials Controls

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are material transactions controlled through controlling accounts and perpetual inventory or stock records?			
2. Are materials shipped or received on consignment for sale or processing properly controlled?			
3. Are returnable containers physically inventoried and reconciled with control account periodically? (Such items should not be charged to contract costs.)			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
4. Are expensed supplies subject to reasonable physical controls?.....			
5. Are costs of expensed supplies reviewed periodically?			

Part I—Surplus, Obsolete and Scrap Material

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Does the transfer of surplus and obsolete material from production or stores require authorization or approval by engineering and production officials?.....			
2. Does the period of retention before final disposal of surplus and obsolete material require authorization or approval by engineering and production officials?.....			
3. Has the time lapse between engineering or production change notices and action taken to cancel unfilled purchase orders (which otherwise may result in additional unrequired material shipments or increase in amount claimed in settlement of cancelled invoices) been held to a minimum?.....			
4. Is scrap including spoilage generated through production and other operations a significant element of cost?.....			
5. Does contractor control scrap movement through independent persons such as a scrap or salvage department?.....			
6. Are scrap materials sorted according to basic content and market valuations?.....			
7. Are scrap shipments by truck properly controlled by means of gate pass or other safeguards?			
8. Is a control of weight of scrap generated and disposed of maintained?.....			
9. Are sales of surplus, obsolete, and scrap material based upon competitive bids?.....			
10. Are proceeds of such sales reflected on the books of account as credits to manufacturing costs?.....			
11. Are applicable credits prorated directly to Government contract cost accounts?.....			
12. Are records of production spoilage for purposes of control (including credits to inventory accounts) and corrective actions maintained?			

Part J—Processing Vendor's Invoices

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are all invoices received by the accounting department direct from the mail room?			
2. Are vendor's invoices compared with copies of purchase orders, and receiving and inspection reports?			
3. Are vendor's invoices for partial shipments noted on purchase orders (or otherwise) to prevent duplicate payment?			
4. Are invoice computations and account distribution verified?			
5. Are transportation bills audited against purchase order, material invoice, and applicable tariff?			
6. Are invoices for utility services verified through independent meter readings, records of telephone calls, and other data?			
7. Is each invoice for services, transportation, and utility charges approved by an authorized official?			
8. Are debit memorandums used to charge vendors for shortages, defective material, etc.?			
9. Are discounts, rebates, debit memorandums, or other allowances deducted from vendor's invoices before payment?			
10. Are cost accounts credited with all charge backs and allowances made by vendors?			
11. Are vendor's monthly statements of account reconciled with the account payable records?			
12. Are subcontracts requiring audit by the contractor or the Government audited prior to final payment?			
13. Are original invoices only used for payment or to support payment vouchers?			
14. Is voucher given a final review before signing of check in payment?			
15. Are voucher and invoice mutilated to prevent duplicate payment?			
16. Are checks mailed without being returned to the accounts payable department?			

Part K—Personnel Records and Procedures

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Is action involving the hiring, dismissal or change in pay rate reviewed by personnel department or independent personnel?			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
2. Are adequate personnel records maintained in a personnel department or by other persons independent of the payroll preparation functions?			
3. Does personnel department formally notify payroll department of personnel actions and pay rates?			
4. Is written approval required for vacations, sickness, and other absences during regular working hours?			
5. Are controls maintained as a protection against overpayment for employee absences in excess of established labor policies?			

Part L—Timekeeping

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Do timekeeping department employees control basic time records, clock cards, labor tickets, piece work and other incentive type records?			
2. Is the basic work record of the employee approved by his supervisor or timekeeper?			
3. Do timekeepers make adequate floor checks and verify time and piece work records?			
4. Does overtime work require executive approval?			
5. Is attendance of salaried employees adequately controlled?			

Part M—Payroll Preparation

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Is the payroll prepared by personnel independent of timekeepers and persons detailed to deliver pay checks or cash to employees?			
2. Are starting pay rates and pay changes independently authorized?			
3. Is the accuracy of payroll computations independently verified?			
4. Are payroll totals cross checked or reconciled with cost or other department labor summaries for control purposes?			
5. Where piece work rates or other incentive plans are used, are quantity and quality of production reconciled to labor costs?			
6. Are payrolls approved by an authorized person?			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
7. Is the payroll forwarded to paymaster for preparation of pay checks or pay envelopes? _____			
8. Are all payroll deductions, not required by statute, evidenced by an authorization signed by the employee? _____			
9. Is a copy of payroll control sheets or summaries showing total of dollars and hours by departments sent to cost accounting departments? _____			

Part N—Payroll Payment

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Is the distribution of pay checks or cash made by independent personnel not connected with timekeeping, payroll preparation or shop supervision? _____			
2. Is employee required to be identified before receiving pay? _____			
3. Where payment is made in cash, are receipts obtained? _____			
4. Are unclaimed pay checks or pay envelopes delivered to the custody of an authorized independent official? _____			
5. Are payroll corrections, interim and special payrolls processed in the same manner as the regular roll? _____			

Part O—Indirect Cost Practices

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are costs unallowable under terms of contract or Government regulations segregated on the records from costs to be apportioned to Government contracts? _____			
2. Where overhead items are claimed as a direct cost of the contract, are other costs of the same nature excluded from the overhead pool for allocation to Government contracts? _____			
3. Are adjustments resulting from physical inventories of small tools, supplies, and indirect materials entered in the cost records? _____			
4. Are acceptable bases established for apportionment of indirect expenses? _____			
5. Is a comparison made of monthly totals of each overhead account with previous monthly totals to determine unusual increases or decreases, and reasons therefor? _____			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
6. Are year end overhead statements prepared in support of final (annual) overhead settlement claim? _____			
7. Are year end adjustments normally of such a nature and amounts as <i>not</i> to distort cost of Government contract? _____			
8. Are significant adjustments of prior period's transactions apportioned between Government and commercial work in the ratio existing at the time of the original transaction? _____			
9. Are incomes (arising from indirect costs) and other credits considered before the allocation of indirect costs? _____			
10. Are travel advances, per diem allowances or actual travel expenses adequately controlled? _____			

Part P—Fixed Assets and Charges for Depreciation

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are fixed asset acquisitions and retirements subject to executive approval? _____			
2. Are policies for distinguishing between charges to fixed assets and to repair and maintenance accounts established, clearly defined, and consistently followed? _____			
3. Are collateral costs of fixed asset acquisitions capitalized: (a) transportation? _____ (b) installations? _____ (c) initial testing? _____			
4. Is plant or any significant part thereof occupied under leasehold agreements? _____			
5. Are additions to fixed assets recorded through work orders or job orders? _____			
6. Are detailed plant and equipment records maintained, and controlled through general ledger control accounts? _____			
7. Are such detailed records balanced periodically with control accounts? _____			
8. Is the physical existence of equipment periodically verified by comparison with detailed records? _____			
9. Are sales, physical retirements and abandonments of fixed assets reported in a routine manner which provides assurance that they will be treated properly in the accounts? _____			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
10. Is control over physical assets for which no further use is anticipated maintained to assure the reporting of and accounting for sales or other disposition (including parts and scrap)?			
11. If contractor's employees are used to construct or install (after purchase) fixed assets, are expenditures for such work subjected to the same internal control and safeguards as those used in controlling operating expenditures for labor, material, services, etc.?			
12. Is a satisfactory system in effect to properly safeguard:			
(a) small tools chargeable to Government contracts?			
(b) moveable equipment?			
13. Does the contractor have idle or excess plant or equipment?			
14. Are maintenance, depreciation, or other expenses incidental to excess facilities controlled or separable from similar expenses applicable to facilities in use?			
15. Are any fixed assets covered by Certificates of Necessity?			
16. Are fixed assets fully depreciated or fully amortized but still in use carried in fixed-asset accounts?			
17. Are fully depreciated or fully amortized fixed assets so identified in the plant, accounting or other records?			
18. Are depreciation rates reasonable and computed in accordance with a definite and consistent policy?			
19. For purposes of computing depreciation, does the contractor use:			
(a) composite rates?			
(b) individual unit rates?			
(c) other? (Specify)			
20. Are the depreciation rates used for cost purposes:			
(a) the same as the rates used for Federal income tax purposes?			
(b) equal to or lower than the rates indicated by the Bureau of Internal Revenue in Bulletin F?			
21. Does equipment depreciation include accelerated depreciation caused by abnormal activity?			

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
22. Are depreciation charges computed by applying the established rate to:			
(a) the cost (less estimated residual value) of the asset?.....			
(b) cost less depreciation (declining balance method)?.....			
(c) other? (specify).....			
23. Are depreciation charges discontinued when an asset or group of assets becomes fully depreciated?.....			
24. Does the contractor follow a uniform policy in the commencement of depreciation provisions for fixed-asset acquisitions and the cessation of provisions for those disposed of?.....			
25. Are Government-owned facilities used?.....			

Part Q—Petty Cash

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Is the imprest system in use?.....			
2. Is responsibility for each fund placed with one custodian?.....			
3. Are petty cash receipt forms used?.....			
4. Are restrictions placed on types of petty cash disbursements?.....			
5. When the fund is reimbursed, are petty cash receipts marked to avoid reuse by the custodian?.....			
6. Are proper safeguards used in cashing of accommodation checks?.....			

Control of Sales, Accounts Receivable and Cash Receipts and Disbursements.

In the preceding pages of this guide, the questions presented are primarily for purposes of evaluation of contractor's internal controls and accounting procedures in connection with the acquisition and usage of materials, supplies, services, and direct and indirect labor (hourly and salary payrolls). The items enumerated generally cover the manufacturing and administrative processes necessary for production of an end product and for determination of the cost of that product, verification of which is the primary purpose of audits of military department contracts. However, the evaluation of internal controls and accounting practices followed in making and recording sales, collection of the sales price, deposit of collections, issuance of disbursement checks, reconciling bank accounts and in other financial procedures, all of which are a part of the cycle of business operations, is also a necessary adjunct to the over-all evaluation of a contractor's procedures.

The auditor should determine the extent of the survey which appears warranted by their pertinence to contract costs in each instance. As these items usually receive close attention of independent auditors, the survey auditor may find, after a review of the independent auditor's report, that the scope of his survey of these items can be significantly reduced. Regardless of the scope of the survey, the auditor must assure himself that:

- (1) records pertaining to cash receipts and receivables reflect miscellaneous incomes creditable to contract costs,
- (2) that liabilities arising from contract performance are paid or, if unpaid at completion or termination, are deducted from subsequent billings or the final payment, and
- (3) that the contractor's billing procedures include such controls, records, and procedures as are necessary to substantiate amounts billed to the Government.

Part R—Sales

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are customers' orders subjected to review and approval before acceptance:			
(a) by sales or order department?.....			
(b) by credit department?.....			
2. Are shipping advices prenumbered?.....			
3. Are invoices checked for accuracy of:			
(a) quantities billed?.....			
(b) prices used?.....			
(c) extensions?			
(d) terms?			
4. Are they compared with the customers' orders?			
5. Are returned items cleared through receiving department?.....			
6. Are invoices summarized and classified by persons independent of the accounting department in a manner to provide a check on recorded sales?.....			
7. Are the following classes of sales cleared and recorded in the same manner as sales to customers:			
(a) sales to employees?.....			
(b) scrap and waste sales?.....			
(c) sales of equipment?.....			
8. Can units of sales be correlated with purchases or production and inventories?.....			
9. Is there an adequate check on freight allowances?			

Part S—Accounts Receivable

	Yes	No	W/P Ref
1. Are accounts independently confirmed by contractor's personnel with customers?			
2. Are the accounts aged periodically for review?			
3. Are disputed items handled by someone other than accounts receivable bookkeepers or cashiers?			
4. Are write-offs of bad debts and adjustments credits made only when approved by a responsible official?			
5. Are credit memoranda approved by proper authority?			
6. Are they under numerical control?			
7. Is credit department approval a prerequisite to payment of customer credit balances?			
8. Are monthly statements sent to <i>all</i> customers?			
9. Are statements independently checked to accounts and kept under control to insure their being mailed by someone other than the accounts receivable bookkeeper?			
10. Are customer accounts regularly balanced with the control account?			
11. Are delinquent accounts periodically reviewed by a responsible official?			
12. Are the duties of the accounts receivable bookkeeper separate from any cash functions?			
13. If there is more than one accounts receivable bookkeeper are the account sections for which they are responsible changed from time to time?			
14. Are cash postings made simultaneously with the posting of the cash receipts records by means of a machine bookkeeping device?			
15. Do allowances for discounts other than regular terms of sale require specific authorization by a responsible official?			
16. Is the collection department independent of and does it constitute a check on accounts receivable bookkeepers?			
17. Is the management of the credit department completely divorced from the sales department?			
18. Is proper control exercised over bad debts after they have been written off?			

Part T—Cash Receipts

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. If cash registers, counter sales slips, collector's receipts, etc., function as proofs of cash receipts, are such proofs checked by an employee independent of the person receiving the cash, to determine that the proofs agree with the amounts recorded and deposited?			
2. Is the mail opened by an employee independent of persons directly responsible for preparing the bank deposits and for posting accounts receivable?			
3. Is a detailed record of receipts prepared by the employee opening the mail and is this record given to someone other than the employee directly responsible for preparing the bank deposits and for posting accounts receivable to verify amounts recorded and deposited?			
4. Are each day's receipts deposited intact and without delay?			
5. Does someone other than the employee who prepares the bank deposit make the bank deposit?			
6. If so, is that person excluded from access to customer's ledgers and customer's statements?			
7. Is a duplicate deposit ticket, after authentication by the bank, received by an employee independent of the persons preparing and making the bank deposits?			
8. Are such authenticated deposit tickets compared with: (a) record of incoming remittances?			
(b) the cash book?			
9. Are deposits or collection items subsequently charged back by bank (because of insufficient funds, etc.) delivered directly to an employee other than the person directly responsible for preparing the deposit?			
10. Are negotiable assets, other than currency, checks or drafts, held in custody of an employee independent of persons directly responsible for cash receipts and for the maintenance of records relating to negotiable assets?			

Part U—Cash Disbursements

	<i>Yes</i>	<i>No</i>	<i>W/P Ref</i>
1. Are checks prenumbered?.....			
2. Are voided checks kept and filed?.....			
3. Is a check protector used?.....			
4. Is a check register prepared simultaneously with the preparation of the check by mechanical device?.....			
5. Is the signing of checks limited to employees whose duties exclude:			
(a) posting accounting records?.....			
(b) recording cash receipts?.....			
(c) handling petty cash funds?.....			
(d) approving vouchers for payment?.....			
(e) payroll preparation?.....			
6. Do supporting data accompany checks when submitted for signature and/or countersignature?.....			
7. Is the signing or countersigning of checks in advance prohibited?.....			
8. Is the practice of drawing checks to "cash" prohibited?.....			
9. Are transfers from one bank to another under accounting control?.....			
10. Are bank reconciliations made by someone who had nothing to do with the disbursement and payroll procedures, including the signing of checks?.....			
11. Does the employee responsible for bank reconciliations obtain the bank statements, or receive the unopened envelopes containing the bank statements, directly from the bank?.....			
12. Is the practice of examining paid checks for date, payee's name, cancellations, signatures, and endorsements, and of accounting for sequence of check numbers, followed in reconciling bank accounts?.....			
13. Where a mechanical check signer is used, is the signature die under adequate control?.....			
14. Is there adequate procedure to avoid duplicate payment of old outstanding checks which have been written off or transferred to a separate liability account?.....			

Part V—Cafeterias, Commissaries, Dormitories and Canteens.

Generally, the internal control standards applicable to the major purpose of the enterprise are equally applicable to cafeterias, commissaries, dormitories, and canteens. However, because of the different nature of their operation and the frequent lack of internal control of such operations,

special comment seems justified. Where these operations are encountered, a separate survey guide which incorporates applicable questions presented in parts B through U and which reflects the statements included in this part should be prepared.

1. Purchases, Invoices, and Payrolls.

- (a) Inasmuch as the purchase of many items, such as food and other perishable items used currently, requires immediate decision each day, the preparation of purchase orders in advance is often not practicable. Such purchases should, however, be systematically reviewed and checked by independent persons.
- (b) If receiving reports are not prepared for cafeteria purchases, the vendor's shipping list should be checked and approved by an independent person and the invoices approved for receipt and price by a responsible person.
- (c) Purchases or expenditures of all kinds handled on a cash basis should be made from imprest funds and currently reimbursed according to regular procedures.

2. Control of Inventories.

- (a) All material and supplies should be stored under lock and key in the custody of a responsible person.
- (b) Food and supplies should be drawn from stores only by requisition approved by an authorized person. Receipt of material issued should be evidenced by the signature of the person to whom it was delivered.
- (c) Physical inventories of food should be taken as often as necessary to permit regular periodic determinations of food costs and operating results.

3. Cash Receipts and Control of Revenue.

- (a) Cash receipts should be safeguarded to the greatest practicable extent through the use of cash registers, sales slips, inventory controls, and the separation of employees responsibilities.
- (b) All gross receipts should be deposited each day intact in a bank account which has been separately established for these operations.
- (c) Revenue should be classified by source and type of sale.
- (d) Statistical controls such as number of meals served, average sale and operating ratios should be utilized to the maximum extent practicable to assist in the control of current operations.
- (e) Where dormitories or similar facilities are operated, records should be prepared by independent persons covering occupancy and availability of rentable rooms, and these records should be checked to guest account charge records and to revenue collection records to provide assurance that all revenue is being properly collected and credited.
- (f) Provision should be made for the independent checking of commissions receivable from the operation of vending machines by having independent persons present when the machines are opened to check the receipts.
- (g) Where a concessionaire's contract provides for price adjustments, provisions should also be made for the independent checking, at reasonable intervals, of profits and commissions

realized from operation of plant cafeterias or restaurants to ascertain whether the income derived is in excess of the amount stipulated in the agreement.

4. Operating Statements.

Profit and loss and other operating statements relating to cafeterias, commissaries, dormitories, and canteens should be prepared at regular monthly (or more frequent) intervals.

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CHAPTER IV

AUDIT PROCEDURES

4-0.000 Scope of Chapter. This Chapter sets forth procedures to be followed by the auditor in the audit of contract costs and other financial representations of contractors incident to procurement contracts of the military departments. Included are basic auditing procedures generally applicable to all such contracts subject to audit, additional auditing procedures applicable solely to specific types of contracts, and other auditing procedures applicable to certain miscellaneous audit assignments arising from contractual obligations or relationships.

The audit procedures set forth in this Chapter are necessarily comprehensive because of the varied situations which may be encountered. Auditors will select and apply those which are applicable to the particular audit, and will add others where appropriate.

Section 1—Procedures Having General Applicability

4-1.000 Scope of Section. This Section presents basic information and suggested procedures for the guidance of the auditor in the approach to audits of contractors' costs or other financial representations. The suggested basic procedures apply to almost all types of audits for the military departments, but modification thereof may be necessary in particular circumstances. Additional procedures that are peculiar to certain types of procurement contracts or other auditing assignments that normally may be encountered are set forth in the succeeding Sections of this Chapter.

Part I—Planning the Audit

4-1.100 Scope of Part. This Part sets forth basic information with respect to planning the audit through preparation of an audit program and planning of the auditing work to be performed.

4-1.101 Source of Contracts. Contracts and subcontracts (and amendments thereto) which require audit of the contractors' records ordinarily will be forwarded to the auditor via the cognizant district director. Such contracts and amendments normally will be accompanied by DD Forms 198¹ and/or 199.² Contracts or subcontracts received from other sources will be referred to the cognizant district director for review and audit assignment.

4-1.102 Survey of Internal Controls and Accounting Practices. The auditor's survey of the contractor's internal controls and accounting practices (Ch. III) provides the basic information needed in planning the audit and is an inseparable part of the audit effort. As the major purpose of the survey is to determine the extent to which reliance may be placed on the contractor's internal controls and accounting practices, the auditor should be continuously planning the nature and scope of audit while making the survey. Where the survey was made other than as a part of the audit assignment presently being

¹ "Contract and Subcontract Transmittal and Control Record—Basic Contract or Subcontract."

² "Contract and Subcontract Transmittal and Control Record (Contract and Subcontract Changes)."

undertaken, the completed survey guide, related working papers, and working papers and audit reports of prior audits must be reviewed prior to beginning the audit.

4-1.103 Audit Program.

(a) The auditor will prepare a written program covering the various steps which he proposes to follow in the conduct of the audit. Such program will indicate the extent to which test checks of recorded transactions will be made. Preparation and reproduction by district directors of suggested standard audit programs for repetitive types of audits are authorized. Such standard audit programs must be adapted to the needs of the particular audit assignment. Auditors must be alert to the dangers inherent in undue reliance upon standard audit programs.

(b) The audit program will be maintained as a permanent working paper file record of the audit as originally prepared by the auditor and will reflect any modifications in the program as were found necessary during the course of the audit assignment. The reasons for such modifications should be briefly noted in the program, and cross-referenced to the source indicating the necessity for the change. Additional items to be included in the program are—

- (1) Names of personnel accomplishing each phase of the program;
- (2) Date on which each phase was completed;
- (3) Signature of the auditor on each page as it is completed; and
- (4) Cross-references to supporting working papers.

Except in those instances where the relative size of the contract or the nature of the audit assignment clearly indicates that a written program is not necessary, failure to prepare and currently maintain an audit program will not be condoned.

4-1.104 Review of Contract and Audit Instructions. A study of the contract and audit assignment instructions (DD Forms 198 and 199) will be made and a brief of provisions therein which relate to cost determination, predetermined rates or amounts, required approvals, and any other subjects requiring audit action will be prepared and included in the audit working paper file.

4-1.105 Review of Certain Contractor's Records. A review of the contractor's records named in this paragraph should be made while preparing the audit program. This review may provide the auditor with information which will indicate a need for the performance of additional audit steps and also will provide valuable background material. The records are—

(a) Minutes of meetings of shareholders, directors, and policy committees so far as they may affect contract performance and costs.

(b) Current Federal income tax returns, noting any significant differences between the returns and the contractor's accounts and financial statements.

(c) Published and internal financial statements, especially with respect to the financial ability of the contractor to carry out his obligations under the contract.

(d) Audit reports and working papers of the contractor's public accountants and internal auditors.

Nothing in this paragraph should be construed as limiting the auditor's review of the records indicated above to the audit planning phase. These records

should be reviewed periodically during contract performance so that the audit program is kept up to date.

4-1.106 Coordination with Contractor's Internal Audit Staff.

(a) Internal audits comprise an element of internal control. The nature and scope of the contractor's internal audit activity will have been determined as part of the survey of internal controls and accounting practices (Ch. III). Maximum reliance, consistent with the nature and scope of the contractor's internal audits, will be placed upon such activity in an effort to reduce the detailed audit work to be performed by the military department auditor.

(b) In circumstances presented in (c) below and where audit residencies exist, the contractor's internal audit staff and that of the military department auditor may join in a common audit effort. Separate phases of the audit program will be assigned to and undertaken by each staff. The separate phases must be rotated every few months so that all phases of the audit program will be accomplished by the resident auditor's staff. When in the opinion of the military department auditor such coordination of audit effort appears warranted, he will consult with the district director. If the latter approves, the auditor will prepare a program for the audit in conjunction with the contractor's internal auditor.

(c) Each of the following conditions must exist before a joint program will be recommended:

- (1) The contractor's internal audit staff must be composed of professionally qualified auditors.
- (2) The internal audit staff must be organizationally independent, have no day-to-day operating responsibilities, and must be administratively responsible to the comptroller or a higher executive.
- (3) Audits made by the contractor's internal audit staff must be comprehensive, directed toward the functional or departmental internal control procedures and flow of the resulting accounting work, rather than being restricted to routine voucher examination.
- (4) The internal auditors must agree to the audit program, participate actively in its preparation, and make their working papers available to the military department auditor for the latter's continuing review. The military department auditor will make reference thereto in his working papers and, where considered necessary because of the significance of the material, he will prepare pertinent extracts thereof for his working paper files.
- (5) The military department auditor will make a continuing review of the working papers prepared by the contractor's internal audit staff to assure himself that the latter's audit effort is of an acceptable nature. If he determines that such effort is inadequate in any respect, he will discuss the circumstances with the contractor's internal auditor. If corrective measures are not taken promptly, he will extend the scope of audit by his staff until the unsatisfactory condition is remedied.
- (6) Responsibility for determinations regarding the admissibility of costs remains with the military department auditor.

4-1.107 Cooperation With Contractor's Independent Public Accountants.

(a) Usually, audits by the contractor's independent public accountants will be directed toward the verification of the contractor's representations made on his financial statements. For this reason, the major audit effort of public accountants usually results in the verification of balance sheet items coupled with a review of income and expense items for the period subject to audit. The major purpose of audits by military department auditors is the verification of product or contract costs. Therefore, major attention is devoted to cost records rather than to balance sheet items.

(b) Because of the factors in the preceding paragraph and others, audits by the contractor's independent public accountants may not be substituted in their entirety for those of the military department auditor. However, both groups of auditors utilize common procedures and techniques. Duplication of audit effort may be avoided where the contractor's independent public accountants have, in the course of their audit, verified certain contractor accounts, cost elements, or procedures which are subject to the review of the military department auditor. The latter should consider a reduction in the scope of his audit of the particular accounts, cost elements, or procedures, in reliance upon the results of audit by the independent public accountants to the extent appropriate in the circumstance. Illustrations of areas in which the audit results may be useful include inventory verification (both book and physical), depreciation analyses, internal control reviews, and accounting system surveys. Also, see the introductory comment to Section 3 (Part R), Chapter III.

(c) The military department auditor continues to be responsible for his findings and recommendations notwithstanding his reliance on any other audit, internal or public. The fact that certain areas of mutual interest have been audited by the contractor's independent public accountants does not in itself permit the military department auditor to lessen the scope of his audit of the contractor's records in those areas. An evaluation of the audit work performed by the independent public accountants must be accomplished as a necessary prerequisite to the possible reduction in scope of the military department audit through reliance on the audit by the contractor's independent public accountants. Such evaluation may result from discussions with the contractor's independent accountants, reviews of their working papers, and reports, or both. Memorandums of such discussions will be prepared and included in the military department auditor's working papers. Where the public accountant's working papers are reviewed, reference thereto will be made in the military department auditor's working papers and, where considered necessary because of the significance of the material, the military department auditor will prepare pertinent extracts thereof for his working paper files. Copies of audit reports should be obtained if readily available.

(d) The rules of professional conduct of the public accounting profession establish a confidential relationship between the independent public accountant and his client. Also, there is no contractual relationship between the independent public accountant and the military department. Therefore, before there may be profitable discussions between the auditors or before access to the public accountant's working papers may be granted, the contractor must request his independent public accountants to cooperate fully with the military

department auditors. It must be recognized by all three parties that the cooperation benefits the contractor as well as the military department and the public accountants.

(e) Should the contractor so request, it is permissible for the military department auditor to discuss with the contractor's independent public accountants in advance of the public accountants' audit, the scope of their examination. The discussion may be only for the purpose of learning the planned scope of the public accountants' audit in an effort to determine to what extent, if any, certain audit steps of the military department auditor may be modified in light of the public accountants' audit program and subsequent determination of the reliability of the results of audit. The scope of the discussion may be broadened so as to include suggestions by the military department auditor regarding extensions of auditing procedures by the public accountants so as to make it possible for the military department auditor to make greater use of the public accountants' audit. Should an advance understanding be reached, the provisions of the preceding subparagraphs of this paragraph will apply.

Part II—Working Papers

4-1.200 Scope of Part. This Part contains general instructions with respect to the preparation and scope of audit working papers.

4-1.201 Purpose and Importance of Working Papers. Working papers are prepared for the following purposes:

- (a) To be permanent record of audit work done;
- (b) To provide the basic information from which an audit report is prepared;
- (c) To provide a basis for the review by supervisory personnel of audit work done; and
- (d) To be utilized by audit personnel when participating as an advisor in subsequent contract negotiations.

These purposes indicate the importance of the preparation of adequate, clear, concise working papers. The auditor should recognize that his abilities will be judged, in part, by the nature and content of his working papers.

4-1.202 Standards of Preparation. As indicated in paragraph 3-2.007, the auditor should keep the following standards in mind when preparing working papers:

- (a) If it becomes necessary to reassign the auditor during an audit, can his replacement continue the audit without a significant loss of time through a review of the survey of internal controls and accounting practices, the audit program, and the audit working papers; and
- (b) Can a reviewer intelligently evaluate the audit report and the audit work done through a review of the working papers without recourse to numerous discussions with the auditor?

4-1.203 Form of Working Papers. Each analysis and schedule prepared in the course of the audit assignment will be prepared in accordance with the following:

- (a) *Heading.* Each working paper sheet must be headed with the name of the contractor, contract number or appropriate identification, the subject matter, and period covered.

(b) *Indexing.* Each working paper will be indexed to its controlling summary sheet, the working paper trial balance, or the audit program, whichever is appropriate. Index letters and numbers should be placed on each working paper so as to be readily visible even after the working papers have been bound. An index of the contents of working papers, exhibits, documents, or other important items contained in the working papers will be prepared and included in the working paper file prior to the completion of the audit assignment.

(c) *Auditor's Name and Date.* The auditor originally preparing an analysis or schedule, or bringing such working papers to a current status, or verifying a contractor-prepared analysis or schedule will place his name and the date completed on each sheet. Approval by supervisory auditors will be indicated immediately thereunder or on summary schedules where prepared. A list of auditors participating in the assignment will be included in the file.

(d) *Analyses.* Clearness, neatness, and legibility are important with respect to all writing efforts, but take on added importance when figures represent a considerable segment of that effort. Extreme care should be exercised to assure that no misinterpretations of what the auditor intended can be made by others not as familiar with the basic data. Each analysis should be classified logically so that the purpose of the analysis, source of information, extent of audit, auditor's conclusions, and tie-in with related accounts and working papers are readily apparent.

(e) *Legend.* All checks, ticks, and symbols appearing in the working papers should be explained in a legend placed therein.

(f) *Cross-Reference.* In addition to the index symbol required by (b) above, each statement or figure having a direct relationship to other working papers, public vouchers, the audit program, specific contract clauses, or the survey of internal controls and accounting practices should be cross-referenced.

4-1.204 Contents of Analyses and Schedules.

(a) No uniform detailed instructions as to what the auditor should include in his working papers can be prepared. The drawing of the line of demarcation between necessary and unnecessary material to be included in working papers calls for professional judgment and experience. An awareness of the use which may be made of working papers will be helpful in determining their contents. These include—

- (1) The basis for the preparation of the audit report;
- (2) The basis for review by supervisory personnel;
- (3) Providing data to rebut contractor's appeals;
- (4) Evidence in case of litigation; and
- (5) Providing data for clearing General Accounting Office exceptions and inquiries.

(b) In many instances, the value of individual analyses and schedules is questionable when measured against the audit effort involved. The auditor should solicit the assistance of the contractor's accounting employees in the preparation of analyses and schedules, preferably in the form prescribed by the auditor, to the fullest extent practicable. Before commencing lengthy analyses or schedules, the auditor should ascertain whether or not the contractor's accounting department has prepared similar analyses or schedules which may be available to him. After verification or review, as necessary, a summary

thereof may be sufficient for the audit files. In the event a full analysis is required, a photostat may be obtained. The auditor will avoid the mere copying of the data from the contractor's records.

(c) Generally, the analysis of an account should disclose the major items included in the account and the aggregate amount of the items not listed. The extent of audit of the account should be indicated through the use of "tick" marks where feasible, or by a written statement. Check marks, initials, or rubber-stamp impressions should not be placed on the books, records, or documents examined to indicate their examination and the nature of the audit procedure performed. A record thereof should be maintained in the working papers and on Government copies of documents. Similar notations of errors, memorandums for the audit report, pertinent discussions with contractor personnel, and information for use in future audits should be made when appropriate.

4-1.205 Agenda. The auditor will find an agenda or "To Do" sheet helpful in making the audit. It is much easier to jot down items that will require future action than it is to rely on one's memory. Such notations should be made as necessary and crossed off when the item has been cleared or accomplished. The agenda is a temporary device and may be retained in the working paper file or disposed of after all items have been cleared or accomplished. Items which may be placed on the agenda include—

- (a) Differences to be investigated;
- (b) Items to be discussed with contractor personnel;
- (c) Additional audit steps to be performed after preparation of an analysis or schedule;
- (d) Unavailable contractor's records to be examined later;
- (e) Follow-up on partially completed transactions; and
- (f) Items requiring discussion with or approval of the Contracting Officer or technical inspectors.

4-1.206 Binding. As each phase of the audit is completed, the related working papers should be placed in a binder comprising the audit assignment file. The contract number, name of contractor, type of audit, and period covered should be placed on the face of the binder. Information which may be of value on future audit assignments should be incorporated in the permanent file or cross-referenced thereto. The auditor's attention is directed to paragraph 3-2.009 "Permanent File."

Part III—Making Audit

4-1.300 Scope of Part. This Part presents the basic auditing procedures from which the auditor will select those appropriate, in light of the circumstances in a particular case, to the audit of contractor's cost or other financial representations. Whenever an audit of subcontractor's costs under a subcontract is made, the procedures herein prescribed for the audit of costs under prime contracts will be applied.

4-1.301 Extent of Auditing.

- (a) As a general rule, the extent of detailed auditing to be performed is directly related to the adequacy and effectiveness of the contractor's accounting

procedures and internal controls. The auditor's survey of internal controls and accounting practices (Ch. III) will have indicated the extent to which reliance may be placed thereon. Where the internal controls and accounting practices are considered adequate, the major audit effort should consist of the verification of selected transactions. Weaknesses or deficiencies which may be disclosed during the audit of the contract will be discussed with the contractor and corrective action requested. Until corrective action is taken, and is effective, the auditor should perform such additional detailed audit tests as may be desirable in the circumstances. Where the contractor's records are not in condition for audit, the auditor will be guided by the provisions of paragraph 1-0.008.

(b) In determining the extent of audit effort, consideration should be given to the following:

- (1) The terms and amounts of military department contracts and subcontracts to be audited;
- (2) The relationship of such contracts to the total production of the contractor;
- (3) The results of the auditor's survey of the contractor's internal controls and accounting practices;
- (4) Operating arrangements and relationships between several plants of the contractor, and between such plants and those of contractor's subsidiaries and affiliates, where such relationships may affect the contract costs; and
- (5) Experience as to the reliability of the contractor's cost representations under current or completed contracts.

4-1.302 Selection of Transactions for Audit.

(a) The selection of individual transactions for audit requires the use of excellent judgment born of experience. The concept of selective testing cannot be restricted to random sampling. Although limited tests in all areas of cost should be made, the auditor should endeavor to devote the major portion of his audit effort to those transactions which are most likely to be susceptible to error or misclassification. Generally, direct materials and direct labor charges require less audit per dollar of cost than overhead costs. Likewise, certain overhead costs will require greater verification than others. The extent of detailed audit work in each of the several cost areas will be the subject of continuing review and modification by the auditor as experience with the contractor dictates.

(b) The objective of selective testing is to obtain a sufficient cross section to justify reliance on the validity of the group of transactions under audit. Before a representative selection of transactions can be made, the auditor should review the nature of transactions that are directly or indirectly related to the contract. Factors to be considered in given situations will include dollar amount of transactions, points of origin, nature of costs, and departments involved. Once a transaction has been selected for verification, difficulties encountered in the process of verification should not deter the auditor from completing the verification of the transaction selected.

4-1.303 Audit Approach under Ideal Circumstances.

(a) The military department audit agencies have for some time been utilizing selective tests in carrying out their audit responsibilities. The pur-

pose of such testing is to permit the auditor to determine, without a detailed examination of each transaction, the extent to which reliance upon the contractor's representations is justified. However, for the most part, auditors are placing their primary audit effort on the verification of contractors' reimbursement vouchers or cost statements after receipt of such representations.

(b) Under ideal circumstances, and where audit residencies exist, the primary audit emphasis should be placed on a continuing audit of the contractor's accounting practices and internal controls. Such ideal circumstances include, but are not limited to, the following:

- (1) The contractor must have demonstrated the highest degree of integrity in all relationships with the Government.
- (2) The contractor must maintain an acceptable accounting and cost system with adequate internal controls. Contractor's cost proposals and reimbursement vouchers should be readily reconcilable to the contractor's accounts, preferably monthly.
- (3) The contractor must be willing to cooperate actively with the auditor. Such cooperation is a matter of self-interest. It increases the efficiency of the contractor's accounting operations and results in a reduction in detailed audit work.
- (4) The contractor must be receptive to the auditor's recommendations for improvement of the contractor's accounting practices and internal controls, and must demonstrate a willingness to take prompt and effective action relating to such recommendations.
- (5) The contractor must undertake, as a part of the recording process, to segregate into separate accounts costs which are unallowable under the terms of the contract.
- (6) The contractor must be willing to call the auditor's attention to all doubtful items of cost and to discuss such items before presentation as a part of any claim or proposal.
- (7) The contractor must notify the auditor of any changes made in the internal controls or accounting practices prior to placing the changes in effect.
- (8) Selective audit tests made on a continuing basis must verify the reliability of the contractor's records.

(c) Where, in the opinion of the auditor, the ideal conditions outlined above can be substantially achieved, the auditor may approve the contractor's reimbursement vouchers or cost statements after a review thereof, since the reliability of the contractor's representations will have been previously established. A review of all cost representations should be made to determine whether the document is in acceptable form, is mathematically correct, bears required approvals and certifications of authorized persons, and includes no obviously questionable items. Other than the above prescribed review, the contractor's voucher or cost statement should not require additional audit verification unless such review indicates the need for further audit or the cost statements include cost projections which require further analysis and evaluation.

(d) Where conditions are somewhat less than ideal, the audit program may provide for a post audit of a number of selected representative vouchers or items of cost. It also necessarily follows that where the above outlined audit ap-

proach does not yield satisfactory results, the scope of audit must be expanded.

(e) This audit approach should not be inaugurated (or continued) in any case where the audit effort required (or reasonably anticipated) by the military department auditor is greater than would be the case if the contractor's representations were audited after presentation.

4-1.304 Initial Auditing Procedures. The audit procedures set forth in items (a) through (f) below will be accomplished so as to build a framework for the selection of appropriate detailed auditing procedures. As is true with respect to other audit procedures, the degree to which items (a) through (f) below are done is dependent upon the auditor's evaluation of the nature and scope of audit to be performed. Reference is made to paragraph 1-0.002 (4), "Access to Contractor's Plant and Records." See also paragraph 1-0.002 (5).

(a) Prepare whatever working trial balances may be indicated by the nature of the audit assignment. Under certain circumstances, a complete pre-closing trial balance of the general ledger may be required while under other conditions a trial balance of a factory ledger or other subsidiary expense ledgers may suffice.

(b) Identify and prepare comparative analyses by months of account balances considered to have a significant bearing on contract costs.

(c) Identify and prepare to audit miscellaneous incomes and credits to expense accounts to determine which items should be credited direct or through *apportionment to contract costs*.

(d) Review current entries in special reserve and surplus accounts for items that may affect contract costs.

(e) Make arrangements for audit of charges to contracts represented by costs incurred under subcontracts or interplant transactions where plants are not in the same locations, if subcontract costs are significant.

(f) Determine requirements with respect to tax exemption certificates and compliance therewith.

4-1.305 Detailed Auditing Procedures.

(a) Detailed auditing procedures are presented in the subsequent paragraphs of this Part. These procedures are equally applicable to the audit of all types of contractual instruments, and to subcontracts as well as prime contracts. Certain additional audit procedures required in particular situations (e. g., terminations, Government-furnished property) are presented in other Parts of this Chapter and Chapter V. The audit procedures set forth hereinafter are necessarily comprehensive because of the varied situations which may be encountered. Auditors will select and apply those which are applicable to the particular audit and will add others where appropriate.

(b) The auditor should make a definite and continued effort to operate with a minimum of personnel, consistent with efficient and adequate performance of an audit assignment. The auditor should periodically make a critical review of the duties performed by his subordinates from the standpoints of scope and necessity. Thus, if a contractor improves his system of accounting or internal control, the auditor should give consideration to an appropriate revision of the audit program. If Government contracts involving a large volume of audit work are nearing completion, the auditor should consider the advisability of reducing audit personnel.

4-1.306 Physical Verifications. Auditors must recognize that journals, ledgers, account analyses, and summaries represent but secondary evidence of a transaction or group of related transactions. Such secondary evidence can have no greater accuracy than that incorporated into the original record by the person preparing it. Therefore, a reasonable portion of the auditor's time should be devoted to physical inspections of the work centers at which the original records of the transactions are prepared. It is through this approach that conditions causing excessive costs frequently are disclosed. The concept of floor-checking of labor costs should be extended to include direct materials and, where practicable, indirect costs. Illustrative of such inspections are observations during the taking of physical inventories and observations of materials receipt, storage, issuance, and consumption. Further illustrations are observation of physical control and use of scrap, returnable containers, plant facilities, etc.

4-1.307 Audit of Charges for Direct Material. Charges for direct material originate from purchases by the contractor specifically for the contract, and from withdrawals from the contractor's stores. The verification of these charges may be subdivided for purposes of presentation into the areas of quantity, quality, pricing, and clerical accuracy. It is not intended that the process of verification necessarily be so subdivided. All verifications should be made with due regard to the standards set forth in Parts C through J, Section 3, Chapter III.

4-1.308 Direct Materials—Verification of Quantity.

(a) The quantities of materials purchased specifically for and charged to the contract should be verified through a comparison of purchase orders, receiving reports, vendors' invoices, contractor's vouchers, and paid checks. Where appropriate, comparisons with bills of material, purchase requisitions, transportation invoices, and bills of lading should be made. Credit memorandums for returns and allowances should be examined to assure credit to contract costs.

(b) In the case of cost-type contracts, those materials purchased direct for Government contracts become contractor-acquired Government property. The auditor must not only verify that the quantities were purchased and paid for, he also must assure himself that such materials were safeguarded and accounted for as Government property.

(c) The quantities of materials withdrawn from the contractor's stores and charged to the contract should be verified by review of stores requisitions for authenticity of signatures and required approvals. Other means of verification of quantities include reference to Government technical personnel, bills of materials, specifications, and materials checkers.

(d) Physical inspections of facilities for storing and safeguarding materials should be made, especially for contractor-acquired Government property. Materials should be traced both as to physical movement and accounting treatment to the work centers. Tests should be made to assure the auditor that employees having responsibility for the preparation of the original records concerning the acquisition and flow of material into work in process are actually following prescribed procedures.

4-1.309 Direct Materials—Verification of Quality. The acceptability of the quality of materials is determined by inspectors of the contractor and the Government. The auditor should make checks to see that the results of inspections are indicated on inspection reports, receiving documents, vendor's invoices, or stores requisitions in accordance with the established procedures of the particular plant. Where deficiencies which require adjustments with vendors are indicated by such checks, selected items should be followed through to establish that the contractor's procedures in obtaining and recording proper credits are effectual and that such credits are equitably apportioned to Government contracts.

4-1.310 Direct Materials—Verification of Prices.

(a) Prices of direct materials purchased for and charged direct to the contract should be checked with related prices on vendor's invoices and quotations, catalogs, price lists, and purchase orders. The market prices of many commodities, particularly basic raw materials, are quoted in financial newspapers and trade publications. Such published prices should be used only as an indication of reasonableness of prices paid by the contractor. It must be recognized that market fluctuations, quantity discounts, transportation costs, and other factors may cause differences between published prices and those paid by the contractor. Particular attention should be devoted to intercompany transactions and those with subsidiaries and affiliates, especially in regard to duplicate profit charges where not covered by contract provisions providing for transfers at "best price" or such other limitations as standard commercial or "line" products. Where cost-type contracts are involved, arrangements for audit of the costs of the contributing plant should be made. Where fixed-price contracts with price redetermination clauses are involved, the basis of pricing such transactions should be determined to the extent deemed appropriate in the circumstance and presented in the advisory audit report when considered significant.

(b) The prices charged for material requisitioned from the contractor's stores should be traced to the perpetual inventory records, if any. Prices indicated on such records should be traced to vendor's invoices and other supporting data to assure that the inventory records are being maintained on an acceptable cost basis. If perpetual inventory records are not the source of pricing requisitions, the reasonableness of prices charged must be determined through comparison with recent vendor's invoices for like items, catalogs, price lists, trade publications, and supplier's quotations or bids.

(c) Transportation costs on materials purchased direct for the contract or for contractor's stores may be included in the cost of material or handled as an overhead item. The contractor may elect to charge transportation costs on material purchased direct for the contract to contract costs and consider transportation costs on stores items as overhead. The auditor's verification will assure that accounting treatment is proper and that the amount charged direct or through the overhead pool is equitable in the circumstance. Carrier's invoices shall be compared with related purchase orders, vendor's invoices, and contractor's receiving reports covering the material transported.

(d) Some contractors follow the practice of adding a "loading" or "handling" charge to the cost of materials purchased and received. Usually, this

charge is determined by applying a given percentage to the invoice cost of the material. In most instances, this percentage is more or less arbitrarily determined without specific identification of the costs it purports to represent. In these cases, such "loading" charges are not acceptable as costs of performing Government contracts. However, actual costs incurred in purchasing, receiving, storing, and handling are properly included in overhead costs. Should the "loading" charge have been developed on an accurate basis; i. e., through the use of time studies or cost accounting techniques, the costs will be acceptable as contract costs, but in such instances the actual costs represented by the loading charge must be excluded from the overhead pool. The auditor must review the method used to determine the percentage to assure that it is reasonable and that the costs it represents are specifically identified and excluded from the overhead pool.

4-1.311 Direct Materials—Clerical Accuracy. The term "clerical accuracy" is intended to include all clerical phases of the recording process from the preparation of the original documents through the compilation of summaries, statements, and Government vouchers. The basic responsibility for clerical accuracy rests upon the contractor. The auditor will make sufficient tests to assure himself that persons having the responsibility for the preparation of the original documents are adequately trained and competent to accomplish their responsibilities. Extensions and footings on purchase orders, receiving reports, vendor's invoices, requisitions, journals, accounts, statements, and Government vouchers should be tested.

4-1.312 Direct Materials—Physical Inventories. Physical inventories of materials should be taken periodically by contractor personnel. The auditor should review the plan for taking the inventory and, where feasible, observe the taking of the inventory to ascertain that the contractor's employees are adhering to the plan. Tests of quantities, pricing, and clerical accuracy should be made as indicated in the paragraphs immediately preceding. Since public accountants devote considerable attention to physical inventories and their valuation, a review of their audit report, if any, may permit reliance thereon to a great extent. Adjustment of inventory valuation resulting from variations in quantities between "book" and physical inventories may be apportioned to Government contracts. Such apportionment should be reasonable. Factors to be considered are the relation between materials used in the contractor's commercial work and that for the Government, and the time intervals between inventory dates as compared with the time devoted to Government work since the last inventory. Adjustments of inventory values to recognize price fluctuations (as distinct from quantity fluctuations) because of market conditions or obsolescence are not acceptable as allowable costs whether charged direct to the contract or to an overhead pool.

4-1.313 Direct Materials—Scrap (Including Obsolete Material). Where practicable, scrap arising from the performance of Government contracts should be physically segregated and separately accounted for. The value of such scrap should be credited direct to contract costs. Where it is not practicable to segregate physically the scrap arising from contract performance, the total value of all scrap arising from both commercial and Government work

may be credited to the overhead pool, provided that such method is equitable in the circumstance. If this method is not satisfactory because of the disproportionate quantity of scrap in relation to the basis for distributing overhead, an arbitrary basis for distribution may be agreed upon by the contractor and the auditor, and where appropriate, the Contracting Officer. Excessive scrap, waste, damage, or misuse of materials, the cost of which is chargeable to Government contracts, should be reported to and discussed with the Contracting Officer or technical inspector. In such instances, consideration should be given to the desirability of questioning or disallowing the costs involved. Because of the varied circumstances in which scrap is generated and the different methods of accounting for scrap, detailed auditing procedures cannot be set forth. The auditor's verification should be directed toward a determination that the quantity of scrap generated is not excessive, that it is properly safeguarded, that its sale or other disposal is equitable, and that contract costs are credited either direct or indirect. The auditor's attention is directed to Part I, Section 3, Chapter III.

4-1.314 Audit of Charges for Salaries and Wages. The procedures for the audit of salaries and wages are applicable to both direct and indirect costs of services of the contractor's employees. The auditor's attention is directed to Parts K through N, Section 3, Chapter III.

4-1.315 Salaries and Wages—Floor Checks.

(a) Floor checks of the contractor's personnel will be made from time to time on an unannounced basis to determine that employees are actually at work, that they are performing in their proper job classification, and that their time is being charged to the correct job or contract. The contractor's system of internal control and internal audit procedures should provide for such checks. Therefore, the frequency of the auditor's checks will be governed primarily by the frequency and effectiveness of similar checks made by contractor personnel.

(b) In making floor checks of the selected department or portion thereof, the following procedures and such other procedures as may be warranted will be observed:

- (1) Witness the ringing in and out of employees.
- (2) Secure or prepare a list of all assigned employees.
- (3) Account for all names on the list, securing explanations for all absences.
- (4) Verify through observations of the work being performed and discussions with employees that cost accumulation records are being properly prepared.
- (5) Observe whether or not there appears to be a consistent pattern of "overgrading" of employees, particularly those working on Government contracts. In some instances, the more efficient workers have been assigned to the contractor's commercial work, while similar Government work has been performed by apprentices and trainees receiving substantially the same rate of pay as the skilled workers.
- (6) Followup on payroll treatment of discrepancies observed in the floor check to assure that such treatment is consistent with the contractor's policies.

- (7) Attendance of salaried employees should be verified on substantially the same basis as indicated above. Normally, such verifications need not be accomplished as frequently as in the case of direct labor charges.

4-1.316 Salaries and Wages—Payroll Audit. In the audit of the payroll itself, the following audit procedures will be observed:

(a) Samples of signatures of persons authorized to approve payrolls will be obtained and compared with those on the payroll.

(b) Selected items on the payroll will be compared with personnel records to establish authenticity of employment and rates used. Tests also will be made of the rates used by reference to labor union or other employment agreements and any applicable contract provisions.

(c) The hours for which employees are paid will be test-checked to basic attendance records, such as time cards.

(d) Clerical accuracy of extensions, footings, and amounts carried forward to summaries will be sampled.

(e) The total payroll should be reconciled, preferably on a departmental or work center basis, with the distribution records.

(f) Where required by contract terms or other instructions, the auditor will submit for consideration of the contracting officer or other designated contract administration authority a list of salaried personnel and their total authorized compensation, including collateral benefits. In connection therewith, the auditor should point out any cases which he considers involve excessive overall compensation.

(g) Where deductions are made from the compensation of employees, the authority for and disposition of the amounts withheld should be verified.

(h) The payroll should be checked with the general ledger accounts in which the costs are accumulated.

(i) In cases where charges for salaries and wages arise from sources other than payrolls, the auditor will apply such of the procedures set forth above for payrolls as may be pertinent and any other auditing procedures as may be required.

4-1.317 Salaries and Wages—Payroll Payment. The actual payments of employees should be witnessed from time to time by the auditor on an unscheduled basis so that over a reasonable period of time all departments working on the contract will be covered. Paid checks or employees' receipts will be compared with the payrolls. Signatures appearing on the checks or receipts will be compared with employees' signatures in the personnel records. A list of unclaimed wages should be made so that their ultimate disposition may be followed. A copy of the list should be given to the contractor with the request that where payments are made in currency signatures be obtained at the time wages are claimed. These signatures should be compared with employees' signatures appearing in the personnel records. Signatures on paid checks should be tested in a like manner. The contractor's bank reconciliations should be reviewed by the auditor. The frequency and extent of such review depends, among other things, on the volume of transactions resulting from government contracts reflected in the bank account.

4-1.318 Direct Charges Other Than Direct Material or Direct Labor. Other direct charges are those which in the usual cost accounting process are classified generally as indirect costs but which, because of their nature, may be properly chargeable direct to the contract. Examples are engineering and design expense, outward freight and transportation, manufacturing royalties and license fees, and special costs of rearranging plant facilities. The contractor must demonstrate that such costs were incurred specifically for the contract. In those cases in which the plant is devoted wholly to the performance of a cost-type contract, it may be practicable and desirable to charge all items of cost direct to the contract.

4-1.319 Direct Charges Other Than Material or Labor—Audit Procedures. The procedures for auditing these costs are fundamentally the same as those followed in auditing charges for direct material, direct labor, and overhead. The auditor must first determine the propriety of the direct charge in view of the relationship between the cost and the nature of the work called for by the contract. If it appears that charging the item direct is proper, test-checking of the transactions will be accomplished to determine that the costs were actually incurred and that the individual transactions were correctly charged. A further step is to determine that the same costs are not duplicated in the overhead pool, and that there also is excluded from the overhead pool costs of the same nature as those charged direct to the contract but which were not related to contract performance.

4-1.320 Indirect Costs. Indirect costs are those which are incurred for joint objectives and, therefore, cannot be identified specifically with a single final objective, such as a product or contract. A cost may be direct with respect to some specific function, which is in itself indirect with respect to the end product. In practice, the distinction between direct and indirect costs is sometimes arbitrary or is based upon convenience and practicality without sacrifice of reasonable accuracy in overall costs of specific objectives. Indirect costs generally are grouped in classes as follows:

- (a) Manufacturing expenses which are incurred in fabricating the article or service rendered;
- (b) Selling and distribution expenses incurred in marketing the product manufactured;
- (c) Engineering expenses, to the extent not included in (a) and (b) above; and
- (d) General and administrative expenses incurred in the overall management, supervision, and conduct of the business.

4-1.321 Audit of Indirect Costs. The audit of indirect costs may be divided into two phases. One phase concerns the method or methods employed in allocating such costs to particular contracts. Another involves the verification of the particular cost and its allowability as a cost under the terms of the contract.

4-1.322 Methods of Allocation of Indirect Costs.

(a) No general rules regarding the allocation of indirect expenses can be stated for all individual cases because the nature of the particular operations and the actual conditions in each instance determine the most suitable method

or methods to be employed. Among the acceptable bases, depending upon the circumstances, of distributing factory overhead are direct labor cost, direct labor hours, machine hours, and units processed—any one or a combination of which may be applied to an entire plant or to its departments or other subdivisions for a representative period. Among the acceptable bases, depending upon the circumstances, of allocating selling, distribution, and general and administrative expenses are processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct material), factory input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basis is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any unusual factors such as charges of subcontractors and fixed asset improvement programs. All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably. Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

(b) The auditor's determination as to the acceptability of the contractor's method or methods of allocation of indirect costs should have been made as a part of the survey of internal controls and accounting practices required by Chapter III. This determination must be reviewed from time to time in light of changing circumstances. The auditor will test-check the accuracy of the actual distribution of the indirect costs to the contract to ascertain that such distribution was made correctly in accordance with the method or methods selected.

4-1.323 Composition of Overhead Distribution Base. The selected overhead distribution base should be reviewed prior to the distribution to ascertain that all base costs incurred during the accounting period are included in the total thereof, and that the portion of the base applicable to the contract is accurately computed. Overtime and shift premiums must be excluded where the direct labor dollars method is utilized, unless equally equitable results may be obtained when included.

4-1.324 Overhead Base Period. The auditor should determine that the base period selected by the contractor for the allocation of overhead expenses is acceptable. The base period should approximate the period of contract performance (or fiscal year, if shorter) or should be representative of that period. The base period should be sufficiently long to avoid inaccuracies in the allocation of costs and must correspond with the period of accumulation of costs in the overhead pool. Any period that furnishes an equitable basis for the determination of an overhead *rate* may be used. If the contractor uses a base period other than that approximating the period of contract performance, the auditor should ascertain that the use of the period selected results in an equi-

table charge to the contract. Before changing the base period, the auditor should consider whether, in view of the amounts claimed, the use of a more equitable base period will substantially affect the contract cost computation and would therefore justify the expenditure of audit time required.

4-1.325 Composition of Overhead Pool.

(a) Consistency in the composition of the overhead pool is as important as is consistency in the basis used for apportionment of the pool (par. 4-1.322). Where the composition of the contractor's overhead pool has not changed with the advent of Government contracts (with due regard to costs unallowable under the terms of the contract), it will be presumed that costs formerly included are properly included during the period of Government contract performance. However, where the contractor elects to charge direct to the Government contract certain costs which previously had been included in the overhead pool, the presumption may no longer be valid. Generally, this situation is equitably adjusted by requiring costs of the same nature as those charged direct to Government contracts to be excluded from the overhead pool. However, an equitable treatment may not materialize in all instances. In those cases in which the composition of the overhead pool is considerably altered through the direct charging to Government contracts of many costs normally considered to be indirect costs, the auditor should not only exclude from the overhead pool those costs of the same nature as the costs charged direct, but he also should review the nature of other costs having but little relationship to the cost of performing Government contracts. Should the auditor's review indicate that the contractor has significantly altered the composition of the pool by charging direct virtually every item of cost than can be identified, the auditor will consider excluding from the pool items of cost unrelated, or but remotely related, to the performance of Government contracts, and will so exclude such costs if more equitable results are thereby achieved.

(b) The nature of costs included in the overhead pool or pools should be screened in light of the following:

- (1) Items charged by the contractor as direct costs must not be included in the overhead pool.
- (2) Items of the same nature as those charged by the contractor as direct costs must not be included in the overhead pool.
- (3) Items which may be identified direct with other classes of work must be excluded from the pool if substantially all items identifiable with Government contracts are charged direct thereto.

(c) Costs which are unallowable under the terms of the contract must be excluded from the overhead pool.

(d) Miscellaneous incomes or cost reductions must be credited to the overhead pool, except in instances where such items have been credited direct to contract costs. Examples of such items are purchase discounts and the value of scrap. Miscellaneous credits arising from transactions involving costs which are not allowable under the terms of the contract need not be included in the overhead pool.

(e) Adjustments of transactions which occurred in prior overhead periods shall be reviewed to determine their materiality and applicability to current contracts.

(f) Adjustments resulting from increases or decreases in surplus reserves, which reserves represent a mere segregation of surplus in anticipation of a future contingency, will be excluded from the pool.

(g) The overhead pool may properly anticipate accounting adjustments to be entered at the close of the accounting period if the contract is completed or terminated before that date.

4-1.326 Audit of Specific Indirect Costs.

(a) Since indirect costs differ from direct costs only in accounting treatment and not in the form or nature of the material acquired or service received, the auditing procedures presented with respect to direct materials and salaries and wages necessarily will be applicable to those indirect costs arising from the use of materials and personal services. In many instances, the audit of direct and indirect costs having the same nature may be done concurrently. For example, floor checks of material receiving, handling, storage, and consumption may be directed toward both direct and indirect material. Also, reference is made to paragraph 4-1.304, "Initial Auditing Procedures," which has a bearing on the audit of indirect costs.

(b) Certain indirect costs do not arise from transactions of the current period but from those of earlier or future periods. Examples are depreciation expenses, amortization of other prepaid costs, or accruals of liabilities. Adjusting entries representing the write-off of prepayments or the establishment of accrued liabilities will be test-checked for accuracy of computation and account distribution, for propriety and reasonableness of the charge to this accounting period, and to the underlying documentation. The extent of such verification should be consistent with the amount of the adjustment. Also, where an adjustment has as its purpose the restatement of an account in which transactions of the current period have been recorded, the verification of the adjustment usually will be made as a part of the audit of the account.

(c) Accounting for depreciation is the process of apportioning the cost of capital assets over the accounting periods during which the particular asset is useful. Obsolescence and physical deterioration are equally important components of depreciation at any time. During emergency periods, obsolescence may well be the controlling factor; particularly in the determination of depreciation on equipment and facilities acquired for specialized production for the Government. Consistently from year to year in the methods and rates of depreciation used is a significant factor in judging the appropriateness of depreciation expense.

The audit of depreciation charges should be made in conjunction with that of related repair, maintenance, and rehabilitation expense accounts. The auditor will examine documents supporting charges to such accounts and will determine that the contractor's policies for distinguishing between capital and revenue charges have been adhered to. Other items to which the auditor should devote his attention in the verification of depreciation, repair, maintenance, and rehabilitation expenses follow:

- (1) Additions and betterments should be examined for proper authorization and accounting treatment. Collateral costs such as transportation and installation should be capitalized, rather than expensed. Where additions or betterments are constructed or installed

by the contractor's employees, the costs thereof, if significant, must be capitalized. Also, costs which are capitalized must not be charged direct or indirect to Government contracts, except as depreciation on the capitalized costs.

- (2) Physical inspections of the plant should be made to determine whether there are excessive idle plant facilities, the depreciation on which should be excluded from the overhead pool. Consideration also should be given to the exclusion of repair and maintenance costs incurred for such facilities.
- (3) Fixed asset retirements should be screened to assure that depreciation on retired assets has not been charged. Likewise, gains or losses resulting from retirements or exchanges should not be included in the overhead pool as depreciation or otherwise.
- (4) Depreciation on fully depreciated assets must be excluded, therefore tests of the fixed asset detail records must be made to exclude such assets from the fixed asset base used for computing depreciation. The fact that fully depreciated assets are still in use calls attention to the possibility that either the rates used on the contractor's other assets are too high or the contractor's accounting policies with respect to major repairs and replacements are not consistent with his depreciation policies.
- (5) "True depreciation" on contractor-owned facilities covered by Certificates of Necessity may have been determined by the cognizant military department Emergency Facilities Depreciation Board. The finding of the cognizant Board, which is binding on procurement and audit personnel of the military departments, will be an amount determined by the Board to represent depreciation fairly assignable to the 5-year period immediately following the completion of construction or acquisition of the facility. One-fifth of this amount will represent the total depreciation to be charged in each of the 5 years. Upon the completion of the 5-year period, cost minus "true depreciation" becomes the amount to be allocated over the then remaining useful life of the facilities. The Board's finding only relieves the auditor from his responsibility for determination of the depreciation rate applicable to the facility. The auditor must verify that the capitalized acquisition costs were in fact incurred and that depreciation on the facilities is properly allocable to the contract.
- (6) Depreciation computations must be verified. Such verification will include tests of arithmetic accuracy and rates used. Depreciation allowed for Federal income-tax purposes may furnish a guide to the reasonableness of depreciation claimed.

Part IV—Standard Costs

4-1.400 Scope of Part. This Part sets forth certain considerations with respect to the use of standard costs in audit of historical costs.

4-1.401 Standard Costs. Standard costs have varying degrees of usefulness in procurement contract pricing depending upon the circumstances surrounding each contract. Standard costs are of great value in the precontract

award negotiations when the item to be purchased is similar to those with which the contractor has prior production and cost experience. Where contracts are subject to audit of historical costs, the audit may, in certain circumstances, be based upon standard costs. These circumstances are presented in the following paragraph.

4-1.402 Standard Costs as Basis for Audit. Generally, the reliability of standard costs for purposes of audit parallels their reliability for cost control. Where the contract calls for the production of standard commercial items or for items with which the contractor has considerable production experience, audit may be based upon previously developed standard costs. As the degree of similarity between the contractor's past production experience and that required by the contract lessens, so will the usefulness of standard costs as a basis for audit lessen. Therefore, standards will be most useful in the audit of terminated fixed-price contracts and those fixed-price contracts with price redetermination provisions under which substantially standard items are produced. They will have limited usefulness in the case of cost-type contracts. However, interim and final payments may be based upon standard costs (with appropriate adjustments for variances and unallowable costs), provided, in the opinion of the auditor, there is a reasonable approximation of historical cost.

4-1.403 Variations in Use of Standard Costs. Standard costs may be used to control all costs, or their use may be restricted to specific classes of cost. They may be incorporated in the accounts, which is preferable, or may be used for purposes of comparison with historical costs after the latter have been accumulated. Where standards are used for comparison only and are not incorporated into accounts, they will not form the basis of audit but will be used only in a collateral manner as an overall check of audit results. When incorporated in accounts, they may be introduced at different stages in the production cycle. For example, purchases may be recorded in the perpetual inventories at actual or standard costs. If recorded at actual cost, standard costs usually are introduced as the material is placed in process. Standards should be established through an analysis of bills of materials, time studies, and other scientific management techniques. They should be based upon the best obtainable objective, rather than theoretically perfect objectives. Also, standards should be revised at reasonable intervals in light of experience.

4-1.404 Audit Where Standard Costs Are Used.

(a) The responsibility as to the nature and scope of audit where standard costs are used rests upon the auditor. The latter will consider the usefulness, applicability, and susceptibility to audit of the contractor's standard costs (including variance accounts) when making his survey of internal controls and accounting practices (Ch. III). The auditor will consider, among other things, the following:

- (1) The method by which the standards were developed. Were bills of material, engineering studies, time studies, and other tools of scientific management employed?
- (2) What is the extent of use of standards? Are all elements of cost covered, or are both standard and historical costs used in combination?

- (3) Are standards adjusted at periodic intervals to reflect changing conditions? As a corollary to this, what has been the magnitude of variances over a recent period?
- (4) For what anticipated range of production were overhead standards developed? What has been the impact of changed conditions (including Government contracts) in relation to this range?
- (5) What is the similarity in production operations between the contractor's commercial production and that under Government contracts?
- (6) If Government contracts are specific regarding the unallowability of certain costs, what adjustment in standard cost is necessary? Also, by what means will appropriate credits be applied to contract costs?
- (7) Where newly developed standards are the basis of pricing, the auditor must be alert to the setting of "loose" standards which may result in the overabsorption of cost. The overabsorption would then be offset by underabsorption where "tight" standards are employed to control the same element of cost. The distribution of the net variance between Government and commercial work would not cure the defect of "loose" standards.

(b) In making the audit, as distinguished from the survey of internal controls and accounting practices, selective tests of actual cost must be made. These will be accomplished by, but to a lesser extent, the same audit procedures employed in the audit of contract costs where standard costs are not a factor. The purpose of such tests is to assure the auditor that continued reliance upon standard costs is justified. Particular attention will be devoted to those costs which are controlled by newly developed standards and those which are unallowable under the terms of the contract.

(c) Direct materials issued from the contractor's stores may be priced at standard cost, provided variances are appropriately distributed. Materials purchased direct for production under Government contracts should be recorded at actual cost, unless such purchases are not a significant element of material cost.

(d) Direct labor costs are preferably charged at actual cost in determining historical costs. However, where operations under Government contracts are similar to the contractor's commercial production methods, or where the work on Government contracts and commercial output is so intermingled as to unduly complicate the accounting process, standard costs (with appropriate adjustment for variances) are acceptable. The auditor must determine the extent to which collateral labor costs (overtime, shift premium, vacation pay, etc.) are intended to be included in the established standard. Duplicate charges could result if the standard is set so as to include these items and they subsequently also are included as indirect costs.

(e) Auditors should consider the effect of the following factors when making a determination as to the usefulness of standard overhead costs as a basis for audit:

- (1) The nature and extent of costs unallowable under the terms of the contract.
- (2) The nature and extent of miscellaneous incomes and other credits.

(3) The possible existence of cost-plus-a-fixed-fee contracts under which overhead reimbursement is on an historical cost basis. Where it is determined that the above factors would necessitate substantial adjustment of standard cost data, the auditor will consider the feasibility of basing his audit on historical costs.

Section 2—Audit Procedures—Fixed-Price Contracts*

Section 3—Audit Procedures—Cost-Type Contracts*

Section 4—General Accounting Office

4-4.000 Scope of Section. This Section sets forth information relating to General Accounting Office audit functions (see also paragraphs 1-0.004, 1-0.005, 7-1.005, 7-1.006, and 7-2.006). For completeness, actions to be taken by Government officers other than the military department auditors are presented herein. Such information is presented only for completeness and is not to be construed as constituting instructions to such officers. Part I presents introductory material concerning the audit activities of the General Accounting Office with respect to all types of procurement contracts. All other parts of this Section are applicable to cost-type contracts only.

Part I—Audit Responsibilities of General Accounting Office

4-4.100 Scope of Part. The General Accounting Office is a part of the legislative branch of the Government. It has from time to time been given broad statutory authority to review the activities of the executive agencies (pars. 7-1.005 and 7-1.006). Its audit responsibilities are carried out, so far as the military department auditor is concerned, by three major programs, which are discussed in the following paragraphs.

4-4.101 Contract Audits—Cost-Type Contracts. The program with which the military department auditor will be primarily concerned is that of the audit of cost-type contracts. The General Accounting Office Division of Audits may, and ordinarily will, conduct audits of all military department cost-type contracts. The audit of a particular contract (if the contract is performed within the continental limits of the United States) ordinarily will be made at the contractor's place of business or at the cognizant military department audit agency branch office. Only in circumstances in which the contract does not require the contractor to retain contract records (par. 4-4.202) and where audit at the above mentioned locations is not feasible will General Accounting Office audits be performed at a centralized location (Indianapolis, Indiana, Army; Cleveland, Ohio, Navy; Denver, Colorado, Air Force), in which case, the audit is considered to be an "off-site" audit. If the audit is made at the contractor's place of business or at the office of the military department audit agency at which the latter's audit working papers and related reports are maintained, the audit is considered to be an "on-site" audit. The distinction between "off-site" and "on-site" audits is solely one of location and in no way indicates a difference in the nature and scope of the audit. The determination as to the nature and scope of audit rests entirely with the General Accounting Office. Off-site audits, however, must be restricted to an audit of the contractor's documents made

*To be published at a later date.

available to the General Accounting Office, except in those cases in which it desires to extend the audit or parts thereof to the contractor's place of business. The General Accounting Office has indicated that where "on-site" audits are made, it will, to the extent practicable, review the audit work and related working papers and reports of the military department auditor in lieu of duplicating an audit of the contractor's records. However, limited selective tests of the contractor's records will be made and the General Accounting Office may, in its judgment, at any time expand the scope of its selective tests. Military department auditors must recognize the advantages inherent in the General Accounting Office approach to the auditing of cost-type contracts and must cooperate in every reasonable manner to make it a success. The attention of the auditor is directed to paragraphs 1-0.004 and 1-0.005 (2).

4-4.102 Contract Audits—Fixed-Price Contracts. The General Accounting Office also possesses the right (PL 245, 82d Congress) of access to and examination of any directly pertinent books, documents, papers, and records, related to any negotiated contract or subcontract for a period of 3 years after final payment under the contract. The records clause incorporated in cost-type contracts imposes a more extensive obligation; therefore, it will be controlling in the case of cost-type contracts. So far as the military department auditor is concerned, the provisions of Public Law 245 will affect negotiated fixed-price contracts, with or without price redetermination provisions. General Accounting Office auditors will audit selected negotiated fixed-price contracts. Military department auditors will expect such audits and will be prepared to cooperate with General Accounting Office auditors in every reasonable way. Where negotiated fixed-price contracts are audited by representatives of the General Accounting Office, such representatives generally will only audit and make reports to the Comptroller General, to the Congress, and to the Department of Defense. In the absence of improper payments under the terms of the contract, illegality, or fraud, the General Accounting Office will not issue informal inquiries or Notices of Exception as the result of its audit of fixed-price contracts.

4-4.103 Comprehensive Audit Program. Secondly, there is the General Accounting Office comprehensive audit program for the audit of Government departments and agencies. Since the close of World War II, that office has been changing the nature of its audit effort so as to depart from detailed voucher examination. It now plans to place the major audit emphasis on an audit of the Government agency's internal controls (including internal auditing) and accounting practices, together with such selective checks of transactions as may be necessary to indicate the continuing reliability of such controls and practices. This changing emphasis parallels a similar change in concept on the part of the military department audit agencies. In connection with the application of the comprehensive audit program to the activities of the military departments, a significant audit effort will be devoted to the procurement function. This effort primarily will be directed toward contract negotiation and administration and will include the military department audit activity to the extent that such auditing is a part of contract administration. Therefore, the auditor may, from time to time, receive inquiries from General Accounting Office auditors in connection with any type of contract or any phase of contract audit (preaward surveys, audit of transactions of current, completed, or terminated

contracts). In replying to such inquiries, the auditor will be responsive to all reasonable requests. If any doubt exists as to the propriety of the request, or if a military security problem is involved, the district director will be consulted.

4-4.104 General Accounting Office Investigations. Certain inspections are performed by the Office of Investigations of the General Accounting Office rather than by the Audit Division. Upon occasion, the auditor may be contacted by representatives of that Office, in which event he will be guided by the instructions contained in the preceding paragraph.

Part II—On-Site (Project) Audits

4-4.200 Scope of Part. This part sets forth procedures relating to on-site (project) audits of cost-type contracts.

4-4.201 On-Site Audit Program. The General Accounting Office has indicated its intention to audit all cost-type contracts performed within the continental limits of the United States at the contractor's place of business or at the office of the military department audit agency branch office having audit cognizance (mobile audits). Only in exceptional circumstances, and then only where the "records" clause of the contract requires the contractor to submit certain original records to the General Accounting Office, will the General Accounting Office audit be made on an off-site basis. On-site audit of cost-type contracts will be assumed in every instance. It is no longer necessary for military department auditors to request on-site audits. Should the General Accounting Office wish to make an off-site audit of any contract, the records clause of which may require the contractor to submit certain documentation, the General Accounting Office will so notify the cognizant military department audit agency district director. The latter will arrange with the contractor, through the Contracting Officer, where appropriate, for the submission of the appropriate documents by the contractor.

4-4.202 Documentation Requirements.

(a) The standard records clause (see par. 7-203.7, ASPR) relieves the contractor of the necessity of providing originals or copies of supporting documentation (except for direct transportation charges) covering expenditures under cost-type contracts. In lieu of supplying the documentation, the contractor is obligated to retain and make available to the auditors of the military departments or the General Accounting Office the supporting documentation for audit, inspection, or reproduction. If the contractor executes a general release, the documents must be retained for 6 years. If no general release is executed, the obligation runs for 10 years. Reproduction may be substituted 2 years after the payment of the particular reimbursement voucher, but the original documentation must be retained for the 2-year period, unless a shorter period is specifically agreed to by the Contracting Officer and the General Accounting Office.

(b) Where the standard records clause is incorporated in the contract, the contractor is obligated only to retain and make available the documents for inspection, audit, or reproduction. He is not obligated to deliver them or copies thereof to the General Accounting Office. However, in agreeing to permit contractors to retain documents the General Accounting Office has retained

the right to call for copies of any such documents to be delivered to any reasonable place it designates. In view of the limited obligation assumed by the contractor (to retain and make available), the military departments have undertaken to reproduce and deliver to the General Accounting Office any documents called for by it. This undertaking is expressed in a memorandum addressed to the Assistant Secretary of Defense (Comptroller) dated 16 February 1952, signed by the Under Secretaries of the Departments of the Army and Air Force, and the Assistant Secretary of the Navy. Therefore, district directors may from time to time receive requests from General Accounting Office Regional Managers that certain contract documents be forwarded to the General Accounting Office. In the case of Army and Air Force contracts, if the contractor is unwilling to furnish the documents without cost, such requests will be acknowledged, but no records will be reproduced until approval therefor has been received from the Contracting Officer. In the case of Navy contracts, the Supervisory Cost Inspector will arrange for reproduction of the documents after obtaining the approval of Bureau of Supplies and Accounts (Cost Inspection Service), Washington, D. C.

(c) The contractor also is obligated to retain beyond the 6- or 10-year period (until such matters have been disposed of) documents and records related to the following:

- (1) Appeals under the "Disputes" clause of the contract;
- (2) Litigation or settlement of claims arising out of the performance of the contract; and
- (3) Items which are the subject of a General Accounting Office exception.

(d) The standard records clause provides for a different handling of transportation expenditures charged direct to cost-type contracts. Paragraph 7-203.7 (3), ASPR, provides that pursuant to instructions from the General Accounting Office the contractor will either submit the supporting documentation with the reimbursement voucher or such documentation will be subject to the call of the General Accounting Office for 2 years after reimbursement. However, the General Accounting Office has indicated that in all cases the supporting documentation should be submitted with the reimbursement voucher or, as an alternative, a separate listing of all such charges, together with the supporting documentation, may be submitted quarterly, or otherwise as appropriate. Military department auditors will so instruct the contractors and will require that reimbursement vouchers or listings covering transportation charges be submitted separately and be supported by original invoices of the carrier in sufficient detail to permit an audit of rates charged. If listings are used, there must be shown with respect to each carrier's invoice listed the number of the contract or contracts to which it was charged. After a desk audit to assure that the charge covered by the vouchers or listings are applicable to the contract, the documentation will be forwarded to the Transportation Division, General Accounting Office, in accordance with the administrative instructions of the cognizant military department audit agency. Transportation charges, as used in paragraph 7-203.7 (3), ASPR, and in this subparagraph apply only to charges for transportation of things and exclude travel costs. Similarly, only direct transportation charges need be documented; apportioned charges need not. When the contract is a research and development contract with a

nonprofit institution, the provisions of this paragraph do not apply. In such case, transportation charges are handled in the same manner as all other charges.

4-4.203 Copies of Public Vouchers for General Accounting Office Auditors. Where on-site audit is performed, additional plain white tissue copies of the public vouchers under the contract or contracts to be audited will be prepared. For Army and Air Force contracts, three tissues will be needed and for Navy contracts, two tissues. The address of the designated General Accounting Office field representative will be placed on the lower part of these tissues and the appropriation and title to which the voucher is to be charged will be shown. Such copies will be forwarded with the request for payment to the Disbursing Officer. The Disbursing Officer will enter on the tissues the Disbursing Officer voucher number, date paid, and the name and symbol number of the Disbursing Officer. After payment, the Disbursing Officer will forward the tissue copies to the General Accounting Office field representative. When the audit of a voucher is completed, the General Accounting Office representative will stamp the tissue copies. One tissue copy will be sent to the Disbursing Officer (Army and Air Force only); one to the General Accounting Office (Indianapolis, Army; Cleveland, Navy; Denver, Air Force); and one to the military department auditor for the latter's files. Navy Disbursing Officers do not require a stamped tissue copy.

4-4.204 Submission, Custody, and Disposition of Required Supporting Documentation. When an on-site audit is made but the contract does not provide for retention of documents by the contractor (see standard records clause—ASPR 7-203.7), the documentation requirements contained in Part V, this Section, will apply. In such case, the auditor also will be guided by paragraph 4-4.302, "Custody of Supporting Documents." Upon the completion of the contract and after audit by the military department and General Accounting Office auditors, the documents should be forwarded to the appropriate General Services Administration Federal Records Center in accordance with the applicable administrative instructions of the military department concerned.

Part III—Off-Site Audits

4-4.300 Scope of Part. This Part sets forth procedures related to off-site audits of cost-type contracts. As indicated in paragraph 4-4.201, General Accounting Office audits of cost-type contracts usually will be made at the contractor's place of business or at the military department audit agency branch office; thereby constituting "on-site" audits. Also, because of the records retention provisions of the standard records clause incorporated in most cost-type contracts, the General Accounting Office will not, if such clause is used, receive documents to be audited. Therefore, off-site audits will be made only where the contractor is contractually obligated to submit documentation and then only if the General Accounting Office determines that "on-site" audit is not feasible.

4-4.301 Documentary Evidence. As stated in paragraph 4-4.201, documentary evidence supporting reimbursements to the contractor must be forwarded to the General Accounting Office when off-site audits are made, pro-

vided the contract permits the General Accounting Office to require submission of documents. The documents required are described in Part V, this Section.

4-4.302 Custody of Supporting Documents. The supporting documents required by the General Accounting Office to be delivered to it should be placed under the custody and control of the auditor when the voucher is submitted or as soon as practicable after the end of each month or other accounting period. The contractor will furnish only one set of documents. Such custody and control must be maintained until the documents are sent to the General Accounting Office for audit. In the event any documents are required to be withdrawn from the custody and control of the auditor for temporary use by the contractor, the release of such documents should be recorded on charge-out cards or other appropriate follow-up records. Locking file cabinets or other safekeeping arrangements should be provided for the auditor's use in maintaining custody of the documents required by the General Accounting Office. Keys to such file cabinets should be in the possession of the military department auditor.

4-4.303 Subcontract Documents. Where no audit is being performed by a military department auditor at the subcontractor's plant, any documents supporting invoices should accompany the subcontractor's invoices to the next higher tier subcontractor or to the prime contractor where there are no intervening subcontracts. If an administrative audit is being performed at the subcontractor's plant, the documents should be retained by the military department auditor for disposition. In such case, the auditor at the prime contractor's plant will accept the certification of the auditor at the subcontractor's plant as to the costs represented by the invoices. Where a General Accounting Office on-site audit of a subcontractor's accounts is being made, the supporting documents will be retained at the subcontractor's place of business if provided for in the subcontract or forwarded to the General Accounting Office in accordance with paragraph 4-4.204.

4-4.304 Submission of Supporting Documents. The contractor will attach the supporting documents to the original public vouchers which they support. The military department auditor will detach the supporting documents which will not accompany the public voucher to the Disbursing Officer. The documents should be shipped by the auditor, together with copies of the public vouchers to which they relate, to the addresses shown in paragraph 4-4.307 not later than 30 days after the completion of the military department audit or upon receipt of the date of payment, if later. These copies of vouchers should show the Disbursing Officer voucher number, the name and symbol number of the Disbursing Officer, and the date of payment. Instructions for shipping are set forth in paragraphs 4-4.305 and 4-4.306.

4-4.305 Method of Shipment. The method of shipping documentary evidence to the General Accounting Office should be determined, with respect to Army and Air Force contracts, to be shipped in accordance with current administrative instructions. With respect to Navy contracts, the instructions in the Navy Shipping Guide should be followed. Navy contract documents ordinarily will be forwarded either by registered mail or will be shipped by freight on a Government bill of lading. If documents supporting Navy con-

tracts are sent by registered mail, a return receipt should be requested. If such documents are shipped by freight, a request should be forwarded to the General Accounting Office with the original bill of lading for acknowledgement of receipt of the documents.

4-4.306 Preparation of Documents for Shipment. In preparing documents for shipment, particular attention should be given to the packing and listing. The copies of vouchers and supporting papers should be arranged in numerical sequence by Disbursing Officer voucher number under the name of each Disbursing Officer. Each box or package used for shipping the documents should be plainly labeled to show the contract number, the name and address of the contractor, and the number of the box in the shipment, such as "No. 1 of 10," "No. 2 of 10," etc.

4-4.307 Where Documents Should Be Sent. Documentary evidence should be forwarded to the addresses below.

Army Contracts

Army Audit Branch
Division of Audits
United States General Accounting Office
634 North Noble Street
Indianapolis 2, Indiana

Navy Contracts

Navy Audit Branch
Division of Audits
United States General Accounting Office
1901 East 13th Street
Cleveland 14, Ohio

Air Force Contracts

Air Force Audit Branch
Division of Audits
United States General Accounting Office
3800 York Street
Denver 5, Colorado

Part IV—Audit Exceptions

4-4.400 Scope of Part. This Part sets forth information and procedures relative to the handling of General Accounting Office exceptions. These may be informal inquiries or notices of exception. Pro forma exceptions and letter exceptions are no longer issued by the General Accounting Office. Ordinarily, audit exceptions arise only in the case of cost-type contracts.

4-4.401 Informal Inquiries.

(a) Informal inquiries are used where a General Accounting Office on-site auditor desires to question an item or items of cost, or obtain additional information. These inquiries take the form of numbered letters from the General Accounting Office auditor to the military department auditor. The informal inquiry procedure is designed to afford a means whereby questions can be resolved on the site. Informal inquiries do not in themselves constitute charges to accounts of Disbursing Officers.

(b) When off-site audits are made, General Accounting Office Form 3010 (Request for Information) will be issued ordinarily for the purpose of obtaining supporting documents. This form is in the nature of informal inquiry but is not referred to as such.

4-4.402 Handling of Informal Inquiries.

~~4-4.402~~ (1) *Distribution of Copies.* Informal inquiries are addressed by the General Accounting Office auditor to the cognizant military department auditor, or to the District Director where a residency has not been established. The auditor will receive the original and two copies, one of which will be forwarded to the contractor. The original will constitute the auditor's record (file) copy and may be entered in a register if considered desirable. The third copy will constitute a "suspense" file and will be returned to the General Accounting Office with the auditor's reply.

~~4-4.402~~ (2) *Replies.* Following receipt of an informal inquiry, the auditor will give prompt attention to the preparation of an appropriate reply which will be addressed to the General Accounting Office on-site auditor who initiated the inquiry. Prompt attention is necessary since, if a reply is not received within 60 days, the General Accounting Office will convert the informal inquiry to a notice of exception. Should the auditor agree that the amount involved did not qualify for reimbursement, he will prepare DD Form 396 (Notice of Costs Suspended and/or Disapproved) and make the deduction on a subsequent voucher. The General Accounting Office will be so notified. Should the auditor not agree with the position of the General Accounting Office, the reply should consist of a succinct statement of the facts which, in the opinion of the auditor, qualify the questioned costs for reimbursement under the contract. The auditor should avoid controversial statements and stereotyped answers. If the effect of the informal inquiry is to question a directive from higher authority, or if it raises a question of sufficient importance, the auditor should, before submitting a reply, take the matter up with his District Director. Where it is necessary to request the contractor to supply additional information, the contractor should be apprised of the time limitation mentioned above.

4-4.403 Removal of Informal Inquiries. If the reply is satisfactory, the duplicate copy is returned by the General Accounting Office auditor to the military department auditor, with a notation "Reply Satisfactory" and his signature subscribed thereto.

4-4.404 Notices of Exception.

(a) If an informal inquiry or General Accounting Office Form 3010 is not answered to the satisfaction of the General Accounting Office, a Notice of Exception (Standard Form 1100, Revised) will be issued. Notices of exception where on-site audits are made will be issued by the regional office of the General Accounting Office upon advice of the on-site auditor. Notices of exception where off-site audits are made will be issued by the General Accounting Office, Army, Navy, or Air Force Audit Branch which made the audit. There may be infrequent instances where a notice of exception is issued without the prior use of an informal inquiry.

(b) A notice of exception is an advice to a disbursing officer that credit for a questionable transaction will be withheld in the absence of a refund or adequate

explanation. Unless the amount thereof is recovered from the contractor, failure to make a satisfactory reply to a notice of exception will result in the amount of the item being included in the balance due the United States on the Certificate of Settlement of Account of the disbursing officer. A notice of exception will be reissued in whole or in part when the General Accounting Office considers the reply to the original notice to be unsatisfactory.

4-4.405 Handling of Notices of Exception. (Reserved)

4-4.406 General Accounting Office Action on Replies. (Reserved)

4-4.407 Recoveries from Contractors. (Reserved)

4-4.408 Withholdings from Contractors Before Final Settlement—Navy Contracts. (Reserved)

4-4.409 Removal of Notices of Exception. When a notice of exception is removed or cleared by the General Accounting Office by reason of the receipt of a satisfactory explanatory reply or recovery of the amount thereof from the contractor, notification of removal is given the responsible disbursing officer by forwarding a copy of the exception involved with the following rubber-stamp impression thereon:

Reply of _____ satisfactory on the present record.
(Date)
 General Accounting Office _____
(Date)

Used interchangeably with this procedure, at the convenience of the General Accounting Office, is circular letter Form A-361. This form reads—

To _____, _____ Officer
 Department or Bureau _____
 Dear Sir: The exception(s) to the voucher(s) listed below has (have) been removed, it being understood, however, that no assurance can be given that the account will not be reopened and restated or that a charge will not be raised against the responsible officer if subsequently determined matters should require such action:

<u>Voucher No.</u>	<u>Period</u>	<u>Activity</u>
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Very truly yours,

 U. S. General Accounting Office

4-4.410 Reclaim Vouchers. A reclaim voucher is a public voucher (Standard Form 1034, Revised) (Public Voucher for Purchases and Services Other Than Personal) submitted by a contractor covering items of cost initially allowed and reimbursed to the contractor, but subsequently deducted from moneys otherwise due, or refunded by the contractor, which deduction or refund was occasioned by the issuance of a General Accounting Office notice of exception.

4-4.410 (1) Preparation. The contractor will initiate and prepare the reclaim voucher when he desires reconsideration of the costs represented by the exception. The voucher should include any applicable documentary evidence, including a copy of the informal inquiry (if one was issued) and the reply made thereto, and a copy of the notice of exception and the reply (if any). A written statement from the contractor stating in reasonable detail the basis upon which the item or items involved are considered to be reimbursable may be included. If any supporting documents, such as vendors' invoices, are involved, these or authentic reproductions should be attached or their absence explained. The

words "Reclaim Voucher" should appear in the lower part of the original and all copies of the public voucher form and the supporting schedules thereto. There should be cited on the voucher or in an attachment the public voucher (DOV. No., month paid, and name and symbol of disbursing officer) on which recovery from the contractor was made for the reclaimed amount; or the certificate of deposit number, date, name, and symbol of disbursing officer, and any other pertinent data if the amount was refunded by the contractor.

4-4.410 (2) Channels for Forwarding. Under Army and Air Force contracts, upon receipt of a reclaim voucher, the military department auditor will forward the voucher to the Contracting Officer with his comments. The auditor will indicate approval or disapproval of the voucher as may be appropriate in the particular case. The Contracting Officer will in turn forward the voucher to the disbursing officer, together with his comments thereon. If the Contracting Officer concurs in the voucher, he may indicate his approval in the usual manner. The disbursing officer, upon receipt of the voucher, will prepare a transmittal letter addressed to the Comptroller General of the United States, in which request will be made for advance decision as to the propriety of making payment thereon. The voucher and covering transmittal letter will be forwarded in the case of Army contracts to the Comptroller General via the Office of the Chief of Finance. Where Air Force contracts are involved, the voucher and letter are sent to the Office of the Director of Finance. In the case of Navy contracts, the Cost Inspector will forward the voucher with his comments via the Supervisory Cost Inspector to the disbursing officer, who will prepare the transmittal letter, as in the case of Army and Air Force contracts. The reclaim voucher and transmittal letter will be forwarded to the Comptroller General through the Bureau of Supplies and Accounts, Cost Inspection Service. After a review of the facts of the case, the Comptroller General will render a decision to the disbursing officer, who will then make payment to the contractor should the Comptroller General's decision so indicate.

4-4.411 Departmental Requests for Decisions of the Comptroller General. In some instances, General Accounting Office auditors may take exception to the allowability of costs which involve an important matter of principle or policy of a military department. If the auditor considers that an exception falls in this category, the matter should be referred to the District Director for further consideration. In submitting any such case, the auditor should forward a copy of the notice of exception with his comments and recommendations to the District Director. If the District Director concurs with the auditor, the matter should be referred to the headquarters office of the audit activity. The headquarters office will consider the case from the standpoint of whether the issue involved is sufficiently important to justify a letter over the signature of the Secretary of the Department to the Comptroller General requesting that the position taken by the General Accounting Office be reviewed. Such request will be processed in accordance with the requirements of the respective military departments. The distinction between a departmental request for a decision of the Comptroller General and the reclaim voucher procedure is that the first is on the initiative of the military department, whereas the second is on the initiative of the contractor. Also, preparation of a reclaim voucher is not a prerequisite to the submission of a departmental request.

Part V—Documentary Evidence Requirements

4-4.500 Scope of Part. This Part covers the documentary evidence and listings supporting reimbursements to contractors required to be submitted to the General Accounting Office in the case of cost-type contracts which do not contain the standard records clause (par. 4-4.202). Documentation required to be submitted to support direct transportation charges to contracts containing the standard records clause is presented in paragraph 4-4.202 (d).

4-4.501 Cost-Type Contracts and Subcontracts. The documentary evidence described in this paragraph will be delivered to the military department auditor by the contractor and forwarded after audit to the General Accounting Office at the addresses given in paragraph 4-4.307, this Section, in the case of "off-site" audits. If the General Accounting Office audit is on an "on-site" basis, the documents will be shipped to the appropriate Federal Records Center (par. 4-4.204). These documents ordinarily include: the originals of vendors' invoices covering purchases charged direct to the contract; copies of purchase orders over \$5,000 issued for such purchases; acknowledgments of such purchase orders (where acknowledgments are made); originals of successful bids (where written bids are obtained in connection with such purchases); originals of receiving reports; any correspondence affecting the terms of purchase orders; signed copies of any subcontracts entered into for the performance of work or services under such contracts (except subcontracts under \$5,000 and those for public utility services the rates for which are controlled by a regulatory body); original payrolls; and receipts where payments are made in cash, or the check number (but not the canceled check itself) where payments are made by check. At yards and plants not operating 100 percent on Government work under such contracts, only direct charges to the contract, for example, purchases charged in their entirety to the contract, need be so supported, and original payrolls need be submitted only where separate payrolls are used for employees engaged exclusively upon work under the contract. At yards or plants operating 100 percent under such contracts, the documents mentioned above will be required in support of all items reimbursed which can be so supported; that is, not only direct charges to the contracts but also indirect charges to the contracts (overhead).

4-4.502 Travel. Where travel is performed on a reimbursement of cost basis, supporting evidence such as receipts for hotel room rent, Pullman berth receipts, and similar items are required by the General Accounting Office only when such supporting receipts are required to be submitted by the travellers to the contractor. Such receipts need not be obtained under Government contracts solely for transmittal to the General Accounting Office. Where travel applies to both a Government cost-reimbursement-type contract and other business, such underlying receipts need not be forwarded, even though the contractor requires them to be submitted by its employees in connection with travel reimbursements. Where travel expense is a direct charge to a cost-reimbursement-type contract, however, evidence in support of such charges must be furnished. This evidence would represent as a minimum the original approved expense reports with travel authorization (if any) submitted by the traveller, but need not include (unless regularly obtained by the contractor) supporting data in the form of Pullman and railroad ticket stubs, etc.

4-4.503 Operation of Cafeterias, Commissaries, etc. If a special working or imprest fund has been set aside to finance the operation of a cafeteria or similar facility, the contractor should submit, not less than once each month, a statement of operations and fund reconciliation for the period, certified by the contractor as correct. The fund may be reimbursed for reasonable losses or the profits may be applied against reimbursement vouchers on the basis of such statement, and no further supporting documents will be required, provided the fund remains substantially unimpaired at all times. If a special working or imprest fund has not been established, it will be necessary to furnish all original invoices, payrolls, etc. in support of the related disbursements, and all receipts also should be supported to the maximum extent practicable in the particular circumstances.

4-4.504 Apportioned Charges. Each element of cost will be classified under the heading of either (a) direct charges to the contract, or (b) apportioned charges to the contract. This classification is to be made only for the purpose of preparation of the contractor's invoices and public vouchers and, in so doing, to indicate the amount for which supporting documents will be furnished to the General Accounting Office. It should not be confused with the regular accounting classification of costs. This classification of cost may be shown on the contractor's invoice, the public voucher, or other convenient document. Direct charges to the contract, that is, items of costs chargeable in their entirety to the contract, will be supported by the same kind of documentary evidence as described under the requirements for plants operating 100 percent under cost-reimbursement-type contracts. Examples of such costs are outside purchases of material and direct labor charges where separate payrolls are maintained for the contract. Apportioned charges to the contract, that is, items of costs which are chargeable partially to cost-reimbursement-type contracts and partially to fixed-price contracts or commercial work, will not be supported by original invoices or other documentary evidence; instead, the summary statement incorporated in the contractor's invoice or shown on the public voucher, certified by the military department auditors, will be acceptable. Examples of apportioned costs are direct labor charges where separate payrolls are not maintained for the contract, material from stores, and overhead expenses.

4-4.505 Contracts Which Provide for Settlement on a Fixed-Price Basis. In the case of contracts under which interim and monthly payments are based upon cost, but which contain a provision for negotiation and final settlement on a fixed-price basis, it will not be necessary to submit supporting documents unless it becomes apparent that the final settlement will not be made on a fixed-price basis. If there is any doubt that final settlement will be on a fixed-price basis, documentation should be obtained currently with the understanding that if settlement of the contract is finally negotiated on a fixed-price basis the documents will be returned to the contractor.

4-4.506 Commissioning Expense Contracts With Schools and Colleges. These are cost without profit contracts with educational institutions covering expansion or alteration of their facilities for the purpose of enabling such institutions to educate or train enlisted personnel, officer candidates, and/or

commissioned officers. Where these contracts are small and the furnishing of the regular documentary evidence would be impracticable, the General Accounting Office will consider the acceptance of a copy of the auditors' final audit reports in lieu of the documents. Where final audit reports are to be submitted for this purpose, the letters transmitting the reports to the General Accounting Office should state briefly the reasons why the submission of documents is impracticable.

4-4.507 Cost Reimbursement Under Navy Fixed-Price Contracts.

Payments under fixed-price contracts for tooling, special plant protection, overtime and shift work, etc. on the basis of costs should be supported as follows:

(a) With respect to expenditures under tooling provisions (cost basis) of fixed-price production contracts for direct charges, the usual documentary evidence should be obtained and submitted, unless the direct charges are relatively small in amount and it is impracticable to obtain supporting documents; in which case the auditor's final audit report will be acceptable. In this connection, it is suggested that direct charges be regarded as "relatively small" if, in the aggregate, they do not exceed \$25,000. In exceptional cases where documentary evidence is required but where it is not practicable to obtain such evidence, a statement setting forth all the pertinent facts in the case will be given consideration by the General Accounting Office.

(b) Ordinarily, separate vouchers will be required to be prepared and submitted for charges for special plant protection and overtime and shift work premiums, setting forth the specific authorization or approval under which related payments are allowable as reimbursable costs under the particular contract. In those cases where the reimbursable costs incurred represent direct charges to the contract, it will be necessary to support such charges with original documentation, unless the direct charges are relatively small in amount and it is impracticable to obtain supporting documents. In exceptional cases (where it is impracticable to obtain required supporting documentary evidence), the General Accounting Office will give consideration to a statement made in writing by the auditor setting forth all the pertinent facts in the particular case.

(c) In those cases where both direct and apportioned charges (par. 4-4.504) are involved, and regardless of amounts, a reasonably detailed summary of the amount paid, showing that the costs were determined in accordance with the provisions of the contracts, will be necessary. The summary should be prepared covering a calendar month or other accounting period, and not on a cumulative basis. It should be a part of the contractor's invoice and should show (a) the nature of the items for which reimbursement is claimed, that is, for example, overtime and shift work premiums, (b) the amount claimed for each of the various accounting classifications involved, such as direct plant labor, indirect plant labor, clerical salaries, etc., and (c) the most informative summary as to hours worked and amounts paid, by departments or classifications, which it is practicable to obtain from the contractor's records. The amounts under (c) should be further detailed, where applicable, as to wages, Social Security taxes, compensation insurance, etc.

(d) It is necessary that the auditor execute a certificate covering the correctness of the amount approved for reimbursement to the contractor. The certificate may be executed on a contractor's invoice or on Standard Form 1035

(Public Voucher for Purchases and Services Other Than Personal—Continuation Sheet) or other suitable document. For overtime payments, this certificate should be in the following form:

I certify that, in accordance with applicable instructions, I have completed the audit of \$----- claimed by the contractor, in its distribution of wages for the period indicated to be directly chargeable to the United States under the provisions of Contract No. -----, and that the amount of \$----- approved for payment is true and correct and has been verified from the original records.

For payments other than overtime, appropriate modification should be made in the certificate to indicate the character of the claim.

(e) A certificate by the technical inspector is also required. This certificate may be executed on the public voucher itself, or on the contractor's invoice.

4-4.508 Original Documents Required.

(a) The General Accounting Office requires the originals of vendors' and subcontractors' invoices and credit memorandums. Originals of the following documents are also required where submission of such documents is prescribed by this Section: subcontracts, payrolls, acknowledgments of purchase orders, successful bids, offers, or quotations, receiving reports, incoming correspondence affecting the terms of purchase orders, and travel expense reports.

(b) For the purpose of the documentary evidence requirements of the General Accounting Office it will be satisfactory to consider as originals (in those cases where the invoices have been prepared by a reproduction process and identification is not readily apparent by inspection) a copy which has been identified by the word "ORIGINAL" printed, stamped, or typed thereon by the vendor or subcontractor. In such instances, no specific certification that the copy is in fact the original will be required. In any particular case, however, not more than one copy of an invoice should be identified or considered as the original. The General Accounting Office requires, as a general rule, the ribbon (first) copy of a typewritten invoice or credit memorandum. When for some valid reason the ribbon copy is not available, a legible carbon copy may be accepted provided a representative of the contractor states in writing why the original cannot be furnished and certifies that it is the only copy which will be treated as an original and that steps have been taken to prevent duplicate payment.

(c) In the case of some highly classified research and development, or other contracts, it may be determined that submission of the documents might reveal the nature of the work being performed, and that such submissions would be inimical to the national security. Such determinations will be made to the auditor by the Contracting Officer in writing. In such cases, the auditor should obtain the documents and hold them until such time as the documents lose their classified status. If such a contract should be completed, and cost determination at the location discontinued, and it is at that time determined by the Contracting Officer that the documents still should not be released, the documents will be held at the plant in the technical custody of the auditor under safekeeping arrangements suited to their classification, until they lose their classified status. If necessary, instructions will be issued by the Washington Headquarters' Office of the cognizant auditing organization as to the disposition to be made of these documents on an individual case basis.

4-4.509 Itemization of Costs Documented. Standard Form 1035 is the Government form usually used for listing invoices supporting disbursements on public vouchers, however, invoices need not necessarily be listed on this form. Instead, whatever form of listing is already available, or is more convenient, should be utilized. This listing may be in the form of work papers, copies of voucher-register sheets (if separate sheets are maintained for invoices charged to government cost-reimbursement-type contracts), or any other form or type of listing which will furnish the minimum required information. The minimum required information is the contract number, the name of the contractor, appropriate identification with the related invoices (by name of vendor or invoice number, and amount), and the number of the public voucher (that is, the preliminary or bureau voucher number) to which the invoices relate. Listings should be made as currently as practicable in order to maintain a dollar amount control over documents submitted, or to be submitted, to the General Accounting Office. In addition to the original listing, which will be submitted to the General Accounting Office, sufficient carbon copies should be provided for the auditor, the contractor, and others concerned.

4-4.510 Documents Applicable to More Than One Contract. Where supporting papers are applicable to two or more contracts, they will be submitted under one of the contracts and cross-referenced by bureau voucher number to the related voucher or vouchers which comprise the remainder of the claim. Debit and credit memorandums will also be cross-referenced to the related transactions. In those instances where two or more government agencies have contracts in progress, some of the required supporting documents may relate to contracts with more than one agency. Where this is the case, the agency having the preponderant interest should have custody of the documents (which relate to more than one contract), with appropriate cross-references being made by other agencies, as necessary.

4-4.511 Lost or Missing Documents. Every reasonable effort should be made to obtain original documentation for forwarding to the General Accounting Office. In those cases where documents are lost or cannot be located, copies should be obtained and furnished. In these instances the auditor should include, either on the supporting schedule with which the documents are associated or on the copy furnished, a brief statement explaining why the originals are not available. Such explanatory statements should be signed by the auditor.

4-4.512 Noncompliance by Contractor With Requirements. Should the contractor be of the opinion that release of documentary evidence for the General Accounting Office is contrary to contractual provisions requiring retention of contract records, the auditor should inform the contractor that such action is not considered to be a failure to comply with the terms of the contract which provide for maintenance and preservation of records for a stipulated period. The purpose of these contractual provisions is to assure that records will not be destroyed, but will be available to the Government when necessary. By turning over the required documents (which do not involve books of original entry, that is, journals, registers, minutes, etc.) to an authorized representative of the Government, such as the auditor, the purpose of the contractual provisions will be accomplished with respect to such items and the contractor will be relieved of any further responsibility in connection

therewith, unless they should be returned to his custody within the period specified in the contract. If a contractor refuses to furnish required documents, or if for any other reason such documents are not furnished, the auditor should notify the contractor that suspension of payments (for those costs which require documentary support) will probably ensue. In discussing the documentary evidence requirements with contractors, auditors may point out that failure to comply results in suspensions by the General Accounting Office in the accounts of Disbursing Officers and the issuance of exceptions. It should be pointed out that the military departments are not in a position to waive these requirements and therefore, should a contractor remain of the opinion that its request for a waiver merits special consideration, the auditor may suggest that the contractor take the matter up direct with the General Accounting Office.

4-4.513 Corrections of Errors on Vendors' Invoices. Invoices will not be acceptable to the General Accounting Office when the amount has been increased to correct for errors, greater quantities than actually delivered, etc., unless such correction is instituted and approved by the vendor or subcontractor. Minor reductions in the amounts of invoices, however, will be acceptable when made to correct errors evident on the face of the invoices. A corrected invoice will be acceptable if the invoice first submitted is attached to it with appropriate cross-reference and appropriate explanation is made on the corrected invoice.

4-4.514 Research and Development Contracts. Cost-type research and development contracts are of two types, viz: (a) cost-plus-fixed-fee and (b) nonprofit contracts. The documentary evidence requirements of the General Accounting Office differ as between these types of contracts and are outlined in the following subparagraphs.

4-4.514 (1) Cost-Plus-Fixed-Fee Contracts. The supporting documents and certifications required by the General Accounting Office under cost-plus-fixed-fee research and development contracts are the same as under any other type of cost-plus-fixed-fee contract (par. 4-4.501).

4-4.514 (2) Nonprofit Contracts.

(a) Under nonprofit contracts, classified and unclassified, the contractors may submit listings of supporting documents and special certificates in lieu of the actual documents. Approval of this procedure by the Contracting Officer is required under Army and Air Force contracts, and is permitted at the option of the contractor under Navy contracts.

(b) Under the listing procedure, the costs claimed will first be segregated on the face of the public voucher (or on Standard Form 1035 if sufficient space is not available) in conformity with the classifications of cost specified in the contract. These costs will then be further detailed on Standard Form 1035 or other schedule used to support the public voucher. For all charges where the individual items amount to less than \$50, one total may be shown without detailed listing or further substantiation. Where the cost of individual items is \$50 or more, a detailed listing of the items must be made. Under this procedure a certificate (in addition to the certificate on the face of the voucher) must be signed by the representative of the contractor authorized to sign the public voucher, and submitted as a part thereof, preferably on the reverse side.

If more convenient, this certificate may appear on the contractor's invoice or on a separate sheet securely fastened to all copies of the voucher and reference made thereto on the face of the voucher. This certificate must read as follows:

I further certify that the personal services and the supplies, equipment, materials, etc., listed thereon were required by and were used in the performance of the work under the contract referred to on this voucher and that payments have been made of all amounts for which reimbursements are hereby claimed; that the amounts claimed for personal services involving part-time work, determined from a distribution of wages for the period indicated to be directly chargeable to the United States under the provisions of the contract referred to on this voucher, are true and correct and that payments of these amounts have been made to all employees whose wages are included in the distribution; that payrolls, procurement records, invoices and requisitions concerned will be kept for at least (period specified in contract), subject to inspection upon request by authorized representative of the United States Government; and that no individual items costing \$50 or more have been included in the subtotals and totals of charges for which no itemizations or evidentiary substantiations are furnished.

(c) Originals or authenticated copies of invoices and payrolls may be furnished by the contractor at his option in lieu of the detailed listings. Unless documentary support (as required under cost-plus-fixed-fee contracts) is furnished for all items of cost (less than \$50 and more than \$50) the special certificate is required. In the event that all documentary support is submitted, the special certificate is not required.

(d) It should be understood that regardless of which procedure is used, the General Accounting Office reserves the right to audit the original documents which must be preserved by the contractor in good order for the period specified in the contracts.

(e) Specimen public voucher forms illustrating the listing procedures are shown in the appendix.

(f) Under basic or fundamental research and development contracts awarded by the Office of Naval Research, an addition to the certificate of the contractor is required. When all documentary evidence is submitted to the General Accounting Office in support of reimbursements, the addition should be made at the end of the contractor's certificate on the face of the public voucher, and if the listing procedure is used, the addition should be made at the end of the contractor's special certificate. The addition is as follows:

I further certify that the research provided for in said contract has been conducted in accordance with terms thereof during that part of the period specified therein to which the costs stated in this voucher are applicable.

Section 5—Audit Reports*

Section 6—Government Property*

Section 7—Other Audit Assignments*

*To be published at a later date.

CHAPTER V
AUDIT PROCEDURES—TERMINATED CONTRACTS

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CHAPTER V

AUDIT PROCEDURES—TERMINATED CONTRACTS

5-0.000 Scope of Chapter. This chapter establishes general procedures to be followed by the audit agencies in auditing settlement proposals submitted by contractors or subcontractors whose contracts have been terminated or partially terminated prior to completion or whose contracts have been changed through engineering change orders. These procedures are also suitable for the use of prime contractors or higher tier subcontractors in auditing the claims of their subcontractors. The procedures stated herein are not intended to limit the exercise of professional judgment by the auditor. The term "Contracting Officer" shall include, in addition to the officers and employees named in paragraph 1-201.5, ASPR, and except as otherwise specifically provided in this chapter, any authorized representative of a Contracting Officer acting within the limits of his authority.

Section 1—Introduction

5-1.000 Scope of Section. This section contains background information concerning current and superseded termination regulations as well as a description of settlement proposal bases for the different types of contracts. Many of the subjects presented herein are covered in more detail in the sections which follow. Auditors will refer to the detailed presentations for guidance in specific cases.

5-1.001 Current and Superseded Termination Regulations Which May Be Encountered.

(a) The Contract Settlement Act of 1944 (P. L. 395, 78th Cong.) authorized the settlement of terminated war contracts by negotiation when the contracts provided for such settlements or were amended to so provide. The Joint Termination Regulation and the Joint Termination Accounting Manual were issued to guide personnel engaged in termination activities. Most government war contracts prior to 1 November 1947 and some military department contracts after that date provide for settlement in the event of terminations under the terms of the Contract Settlement Act of 1944 and/or the Joint Termination Regulation.

(b) Army Procurement Regulation 1 November 1947, later designated as Joint Procurement Regulation by Joint Army and Air Force Procurement Circular 1, 1948, was applicable to all Army and Air Force procurement on or after 1 November 1947. In Part 5 "Termination of Contracts for the Convenience of the Government" this regulation directed that certain uniform contract termination clauses be used, and specified the procedure to be followed in effecting settlements in the event of termination.

(c) Department of the Navy, Chief of Naval Material letter (OGC/ELR :AG) 13 May 1948, directs that contracts executed as of a date prior to 19 May 1948 shall be subject to termination, in accordance with their terms, under the provisions of the Contract Settlement Act of 1944 and the Joint Termination Regulation and that contracts executed on or after 19 May 1948 should

include to the extent required or permitted under existing Navy directives the appropriate Uniform Termination Article as set forth in the Joint Termination Regulation (except that all reference to the Contract Settlement Act of 1944 will be deleted) and the procedures set forth in that regulation should be followed except those provisions of the Contract Settlement Act of 1944 which relate to the following:

- (1) Allowance of interest on a termination claim.
- (2) Direct settlement of subcontractors' termination claims.
- (3) Company-wide settlements which involve contracts of other departments or agencies.
- (4) Interim financing, including penalties with respect to overpayment to contractors.
- (5) Appeals to the Appeals Board of the Office of Contract Settlement.
- (6) Procedures with respect to reclaim vouchers under CPFF contracts and exceptions of the General Accounting Office.

(d) Armed Services Procurement Regulation, Section VIII, "Termination of Contracts," prescribes Standard Termination Clauses to be inserted in contracts executed on or after 1 March 1952. The provisions of Section VIII are applicable to the termination of contracts containing such Standard Termination Clauses. Section VIII prescribes forms and procedures for the settlement of both cost-type and fixed-price terminated contracts. A "Statement of Principles for Consideration of Costs" applicable to the settlement of terminated fixed-price contracts is contained in Section VIII. ASPR, Section XV, prescribes "Contract Cost Principles" applicable to cost-type contracts negotiated on and after 1 March 1949 which incorporate the "Contract Cost Principles" directly or by reference. For such contracts, Section XV, ASPR, is equally applicable in the event of termination unless the termination article of the contract specifies otherwise.

(e) The Joint Termination Regulation, the Joint Procurement Regulations and the Armed Services Procurement Regulation each have certain stated principles and regulations for the settlement of terminated contracts and for determining costs, not all of which are uniform. In the event that a terminated fixed price contract contains no reference to the manner of determining costs on termination, the Statement of Principles for Consideration of Costs stated in ASPR, 8-402 will be followed by the auditor. The auditor assigned to audit a termination settlement proposal must, in each individual case, first carefully read the contract and ascertain what basic cost principles are to be followed in determining costs under the terms of that particular contract.

5-1.002 Settlement Proposal Bases.

5-1.002 (1) Fixed-Price Contracts.

(a) The Joint Termination Regulation gives the contractor the option of presenting his settlement proposal on either the "inventory basis," the "total cost basis" or, under certain conditions, on the "estimated percentage of completion basis" or on any other basis which will provide fair compensation.

(b) The Joint Procurement Regulations authorize only the "inventory basis." Any other basis which the contractor may wish to use must first be approved by the chief of the procurement service concerned.

(c) The Armed Services Procurement Regulation in paragraph 8-503.2 states that the "inventory basis" will be generally preferred. The "total cost basis" may be used if approved by the Contracting Officer. No other basis may be used without the prior approval of the Secretary of the Department concerned or his duly designated representative.

(d) Under the "inventory basis" the settlement proposal consists primarily of the summary totals of groups of similar items of inventory priced at purchase or manufacturing cost. To the inventory values may be added an item for profit (or, under Section VIII, an adjustment made for loss), the cost of settlements with subcontractors and the amount of settlement expenses incurred. Advances, partial payments, and disposal credits are to be deducted to arrive at the net amount of the claim.

(e) The "total cost basis" was devised for situations where it was difficult or impractical to segregate costs between the completed and the uncompleted portions of the contract. When the use of the total cost basis is authorized, all costs incurred under the contract to the date of termination will be summarized and an allowance for profit added. If a loss would have been suffered had the contract been completed, an amount representing the indicated rate of loss should be deducted from the total cost to date of termination. (The method of computation for loss contracts described in Joint Termination Accounting Manual 9b (2) is not authorized by the Armed Services Procurement Regulation and will be used only in connection with those contracts which specifically so require, CAM 5-4.315 (c).) All payments previously made or to be made by the Government for completed units are then deducted. To the costs so determined there may be added the cost of settlements with subcontractors and other settlement expenses incurred. Deductions should be made for advance and partial payments and disposal credits to determine the net amount of the claim.

5-1.002 (2) Cost-Type Contracts. The Armed Services Procurement Regulation, the other regulations of the military departments, and the prescribed standard termination clauses for cost-type contracts, either require or permit the vouchering out of all costs and the negotiation of the fixed fee. The Armed Services Procurement Regulation authorizes the contractor to elect to negotiate both costs and fee or to restrict negotiations to the fee only (Part II, Sec. 4, Ch. V).

5-1.003 Settlement Proposal Forms. The standard forms listed below are prescribed for use in the settlement of terminated contracts:

DD Form 540 for settlement of terminated fixed price contracts on the inventory basis.

DD Form 541 for settlement of terminated fixed price contracts on the total cost basis.

DD Form 547 for negotiated settlement of costs of terminated portion of cost-type contracts.

DD Form 547-1 for use by disbursing officers as notice of audit status date.

DD Forms 542, 542-1, 543, 543-1, 544, 544-1, 545, 545-1 for listing detail of the inventories summarized on any of the above listed forms of settlement proposals.

DD Form 546 for stating contractor's termination accounting policy and other desired accounting information.

DD Form 548 for use by contractor in applying for partial payments.

Specimen forms appear in Section VIII, ASPR.

5-1.004 Effective Date of Termination. As specified in ASPR 8-211, the effective date of termination shall be as follows:

- (a) The date stated in the termination notice, if a date is specified.
- (b) In the event the termination notice directs the contractor to stop work after completion of a designated number of items or upon the occurrence of some other event, then the date the designated number of items are completed, or the date the specified event happens, is the effective date of termination.
- (c) Should the termination notice direct the contractor to stop work "immediately" or use any similar indefinite language, the date on which such notice is received by the contractor will be considered as the effective date of termination.

Section 2—Departmental Policies

5-2.000 Scope of Section. This section states the policy of the Department of Defense regarding certain subjects related to the audit of terminated contracts.

5-2.001 Negotiated Settlements. In the event of the termination of any contract for the convenience of the Government, it is desired that an agreement be negotiated with the contractor which will provide fair and equitable compensation for costs incurred in connection with the terminated portion of the contract, which have not been or will not be otherwise compensated for. Such costs will be equitably adjusted for any indicated rate of loss, or if no loss is indicated a fair profit will be added.

5-2.002 Settlement by Determination (Formula Settlements).

(a) "To the extent that the contractor and the Contracting Officer are unable to agree upon the settlement of a terminated contract, or if a termination claim is not submitted within the period required by the termination clause contained in the contract, the Contracting Officer shall determine the amount due in accordance with the termination clause and the principles set forth in Part 4, Section VIII, ASPR." (ASPR 8-309.)

(b) Usually a settlement by determination is made after due notice to the contractor and an invitation to submit pertinent information, if he has not already done so. The contractor may submit vouchers, transcripts of accounts, affidavits, oral testimony, or other evidence. If the contractor's records have been audited to verify the claim for purposes of negotiation, another audit is usually not made in connection with a settlement by determination, but an audit may be requested by the Contracting Officer. However, at least one audit must be made as required by paragraph 5-2.006 and ASPR 8-515. Audits for the purpose of settlement by determination will be conducted in the same manner as for a negotiated settlement except as otherwise required by the contract terms.

(c) After consideration of the evidence submitted by the contractor, the auditor's report, and any other data, the Contracting Officer will make a determination (with due allowance for profit under the contractual provisions related to settlement by determination) of the amount due the contractor. The latter is bound by such determination unless an appeal to higher authority is taken as provided for in the contract.

5-2.003 Relations With Contractors.

(a) When large or complicated termination settlements are anticipated, a conference should be held with the contractor as promptly as possible after notice of termination to develop a definite program for making the settlement. Such a conference will ordinarily be arranged by the Contracting Officer and will usually include contractor representatives, the contracting officer, the auditor, the property officer and government legal and inspection personnel. However, should such a joint meeting not be arranged by the contracting officer with reasonable promptness, the auditor may, nonetheless, confer with contractor executive and accounting personnel to establish from an accounting viewpoint the basis and general principles for settlement and to determine the knowledge and experience of contractor personnel in termination matters and the information and help which the contractor will require in preparing an acceptable termination settlement proposal. The contractor should be advised that the settlement of a terminated contract by agreement is always expedited when the contractor has adequate records and documentary evidence to support the claim presented and is able to provide government representatives with adequate and dependable information to serve as a basis for the negotiation of a fair settlement on a sound business basis.

(b) At any time prior to the presentation of a settlement proposal, the auditor may advise the contractor regarding the desired manner of preparing, presenting, and supporting the termination settlement proposal. The auditor will inform the contractor of any questionable items arising during the audit in order that the contractor may have full opportunity to make explanations and furnish additional supporting information before the auditor completes his examination. Prior to the issuance of the audit report the auditor may discuss with the contractor any specific problems and questions relating to the audit, to the extent that the interests of the Government require, to clarify the problem, or settle the question, but should avoid any impression of definitely committing the Government to the acceptance or nonacceptance of any item of cost. The above is not intended to prohibit or restrain the auditor from adopting a confident and firm position regarding any item of claimed cost in any subsequent negotiation conferences or appeal hearings. The auditor shall not prepare the contractor's settlement proposal nor assist in its preparation other than as authorized above.

(c) Contractors frequently express the desire to revise their termination settlement proposals during the progress of the audit. The auditor will inform the contractor that any revised or supplemental settlement proposals must be filed on a formal basis. The auditor will not change his copy of the settlement proposal nor permit the contractor to change it. The auditor's report will be based on the settlement proposal as originally submitted unless a revised proposal is received through the usual channels. The auditor should include in the audit report the contractor's statement of intention to revise the proposal, with pertinent comment regarding all revisions of costs proposed. When the proposed revisions include additional items of cost an examination of the costs and comment thereon in the audit report may make an additional trip to the plant unnecessary. Conversely, full acceptance of the contractor's stated intent to revise his settlement proposal may result in later embarrassment to the auditor if the contractor changes his mind and does not file a revised settlement proposal.

5-2.004 Relations With the Property Administrator.

(a) The contract administrator and the designated property administrator have primary responsibility for the control and verification of government property (whether government-furnished or contractor-acquired) which was utilized in the performance of a terminated contract (ASPR Appendixes B and C). Immediately prior to starting the audit the auditor will contact the property administrator and determine whether any government property was in the possession of the contractor for use in performance of the terminated contract at the time of termination. If so, the auditor will ascertain whether the property account has been cleared. If not cleared, appropriate comment will be included in the termination audit report; if cleared, a statement to that effect and a citation to the final property audit report will be included. Regardless of the status of the property account the auditor must assure himself, by inquiry or audit, that government property has been appropriately safeguarded and accounted for.

(b) Appendixes B and C, ASPR, apply only to government property. Therefore, the property administrator does not have the same responsibilities for contractor-owned inventory as he has for government property. Where the inventory contains contractor-owned property, the auditor will be guided by paragraph 5-2.011.

5-2.005 Statement of Contractor's Termination Accounting Policies and Procedures. Contractors will not be required to submit a statement of termination accounting policies except when in the opinion of the auditor the claim is sufficiently large or complex to require more accounting information than that submitted on the DD Form 546 which is required in connection with every termination (CAM 5-1.003).

5-2.006 Required Audits.

(a) It is the policy of the Department of Defense as stated in ASPR 8-515 that settlement proposals submitted by prime or subcontractors in connection with terminated fixed price or cost-type contracts shall be reviewed by the audit agency of the department concerned, or by the cognizant audit agency, whichever is applicable. The contracting officer, (or authorized representative) shall request the review in writing and may specify a minimum scope but shall in no way limit the audit agency from extending the scope of the audit. The contracting officer shall attach to his request, a copy of the contractor's Settlement Proposal, a copy of DD Form 546 "Schedule of Accounting Information" and a complete set of the Termination Inventory Schedules. The audit agency will make the audit and will submit a written report to the contracting officer in accordance with the procedure prescribed in Section 6 of this chapter. Although ASPR 8-515 exempts from mandatory audit requirements all subcontractor claims under \$25,000, requests for audit of such claims may be initiated by the contracting officer. Should the subcontractor's claim not have been audited prior to the settlement of the prime contractor's claim, the auditor should review such settlements when submitted as a part of the prime contractor's settlement proposal and should arrange for field audits of such subcontractor's claims in any cases where such activity appears to be in the Government's interest.

(b) If for any reason the contracting officer fails to make a timely request for an audit of any termination settlement proposal, the district director having audit cognizance may initiate the audit.

5-2.007 Purpose of Audit. The purpose of the audit is to protect the interests of the government by subjecting the contractor's settlement proposal and the documents and books of account supporting the costs claimed to a review by technically qualified audit personnel. The contractor's records will be examined and tested to the extent deemed necessary by the auditor who will advise the Contracting Officer as to the acceptability from an accounting standpoint of the items included in the settlement proposal.

5-2.008 Scope of Review and Audit.

(a) The auditor will determine the scope of the audit to be performed in relation to each terminated contract in accordance with his best professional judgment and the instructions set forth in this manual, but not less than the minimum audit requested by the contracting officer. The Contracting Officer may not restrict the scope of the audit nor the amount of audit time and effort expended on any individual case. No termination settlement proposal will be reported upon until an audit considered adequate by the responsible auditor has been completely performed. If the proposal has been so inadequately prepared as to render an audit impracticable, or the supporting records are not in condition for audit, or access to the contractor's records is denied, the settlement proposal will be returned to the contracting officer with an appropriate explanation of the reasons why no audit was made. See Chapter V, paragraph 5-2.010.

(b) The auditor responsible for the audit of a settlement proposal will first make an *office review* of the contract, the settlement proposal and all available supporting data in the manner prescribed in Section 3 of this chapter. The auditor should discuss matters concerning the claim with the contracting officer, the property officer and the technical inspector when such officers are reasonably accessible. Ordinarily, the office review will be made to acquaint the auditor with basic and background information essential to planning the field audit. The auditor may base his report on the office review when such a decision appears to be in the government's interest because of emergency conditions, or in cases where the cost of the audit clearly would be uneconomical in comparison with the amount of the claim, or when available data and the audit agency's past experience with the contractor indicates that the contractor's certification can be relied upon. In the event that an audit report is written based on an office review, the auditor will state in the report the reasons why a field audit was not deemed necessary.

(c) Except as provided in the preceding subparagraph, a selective examination of the contractor's working papers, books of record and supporting documents will be made to the extent deemed necessary by the auditor to provide a firm basis for an intelligent recommendation for acceptance or for nonacceptance of every item of claimed cost which is subject to an accounting determination. Those items which do not appear to be subject to an accounting determination will be handled in accordance with paragraph 5-2.010.

5-2.009 Overall Limitation on Settlements. It is directed in ASPR 8-507, that: "The total amount payable to the contractor on account of a settle-

ment, whether made through negotiation or by determination, before deducting disposal credits and exclusive of sums paid to compensate the contractor for settlement expenses, shall not exceed the contract price less payments otherwise made or to be made under the contract." When settlements are to be made other than under the Armed Services Procurement Regulation, the auditor will determine that the total amount recommended for acceptance does not exceed the overall limitation imposed by applicable regulations or by the contract.

5-2.010 Costs Not Susceptible of Audit.

5-2.010 (1) Contracts With Cost and Accounting Data Requirements. Most cost-type contracts and fixed-price contracts with price redetermination clauses require the contractor to maintain adequate books and cost records for contract administration purposes, which books and records are equally useful in the event of termination. Should all or a part of the items in the contractor's settlement proposal be found not susceptible of an audit determination because of the contractor's failure to keep the records required by contract, the auditor may be justified in recommending such items for nonacceptance since it is, basically, the responsibility of the contractor to substantiate his claim. Inasmuch as he was contractually obligated to keep adequate books and records, the contractor should not be permitted to profit by his own negligence and failure to comply with the contract terms.

5-2.010 (2) Contracts Without Cost and Accounting Data Requirements. Some contracts do not contain any provision requiring the contractor to maintain detailed cost records. Consequently, after termination the contractor may be unable to provide accurate cost data in support of some or all items on the settlement proposal which may have been estimated or determined by other methods not subject to audit verification. When such amounts are substantial, the auditor will carefully survey the contractor's records for an accounting basis of determining cost that may have been overlooked by the contractor. If the auditor is able to compute or determine on an accounting basis the costs applicable to the terminated portion of the contract and the costs so determined are more than the amount claimed, the auditor will recommend the amount claimed for acceptance. If the amount computed by the auditor is less than the amount claimed by the contractor, the auditor will recommend for acceptance the amount determined by him to be acceptable and will recommend the balance of the amount claimed for nonacceptance. In the event that the auditor is unable to make a determination on an accounting basis he will obtain as much information as is available concerning the costs in question and will recommend an equitable amount of such costs for further consideration by the contracting officer. The auditor will state in the audit report the reason why an audit determination could not be made and will include all information and comment that might assist the contracting officer in negotiating a settlement.

5-2.010 (3) Records Withheld or Unavailable. When contractor's records are withheld or unavailable, the provisions of paragraph 1-0.008 will apply.

5-2.011 Verification of Contractor-Owned Inventories.

(a) Appendixes B and C, ASPR, apply only to government property. Paragraph 8-604.1, ASPR, assigns to the Contracting Officer the primary responsibility for the verification of contractor-owned inventory. It is to be expected that the contracting officer will assume the leadership responsibility by

directing the taking of an appropriate physical inventory of contractor-owned property allocable to the terminated contract and expected to be included in the settlement proposal.

(b) With respect to the items included as inventory in the settlement proposal the auditor must satisfy himself that the termination inventories either are or are not—

- (1) Properly allocable to the terminated contract,
- (2) Correctly stated as to physical count and stage of completion,
- (3) In conformance with the specifications and technical requirements of the contract,
- (4) Reasonably usable on other work of the contractor,
- (5) Excessive in light of reasonable quantitative requirements of the contract.

This he may do through correspondence or discussion with the Contracting Officer or other Government representative. Should, for one reason or another, the auditor not be able to secure the desired information from other Government representatives prior to the submission of the audit report he may make a reasonable effort to develop it through extensions of his audit procedures. Because of the importance of inventories in the settlement proposal, the audit report will always include a comment regarding the nature and adequacy of physical inventory verification accomplished by others or himself.

(c) The auditor is responsible for verifying inventory pricing and for appropriate checks for clerical accuracy. The auditor will also make at least a minimum test check of inventory items for physical count and allocability to the terminated contract. The work-in-process inventory will be tested as to stage of completion and pricing of material, labor, and overhead. The extent of the test check will depend on the effectiveness of the work previously performed by other contract administration personnel and the conditions encountered. If numerous errors are discovered, the scope of the test checks will be expanded to the extent deemed necessary under the circumstances to protect the Government's interest.

5-2.012 Disposition of Inventories. The manner of disposing of termination inventories is set forth in ASPR 8-601. The termination audit report will not be delayed pending disposition of termination inventories but the auditor will inquire into the status of disposition and will report on any unusual or unfavorable factors discovered. If disposition of inventories has been accomplished in total or in part and the contractor has been unable to deliver any portion thereof because it was lost, destroyed, stolen or damaged, the value of such inventory items shall be recommended for nonacceptance. (See ASPR 8-615 and 8-616.) Hasty disposition of inventories prior to audit verification has in some past cases reacted to the disadvantage of the Government. A complete statement of the facts concerning such instances will be included in the audit report.

5-2.013 Auditing Partial Payment Requests.

(a) Partial payments (not to be confused with partial settlements, see par. 5-4.314) may be made after written request of the contractor when authorized by the contracting officer, in accordance with ASPR 8-522. Auditors assigned to review partial payment requests will first make an office review of the partial

payment request and all available supporting data including the contract and audit files relating to the contractor. The auditor may base his recommendations on the office review when such action appears to be in the Government's interest because of emergency conditions, or when the cost of a field audit would be disproportionate, or when available data and the audit agency's past experience with the contractor indicate that the contractor's certification may be relied upon. The auditor will state in the report why a field audit was not considered necessary.

(b) In making a field audit of a partial payment request, it is not intended that an audit of basic cost data be made to the extent required in the audit of a termination settlement proposal, but the auditor will examine the contractor's working papers, books of account and cost data to the extent deemed necessary to provide a basis for recommending acceptance or rejection of all or a part of the partial payment request.

(c) Overpayment to contractors based on partial payment requests is to be avoided. Therefore, whether the auditor's recommendations are based on an office accounting review or on a field examination, the auditor will recommend payment based on only those costs which are clearly and reasonably acceptable. Other costs claimed will be questioned and appropriate comment made in accordance with the available facts.

Section 3—Office Reviews of Settlement Proposals

5-3.000 Scope of Section. This section is a general guide to procedures to be followed by the auditor when making the office review of a contractor's termination settlement proposal in accordance with the policy stated in paragraph 5-2.008.

5-3.001 Utilization of Existing Data. Maximum use should be made of all readily available supplementary data pertaining to the contractor's activities such as—

(a) Reports and working papers of surveys or audits made in connection with other contract terminations, redetermination of prices, or renegotiation of profits, or cost reimbursement contracts.

(b) Information from other Government personnel having contacts with the operations of the contractor.

(c) Bid data, cost estimates, bills of material, production schedules, cost and profit forecasts, production records, and similar data.

(d) Copies of reports to other government bodies, such as Securities and Exchange Commission and Bureau of Internal Revenue reports.

(e) Reports of public accountants.

Since such supplementary data are usually prepared for purposes other than the preparation of the termination settlement proposal, they will be used only as a guide. Their usefulness will be greatest when prepared on bases and classifications corresponding to those utilized in the settlement proposal.

5-3.002 Contractor's Accounting Policies, Practices, and Internal Controls. The auditor will review and appraise the contractor's statements of accounting and termination policies, practices and internal controls as stated on DD Form 546 and as may be available from any other source for any indication that unacceptable accounting practices have been followed. When such

a review and appraisal disclose significant unacceptable accounting practices to an extent to indicate that reliance upon the contractor's representation is not justified, a field audit will be made.

5-3.003 Office Review Procedure. The extent to which particular procedures may be carried out will vary depending upon the nature of the settlement proposal submitted and the supporting and related information available. The following are examples of the matters which should be considered to the extent appropriate:

(a) Available information bearing on the conformity of each item of claimed cost with the contract terms, the applicable procurement regulations and statement of cost principles.

(b) The reasonableness of the relationship between the several items of cost.

(c) The relationship between the amounts claimed per unit and the contract price of completed units.

(d) The reasonableness of the amount represented as the cost of the work-in-process inventory in relation to the stage of completion.

(e) Whether overall limitation on costs claimed has been exceeded. (See par. 5-2.009.)

(f) Information as to whether inventories are on hand, are properly allocable to the contract, are reasonably priced and do not represent over-commitments.

(g) Contract files, reports, and work papers related to prior audits should be reviewed for any evidence that costs applicable to other work have been included in the settlement proposal.

(h) Any evidence having a bearing on the soundness and equity of the bases used in allocating cost to the contract.

(i) Any evidence of duplication of charges.

(j) That, where the settlement proposal is on a total cost basis, proper deduction for finished units invoiced or to be invoiced had been made.

(k) That settlements with subcontractors have been approved by the prime contractor and the Contracting Officer to the extent required by the contract and ASPR 8-518.

(l) That the settlement proposal and supporting schedules are mathematically correct.

Section 4—Field Audit Procedure

5-4.000 Scope of Section. This section is a general guide to procedures to be followed by auditors making field audits of costs claimed on contract termination settlement proposals. It supplements the basic auditing procedures set forth in Chapter IV of the Contract Audit Manual.

Part I—Procedures Applicable to All Contracts

5-4.100 Scope of Part. This part contains auditing instructions applicable to both fixed price and cost-type contracts. The coverage of specific items of cost in some detail has been included for the guidance of the auditor. Specific instructions concerning each type of contract are contained in subsequent parts of this section.

5-4.101 Survey of Contractor's Plant. The auditor should survey the contractor's physical plant, manufacturing processes, and general types of products. The survey will provide background information to aid in evaluating the settlement proposal and the accounting procedures and costing techniques employed by the contractor in its preparation.

5-4.102 Review of Contractor's Schedule of Accounting Information. The contractor's Schedule of Accounting Information (DD Form 546) should be reviewed by the auditor prior to complying with the provisions of the following paragraph.

5-4.103 Survey of Contractor's Accounting Practices and Internal Controls. A survey will be made (or if previously made will be brought to a current status) in the manner and to the extent directed in Chapter III. Particular attention will be devoted to the contractor's accounting practices relating to termination matters. The auditor will note in his working papers the manner in which the termination accounting practices compare with the contractor's Schedule of Accounting Information (DD Form 546).

5-4.104 Principles for Determination of Costs. The auditor will be guided in determining allowable costs by the following:

- (a) The terms of the contract,
- (b) The Armed Services Procurement Regulation,
- (c) The Contract Audit Manual,
- (d) Applicable departmental regulations,
- (e) Generally accepted professional practices and standards of cost determination.

In case any of the guides listed above are found to be in conflict, the auditor will base his determination on the guide first listed above. In the absence of any statement of, or reference to, cost principles in the contract, the auditor will use the cost principles set forth in ASPR, Section XV for cost-type contracts and the cost principles set forth in ASPR, Section VIII for fixed-price contracts.

5-4.105 Audit Program. An audit program will be developed in the manner required in paragraph 4-1.103 and included in the audit working papers.

5-4.106 Basic Audit Guides. Termination audit procedure will conform to the general basic requirements set forth in Chapter IV except as otherwise stated in this chapter. One of the principal basic differences is that in screening termination costs related to a settlement proposal submitted on an inventory basis, an additional factor is present, in that, to be allowable costs must not only be applicable to the terminated contract but also *applicable to the terminated portion of the contract*. Costs will be examined and tested for allowability in accordance with the guides set forth in paragraph 5-4.104. The audit will be made by the use of selective tests. Emphasis should be placed on "sensitive" items and costs that involve discretionary action by the contractor and his accounting personnel. The auditor's working papers should include analyses of these items and indicate the methods by which the amounts applicable to the terminated portion of the contract were determined. Special attention should

be given to items which are large in amount or uncommon in nature. The procedures which involve the distribution of costs are of special importance. The possibility of computations based on unsound accounting principles, inequities, and errors in the allocations or distributions of expenses should not be overlooked. Costs incurred after the contractor received advance notice of termination or had any reason to expect a termination should be reviewed for any evidence of unnecessary intensification of productive activity. The auditor should determine how promptly the contractor discontinued incurring costs after receipt of Notice of Termination, and the promptness with which notices of termination were sent to subcontractors. Special attention should be given to adjusting entries made just prior to termination or with a retroactive effect at any time subsequent to that date.

5-4.107 Audit of Material Costs. The procedure for the audit of material costs will receive further attention in later paragraphs under specific types of contracts and bases of settlement. However, the following instructions have general application.

(a) Material acquired prior to date of contract should not be included in the settlement proposal unless the contractor can establish that the material could have been sold at a favorable price or used on other production but was not, because of reservation for the terminated contract, or was acquired specifically for the contract. Such material, if allowable, will ordinarily be included at cost provided the cost does not exceed the price at which the material could have been acquired at the date of the contract. The cost of any required modification of such material is allowable, if added to the original cost, to the extent that the combined costs do not exceed the price at which the material could have been acquired at the date of the contract.

(b) The auditor in reviewing all items on the contractor's settlement proposal should be alert for "common items." These may often be uncovered by checking purchases allocated to other contracts, by reviewing stock record cards for withdrawals to other work and by checking bills of material and procurement schedules for projects similar to the terminated contract. The cost of items which are common to the terminated contract and other work of the contractor such as basic raw materials (pig iron, cotton, rubber), standard parts (screws, bolts and nuts), fabricated component parts (spark plugs, starters, motors, generators), including the claims of vendors and subcontractors supplying such items, should be very carefully examined by the auditor before approval. Common items may be included as a part of the termination settlement proposal only to the extent that the sum of quantities on hand, in transit and on order is in excess of the reasonable quantitative requirements for other work. In other words, the total available quantity (inventory, in transit and on order) should first be allocated to continuing or anticipated government or commercial production and only the excess beyond such requirements is allocable to the terminated contract. The contractor should assign to the terminated contract the least processed inventory and the purchase commitments which may be terminated at the least cost to the Government. The "burden of proof" that this action has been taken rests on the contractor. The fact that retention of common item inventory by the contractor will result in an abnormally large inventory in relation to remaining production shall not entitle

the contractor to claim the excess as a termination cost if the material is usable on foreseeable production. If the contractor is awarded other contracts or receives other commercial orders, after termination date but prior to final settlement, on which common items of inventory can be used; such items as are usable on the new work should be withdrawn from the claim and if not so withdrawn will be recommended for nonacceptance by the auditor.

(c) Purchase discounts of whatever nature including rebates and quantity discounts earned and accrued will be passed on to the Government in the form of a reduction in contract cost. Quantity discounts and rebates based on yearly purchases or other periodic computations may be estimated if necessary. Usually, the contractor is required to pass on to the Government only the cash discounts *earned*; however, if the contract so requires the contractor must give the Government the benefit of all cash discounts offered by vendors whether earned or not. It is preferred that the cost of each item purchased be priced at net cost less all discounts, rebates and allowances. If such is not the contractor's usual practice, any other equitable method may be accepted. A method that is usually acceptable is to establish a percentage relationship between discounts earned and direct materials (since the material factor in overhead items is not usually apparent) and apply the same percentage to the direct materials (including material in work-in-process) included in the termination settlement proposal. Unless for some reason the discounts applying to the contract purchases are materially higher or lower than those on the contractor's other purchases, this method will usually be satisfactory. Deduction of purchase discounts earned from the general administrative expense pool, thus reducing the rate, usually will give satisfactory results, although the effect on a particular claim could be quite different from that resulting from a direct deduction. The least acceptable method is a deduction of purchase discounts from the manufacturing overhead expense pool. This method will result in inequity to either the contractor or the Government except in those cases where the ratio of direct material, labor, and manufacturing overhead included in the termination settlement proposal is in reasonable relation with the normal ratio of such components of cost of manufacturing for the contractor. Auditors are cautioned to always review the matter of trade and cash discounts earned as this item of cost reduction is frequently overlooked by the contractors in preparing settlement proposals.

5-4.108 Audit of Labor Costs. The procedures for the audit of labor costs will receive further attention in later paragraphs under specific types of contracts and bases of settlement; however, the following has general application: Sole proprietors' and partners' wages or salaries are allowable costs to the extent that services were actually rendered and provided that the amount charged for such services does not exceed the cost of a service of similar skill if obtained elsewhere. Normally, such compensation will be included in the overhead pool. Sole proprietors' and partners' wages or salaries are allowable as a direct charge to the terminated contract only if acceptable time records are available to substantiate the charge and to account for the full time of the individual or individuals concerned.

5-4.109 Audit of Manufacturing Expense.

(a) The general objective of the termination auditor is to determine that the manufacturing expense pool is composed of items which are correct in amount and are properly admissible under the terms of the contract and applicable cost principles, that an acceptable base period has been selected, and that the allocation has been made on an equitable basis. The auditor should consider in advance in view of the amounts claimed whether any adjustments resulting from the analysis of any specific account or the use of more acceptable base periods or methods of allocation will substantially affect the total settlement proposal, and would justify the expenditure of audit work required.

(b) The length of the base period used for making allocations to the settlement proposal where practical should be approximately the same as the contract period where the settlement proposal was prepared on the total cost basis or approximately the same as the period during which the work-in-process inventory was produced where the settlement proposal was prepared on the inventory basis. In either case, it should be determined that the period is sufficiently long that inaccuracies in the allocation of costs are avoided. Any period which furnishes an equitable basis for the determination of overhead may be used. If the contractor uses a base period other than that approximating the period of performance, the auditor should ascertain that the use of the period thus selected has resulted in a fair charge to the contract.

(c) A schedule of the accounts and the amounts thereof included in the manufacturing expense pool for the base period should be obtained and checked for agreement with the books. "Sensitive" and significant items should be examined and tested. Abnormal fluctuations in the expense accounts between periods should be analyzed. A determination should be made as to whether the expenses included are applicable to the terminated portion of the contract and are acceptable under the contract and applicable regulations. The auditor should determine whether physical inventories of supplies and indirect materials on hand in storerooms or elsewhere have been taken at the date of termination and whether the related overhead accounts were appropriately adjusted. If physical inventories were not taken and there are indications that quantities on hand increased during the base period, consideration should be given to a suitable adjustment. All accrued prepaid and deferred items should be reviewed and checked for supporting computations, applicability, and acceptability. The auditor should determine that all scrap sales, miscellaneous income, and other credits properly allocable as a reduction of the manufacturing expense pool have been properly applied.

(d) Expenses of the type charged direct to the terminated portion of the contract may not also be included in whole or in part in the overhead expense pool. Direct charges included in the settlement proposal for types of expenses normally considered to be overhead will be checked to the records for any duplication.

(e) As a general rule, the contractor's basis of allocating overhead will be acceptable if it has been consistently used by the contractor, is in accordance with generally accepted accounting practice and produces equitable results.

Appropriate tests should be made to determine the accuracy and uniformity with which amounts or quantities used as bases of proration (such as direct labor hours) are developed. If audit adjustments have been made to the amounts or quantities which are to be used as bases for proration, a reapportionment of overhead may be necessary. If a labor base is used, consideration should be given to whether other contracts or work on which little or no productive labor was performed have been charged with their proper share of manufacturing expense.

(f) The following classes of manufacturing expenses will require the special attention of the auditor when included in a termination settlement proposal:

- (1) Rejected Manufactured Parts and Subassemblies, (par. 5-4.304 (b)).
- (2) Depreciation Expense (CAM 4-1.325 (c)). At the close of World War II depreciation applicable to future periods was includible in the termination claim if the contractor could demonstrate that the facilities were no longer useful. No similar provision is included in the existing statutes and regulations. Therefore, allowable depreciation will be limited to the allocable "true depreciation" and no acceleration of "true depreciation" is permissible. This paragraph is not intended to contravene paragraph 8-402 (b) (16) ASPR which covers special machinery and equipment.

5-4.110 Other Direct Charges. Under settlement proposals prepared either on an inventory or total cost basis there may be included as "Other Direct Charges" such items as dies, jigs, fixtures, special tools and engineering, and development related to the development of the design of the contract end product. The portion of these charges which may be included will be different in connection with an inventory claim, which should include only those costs applicable to the terminated portion of the contract, whereas a total cost claim may include all of the costs applicable to the entire contract. When the item under consideration is "special" to the terminated contract and to one or more other contracts or products, an apportionment must be made on an equitable basis between the terminated contract and the other contracts or products. If an inventory claim is to be presented, the amount apportioned to the terminated contract must then be apportioned between the completed and the terminated portion of the contract (and continued portion, if any). To the extent practicable, the auditor should review bid proposals related to other contracts, previous termination settlement proposals and records related to commercial production, to determine whether costs claimed as direct charges may have been previously reimbursed or charged off against other production or terminated contracts. No similar items attributable exclusively to other contracts or commercial products may be included in the overhead pool. The auditor may require engineering or other technical assistance to determine whether the direct charges claimed were "special" to the contract and whether such charges, if "special," were applicable, necessary and reasonable. In such cases the auditor will seek the advice of qualified government technical personnel. If such technical assistance cannot be obtained, the auditor will recommend the charges for further consideration and suggest a review by qualified experts. The items most commonly claimed as "other direct costs" are commented on in the following subparagraphs. See also ASPR 8-402 (d).

(a) The cost of dies, jigs, fixtures, and special tools of the type designed and acquired especially for the contract (or for the contract and other contracts) and which ordinarily lose utility because of obsolescence rather than through wear and usage may be charged directly to the terminated contract. In commercial practice such costs are ordinarily written off over the period of the production for which acquired. Costs of purchased items must be properly supported by invoices and credit allowed for all discounts. Cost of items constructed in the contractor's own plant, installation, and setup charges must be supported by adequate job order or other cost records. See ASPR 8-611.

(b) Engineering and development expense related to the design and development of the end product, the detailed engineering specifications for the tooling, production processes, layout, and similar functions may be approved as direct charges if otherwise correct.

(c) Initial or starting load costs are those expenses of a nonrecurring nature which arise in the early stages of production because of unfamiliarity with the product and may include preparatory expenses such as plant rearrangement. Such costs, if segregated, recorded, and amortized on the books of the contractor, or, if clearly indicated and supportable by acceptable cost records or reports, may be claimed as a direct charge against the contract. Both labor and overhead expenses may be included if unusually high in the early stages of production because of inexperienced labor, idle time, excess cost due to subnormal production cost of testing and adjusting equipment and changing methods of processing and training employees. Abnormal labor and material costs in early stages of production due to excessive defective work and abnormal scrap losses may also be included. However, all such costs are includible only because of their special nature as starting load costs and not merely because they are high. Cost of engineering and developing equipment, tooling, and setup expenses are not considered as starting load costs but if not readily separable (and are otherwise acceptable) should not be excluded by the auditor for that reason alone. Starting load costs should include only the excessively high production costs which may be incurred during the early stages of operation under contracts for new products, or under expansion programs for greatly increased production under existing contracts, which result from unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit costs usually will tend to level off, indicating the end of the initial period of production. This leveling off point does not necessarily represent the lowest unit cost eventually attainable during the operation of the entire contract. The amount designated as starting load costs should be subjected to a qualitative analysis to eliminate any consequential items which do not arise from unfamiliarity with the product in the initial stages of production. For example, high unit costs early in the contract due to high material prices which were later reduced, would not be acceptable starting load costs. Another example would be costs which were high because of labor disturbances. If the contractor has not segregated or recorded in an acceptable manner any starting load costs, but nevertheless maintains that such costs were incurred and should be included in the settlement proposal, generally such costs should not be estimated or computed on any theoretical basis but rather, in this situa-

tion, the most acceptable method of obtaining full recognition of initial costs is to prepare the claim by the total cost method. This is one of the situations in which the use of the total cost method is indicated. If the settlement proposal has been submitted on the inventory basis and starting load costs have been included as a direct charge which charge is not supported by the existing records but the auditor believes that such charges might be justified, then the best possible test is to recompute the claim on the total cost basis after the audit is otherwise completed.

(d) Loss on special machinery and equipment (other than (a) above), when claimed as a part of a termination settlement proposal, will require the very careful consideration of the auditor. Acceptability of such costs will depend upon the contract terms and the statement of cost principles applicable to the particular contract and will usually involve legal and technical questions which are outside the field of accounting and auditing. The accounting aspects of a loss on machinery and equipment are usually simple, involving the amortization of cost over all Government contracts for which the facilities were acquired or which benefited from the facilities. The title must be transferred to the Government or the sales price shown as a disposal credit. However, there are many reasons why the facilities may not be considered special to the contract. They may be similar to other facilities owned by the contractor or they may be usable on continuing work. The determination that a particular facility is "special" is a question of fact; therefore, unless the case is unusually clear, the auditor should not recommend loss on facilities for acceptance. Instead, after the propriety of the computation has been checked, the item should be recommended for further consideration with a complete statement of all the facts known to the auditor included in the audit report. The auditor is, of course, not debarred from making a recommendation for nonacceptance, if a reasonable basis exists such as where the contractor continues to use the facilities.

(e) Material handling charges are discussed in paragraph 4-1.310 (d), to which the auditor is referred.

5-4.111 General and Administrative Expenses.

(a) The costs contemplated hereunder are those expenses incurred in the general management and operation of a business which are not directly related to production. They may include such items as officers' salaries and wages of their assistants and clerical help, general office expenses, professional fees, and, under some conditions, general selling expense. The items classified as general and administrative expenses will vary between contractors and the classification normally used by a contractor ordinarily will be accepted if its application yields equitable results.

(b) Before attempting an allocation to the terminated contract, there should be excluded from the general and administrative expense pool all items specifically required to be so excluded by the terms of the contract or the applicable cost principles. Also to be excluded are all costs which were charged direct to the terminated contract, all similar costs, and all costs which may be exclusively identified with particular phases or functions of the contractor's business as opposed to those costs attributable to the business as a whole, such as selling expenses related to non-Government business. Cash discounts allowed on sales should not be included in the claim as a part of the general and admin-

istrative expense pool or in any other manner, since such discounts are a reduction in sales price and are not a true cost. If corporate officers or executives are in charge of factory operations or engineering, their salaries are more properly charged to those functions than to general administration. Similarly, clerical wages, professional fees, and similar expenses may pertain to functions other than administration. The nature of the service performed rather than the name given to the expense item should determine the acceptability of the expenditure and the method of allocation or proration to specific contracts.

(c) If the contractor's organization is not highly specialized, or the contractor's books do not provide for the usual separation of costs, or the amounts involved are too small to justify meticulous treatment, "broad brush" procedures may sometimes be applied to costs which, in theory, should be treated in a more precise manner. For example, the contractor's organization or his accounting system may be such that the expense of purchasing, engineering research, etc., may be included in the administrative expense pool. The result is that these costs will be prorated between the terminated contract and other work on the same basis as true general administrative expenses, even though, under usual procedures, such items should receive different treatment. In such a situation, if the apportionment appears equitable, there need be no insistence on separation of these items from the administrative expense pool solely because in theory they would be more properly treated on some other basis. However, this latitude in the treatment of types of cost, some part of which is includible in the termination settlement, should not be extended to those which are in no way related either to the contract or to the general administration of the contractor's business. It is obvious, for example, that losses on other contracts and provisions for contingencies should be completely excluded from any expense pool which is to be prorated to the terminated contract.

(d) Any base period that is reasonable in the light of the circumstances may be used in computing a general rate for the allocation of general and administrative expenses. In appropriate cases, it may be the time required to produce the termination inventory, the most recent fiscal period or the period of contract performance.

(e) Any method of allocating general and administrative expenses to terminated contracts may be used provided it is reasonable in the light of the circumstances of the particular case and is consistent with the policies stated herein. For manufacturing operations a rate based on processing cost is best from a strictly theoretical viewpoint, since processing cost most closely reflects the activity which it is the function of general administration to supervise. A rate based on processing cost plus the cost of direct material (factory input cost) is often easier to compute and serves the purpose adequately in most cases. A rate based on cost of sales is also easy to compute and may in some cases, be as satisfactory as a rate based on "cost of production." However, cost of sales may not satisfactorily reflect productive activity in the particular period involved, since manufacture is not necessarily concurrent with sales. A rate based on sales is generally unsatisfactory for the same reason, and also because difference in profit margin may distort the distribution. An analysis of "cost of sales" or "cost of production" into the constituent elements of direct material, direct labor, and manufacturing overhead will furnish a "pattern" as to the

proportion of each element of the total. This pattern should be compared to the pattern of similar elements in the claim and, if no marked differences exist, a general administrative rate applied to all of the contractor's own costs is acceptable. However, if, for example, the proportion of direct material in the claim exceeds to a marked extent that in the pattern, and the use of a rate based on processing cost is not practicable because of the difficulty of ascertaining processing cost, it may be necessary to adjust the rate or to use some other basis of allocation. If the auditor is not able to make a determination on a strict accounting basis, he may take all the known facts into account and using his best judgment recommended an equitable amount for acceptance, any clearly excessive amount for nonacceptance, and the balance for further consideration. Although it is true that the "rate" of general and administrative expense is not in itself controlling because of lack of uniformity in classification of expenses in both the pool and the base and, therefore, no arbitrary stand should be taken to disallow rates above any certain level; yet a rate higher than those which the auditor has come to expect in a certain industry should be the signal for a more intensive analysis of the components and basis of administrative expense. This is particularly necessary in view of the liberality of allowing the rate to be applied, in most cases, to all elements of the contractor's own costs in the claim. The methods of allocation indicated above will not ordinarily be suitable for contractors engaged primarily in nonmanufacturing operations such as engineers, architects, and writers whose termination claims will include little or no inventory. The operations of such contractors require a greater use of the direct application of expenses. If the direct application of general and administrative expenses is not practicable, allocation may be made on the best basis available, provided the amount allocated to the terminated contract bears a reasonable relation to the work done. The treatment of administrative expense in termination claims is unavoidably marked by lack of definiteness. The costs involved are of the most indirect character and "recognized commercial accounting practices" leave much to the judgment of the accountant. The following types of expense are often particularly troublesome to the auditor:

- (1) *Selling and distribution expenses.*—These expenses may be included if they are of a broad, general character which can fairly be said to apply to the business as a whole, such as the selling and distribution activities of the general corporate executives or the owners of an unincorporated business or the salaries and expenses of general sales officials if their functions include attention to government sales. Other selling expense of a more specific character may be included if such expenses have some relationship to the terminated contract. To be excluded from the settlement proposal are costs related to commercial products only such as sales salaries and commissions, sales promotion costs, expenses of sales offices and organizations maintained at distant points. When the proposal is submitted on the inventory basis, costs related solely to delivered products such as packing, shipping, warehousing, and outbound freight normally will be excluded. Some costs related solely to the delivered product may be acceptable as a part of a total cost claim.
- (2) *General experimental, research, and development expense.*—The term as used herein refers to expenses incurred on projects of a basic

and general nature and in the development of new ideas and processes as distinguished from process engineering, tool development, and similar activities related to particular contracts. This type of expense will be approved if the contractor can show that the terminated contract or the defense program benefited to some extent from such research or that there is at least a traceable relationship. If income from royalties or from the sale of patents or rights is derived from past or current general experimental, research and development programs, such income should be deducted from the amount of expense before any allocation is made.

- (3) *Fines and penalties.*—Fines for violations of Federal, state or local laws or statutes are not allowable costs. Penalties assessed for failure to comply with legal directives or for failure to pay taxes, etc., when due are not allowable as costs. There appears to be no equitable reason why a contractor who has broken the law or failed to obey the law or to pay his obligations promptly should expect the Government to share in and thereby reduce the burden of the fine or penalty imposed.
- (4) *Commissions and fees.*—Any sales or other commissions, legal or other fees, billed or otherwise which appear to be contingent on the ability of the contractor to collect or recover the amount from the Government shall be critically examined by the auditor. If he is not satisfied as to its reasonableness, the amount will be set forth for further consideration of the contracting officer.

(f) The rate should be applied only to the type of items in the termination settlement proposal used in determining the rate. For example, a rate based on the relation of total administrative expenses to total cost of production should be applied to corresponding items in the settlement proposal such as the cost of raw materials, purchased parts, work in process, dies, jigs, fixtures, special tools, and other similar costs other than administrative and settlement expenses. On the other hand, a rate based on processing costs should be applied only to the contractor's direct labor and manufacturing overhead expenses excluding direct material costs. Where the proportions of the component cost elements in the contractor's settlement proposal are substantially different from the cost pattern used in arriving at a general rate, such as where the claim includes a disproportionate amount of raw materials, it may be necessary to adjust the rate or to use some other basis or method of allocation.

(g) A general rate for the allocation of administrative expense should not be applied to the amount of subcontractor's claims, nor to settlement expenses included in the settlement proposal of the contractor. However, such administrative expenses as may be incurred in the settlement of subcontractor's claims may be included directly as settlement expenses. While administrative expense related to effecting settlements and to a subcontracting program may be included in claims to the extent incurred, a computation by means of a percentage application to the amounts of settlements with subcontractors is not acceptable. Any allowance on a percentage basis would furnish an incentive to the contractor to keep subcontractor's settlements at a high level.

Part II—Procedures Applicable to Cost-Type Contracts

5-4.200 Scope of Part. This part contains more specialized audit instructions applicable to terminated cost-type contracts only.

5-4.201 Determining Method of Settlement.

(a) Unless the contract specifies otherwise, the Contracting Officer at the request of the contractor shall limit the negotiations for settlement of a terminated cost-type contract to the fixed fee, in which event the contractor will continue to voucher his cost and the instructions set forth in CAM 5-4.202 will apply. If the contract permits and the contractor elects to negotiate both the then unvouchered costs and the fixed fee, the instructions set forth in CAM 5-4.203 and 5-4.204 will be followed. See ASPR 8-508.

(b) In the event of a partial termination of cost-type contract, an adjustment of the fixed fee will be negotiated but no change in the method of vouchering costs will be made by the contractor, nor by the contracting officer except under the special conditions stated in ASPR 8-514.

(c) In the event both unvouchered costs and fee are to be negotiated, the contractor will be encouraged to submit only *one* settlement proposal which will be final and will include all unvouchered costs. However in unusual cases, where the determination of certain costs is unduly delayed, the contractor may submit partial settlement proposals, clearly identified as such, covering specific items of cost which will be audited in the same manner as a final settlement proposal and which may be the basis for a partial settlement by the contracting officer. The amounts of any partial settlement proposals previously submitted will be clearly shown on any subsequent partial or final settlement proposals submitted by the contractor. See ASPR 8-308.

5-4.202 Procedure When Negotiation Is Limited to Fixed Fee.

(a) The contractor is expected to submit on cost vouchers all costs reimbursable under the contract including the contractor's own costs allocable to the terminated portion of the contract, cost of settlements with subcontractors and vendors, and all other applicable costs including settlement expenses. Before requesting reimbursement for settlements with subcontractors, the contractor should obtain whatever approvals are required by the terms of the contract and applicable regulations.

(b) All cost vouchers (including reclaim vouchers) submitted after termination will be subject to the same audit procedures and documentary evidence requirements as those submitted under current contracts.

5-4.203 Procedure When Both Costs and Fixed Fee Are To Be Negotiated.

(a) When the contractor elects to negotiate the costs applicable to the terminated portion of the contract, the contractor will submit cost vouchers for all costs incurred prior to the effective date of his election. It is recognized, however, that a sharp cut-off is neither practical nor necessary. Vendor's invoices applicable to both periods and overlapping payrolls may be accepted by the auditor when submitted by cost voucher. "Resubmission" and "reclaim" vouchers and pending appeals covering costs originally submitted on Standard Form 1034 vouchers will be treated as though the contract had not

been terminated. The contractor will identify as such the last cost voucher to be submitted. Thereafter, costs must be included in the settlement proposal. The auditor will make reasonable tests to determine that the settlement proposal includes no costs previously submitted on cost vouchers.

(b) After the last cost voucher has been submitted, the contractor is permitted to submit a settlement proposal setting forth the unvouchered cost and fixed fee claimed as applicable to the terminated portion of the contract. The settlement proposal will be submitted on DD Form 547 and will be accompanied by the inventory schedules prepared on prescribed forms as required by ASPR 8-603. Items of cost on the settlement proposal should be supported by detailed statements or schedules where necessary and appropriate. The contractor is not required to support the expenses claimed in the settlement proposal with documentary evidence such as the original invoices but the contractor must have schedules, work papers, books, accounting records, and basic documents, etc., on file and available to the auditor which will support every item of cost in substantially the same manner as would have been required had no termination occurred. Allocations and estimates of costs not based on accounting determinations will not ordinarily be recommended for acceptance by the auditor unless clearly less than amounts which would have been determined through the use of accepted accounting procedures.

(c) The auditing procedures to be followed in verifying settlement proposals submitted in connection with terminated cost-type contracts are substantially the same as those specified in Chapter IV and Part 1 of this section. The provisions of the particular contract governing allowable costs will constitute the auditor's guide in the event of termination the same as if the contract had not been terminated. If costs which previously have been disapproved by the auditor because they were considered to be unallowable costs are included in the settlement proposal, they will be recommended for non-acceptance unless additional evidence which establishes the allowability of the item to the satisfaction of the auditor is presented by the contractor. In the event that there is included in a settlement proposal any amount which was previously formally disallowed and the contractor had lost the right to appeal or reclaim due to failure to act within the established time limits, the auditor will recommend nonacceptance of the amount with appropriate explanation. It is the auditor's responsibility to identify and disclose items presented which are identical in nature to other expenses previously disallowed by the General Accounting Office. See ASPR 8-512.2. The auditor will not indicate approval nor make deletions on the settlement proposal form or supporting exhibits submitted by the contractor. The auditor will submit his comments and audit findings in the manner prescribed in Section 6 of this chapter. In reporting on costs not susceptible of audit, the auditor will be guided by the instruction in paragraph 5-2.010.

(d) A record of each partial payment request, partial settlement proposal and the final settlement proposal will be entered by the auditor on the authorized Voucher Control Record. Such changes in columnar heading will be made as may be required to adequately record the request or proposal and the action taken and recommendations made by the auditor. Such entries will be separated by several spaces from the last voucher recorded and it may be preferable

to use a separate page. The amounts of settlement proposals submitted will not be added to previous totals of costs submitted on cost vouchers. Vouchers for payments to the contractor resulting from partial payment and partial and final settlements will be reviewed by the auditor and entered on the Voucher Control Record in the same manner as prior cost vouchers and will be added to the previous totals to complete the record of contract costs. Vouchers for partial or final termination settlements need be supported only by the signed partial or final settlement agreement.

5-4.204 Audit Status Date. When the contractor makes a decision under ASPR 8-508 that a terminated cost-type contract settlement will include costs, the auditor will be guided by paragraph 8-511 ASPR relative to the establishment of the audit status date.

5-4.205 Procedure Applicable to Terminated Cost-Type Subcontracts Under Cost-Type Prime Contracts.

(a) In the event that a cost-type subcontractor to a cost-type prime contractor is to continue to invoice all of the costs of the terminated subcontract and the fee alone is to be negotiated, the government or prime contractor's auditor responsible for the audit of the subcontractor's commercial invoices will continue to audit and approve or adjust such invoices as appropriate, including those for settlement expenses. The prime contractor will present the subcontractor's commercial invoices for payment as a part of the prime contractor's settlement proposal or as the documentary support to a cost voucher, depending on whether the prime contract has been terminated, and if so depending on the manner in which he is submitting his costs. The auditor responsible for the audit of the prime contractor's costs will determine that the commercial invoices have been properly approved by both the auditor, and the contracting officer as required, having cognizance of the subcontract.

(b) In the event that a cost-type subcontract to a cost-type prime contract is to be settled by a negotiation of costs (and fee, if any), the Government or prime contractor's auditor responsible for the audit of the subcontractor's cost vouchers will also audit the subcontractor's settlement proposal. In general, the instructions for the audit of prime contractor's settlement proposals are also applicable to the audit of subcontractor's settlement proposals. The auditor's report will be forwarded to the contracting officer who is responsible for negotiating or approving a settlement. A copy of the auditor's report will also be forwarded direct to the auditor responsible for the audit of the prime contractor's costs. The requirements of ASPR 8-518.5 concerning the submission of subcontract settlements to the contracting officer for approval or ratification must be observed. The auditor (prime contractor) will determine that the amount claimed by the prime contractor in partial or complete settlement of the subcontractor's claim is supported by a subcontractor's commercial invoice and that the settlement is approved by the Contracting Officer. Should the prime contractor make any partial payments (as distinct from partial settlements) to a cost-type subcontractor and claim such expenditures as a cost in his settlement proposal, the auditor will recommend such amounts for further consideration unless they have received the prior approval of the contracting officer as contemplated by ASPR 8-522. *Note.*—Claims of subcontractors holding cost-type subcontracts under fixed price prime contracts

and claims of subcontractors with fixed price subcontracts under cost-type prime contracts will be audited by Government auditors when required by ASPR 8-515, or the regulations of the contracting department, or at the request of the Contracting Officer, or at the initiative of the audit agency.

5-4.206 Adjustment of Fixed Fee. In the event that both costs and fixed fee are to be negotiated, the contractor is expected to include a claim for fixed fee as a part of the settlement proposal. In the event the negotiation is limited to the fee, the contractor is expected to submit a claim for an adjusted fee in the amount deemed equitable in accordance with the contract terms, usually on the basis of percentage of completion. The amount of the reduced fixed fee will be negotiated for the Government by the representative specified in the contract, usually the Contracting Officer, as directed in ASPR 8-509.2. Unless otherwise stated in the contract or applicable regulations the auditor's responsibility with respect to the fee will be limited to determining that the amount claimed does not exceed any limitations imposed by the contract terms or departmental regulations and to verify the amounts of previous fee payments. The auditor may render any reasonable assistance in the negotiation of the fixed fee that is requested by the responsible officer, such as—

- (a) An analysis of the method used by the contractor in determining the amount claimed.
- (b) Verification of the accuracy of the contractor's calculations.
- (c) An audit verification of the elements entering into the contractor's calculations.
- (d) Contract cost data, including costs and fee paid to contractor on Standard Form 1034 vouchers.
- (e) A statement of the estimated costs, which would have been incurred had the contract been completed, if readily available.

Other than as authorized above, or required by contract or departmental regulations, the auditor will not ordinarily express any opinion regarding the reasonableness of the contractor's claim for fixed fee or the amount negotiated by the responsible officer. However in instances in which the amount of the claim appears excessive in light of the facts known to the auditor, he will bring the facts to the attention of the Contracting Officer.

Part III—Procedures Applicable to Fixed-Price Contracts

5-4.300 Scope of Part. This part contains more specialized audit instructions applicable to terminated fixed-price contracts only.

5-4.301 Settlement Proposals on Inventory Basis. Preference for the use of the inventory basis for settlement is expressed in ASPR 8-503.2 (a). It is therefore the type of settlement proposal with which the auditor will be most frequently confronted. This is advantageous because the inventory-type of claim normally presents fewer problems to the auditor than other types of claims. In proceeding with the audit verification of a contractor's settlement proposal prepared on the inventory basis, the auditor will be guided by the preceding general instructions as well as the more specific suggestions which follow. Special attention is invited to Paragraph CAM 5-2.011. Checks should be made of the clerical accuracy of the unit costs applied to the inventory schedules, the amounts extended, and the summarization of the amount of the

inventory as carried from the inventory schedules to the settlement proposal form.

5-4.302 Audit of Raw Material—Inventory Basis. Raw material inventory schedules will be subjected to a selective check to verify the accuracy of the pricing and applicability to the contract by reference to the vendor's invoices and the applicable purchase orders. No additions to the invoice cost of materials will be approved for such overhead items as transportation, internal handling, and storage unless the computation is made on a sound basis and expenses of a similar type are excluded from the overhead pools (par. 4-1.310). The auditor should determine that cash and trade discounts and quantity purchase rebates and allowances earned are deducted from material costs or from overhead as directed in paragraph 5-4.107 (c).

5-4.303 Audit of Work in Process—Inventory Basis. Work-in-process inventories often present the auditor with a complicated problem of verifying unit cost data which have been applied to units and components in various stages of production and which include direct material, direct labor, and manufacturing overhead. The contractor may have determined the prices used by any number of cost methods and combinations and variations thereof, the most common of which are the historical (actual) cost and the standard cost methods. It is assumed that the auditor is familiar with the various types of cost systems and no discussion or description thereof are included herein. Audit procedures applicable to the various types of manufacturing cost computations are presented in Chapter IV and in the preceding paragraphs of this chapter. Unit cost data of a statistical nature, not controlled by the general ledger accounts, are ordinarily less reliable and should be subjected to more extensive review and verification than those which are controlled. Consideration should be given to the reasonableness of the accumulated manufacturing cost plus applicable administrative expenses and profit of substantially finished units in relation to the contract price. The auditor should make full use of all available cost data, cost reports, cost standards, engineering and bid estimates, bills of material, and other information having a bearing on the cost of operations, parts, components, or the end product or of cost centers, departments or operating units which will provide an indication of the accuracy of the cost data used in pricing the inventory.

5-4.304 Audit of Material in Process—Inventory Basis.

(a) The quantity of the material element in a part or a unit of production may be checked by reference to engineering specifications or to actual production records. If standard material costs are used, the auditor should test check the reasonable accuracy of the contractor's method of setting standards applicable to the contract and to other products, examine variance accounts and other records to determine that the standard costs used in pricing the inventory bear a reasonable relationship to actual costs. When unit prices for direct materials include an allowance for cutting waste, spoilage, and other production scrap, the auditor should verify such factors by comparison to actual losses. Most factory offices maintain for statistical and factory management purposes production and scrap collection records which can be checked for a selected period. An unwarranted allowance for waste and spoilage is one of the most frequently used and least frequently detected methods of inflating costs.

(b) Material, component parts, partly fabricated assemblies, or completed end items may have been rejected during or at the end of the manufacturing process. Normally, a greater proportion of rejects will arise during the early period of contract performance. The rate of rejection should decrease considerably as production experience is gained. Because rejection occurs throughout contract performance, a great portion of the cost of rejected items is applicable to the completed portion of the contract and the contractor is presumed to be compensated therefor in the purchase price. Only a minor portion representing rejects arising from work in process at the time of termination is applicable to the termination claim. The portion of the cost of rejected items applicable to work-in-process inventory may have been provided for through inclusion of an allowance for such costs in establishing standard costs or burden rates. In such cases no adjustment need be made but the auditor must guard against the cost being included as a specific item in the claim and duplicating the allowance through its inclusion in standard costs or burden rates. If the contractor can demonstrate that such costs have not been provided for in any predetermined rate or amount, he may calculate an allowable amount by apportioning the total cost of rejects between direct material placed in process for completed units and that included in work in process, provided such method is equitable. It will be equitable only when there is a constant rate of rejection. Should the rate not be constant, which will be most frequent, an adjustment in the apportionment must be made. Since rejects frequently are in the nature of starting load costs, a more equitable treatment may result if the claim is prepared on the total cost basis. Rejected items, if included in the termination inventory, must be priced at scrap value.

5-4.305 Audit of Labor in Process—Inventory Basis.

(a) When factory workers are paid on a piecework basis, the task of the auditor is much simplified. A list of the authorized piecework rates paid for each operation should be obtained and checked against the operations performed on selected items from the work-in-process inventory. The list of rates should then be checked to a selected payroll computation to verify that the rates used in costing are the same rates used in computing the payroll. The auditor should also determine that the employees are paid for all the various operations used in costing. The auditor should also investigate the contractor's policy in pricing production accomplished by learners and apprentices and for reworking defective production. Inventories are sometimes overstated by charging the entire wages of learners, apprentices and rework craftsmen to overhead accounts as well as including the piecework rates in direct labor costs. Only the excess over piecework rates is properly included in overhead.

(b) When the contractor uses standard labor costs in pricing labor in process, the auditor will determine the acceptability of the method of determining standard rates and will appraise the equity of the rates assigned to Government production in comparison with the rates assigned to other work in the same variance pool. The auditor will make test checks to verify that the correct standard costs applicable to the operations performed up to the stage of completion of each part or component tested have been correctly applied. The auditor will analyze the labor variance account and other records to determine that the standard cost used in pricing the inventory bears a reasonable relationship to actual cost.

(c) It is when the contractor is accumulating direct labor costs on other than piecework or standard cost bases that the auditor faces his most difficult problem in verifying such costs in connection with work-in-process inventory. Cost systems designed to give an accurate picture of the cost of the *entire* contract when completed ordinarily provide little information regarding the cost of any particular manufactured part or assembly. The contractor is therefore usually forced to use engineering or other estimates or calculations to price work-in-process inventory. As in the case of the use of standard costs the auditor should determine that the estimated rates used are not higher than actual costs. This will be accomplished by whatever means are available in the particular circumstances. One method is to price out the production records for a sample payroll period at the rates used in costing the inventory and comparing the total with the actual direct labor payroll for the period; also, price out completed production at prices used in claim, add termination inventory, and compare total with accumulated "actual" cost as per books.

5-4.306 Audit of Overhead in Process—Inventory Basis. The auditor will review the items making up the overhead expense pool and make appropriate adjustments where indicated. The propriety and composition of the allocation base and the accuracy of the rate computation will be appraised by the auditor. The accuracy of the application of the manufacturing expense rate to work-in-process inventory also will be verified by suitable tests or recomputed in the event the auditor has adjusted the rate.

5-4.307 Audit of Finished Units—Inventory Basis. The auditor should ascertain that the pricing of the finished units is in accordance with the terms of the contract and that the inventoried items are in fact finished accepted units and not rejects, units completed as a result of unreasonable anticipation of contract schedules, or units diverted from or left over from another contract. If such unacceptable units are included, the auditor will endeavor to develop an equitable adjustment to be recommended for nonacceptance. If the contract requires crating or delivery at a specified point, the auditor should determine that the price to the Government has been adjusted to reflect the savings in cost of crating, cartage, and freight which the contractor would have incurred if delivery had been required.

5-4.308 Settlement Proposals on Total Cost Basis. The use of the total cost basis requires prior approval of the Contracting Officer. The auditor assigned to the audit of a settlement proposal prepared on a total cost basis is faced with the audit of the entire incurred costs of the contract in contrast to the verification of the cost of residual inventories only as in case of an inventory claim. The use of total cost claims is usually justified only when the contractor's records do not provide information for accurate pricing of inventories or when unusual cost factors such as starting load costs are an important element of cost but not separable from other costs (par. 5-4.110 (c)). In contrast to an inventory claim where the auditor must be alert for *overstatement* of inventories and costs in the verification of total cost settlement proposals and accompanying inventory schedules, the auditor must be alert for overstatement of cost and for *understatement* of the inventories. Also the element of profit takes on an unusual importance (par. 5-1.002 (1) (e) and

5-4.315 (c)). The audit procedures to be followed in verifying the individual items of cost as stated on the contractor's settlement proposal will be substantially the same as previously set forth in this manual. However, for the guidance of the auditor additional comments pertinent to total cost claims are presented in paragraph 5-4.309 through 5-4.312.

5-4.309 Inventories—Total Cost Basis. The Government is entitled to an accounting for all materials and purchased parts which were not consumed in production. Since the contractor's claim is not based on the inventory schedules, there is an ever-present temptation to acquire valuable material at the expense of the Government by omitting such items from the schedule of residual inventory; just as in the case of a claim on the inventory basis there may be attempts to "sell" unwanted material to the Government by including such items in the schedules of termination inventory. Auditors should verify inventory schedules submitted with a total cost settlement proposal as stated in paragraph 5-2.011. An examination of purchase orders, vendors' invoices, perpetual inventory and stock room records should be made. A comparison between final residual inventory schedules and schedules of the latest physical inventories taken prior to termination will often reveal missing items and surprising discrepancies. The auditor should obtain from production records or qualified personnel sufficient information regarding the procurement policies of the contractor and the production cycles relating to the particular contract in order that, while verifying the pricing and allocability to the contract of the total material costs claimed, the auditor may also judge the reasonableness of the residual inventory reported for each kind of material or purchased part.

5-4.310 Audit of Direct Materials—Total Cost Basis. The auditor's general objective is to determine that the material costs included by the contractor in the total cost settlement proposal are all applicable to the contract, reasonably necessary to the performance of the contract, do not exceed the reasonable quantitative requirements of the contract, are correctly priced and computed, and supportable by accounting evidence. The usual starting point in analyzing the cost of direct materials is to compare the amount claimed with the total shown in the corresponding account in the general, factory, or cost ledger. By classifying the debit and credit entries to the account by source of entry, the auditor may segregate the usual entries from voucher registers, purchase distributions, and summaries of stores requisitions for selective testing. The more unusual entries recording returned material, scrap, and other adjustments should be more thoroughly tested or the absence of such credit entries should be investigated. Returned material credit memorandum should be reviewed for credits applicable to the contract. Shipping documents should be checked for returned material that should have been credited to the contract. Receiving reports should be examined for notations of shortages and rejected and defective materials that should have resulted in a credit to the contract. The correspondence files and the accounts payable and receivable of principal vendors supplying material for the contract should be reviewed for any pending, unrecorded, or incorrectly posted entries affecting the contract cost. Material costs should be reduced by all earned cash, trade or quantity discounts and rebates, and allowances earned and accrued unless such credits are satisfactorily applied through a reduction in the overhead expense pool. Material

costs also should be reduced by all applicable credits from the sale of scrap, waste and defective parts, and materials generated by the contract operations. (If segregation of scrap is not possible from the records, an equitable reduction in cost by crediting the overhead pool with income from scrap sales may be acceptable.) The auditor will determine the sources of contract scrap and will obtain from engineering estimates, bills of material, production records or similar sources the quantities of scrap (actual or estimated) generated by the various manufacturing operations. The auditor's computation should then be compared with the amounts credited to the contract costs by the contractor (either direct or through overhead) and any significant differences investigated. If small tools are a direct charge to the contract, the auditor should determine that the contractor has accounted for small tools and production equipment the cost of which was included in total production costs.

5-4.311 Audit of Direct Labor—Total Cost Basis. The auditor's general objective is to determine that labor costs included by the contractor in the total cost settlement proposal are applicable to the terminated contract, were correctly computed, and are supportable by acceptable accounting evidence. The amount claimed should be traced to the corresponding account in the general, factory, or cost ledger and the entries therein reviewed as to source of posting. Routine entries should be test checked back through all intervening records to the basic time records. All unusual entries should be carefully and completely verified. A representative number of individual job tickets will be compared with contractor's records of floor check (if any). Rates of pay and payroll computation of both hours and amounts will be tested. The auditor will relate the total direct labor charged to the contract to the quantity of end product completed by the termination date and the stage of completion of the work-in-process inventory for overall reasonableness.

5-4.312 Audit of Overhead—Total Cost Basis. The procedure for verifying overhead expenses is substantially the same in connection with a total cost settlement proposal as with other types of claims. If the cost of small hand tools and manufacturing supplies is included in the settlement proposal other than through depreciation, the claim must be reduced by the proportionate share of the residual value of such tools and supplies.

5-4.313 Settlement Proposals on Other Bases. Under existing regulations few (if any) claims will be authorized under other than the inventory and total cost bases. If any settlement proposal that has been approved for preparation on the "percentage of completion," "estimated cost," or other such basis is submitted for audit, the auditor will carefully review the claim and the contract and will survey the contractor's records. If the auditor is able to compute or determine on an accounting basis the contract costs applicable to the terminated portion of the contract and the costs so determined are more than the amount claimed, the auditor will recommend the amount of the claim for acceptance. If the amount determined by the auditor is less than the amount claimed by the contractor, the auditor will recommend for acceptance the amount determined by him to be acceptable and the balance of the amount claimed will be recommended for nonacceptance. If the claim is not susceptible of audit, the auditor will proceed in accordance with the provisions of paragraph 5-2.010.

5-4.314 Partial Settlement Proposals. In the interest of conserving manpower and travel expense, it is considered highly desirable that the contractor submit one settlement proposal covering all costs claimed as applicable to the terminated contract or terminated portion thereof. However in cases where the determination of the amount of certain expenses such as settlements with subcontractors or contractor's own settlement expenses are unduly delayed, partial settlement proposals may be accepted by the contracting officer and submitted to the auditor for verification. (Partial settlement proposals are not to be confused with partial payment requests—par. 5-2.013.) Partial settlement proposals when authorized must cover severable portions of a termination claim and must be clearly identified by the contractor as "partial" settlement proposals. Subsequent settlement proposals also should be prominently identified as "partial" or "final" and should contain a statement of the costs previously submitted on partial settlement proposals. The auditor assigned to the audit of a partial settlement proposal will proceed as required for a complete and final settlement proposal except that subsequent partial and final settlement proposal audits will require little or no survey activity but will require careful reference to previous audit working papers and coordination with the auditor who accomplished the previous audit if different personnel is used. The auditor will identify all working papers and the audit report with the partial settlement proposal.

5-4.315 Profit.

(a) Contract termination articles and departmental regulations generally provide that the contractor may be allowed a reasonable profit for the amount of work done on the terminated portion of the contract, excluding settlement expenses and settlements with subcontractors. What represents a fair profit will depend upon all circumstances and is to a large degree a matter for negotiation subject to the provisions of paragraph 8-404, ASPR. The auditor may include in the audit report a separate paragraph which makes recommendations regarding the profit claimed in connection with fixed-price contract settlement proposals when such recommendations appear to be in order based on accounting factors, determinations and adjustments. If the available information regarding profit does not justify a recommendation regarding the rate or amount of profit, the auditor should include, when reasonably available, in the audit report such information and comment as will be of assistance to the negotiator, such as—

- (1) The amount the parties agreed upon as representing a fair profit in the negotiation of the contract.
- (2) The rate of profit per unit on the end products completed to date of termination.
- (3) The indicated rate of profit that the contractor would have earned had the contract been completed.
- (4) The amount of profit the contractor would receive under a formula settlement.
- (5) The contractor's average rate of profit on similar products.
- (6) The contractor's average rate of earnings on cost of sales.

(b) If work under the contract was resulting in a loss or if it appears that the contractor would have suffered a loss had the contract been completed,

no part of the loss on the completed portion of the contract should be considered as an item of cost, no profit should be allowed, and the amount of the contractor's claim should be reduced by the indicated rate of loss. See ASPR 8-403.

(c) The profit factor becomes a matter of unusual importance in relation to a settlement proposal submitted on a total cost basis. In that event, unless the rate of profit added by the contractor to the total costs incurred to date of termination is nicely balanced with the rate of profit earned on the finished product completed to termination date an inequity will result. The auditor should, to the extent practicable, determine the contractor's rate of profit on the end products completed to date of termination and compare that rate with the rate of profit applied to costs in the settlement proposal. This may be accomplished by a unit cost analysis in relation to completed production or by a projection of cost statistics, or production cost charts according to the records available. If the rate of profit claimed by the contractor is in excess of the rate of profit earned on completed units, the claim will be reduced by the amount which is in excess of the earned profit rate on completed units. This adjustment is of particular importance when a loss contract is involved. If the computed unit cost or total contract cost projection indicates a loss contract, the total costs related to the terminated contract should be reduced by the percentage of indicated loss by entering the loss as a credit in the proper amount in the "profit" line. Of course, no profit will be allowed on such claims. This method is different from that previously prescribed in the Joint Termination Regulation, whereby the amount of the finished product was increased to represent the cost, because the new method adjusts the entire contract cost including the cost of the uncompleted portion of the contract.

5-4.316 Settlement Expenses. The contractor will ordinarily be allowed the accounting, legal, clerical, travel, and similar expenses reasonably necessary for the preparation of the contractor's own settlement proposal and supporting schedules, for the termination and settlement of subcontracts and purchase orders, and for the inventorying, protection, preservation, and disposition of the termination inventories. Factory and administrative overhead may be included as settlement expense only to the extent that the elements of such overhead pools are properly allocable to the termination activity. The total amount of settlement expenses shall not exceed an amount reasonably necessary to settle the contract in question. Numerous methods of computing settlement expenses have been used by contractors. In many cases charges are made only for direct labor and material used. In other cases the labor charges are loaded with overhead to cover supervision, space and equipment, and similar indirect costs. Where a contractor has established a special termination organization, it is not unusual for all costs related to termination activities to be segregated and accumulated. Direct charges to specific settlements are usually separately tabulated and a burden rate is added to cover the other costs of the termination department. Burden may be added at a rate per dollar, or hour of labor, or per dollar of total direct costs. The audit of settlement expenses involves the usual objective of determining the general accuracy and acceptability of the amounts stated. To a major extent the same procedures which have been outlined for the contractor's other charges are equally applicable to the verification of this particular group of costs. In the review of settlement expenses and costs of protection and disposition of

termination inventories, special consideration should be given to the following matters:

(a) Evidence that personnel for whom compensation is included in the settlement expenses were actually engaged in activities incident to the termination function stated. This is particularly important when a part of the time of officers and executive personnel is included since accurate time records may not have been maintained.

(b) Where separate storage contracts between the contractor and the Government exist, the auditor should determine that costs properly allocable to such contracts are not included as settlement expenses.

(c) Where a termination department (or other separate operating unit) has been set up within the contractor's organization, the auditor should review the method of accumulating the costs of that department and the acceptability of the items of cost included therein. The basis of allocation of the departmental expense to the individual terminated contracts should be evaluated. Under no circumstances will any method of allocation be approved which would permit at any time the totals of all allocations to the individual terminated contracts to exceed the total expenses incurred.

(d) Settlement expenses applicable to no-cost settlements should be absorbed by the contractor. However, when the settlement expenses applicable to no-cost settlements have not been segregated and are believed to be too small to justify screening out, they may be ignored.

(e) Where items of manufacturing and administrative expense are applied to direct settlement charges, such items should be restricted to those elements of overhead which are actually related to the work done. For example, if regular factory employees take the termination inventory their wages should not be loaded with the regular factory overhead rate since that rate would include such costs as depreciation on machinery, production supplies, and other cost elements which contribute nothing to the inventory taking operation.

(f) Charges in excess of those reasonably necessary for a particular settlement may arise from a number of sources and reasons; the most common being unnecessary work, unreasonable professional fees, costs of appeals, other settlement delays, inequitable methods of allocation of expenses as settlement charges, or the loading of settlement expenses with conversion costs. Where the auditor finds such costs to be clearly unreasonable, he will recommend the excessive portion for nonacceptance. If the amount which would be reasonable under the circumstances cannot be satisfactorily established, the auditor will recommend the entire amount for further consideration and report all the available facts for the assistance of the negotiator.

(g) Termination settlements often require handling of finished product in the inventory in a different manner from that involved in normal shipping and billing. When the contractor is required to handle finished goods in other than the normal manner, the settlement may include any additional costs incurred. The auditor will make sure, however, that the additional costs are offset by the probable cost of all normal operations, materials, and expenses which were not required of the contractor.

(h) Contractors sometimes propose that they be permitted to leave packing and shipping expenses in their overhead pools in return for which they will pack and ship the termination inventory without any specific other charge.

Such bargaining is very definitely in the field of negotiation and the auditor will refer any such proposals to the contracting officer with appropriate comment. Such an arrangement is not usually advantageous to the Government. However, it is impossible to determine even approximately the equity of the arrangement unless the disposition to be made of the inventories is known. It is possible to make an actual determination only after disposition of inventories has been completed. If such a decision is made in advance and the contractor eventually retains the inventory or the inventory is scrapped or picked up at site by purchaser, there would be no packing and shipping charges and the arrangement would be highly profitable to the contractor. It should be noted also that such an arrangement would result in increasing the contractor's own costs in the claim on which general and administrative expense and profit loadings are customarily computed.

5-4.317 Settlements With Subcontractors and Vendors. The prime contractor and each subcontractor are primarily responsible for settling the termination claims of their immediate subcontractors in accordance with the contract terms and applicable regulations. The prime or higher tier contractor may be allowed the cost of subcontractor's claims, including a reasonable profit to the subcontractor or vendor, and the expenses of settling such claims to the extent that the costs claimed are reasonable and allocable to the terminated portion of the contract. In his review of the contractor's settlement proposal the auditor's minimum responsibility in connection with the cost of settlements with subcontractors is to determine that the contract terms and applicable regulations have been followed, that the amount claimed is supported by a signed and approved settlement agreement, and that all the required certifications and approvals are in evidence. Settlement proposals relating to terminated cost-type or fixed-price subcontracts submitted by subcontractors to higher-tier contractors under a fixed-price prime contract may be audited by Government auditors whenever the regulations of the contracting department require such an audit, whenever the Contracting Officer (or the contractor through the Contracting Officer) requests such audit or when, in the opinion of the responsible auditor of the audit agency having audit cognizance, such an audit appears to be in the Government's interest. Audits of subcontractor's settlement proposals should be conducted in general conformity with the principles and procedures set forth in this manual relating to the audit of prime contractor's settlement proposals. Should the contractor as a result of failure to include a termination clause in the subcontract or purchase order become liable to the subcontractor for loss of anticipated profits or damages as a consequence of termination, such expense shall be for the account of the contractor and will be recommended for nonacceptance by the auditor. See ASPR 8-518.3. The Government auditor's report resulting from the audit of subcontractor's or vendor's termination settlement proposals will be made in substantially the same format as outlined in Section 6 of this Chapter. The auditor's report will be forwarded to the Contracting Officer who is responsible for negotiating or approving a settlement. Any requests by the contractor or higher-tier subcontractor responsible for the settlement of a subcontractor's claim for copies of the audit report will be referred to such Contracting Officer. The sentence immediately preceding does not contravene paragraph 5-2.003 (b).

5-4.318 Interest. Unless authorized by the contract, interest on the settlement claim is not an allowable item of cost. The allocable portion of interest on borrowings may be included in the termination claim (ASPR 8-402 (b) (14)) but no element of profit is to be allowed thereon.

5-4.319 Deductions.

(a) *Disposal Credits.* There should be deducted from the total cost and profit claimed the agreed price for any part of the termination inventory purchased by the contractor and the proceeds of the sales of any Government inventory directed by the Contracting Officer which has not been otherwise paid or credited to the Government.

(b) *Property Undeliverable.* Unless otherwise stated in the contract the risk of loss of termination inventory remains on the contractor until the property is delivered to the Government or otherwise disposed of as directed by the Government's authorized representative. If any termination inventory or government property in the custody of the contractor is destroyed, lost, stolen, damaged or otherwise becomes undeliverable, the full value (including applicable overhead) thereof is to be treated as a reduction of the amount due the contractor by a deduction from the contractor's claim in the same manner as a disposal credit. See ASPR 8-616.

(c) *Previous Payments.* Any amounts previously paid to the contractor such as advance payments, partial payments and partial settlements should be deducted from the amount of the termination settlement. Any amounts due the Government from the contractor for any other reason may also be "set off" by the Contracting Officer or Disbursing Officer.

(d) The Contracting Officer is responsible for the sufficiency and accuracy of all deduction items. However, while examining the contractor's books of record the auditor will verify the accuracy of the deductions indicated by the settlement proposal and should make a reasonable search of the records for other applicable deductions. Any pertinent information developed will be included in the audit report.

Section 5—Working Papers

5-5.001 Preparation and Indexing. The termination auditor's working papers will be prepared and indexed as directed in Chapter IV, Section 1, Part II.

5-5.002 Office Reviews. The auditor will include in the working paper file related to each termination audit report based on an office review (Sec. 3 of this ch.) the following material:

- (a) A copy of the contractor's settlement proposal.
- (b) A copy of the contract (if readily available) or a summary of pertinent provisions thereof.
- (c) A copy of the notice of termination.
- (d) A copy of the Contracting Officer's request for audit or a reference to the authority under which review is being made.
- (e) The contractor's Schedule of Accounting Information (DD Form 546) or a reference to the file where it may be found (par. 5-3.002) together with the auditor's comment thereon.

(f) A statement of the principles for determination of cost which the auditor considered applicable to this particular termination settlement proposal (par. 5-4.104).

(g) Copies of any significant correspondence related to the contract or the determination of costs thereunder.

(h) Notes of auditor's conferences with Government or contractor personnel regarding the settlement proposal.

(i) Program of review followed by the auditor.

(j) Analyses made by the auditor in reviewing the settlement proposal and supporting schedules, including cross-references to available working papers and reports resulting from previous audits.

(k) Record of the auditor's conclusions and recommendations including an adequate explanation of the basis or reasons for the conclusions reached and recommendations made.

(l) A statement of the reasons why a field audit was not considered necessary.

(m) The pencil draft of the auditor's report.

(n) The reviewer's notes.

(o) A copy of the audit report as issued.

5-5.003 Field Audits. The auditor's working paper file in connection with each field audit will contain all the material specified in paragraph 5-5.002 except item "l." The following additional items will be included:

(a) Memorandum record of the auditor's survey of the contractor's plant (par. 5-4.101).

(b) Record of the auditor's survey of the contractor's accounting procedures, practices and internal controls (par. 5-4.103) or a reference to the working paper file resulting from a previous survey.

(c) The auditor's field audit program (par. 4-1.103).

(d) The auditor's analysis of each account or record examined, together with a statement of the auditor's findings and recommendations in connection therewith.

5-5.004 Preservation and Final Disposition. Termination audit working papers will be filed, preserved, protected and finally disposed of as directed in the instructions of the cognizant audit agency.

Section 6—Audit Reports*

*To be published at a later date.

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CONTRACT AUDIT MANUAL

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CHAPTER VI

AUDIT COORDINATION

6-0.000 Scope of Chapter. This chapter contains information and instructions concerning the coordination of all contract audit work to be performed at designated locations, under the cognizance of one audit agency representing all of the military departments. To the extent applicable, these instructions also may be used for the coordination of audits conducted on a mobile basis. Audit coordination, as required by this chapter, is not necessary for infrequent assist audits requested of one district director by another. The following paragraphs are applicable to instances where reassignments of audit cognizance are effected, as well as to instances where audit cognizance is initially established.

6-0.001 Definition and Purpose of Audit Coordination. The term "audit coordination", as used in this manual, means an arrangement under which one audit agency is delegated authority and responsibility for all contract audit work to be performed at a contractor's plant (or other location) for all of the military departments. The primary purposes of audit coordination are to reduce the over-all cost of contract auditing, and to confine to one military department the use of the contractor's accounting records.

6-0.002 Determination of Audit Cognizance.

6-0.002(1) Development of Factual Information. When an auditor finds that more than one military department has contracts which may require audit at a contractor's plant he will notify his district director who will determine whether audit coordination is practicable. District directors who may have an interest in the determination should be notified that audit coordination is to be considered. All factual information bearing upon the subject should be developed by one of the district directors for joint consideration at the supervisory-office level. Such information should include the following:

(a) Data relating to existing and prospective contracts, such as contract identification, number and type of contracts, estimated contract costs (volume), amounts of unaudited costs, periods of contract performance and prospective contract completion dates.

(b) The military department having the preponderant audit interest as indicated by the contract volume requiring audit. In this connection consideration will be given to current negotiations for new procurement contracts.

(c) Accessibility of the contractor's plant (or other location) to an established audit office, particularly when the volume of work does not warrant the assignment of an auditor or an audit staff on a full-time basis.

(d) The military department, if any, responsible for procurement and mobilization planning responsibilities.

(e) The audit agency, if any, having audit cognizance.

(f) Opinions of the contractor and resident contract administration personnel.

(g) The availability of audit personnel.

(h) The possibility of significant savings in travel expense.

6-0.002(2) Consideration at Supervisory-Office Level of Information Developed. Following the development of the factual information required to initially consider audit cognizance, a meeting of the interested district directors should be held to consider the desirability of audit coordination. If it is decided to recommend a coordinated audit, consideration will be given to the selection of the audit agency to which audit cognizance will be assigned. In this connection it should be noted that if the Munitions Board has assigned mobilization planning and procurement responsibilities at a plant to one military department, audit coordination may, but not necessarily will, be recommended in conformity therewith. The audit agencies in no way are constrained by such Munitions Board action from arranging audit cognizance to their mutual satisfaction.

6-0.002(3) Submission of Joint Recommendations to Audit Agencies' Headquarters. After conference and review of the facts by the district directors concerned, joint recommendations should be prepared and submitted to the respective audit agencies' headquarters for consideration and appropriate action. The joint recommendations should include a statement as to whether the agency recommended for audit cognizance is to accept responsibility for any or all of the audit backlog and the submissions should include information as to the bases upon which the recommendations are predicated. It is expected that in most cases there will be no disagreement at the supervisory-office level; however, in the event of a dissent, this fact should be noted in the submission, indicating the dissenting activity and the reasons for the dissent. Pending approval by audit agency headquarters, district directors will assure that there is no undue delay in effecting reimbursements.

6-0.003 Action by Audit Agency Headquarters. The joint recommendations submitted pursuant to paragraph 6-0.002(3) will be considered in the audit agencies' headquarters' offices. Approvals will be incorporated in joint audit coordination letters. Where the recommendations are not approved, the supervisory offices will be advised accordingly.

6-0.004 Reassignment of Audit Cognizance. It is not intended that audit coordination assignments be frequently disturbed. However, there will be cases where reassignment of audit cognizance will be desirable particularly where contracts with one or more military departments have been completed and no new contracts of significant importance are in process of negotiation or where the preponderance of interest has changed. When it is concluded that reassignment is desirable, a joint recommendation will be submitted in the same manner as prescribed for initial submissions.

6-0.005 Assuming Audit Cognizance. Upon receipt of a joint coordination letter the district director designated to accept audit cognizance will prepare a program to accomplish the assumption of audit cognizance. Among other things, consideration should be given to any existing audit backlog; personnel; effective dates; liaison arrangements with the contracting officer or technical inspector; and working papers, files and other audit records. These matters are discussed in more detail in the following subparagraphs.

6-0.005(1) Audit Backlog. If a decision to reduce or eliminate the audit backlog prior to acceptance of audit cognizance or a decision to

assume the backlog was previously agreed upon, that agreement should be effectuated. If no prior agreement was reached, the matter should be settled since the agency which accepts audit cognizance is not obligated to assume abnormal audit backlogs except by voluntary agreement.

6-0.005(2) *Personnel.* When assuming audit cognizance, consideration should be given to the availability of personnel at the location. Where allotments permit, it may be advantageous to transfer audit personnel between the military departments involved if agreeable to the departments and the personnel involved. Effecting such personnel transfers avoids the necessity for personnel moving to other areas with attendant family dislocations, difficulty in locating suitable living accommodations and other related problems. It may be noted that the Civil Service Regulations (Federal Personnel Manual) provide for inter-agency transfers of employees in instances where there is a complete transfer of functions.

6-0.005(3) *Effective Dates.* Agreement should be reached as to (a) the date, with respect to costs incurred or vouchers submitted, as of which the audit agency accepting cognizance is to assume responsibility, (b) the date working papers, files and other audit records will be transferred, and (c) if an existing residency is involved, the date audit personnel will be transferred to or replaced by the audit agency assuming cognizance. In the event personnel are to be replaced, it may be desirable to retain the existing staff for a reasonable agreed period after the new personnel report at the contractor's plant in order to acquaint the new personnel with procedures, requirements, and other matters peculiar to the audit. The utmost cooperation is expected from both the outgoing and the incoming audit staffs, and district directors and staff auditors will promote harmonious relations during the period of transfer.

6-0.005(4) *Notification to Contractor, Contracting Officers and Technical Inspectors.* After the effective date of the acceptance of audit cognizance is agreed upon, the contractor, contracting officers, technical inspectors and other interested parties will be notified by the district director of the audit agency which accepts audit cognizance that audit responsibility is being assumed. The letter of notification should include the names, titles and addresses of personnel of the cognizant audit agency with which contact may be made or to whom inquiries may be addressed; and such effective dates as may be appropriate in the circumstances.

6-0.005(5) *Transfer and Custody of Working Papers, Files and Other Audit Records.* The agency accepting audit cognizance will be given custody of all audit working papers, vouchers and correspondence files and other audit records applicable to the contracts subject to the audit coordination action. The transfer will be evidenced by receipts with appropriate attention to security regulations. The agency will, also, be responsible for safekeeping and protection of working papers, files and records during audit performance, and for packing, shipping or other final disposition in accordance with the regulations of the cognizant audit agency on completion or termination of the audit. These records will not be sent to permanent storage until required final cost statements or final audit reports have been completed, including necessary review and approval.

6-0.005(6) *Access to Working Papers, Files and Other Audit Records.* The audit agency of the military department having procurement cognizance may desire access to working papers, files or other audit records,

which are in the custody of the military department assigned audit cognizance. Requests shall be kept to a minimum and when made will be in writing with reasons therefor. Such working papers, files or records will be promptly returned when the purpose for which they were required has been served.

6-0.005(7) Authority to Sign Auditor's Certificates on Public Vouchers and Related Documents. The authorizations to be given to individuals and their alternates to sign auditor's certificates will cover contracts of all military departments for which audit work is being done. A copy of the form (DD 360) to be used for this purpose and the instructions relative thereto are included in the appendix.

6-0.005(8) Additional Audit Assignments. When audit coordination covering a particular contractor's plant or other location has been formally authorized, contracts and any other audit assignments will be forwarded to the cognizant district director without further reference to or approval by the headquarters' offices of the audit agency of the military department which executed the contracts. Should a reassignment of audit cognizance be indicated, the provisions of paragraph 6-0.004 will apply.

6-0.006 Responsibilities of Cognizant Audit Agencies.

6-0.006(1) Over-all Responsibilities. The agency having audit cognizance is responsible for proper over-all performance of the audit and review of the work done. Additional responsibilities include requests for General Accounting Office on-site audits; execution of auditor's certificates on public vouchers and related documents; preparation of replies to General Accounting Office inquiries and exceptions; and preparation, review, and distribution (without further review by the District Director of the military department which executed the contract) of required audit reports including, but not limited to, advisory audit reports, final audit reports, final public vouchers, final cost statements, and Navy appeal and review briefs. It is recognized that following receipt of audit reports by the military department for which the audit was made, occasional question may arise relative to the contents thereof, and that additional information sometimes will be needed. In such instances, the district director of the agency which performed the audit will be responsive to reasonable inquiries and requests.

6-0.006(2) Compliance with Departmental Procedures and Instructions. The cognizant audit agency will comply with applicable procedures and instructions of the military department which executed the contract and for which the audit is being performed, when such procedures and instructions do not conflict with this Manual.

6-0.006(3) Decisions Regarding Allowability of Costs. The responsibility for decisions relative to allowability of costs is normally designated in the contract. The auditors and district directors of the cognizant audit agency will have the same responsibilities and authority in matters regarding allowability of cost as the auditors and district directors of the contracting military department.

6-0.006(4) Appeals from Cost Disallowances. Appeals by contractors will be processed in accordance with the procedures of the military department which executed the contract under which the appeal is made.

6-0.007 Visits by Supervisory Personnel of Audit Agencies Other than the Cognizant Audit Agency. In view of the over-all responsibilities

as indicated in paragraph 6-0.006 (1) above, and in the interest of harmonious inter-departmental relations, visits by supervisory audit personnel of other than the cognizant audit agency will be limited to exceptional cases. In these exceptional cases, advance notice of the visits should be given to the district director of the cognizant audit agency, and the reason for the visit explained.

6-0.008 Inter-Departmental Distribution of Publications and Instructions. Inter-departmental distribution of publications and instructions having applicability to coordinated audit assignments will be accomplished, among the field activities of the audit agencies, through the respective supervisory offices. It is the responsibility of the district directors to see that adequate distribution is made to each auditor responsible for a coordinated audit to permit compliance with paragraph 6-0.006(2).

6-0.009 List of Contractors Under Coordinated Audit Program. A list of contractors under the coordinated audit program and of the military departments having audit cognizance will be issued periodically by headquarters offices.

**CHAPTER VII—LAWS, GOVERNMENT REGULATIONS
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CHAPTER VII

LAWS, GOVERNMENT REGULATIONS AND SECURITY

7-0.000 Scope of Chapter. Section 1 sets forth information concerning certain laws, Executive orders and Government regulations which may have some bearing on particular contract audit assignments. The data included therein are necessarily brief and are intended to serve as a helpful source of information rather than as a treatise on the administrative, legal, and accounting aspects of the statutes, orders, and regulations covered. The auditor must exercise caution in applying this information to the issues in a particular case. Preferably he should refer to complete copies of the statutes, orders and regulations. When necessary, legal advice may be obtained through the auditor's supervisory office from legal staffs maintained by the individual military departments. Section 2 contains information relating to the security of military information.

Section 1—Laws, Executive Orders and Government Regulations

7-1.001 “National Security Act of 1947” (approved 26 July 1947 (61 Stat. 496) as amended by Public Law 36, 81st Congress, approved 2 April 1949 (63 Stat. 30) and by the “National Security Act Amendments of 1949”, Public Law 216, 81st Congress, approved 10 August 1949, (63 Stat. 579)). The declaration of policy incorporated in the Act states that it is the intent of Congress to provide a comprehensive program for the establishment of integrated policies and procedures for the departments, agencies and functions of the Government relating to the national security. The legislation established the National Security Council; the Central Intelligence Agency; the National Security Resources Board; the Department of Defense which included as separately administered military departments, the Department of the Army, the Department of the Navy, and the Department of the Air Force; and, within the Department of Defense, the Armed Forces Policy Council, the Joint Chiefs of Staff, the Munitions Board, and the Research and Development Board. The mission of the Munitions Board is stated in Sec. 213(c) as follows:

“(c) Subject to the authority and direction of the Secretary of Defense, the Board shall perform the following duties in support of strategic and logistic plans and in consonance with guidance in those fields provided by the Joint Chiefs of Staff, and such other duties as the Secretary of Defense may prescribe:

“(1) coordination of the appropriate activities with regard to industrial matters, including the procurement, production, and distribution plans of the Department of Defense;

“(2) planning for the military aspects of industrial mobilization;

“(3) assignment of procurement responsibilities among the several military departments and planning for standardization of specifications and for the greatest practicable allocation of purchase authority of technical equipment and common use items on the basis of single procurement;

“(4) preparation of estimates of potential production, procurement, and personnel for use in evaluation of the logistic feasibility of strategic operations;

“(5) determination of relative priorities of the various segments of the military procurement programs;

“(6) supervision of such subordinate agencies as are or may be created to consider the subjects falling within the scope of the Board's responsibilities;

“(7) regrouping, combining, or dissolving of existing interservice agencies operating in the fields of procurement, production, and distribution in such manner as to promote efficiency and economy;

"(8) maintenance of liaison with other departments and agencies for the proper correlation of military requirements with the civilian economy, particularly in regard to the procurement or disposition of strategic and critical material and the maintenance of adequate reserves of such material, and making of recommendations as to policies in connection therewith; and

"(9) assembly and review of material and personnel requirements presented by the Joint Chiefs of Staff and by the production, procurement, and distribution agencies assigned to meet military needs, and making of recommendations thereon to the Secretary of Defense.

The position of Comptroller of the Department of Defense was established by Sec. 401:

"SEC. 401. (a) There is hereby established in the Department of Defense the Comptroller of the Department of Defense, who shall be one of the Assistant Secretaries of Defense.

"(b) The Comptroller shall advise and assist the Secretary of Defense in performing such budgetary and fiscal functions as may be required to carry out the powers conferred upon the Secretary of Defense by this Act, including but not limited to those specified in this subsection. Subject to the authority, direction, and control of the Secretary of Defense, the Comptroller shall—

"(1) supervise and direct the preparation of the budget estimates of the Department of Defense; and

"(2) establish, and supervise the execution of—

"(A) principles, policies, and procedures to be followed in connection with organizational and administrative matters relating to—

"(i) the preparation and execution of the budgets,

"(ii) fiscal, cost, operating, and capital property accounting,

"(iii) progress and statistical reporting,

"(iv) internal audit, and

"(B) policies and procedures relating to the expenditure and collection of funds administered by the Department of Defense; and

"(3) establish uniform terminologies, classifications, and procedures in all such matters."

The Comptrollers of the military departments are established by Sec. 402:

"SEC. 402 (a) The Secretary of each military department, subject to the authority, direction, and control of the Secretary of Defense shall cause budgeting, accounting, progress and statistical reporting, internal audit and administrative organization structure and managerial procedures relating thereto in the department of which he is the head to be organized and conducted in a manner consistent with the operations of the Office of the Comptroller of the Department of Defense.

"(b) There is hereby established in each of the three military departments a Comptroller of the Army, a Comptroller of the Navy, or a Comptroller of the Air Force, as appropriate in the department concerned. There shall, in each military department, also be a Deputy Comptroller. Subject to the authority of the respective departmental Secretaries, the comptrollers of the military departments shall be responsible for all budgeting, accounting, progress and statistical reporting, and internal audit in their respective departments and for the administrative organization structure and managerial procedures relating thereto. The Secretaries of the military departments may in their discretion appoint either civilian or military personnel as comptrollers of the military departments. Departmental comptrollers shall be under the direction and supervision of, and directly responsible to, either the Secretary, the Under Secretary, or an Assistant Secretary of the respective military departments: Provided, that nothing herein shall preclude the comptroller from having concurrent responsibility to a Chief of Staff or a Chief of Naval Operations, a Vice Chief of Staff or a Vice Chief of Naval Operations, or a Deputy Chief of Staff or a Deputy Chief of Naval Operations, if the Secretary of the military department concerned should so prescribe. Where the departmental comptroller is not a civilian, the Secretary of the department concerned shall appoint a civilian as Deputy Comptroller."

7-1.002 "Armed Services Procurement Act of 1947", (Public Law 413—80th Congress, approved 19 February 1948 (62 Stat. 21) (41 USC 151-161) as amended.) This statute which became effective 19 May 1948, represents the principal legislative basis for the Armed Services Procurement Regulation (CAM 7-1.003). The Act requires that all purchases and contracts shall be made by advertising and competitive bidding except that under certain specified circumstances procurement by negotiation is authorized. The sections of the law of greatest interest to the auditor are quoted here:

"Sec. 4(a) Except as provided in subsection (b) of this section, contracts negotiated pursuant to section 2 (c) may be of any type which in the opinion of the agency head will promote the best interests of the Government. Every contract negotiated pursuant to section 2 (c) shall contain a suitable warranty, as determined by the agency head, by the contractor that no person or selling agency has been employed or retained to solicit or secure such contract upon an agreement or understanding for a commission, percentage, brokerage or contingent fee, excepting bona fide employees or bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business, for the breach or violation of which warranty the Government shall have the right to annul such contract without liability or in its discretion to deduct from the contract price or consideration the full amount of such commission, percentage, brokerage, or contingent fee.

"(b) The cost-plus-a-percentage-of-cost system of contracting shall not be used, and in the case of a cost-plus-a-fixed-fee contract the fee shall not exceed 10 per centum of the estimated cost of the contract, exclusive of the fee, as determined by the agency head at the time of entering into such contract (except that a fee not in excess of 15 per centum of such estimated cost is authorized in any such contract for experimental, developmental, or research work and that a fee inclusive of the contractor's costs and not in excess of 6 per centum of the estimated cost, exclusive of fees, as determined by the agency head at the time of entering into the contract, of the project to which such fee is applicable is authorized in contracts for architectural or engineering services relating to any public works or utility project). Neither a cost nor a cost-plus-a-fixed-fee contract nor an incentive-type contract shall be used unless the agency head determines that such method of contracting is likely to be less costly than other methods or that it is impractical to secure supplies or services of the kind or quality required without the use of a cost or cost-plus-a-fixed-fee contract or an incentive-type contract. All cost and cost-plus-a-fixed-fee contracts shall provide for advance notification by the contractor to the procuring agency of any subcontract thereunder on a cost-plus-a-fixed-fee basis and of any fixed-price subcontract or purchase order which exceeds in dollar amount either \$25,000 or 5 per centum of the total estimated cost of the prime contract; and a procuring agency, through any authorized representative thereof, shall have the right to inspect the plants to audit the books and records of any prime contractor or subcontractor engaged in the performance of a cost or cost-plus-a-fixed-fee contract.

"(c) All contracts negotiated without advertising pursuant to authority contained in this Act shall include a clause to the effect that the Comptroller General of the United States or any of his duly authorized representatives shall until the expiration of 3 years after final payment have access to and the right to examine any directly pertinent books, documents, papers, and records of the contractor or any of his subcontractors engaged in the performance of and involving transactions related to such contracts or subcontracts.

"Sec 5(a) The agency head may make advance payments under negotiated contracts heretofore or hereafter executed in any amount not exceeding the contract price upon such terms as the parties shall agree: Provided, that advance payments shall be made only upon adequate security and if the agency head determines that provision for such advance payments is in the public interest or in the interest of the national defense and is necessary and appropriate in order to procure required supplies or services under the contract."

7-1.003 Armed Services Procurement Regulation. When the President signed the "Armed Services Procurement Act of 1947" on 19 Febru-

ary 1948, he wrote the Secretary of Defense asking him to specify detailed standards to guide procurement officers concerning the placing of business with small concerns and the circumstances under which they may waive the general policy of advertising for bids. The Armed Services Procurement Regulation issued pursuant to that request carries out on a policy level the instructions contained in the President's letter. The Regulation contains the following sectional arrangement:

Section	I	General Provisions
Section	II	Procurement by Formal Advertising
Section	III	Procurement by Negotiation
Section	IV	Coordinated Procurement
Section	V	Interdepartmental Procurement
Section	VI	Foreign Purchases
Section	VII	Contract Clauses and Forms
Section	VIII	Termination
Section	IX	Patents, Inventions, and Copyrights
Section	X	Bonds and Insurance
Section	XI	Taxes
Section	XII	Labor
Section	XIII	Government-Furnished Property
Section	XIV	Inspection and Acceptance
Section	XV	Contract Cost Principles
Appendix	A	Charter and Rules of Armed Services Board of Contract Appeals
Appendix	B	Manual for Control of Government Property in Possession of Contractors

Auditors should be familiar with the requirements of the Armed Services Procurement Regulation. Section XV, Contract Cost Principles, is incorporated as appendix H of this Manual.

7-1.004 Labor Legislation. As a reference source the auditor's attention is directed to Armed Services Procurement Regulation Section XII, Labor, which (a) deals with general policies regarding labor, so far as they relate to procurement, (b) sets forth pertinent labor laws and requirements, indicating in connection with each its applicability and any procedures thereunder, and (c) prescribes the contract clauses with respect to each labor law or requirement. Included therein are references to convict labor, Eight-Hour Law of 1912, Davis-Bacon Act, Copeland Act, Walsh-Healey Public Contracts Act, and the Fair Labor Standards Act of 1938.

7-1.005 "Budget and Accounting Act of 1921", (approved 10 June 1921 (42 Stat. 20) as amended). This legislation created the General Accounting Office and established the position of Comptroller General of the United States. It provided, among other things, that all claims and demands whatever by or against the Government of the United States, and all accounts whatever in which the Government of the United States was concerned, either as debtor or creditor should be settled and adjusted in the General Accounting Office. It provided further that disbursing officers, or the head of any executive department, or other establishment not under any of the executive departments, might apply for and receive a decision upon any question involving a payment being made by them or under them, which

decision, when rendered, should govern the General Accounting Office when passing upon the account containing said disbursement.

7-1.006 "Budget and Accounting Procedures Act of 1950" (Public Law 784, 81st Congress, second session, approved 12 September 1950.) The Act supplements the Budget and Accounting Act of 1921. It makes provision for a completely revised and modernized budgeting program, full disclosure of the results of Federal financial operations and for effective control over income, expenditures, funds, property, and other assets. The Act implements the joint and continuous program of the Comptroller General of the United States, the Secretary of the Treasury, and the Director of the Bureau of the Budget to bring improvement of accounting and financial reporting in the Government. Part II of the "Budget and Accounting Procedures Act of 1950" is further identified as the "Accounting and Auditing Act of 1950." This portion of the Act provides that, in addition to determining legality of financial transactions, auditing performed by the Comptroller General is to be directed at determining whether accounting and financial reporting systems, including internal financial control, are adequate and efficient and afford an effective basis for settlement of accounts of accountable officers. It directs that emphasis be placed on effecting improvements resulting in simplified and more effective accounting, financial reporting, budgeting and auditing requirements and procedures, and on elimination of those which involve duplication or which do not serve a purpose commensurate with the costs involved.

7-1.007 "Federal Property and Administrative Services Act of 1949" (approved 30 June 1949 (63 Stat. 378), (41 USC 201-274), as amended by Public Law 754, 81st Congress, second session, approved 5 September 1950). The Act established the General Services Administration and provided for the transfer to that agency of the functions of the Bureau of Federal Supply, the Office of Contract Settlement, the Federal Works Agency, the National Archives Establishment and the War Assets Administration. The legislation was enacted to provide an economical and efficient system for procurement and supply of personal property and non-personal services, the utilization of available property, the disposal of surplus property, and records management.

7-1.008 Photographic Reproduction of Documents—Public Law 129, 82nd Congress, approved 28 August 1951, amends section 1732 of Title 28, U.S. Code as follows:

"(b) If any business, institution, member of a profession or calling, or any department or agency of government, in the regular course of business or activity has kept or recorded any memorandum, writing, entry, print, representation or combination thereof, of any act, transaction, occurrence, or event, and in the regular course of business has caused any or all of the same to be recorded, copied, or reproduced by any photographic, photostatic, microfilm, microcard, miniature photographic, or other process which accurately reproduces or forms a durable medium for so reproducing the original, the original may be destroyed in the regular course of business unless held in a custodial or fiduciary capacity or unless its preservation is required by law. Such reproduction, when satisfactorily identified, is as admissible in evidence as the original itself in any judicial or administrative proceeding whether the original is in existence or not and an enlargement or facsimile of such reproduction is likewise admissible in evidence if the original reproduction is in existence and available for inspection under the direction of court. The introduction of a reproduced record, enlargement, or facsimile does not preclude admission of the original. This subsection shall not be construed to exclude from evidence any document or copy thereof which is otherwise admissible under the rules of evidence."

7-1.009 "Surplus Fund-Certified Claims Act of 1949," (approved 6 July 1949 (63 Stat. 407), (31 USC 714a-712b)). The purpose of the Act is to permit the Comptroller General to pay claims chargeable against lapsed appropriations and to provide for the return of unexpended balances of such appropriations to the surplus fund of the Treasury. In most cases it will accelerate payments of such claims as compared to the former procedure which required legislation, as well as approval by the Comptroller General. The legislation provides that, unless a longer period of availability for expenditure is specifically provided in an appropriation or other law, on 1 July in each year the unexpended balances of all appropriations which shall have remained upon the books of the Government for two fiscal years following the fiscal year or years for which appropriated shall lapse, and that such balances shall be transferred to a consolidated appropriation account to be known as "Payment of Certified Claims." Such funds shall remain available until expended for the payment of claims, within the limits of and chargeable to the respective balances of any lapsed appropriations, which may be certified by the Comptroller General to be lawfully due: Provided, however, that on 1 July of each year, all funds in the appropriation account "Payment of Certified Claims," certified by the Comptroller General as not required for the payment of claims thereunder, shall be carried to the surplus fund of the Treasury. The Act does not apply to permanent specific appropriations or appropriations for rivers and harbors, lighthouses, or public buildings, or to appropriations for the Post Office Department or the postal service.

7-1.010 "Air Corps Act of 1926" (approved 2 July 1926 (44 Stat. 787), (10 USC 310 "ell"), as amended). Section 10 ("ell") of the Act as amended contains the following provision which is currently effective:

"The manufacturing plant, and books, of any contractor for furnishing or constructing aircraft, aircraft parts, or aeronautical accessories, for the Department of the Army or the Navy Department, or such part of any manufacturing plant as may be so engaged, shall at all times be subject to inspection and audit by any person designated by the head of any executive department of the Government."

7-1.011 "Contract Settlement Act of 1944," (Public Law 395, 78th Congress, approved 1 July 1944 (58 Stat. 649), (41 USC 101-125)). The Act is the statutory authority for settlement, by agreement and/or determination, of terminated World War II contracts by contracting agencies authorized to make contracts pursuant to Section 201 of the "First War Powers Act, 1941." The procedures prescribed for the settlement of contracts terminated under the Act were incorporated in the Joint Termination Regulation (see CAM 2-2.005). Reference is also made to Chapter V, Audit Procedures—Termination Settlement Proposals.

7-1.012 "Lucas Act," (Public Law 657, 79th Congress, approved 7 August 1946, (60 Stat. 902)). The Act was applicable to war contractors who had filed claims for relief under the "First War Powers Act, 1941" prior to 14 August 1945, which had not been acted on before that date, and which were not considered after that date because of the interpretation that the authority for granting of relief under the First War Powers Act had lapsed because the war had ended. The Act of 7 August 1946 authorized settlement of claims for losses (not including diminution of anticipated profits) sustained, without fault or negligence, between 16 September 1940 and 14 August 1945 in connection with work, supplies, or services furnished between those dates under contracts or subcontracts entered into under the

First War Powers Act. Relief was limited to an amount not in excess of the net loss (less amount of any relief granted subsequent to establishment of such loss) on all contracts or subcontracts held by the claimant under which work, supplies, or services were furnished the Government between the above dates. Claims had to be filed within six months after date of approval of the Act and were limited to those instances where a written request for relief had been filed with the Government department or agency concerned on or before 14 August 1945. Regulations issued under this Act are contained in Executive Order 9786 dated October 5, 1946.

7-1.013 "Vinson-Trammell Act (Naval Parity)" (Public Law 135, 73d Congress, approved 27 March 1934 (48 Stat. 503) as amended by Public Law No. 804, 74th Congress, approved 25 June 1936 (49 Stat. 1926); by Public Law No. 18, 76th Congress, approved 3 April 1939 (53 Stat. 555), and by Public Law 615, 79th Congress, approved 7 August 1946 (60 Stat. 866)). This legislation requires contractors to pay into the Treasury all profit, in excess of 10 percent of total contract prices for the construction and/or manufacture of any complete naval vessel or portion thereof, and in excess of 12 percent of total contract prices for construction and/or manufacture of any complete aircraft or portion thereof, completed within the income taxable year. Profit limitations are also applicable to any subdivision of any contract or subcontract involving an amount in excess of \$10,000. Upon completion of contracts, contractors are required to file reports in the form prescribed by the Secretaries of Army, Navy or Air Force, copies of which are to be transmitted to the Secretary of the Treasury. Contractors' records may be audited by representatives of any of the Secretaries previously mentioned. Annual reports are also required to be filed with Collectors of Internal Revenue. Regulations of the Treasury Department are incorporated in Treasury Decisions 4906 (for Navy contracts) and 4909 (for Army and Air Force contracts). The Vinson-Trammell Act was temporarily suspended during World War II by Sec. 401 of the "Second Revenue Act of 1940", approved October 8, 1940 (54 Stat. 1003) but was reinstated with the repeal of the excess profits tax by Sec. 122 (a) of the "Revenue Act of 1945", approved November 8, 1945 (59 Stat. 556) and is applicable to contracts entered into in 1946 or later. Section 622 (b) of the "National Military Establishment Appropriation Act, 1950", approved 29 October 1949 (63 Stat. 989) provides that notwithstanding any agreement to the contrary, the profit limitation provisions of the Act of March 27, 1934 (48 Stat. 503, 505) as amended and supplemented, shall not apply to any contract or subcontract which is subject to the "Renegotiation Act of 1948", approved 21 May 1948 (62 Stat. 759). This action is retroactive to 21 May 1948. Section 618 (b) of the "General Appropriation Act, 1951" (Public Law 759, 81st Congress, second session, approved 6 Sept. 1950) carries the same provision reiterated *supra* contained in section 622 (b) of the "National Military Establishment Appropriation Act, 1950".

7-1.014 "First War Powers Act, 1941", (approved 18 December 1941 (50 USC App 611-622), (55 Stat. 838) as amended). Sec. 201, Title II, of the Act was amended by Public Law 921, 81st Congress, approved 12 January 1951, to read as follows:

"The President may authorize any department or agency of the Government exercising functions in connection with the national defense, in accordance with regulations prescribed by the President for the protection of the interests of the Government,

to enter into contracts and into amendments or modifications of contracts heretofore or hereafter made and to make advance, progress and other payments thereon, without regard to the provisions of law relating to the making, performance, amendment, or modification of contracts whenever he deems such action would facilitate the national defense: Provided, That nothing herein shall be construed to authorize the use of the cost-plus-a-percentage-of-cost system of contracting: Provided further, That nothing herein shall be construed to authorize any contracts in violation of existing law relating to limitation of profits: Provided further, That all acts under the authority of this section shall be made a matter of public record under regulations prescribed by the President and when deemed by him not to be incompatible with the public interest: Provided further, That all contracts entered into, amended, or modified pursuant to authority contained in this section shall include a clause to the effect that the Comptroller General of the United States or any of his duly authorized representatives shall have access to and the right to examine any pertinent books, documents, papers, and records of the contractor or any of his subcontractors engaged in the performance of and involving transactions related to such contracts or subcontracts."

7-1.015 "Second War Powers Act, 1942", (approved 27 March 1942 (56 Stat. 176), (50 USC App 631-645b)). Title III of this Act amended section 2(a) of the Act of June 28, 1940 (54 Stat. 676) as amended, and authorized the Secretary of the Navy to negotiate contracts for acquisition, construction, repair, or alteration of complete naval vessels or aircraft, or any portion thereof, and also for machine tools and other similar equipment, with or without advertising or competitive bidding upon determination that price was fair and reasonable. It prohibited the cost-plus-a-percentage-of-cost system of contracting but permitted the cost-plus-a-fixed-fee form of contract when deemed necessary by the Secretary of the Navy. These provisions of Title III expired under the provisions of the "First Decontrol Act of 1947", approved 31 March 1947 (61 Stat. 34). Title XIII of the "Second War Powers Act, 1942", contained a provision to the effect that the provision of Section 10 ("ell") of the Act approved July 2, 1926 (giving the Government the right to inspect the plant and audit the books of certain contractors—see CAM 7-1.010) shall apply to the plant, books, and records of any contractor with whom a defense contract has been placed at any time after September 8, 1939 and before termination of World War II. Executive Order No. 9127, dated April 10, 1942, designated the departments and agencies which were authorized to inspect contractors' plants and audit their books and records. The provisions of Title XIII remain in effect.

7-1.016 "Renegotiation Act of 1948".

(a) The "Renegotiation Act of 1948" (sec. 3, "Supplemental National Defense Appropriation Act, 1948"—Public Law 547, 80th Congress, approved 21 May 1948) required that all contracts in excess of \$1,000 entered into under authority of that Act, and all subcontracts thereunder in excess of \$1,000 contain a renegotiation article. However, a contractor is not renegotiated in any fiscal year in which the aggregate of the amounts received or accrued on account of such contracts was less than \$100,000. It exempted those contracts or subcontracts specified in subsection (i) (1) of the Renegotiation Act of February 25, 1944, as amended, and authorized the Secretary of Defense, in his discretion, to exempt any other contracts or subcontracts both individually and by general classes or types. General exemptions are published in the Federal Register. Authority to exempt individual contracts has been dele-

gated to the respective Secretaries of the Departments of the Army, Navy and Air Force (see Military Renegotiation Regulations 423.350 to 423.354). For the purpose of administering this section of Public Law 547, the Secretary of Defense was granted the right to audit the books and records of any contractor or subcontractor subject to this section. The Act also provided that in the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue should, upon request of the Secretary of Defense and with the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purpose of making examinations and audits under this section.

(b) Section 401 of the Second Deficiency Appropriation Act, 1948 (Public Law 785, 80th Congress, approved 25 June 1948) authorized the Secretary of Defense, whenever in his judgment the best interests of the United States so require, to direct insertion of the renegotiation clause in contracts for procurement of ships, aircraft, aircraft parts and the construction of facilities and installations outside continental United States entered into by or on behalf of the Departments of Army, Navy, and Air Force which obligated any funds made available for obligation in the fiscal year 1949. Accordingly, on 30 June 1948, the Secretary of Defense directed the inclusion of the renegotiation clause in contracts for the procurement of aircraft and aircraft parts. This directive became effective 1 July 1948. Funds made available for obligation in the fiscal year 1949 were appropriated by Public Laws 753 and 766, 80th Congress.

(c) Under provisions of section 622 of the "National Military Establishment Appropriation Act of 1950" (Public Law 434, 81st Congress, approved 29 October 1949—63 Stat. 989) and section 618 of the "General Appropriation Act of 1951" (Public Law 759, 81st Congress, approved 6 September 1950) all negotiated contracts for procurement in excess of \$1,000 entered into during the Fiscal Years 1950 and 1951 by or on behalf of the Department of Defense (including the three Military Departments) and all subcontracts thereunder in excess of \$1,000 were made subject to the Renegotiation Act of 1948. Public Laws 434 and 759, 81st Congress, provided that, in determining whether amounts received or accrued by a contractor or subcontractor during his fiscal year from contracts and subcontracts subject to the "Renegotiation Act of 1948" amount in the aggregate to \$100,000, receipts or accruals from contracts and subcontracts made subject to such Act by Public Laws 434 and 759 shall be added to receipts or accruals from all other contracts and sub-contracts subject to the "Renegotiation Act of 1948".

(d) To summarize, renegotiation under the 1948 Act applies to certain specific contracts which obligate money appropriated by Public Laws 547, 753 and 766, 80th Congress, and to all negotiated contracts entered into during the 1950 and 1951 fiscal years, subject to certain mandatory and specific exemptions; provided such specific contracts and negotiated contracts individually exceed \$1,000; and provided further that amounts received or accrued in any fiscal year under such contracts amount in the aggregate to \$100,000.

(e) The "Renegotiation Act of 1948" is administered by the Military Renegotiation Policy and Review Board, which is composed of the three chairmen of the divisions of the Armed Services Renegotiation Board—

the Army Renegotiation Division, the Navy Renegotiation Division, and the Air Force Renegotiation Division.

7-1.017 "Renegotiation Act of 1951".

(a) This act, approved 23 March 1951 (Public Law 9, 82nd Congress), provides for the renegotiation of contracts and requires the elimination of excessive profits from contracts made with the United States and from related subcontracts. The provisions of Title I of the act apply to all contracts with certain specified Departments, including among others the Department of Defense, the Department of the Army, the Department of the Navy and the Department of the Air Force to the extent of the amounts received or accrued by a contractor or subcontractor on or after 1 January 1951, whether such contracts or subcontracts were made on, before or after such first day, provided that such amounts were not attributable to performance prior to 1 July 1950, but the provisions of this title shall not be applicable to the receipts or accruals attributable to performance after 31 December 1953.

(b) The Renegotiation Act of 1948 is not repealed; however, it shall not be applicable to any contract or subcontract to the extent of the amounts received or accrued by a contractor or subcontractor on or after 1 January 1951, whether such contract was made on, before, or after that date. In case of a fiscal year beginning in 1950 and ending in 1951, if a contractor or subcontractor has receipts or accruals prior to 1 January 1951, from contracts or subcontracts subject to the Renegotiation Act of 1948, and also has receipts and accruals after 31 December 1950, to which the provisions of the Renegotiation Act of 1951 are applicable, the provisions of the Renegotiation Act of 1951 shall apply to such receipts and accruals if the Board and such contractor or subcontractor agree on such application.

(c) Contracts entered into thirty days or more after the date of the act are required to contain a Renegotiation Clause. Contractors are required to file on or before the first day of the fourth calendar month following the close of each fiscal year, a financial statement setting forth such information as the Board may by regulations prescribe. The Board shall have the right to audit the books and records of any contractor or subcontractor subject to the act. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of the Board and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury, for the purpose of making examinations and audits under this title.

(d) If the aggregate of the amounts received or accrued during the fiscal year by a contractor or subcontractor, and all persons under control of or controlling or under common control with the contractor or subcontractor, is not more than \$250,000 the receipts from such contracts and subcontracts shall not for such fiscal year, be renegotiated. Subcontractors whose income is derived from fees and commissions based on renegotiable contracts or subcontracts are renegotiable for any year in which receipts or accruals are more than \$25,000. The Act also provides certain other mandatory and permissive exemptions.

(e) There is created as an independent establishment, a Renegotiation Board of five members appointed by the President, by and with the

advice and consent of the Senate. The Secretaries of the Army, the Navy and the Air Force respectively, subject to the approval of the Secretary of Defense, and the Administrator of General Services shall each recommend to the President, for his consideration, one person from civilian life to serve as a member of the Board. The President shall, at the time of appointment designate one member to serve as Chairman. The principal office of the Board shall be in the District of Columbia. Contractors or subcontractors aggrieved by an order of the Board may file a petition with The Tax Court of the United States for a redetermination thereof.

(f) The Renegotiation Act of 1942 is not repealed. Certain powers, functions and duties of the War Contracts Price Adjustment Board have been transferred to the Administrator of General Services, and others were transferred to the Renegotiation Board.

7-1.018 Internal Revenue Code Section 3806, "Mitigation of Effect of Renegotiation of War Contracts or Disallowance of Reimbursement". The auditor should be familiar with this section, part of which provides that, if renegotiation results in the elimination of excessive profits for a prior taxable year, the amount of excessive profits so eliminated shall be reduced by a credit for Federal income and excess profits taxes attributable to such excessive profits. In the case of a cost-plus-a-fixed-fee contract the section also provides that if an item, for which reimbursement has been received or accrued in a prior taxable year, is disallowed as an item of cost chargeable to such contract, there shall be credited against the amount disallowed the amount by which the tax for the prior year is decreased. The text of section 3806 of the Internal Revenue Code and related regulations of the Bureau of Internal Revenue may be found also in sections 428.831 through 428.835 of Military Renegotiation Regulations. See also Chapter IV, Section 3 of this Manual.

7-1.019 Criminal Conduct—U.S. Code. CAM—1-0.010 and ASPR 1-111 requires the auditor to report suspected criminal conduct. Excerpts from sections of new Title 18, U. S. Code, relating to the type of criminal conduct which the auditor may encounter, follow:

"Sec. 201 Offer to Officer or other person. Whoever promises, offers, or gives any money or thing of value, or makes or tenders any check, order, contract, undertaking, obligation, gratuity, or security for payment of money or for the delivery or conveyance of anything of value, to any officer or employee or person acting for or on behalf of the United States, or any department or agency thereof, in any official function, under or by authority of any such department or agency or to any officer or person acting for or on behalf of either House of Congress, or of any committee of either House, or both Houses thereof, with intent to influence his decision or action on any question, matter, cause, or proceeding which may at any time be pending, or which may by law be brought before him in his official capacity, or in his place of trust or profit, or with intent to influence him to commit or aid in committing, or to collude in, or allow, any fraud, or make opportunity for the commission of any fraud, on the United States, or to induce him to do or omit to do any act in violation of his lawful duty, shall be fined not more than three times the amount of such money or value of such thing or imprisoned not more than three years, or both.

"Sec. 202 Acceptance or solicitation by officer or other person. Whoever, being an officer or employee of, or person acting for or on behalf of the United States, in any official capacity, under or by virtue of the authority of any department or agency thereof, or an officer or person acting for or on behalf of either House of Congress, or of any committee of either House, or of both Houses thereof, asks, accepts, or receives any money, or any check, order, contract, promise, undertaking, obligation, gratuity,

or security for the payment of money, or for the delivery or conveyance of anything of value, with intent to have his decision or action on any question, matter, cause, or proceeding which may at any time be pending, or which may by law be brought before him in his official capacity, or in his place of trust or profit, influenced thereby, shall be fined not more than three times the amount of such money or value of such thing or imprisoned not more than three years, or both; and shall forfeit his office or place and be disqualified from holding any office of honor, trust, or profit under the United States."

"Sec. 283 Officers or employees interested in claims against the Government. Whoever, being an officer or employee of the United States or any department or agency thereof, or of the Senate or House of Representatives, acts as an agent or attorney for prosecuting any claim against the United States, or aids or assists in the prosecution or support of any such claim otherwise than in the proper discharge of his official duties, or receives any gratuity, or any share of or interest in any claim in consideration of assistance in the prosecution of such claim, shall be fined not more than \$10,000 or imprisoned not more than one year, or both."

"Retired officers of the armed forces of the United States, while not on active duty, shall not by reason of their status as such be subject to the provisions of this section. Nothing herein shall be construed to allow any such retired officer within two years next after his retirement to act as agent or attorney for prosecuting or assisting in the prosecution of any claim against the United States involving the department in whose service he holds a retired status, or to allow any such retired officer to act as agent or attorney for prosecuting or assisting in the prosecution of any claim against the United States involving any subject matter with which he was directly connected while he was in an active-duty status.

"This section shall not apply to any person because of his membership in the National Guard of the District of Columbia nor to any person specially excepted by enactment of Congress.

"Sec. 284 Disqualifications of former officers and employees in matters connected with former duties. (a) Whoever, having been employed in any agency of the United States, including commissioned officers assigned to duty in such agency, within two years after the time when such employment or service has ceased, prosecutes or acts as counsel, attorney, or agent for prosecuting, any claims against the United States involving any subject matter directly connected with which such person was so employed or performed duty, shall be fined not more than \$10,000 or imprisoned not more than one year, or both.

"Sec. 1361 Government property or contracts. Whoever willfully injures or commits any depredation against any property of the United States, or of any department or agency thereof, or any property which has been or is being manufactured or constructed for the United States, or any department or agency thereof, shall be punished as follows: If the damage to such property exceeds the sum of \$100, by a fine or not more than \$10,000 or imprisonment for not more than ten years, or both; if the damage to such property does not exceed the sum of \$100, by a fine of not more than \$1,000 or by imprisonment for not more than one year, or both.

"Sec. 1364 Interference with foreign commerce by violence. Whoever, with intent to prevent, interfere with, or obstruct or attempt to prevent, interfere with, or obstruct the exportation to foreign countries of articles from the United States, injures or destroys, by fire or explosives, such articles or the places where they may be while in such foreign commerce, shall be fined not more than \$10,000 or imprisoned not more than twenty years, or both.

"Sec. 2155 Destruction of national-defense materials. Whoever, with intent to injure, interfere with or obstruct the national defense of the United States, willfully injures or destroys, or attempts to so injure or destroy, any national defense material, national defense premises, or national defense utilities, shall be fined not more than \$10,000 or imprisoned not more than ten years, or both.

"Sec. 2156 Production of defective national defense material. Whoever, with intent to injure, interfere with, or obstruct the national defense of the United States, willfully makes or attempts to make in a defective manner, any national defense material, or any tool, implement, machine, utensil, or receptacle used or employed in making, producing, manufacturing, or repairing any such national defense material, shall be fined not more than \$10,000 or imprisoned not more than ten years, or both."

7-1.020 Fraudulent Claims and Accounts—U.S. Code. There have been numerous enactments covering the submission of false, fictitious and fraudulent claims to the Government. The existing statutes subject to fines and imprisonment or other punishment any person who is found guilty of placing a fraudulent claim against the United States. It is not necessary that any pecuniary loss to the Government be involved but only that an attempt be made to defraud the Government or that there be participation in a conspiracy to defraud. The purposes of these statutes are to prohibit the drawing of any money from the Treasury of the United States by false or fictitious claims (*RODRIGUEZ v Weekly Publications*, District Court, New York, 1946). The statutes are intended to reach any person knowingly causing or assisting in causing the Government to pay fraudulent claims, regardless of whether the person has direct contractual relationships with the Government, as well as those receiving money from the Government as a result of their fraud (*U. S. v Samuel Kunkel & Co.*, District Court, New York, 1945). An account including items for services not actually rendered or money not actually paid is a false account (*U. S. v Russell*, District Court, Texas, 1884). A fraudulent claim against the Federal Government is a false or fictitious claim gotten up or contrived by some person or persons with the intent to present it for approval and thus to defraud the Government (*Mandel v Cooper Corporation*, District Court, New York 1941). CAM 1-0.009 requires an auditor to report suspected fraud. Excerpts from the U. S. Code relating to some types of fraud which the auditor may encounter, follow:

(New) Title 18, U. S. Code

“Sec. 286 Conspiracy to defraud the government with respect to claims. Whoever enters into any agreement, combination, or conspiracy to defraud the United States, or any department or agency thereof, by obtaining or aiding to obtain the payment or allowance of any false, fictitious or fraudulent claim, shall be fined not more than \$10,000 or imprisoned not more than ten years, or both.

“Sec. 287 False, fictitious or fraudulent claims. Whoever makes or presents to any person or officer in the civil, military, or naval service of the United States, or to any department or agency thereof, any claim upon or against the United States, or any department or agency thereof, knowing such claim to be false, fictitious, or fraudulent, shall be fined not more than \$10,000 or imprisoned not more than five years, or both.”

“Sec. 371 Conspiracy to commit offense or to defraud the United States. If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than five years, or both.”

“Sec. 443 War contracts. Whoever willfully secretes, mutilates, obliterates, or destroys—

(a) any records of a war contractor relating to the negotiation, award, performance, payment, interim financing, cancellation or other termination, or settlement of a war contract of \$25,000 or more; or

(b) any records of a war contractor or purchaser relating to any disposition of termination inventory in which the consideration received by any war contractor or any government agency is \$5,000 or more, before the lapse of (1) five years after such disposition of termination inventory by such war contractor or government agency, or (2) five years after the final settlement of such war contract, or (3) five years after the termination of hostilities in the present war as proclaimed by the President or by a concurrent resolution of the two Houses of Congress, whichever applicable period is longer, shall, if a corporation, be fined not more than \$50,000,

and, if a natural person, be fined not more than \$10,000 or imprisoned not more than five years, or both.

"The Director of Contract Settlement, by regulation, may authorize the destruction of such records upon such terms and conditions as he deems appropriate, including the requirement for the making and retaining of photographs or microphotographs, which shall have the same force and effect as the originals thereof.

"The definitions of terms in Section 103 of Title 41 shall apply to similar terms used in this section."

"Sec. 1001 Statements or entries generally. Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than \$10,000 or imprisoned not more than five years, or both."

"Sec. 1018 Official certificates or writings. Whoever, being a public officer or other person authorized by any law of the United States to make or give a certificate or other writing, knowingly makes and delivers as true such a certificate or writing, containing any statement which he knows to be false, in a case where the punishment thereof is not elsewhere expressly provided by law, shall be fined not more than \$500 or imprisoned not more than one year, or both."

"Sec. 1022 Delivery of certificate, voucher, receipt for military or naval property. Whoever, being authorized to make or deliver any certificate, voucher, receipt, or other paper certifying the receipt of arms, ammunition, provisions, clothing, or other property used or to be used in the military or naval service, makes or delivers the same to any other person without a full knowledge of the truth of the facts stated therein and with intent to defraud the United States, or any agency thereof, shall be fined not more than \$10,000 or imprisoned not more than ten years, or both.

"Sec. 1023 Insufficient delivery of money or property for military or naval service. Whoever, having charge, possession, custody, or control of any money or other public property used or to be used in the military or naval service, with intent to defraud the United States, or any agency thereof, or any corporation in which the United States has a proprietary interest, or intending to conceal such money or other property, delivers to any person having authority to receive the same any amount of such money or other property less than that for which he received a certificate or took a receipt, shall be fined not more than \$10,000 or imprisoned not more than ten years, or both."

Title 31, U. S. Code

(Note—In addition to the penalties provided for the crime of making false, fictitious or fraudulent claims as set out in Section 287 of new Title 18 of the U. S. Code, the following provisions of Section 231 of Title 31 make the claimant liable for damages and gives the United States the right to sue for recovery of money obtained from it by means of the fraudulent claim.)

"Sec. 231 Liability of persons making false claims. Any person not in the military or naval forces of the United States, or in the militia called into or actually employed in the service of the United States, who shall make or cause to be made, or present or cause to be presented, for payment or approval, to or by any person or officer in the civil, military, or naval service of the United States, or any department or office thereof, knowing such claim to be false, fictitious, or fraudulent, or who, for the purpose of obtaining or aiding to obtain the payment or approval of such claim, makes, uses, or causes to be made or used, any false bill, receipt, voucher, roll account, claim, certificate, affidavit, or deposition, knowing the same to contain any fraudulent or fictitious statement or entry, or who enters into any agreement, combination, or conspiracy to defraud the Government of the United States, or any department or officer thereof, by obtaining or aiding to obtain the payment or allowance of any false or fraudulent claim, or who, having charge, possession, custody, or control of any money or other public property used or to be used in the military or naval service, who, with intent to defraud the United States or willfully to conceal such money or other property, delivers or causes to be delivered, to any other person having authority to receive the same, any amount of such money or property less than that

for which he received a certificate or took a receipt, and every person authorized to make or deliver any certificate, voucher, receipt, or other paper certifying the receipt of arms, ammunition, provisions, clothing, or other property so used or to be used, who makes or delivers the same to any other person without a full knowledge of the truth of the facts stated therein, and with intent to defraud the United States, and every person who knowingly purchases or receives in pledge for any obligation or indebtedness from any soldier, officer, sailor, or other person called into or employed in the military or naval service any arms, equipments, ammunition, clothes, military stores, or other public property, such soldier, sailor, officer, or other person not having the lawful right to pledge or sell the same, shall forfeit and pay to the United States the sum of \$2,000, and, in addition, double the amount of damages which the United States may have sustained by reason of the doing or committing such act, together with the costs of suit; and such forfeiture and damages shall be sued for in the same suit. (R.S. Section 3490, 5438)."

Section 2—Military Security

7-2.001 Security of Military Information. The security of classified records depends primarily upon the alertness, reliability and devotion to duty of each individual in the possession of such records. Consequently, each individual employed by the audit agencies must be security minded with respect to matters within his jurisdiction or within his knowledge. In the interest of national security, it is imperative that a true state of security exists in time of peace as well as in time of war. Even a partial compromise of security represents a loss which may never be regained. To prevent such a contingency requires the complete and unfailing cooperation of each and every employee, irrespective of position. Any employee, through carelessness, negligence, or relaxation of security vigilance, even temporarily, may cause vital information to fall into the hands of unfriendly interests who are always alert to take advantage of such lapses. Aside from the potentially grave consequences which circumstances of this kind may cause, the value of vital documentary material assembled at the expense of great effort by the military departments may be completely nullified. Therefore, it is the responsibility of each individual employee to train himself in the perpetual and unrelenting observance of all elements of security. Effective security is largely a matter of habit, a habit of discretion and care which becomes second nature through constant usage. The habit must be cultivated by all employees if effective security is to be fully realized.

7-2.002 Applicable Federal Statutes, Executive Orders and Departmental Regulations.

- (a) Title 18, U. S. Code, Sections 793, 794, 795, 797, and 2151 through 2156.
- (b) Title 50, U. S. Code, App. 781-783.
- (c) Air Corps Act of 1926.
- (d) Internal Security Act of 1950 (Public Law 831—81st Congress).
- (e) Executive Order 10104, February 1, 1950.

The foregoing statutes and executive order are listed for reference purposes. They are considered too lengthy for reproduction in this Manual. The auditor should be familiar with the security regulation of his military department as cited in CAM 7-2-009 and with the following:

Title 18, U. S. Code, Sec. 793 (f). "Whoever, being entrusted with or having lawful possession or control of any document, writing, code book, sketch, photograph, photographic negative, blueprint, plan, map, model, instrument, appliance, note, or

information, relating to the national defense (1) through gross negligence permits the same to be removed from its proper place of custody or delivered to anyone in violation of his trust, or to be lost, stolen, abstracted, or destroyed, or (2) having knowledge that the same has been illegally removed from its proper place of custody or delivered to anyone in violation of his trust, or lost, or stolen, abstracted, or destroyed, and fails to make prompt report of such loss, theft, abstraction, or destruction to his superior officer—shall be fined not more than \$10,000 or imprisoned not more than ten years, or both.”

7-2.003 Security Classifications.

Top Secret. Information and material (matter), the security aspect of which is paramount, and the unauthorized disclosure of which would cause exceptionally grave damage to the nation.

Secret. Information and material (matter), the unauthorized disclosure of which would endanger national security, cause serious injury to the interests or prestige of the nation, or would be of great advantage to a foreign nation.

Confidential. Information and material (matter), the unauthorized disclosure of which would be prejudicial to the interests or prestige of the nation or would cause unwarranted injury to an individual, or be of advantage to a foreign nation.

Restricted. Information and material (matter), which requires security protection other than that determined to be necessary for top secret, secret, or confidential information or material. The term “restricted” as used herein is not to be confused with the term “Restricted Data” as defined in the Atomic Energy Act of 1946.

Restricted Data (Atomic Energy Commission Term). All data concerning the manufacture or utilization of atomic weapons, the production of fissionable material, or the utilization of fissionable material in the production of power, but shall not include any data which the (Atomic Energy) Commission from time to time determines may be published without adversely affecting the common defense and security. The phrase “restricted data” shall not be confused with the military security classification category “Restricted” but shall indicate that special additional safeguards shall be utilized in the handling of such matters.

7-2.004 Grading Classified Matter. The content of specific matter is the guide to the classification to be accorded thereto. Material which requires safeguarding shall be assigned the lowest classification consistent with its content; however, the classification of a file or physically connected group of papers shall be that of the highest grade included therein. Generally, audit and financial reports, which deal with the accounting aspects of contract performance need not receive as high a classification as the contract itself, but in any questionable or borderline case the classification accorded shall be as high as deemed necessary to properly protect the contents. Because contracting officers and others receiving such reports have access to the contract documents the auditor should, in the preparation of the reports, omit so far as possible, reference to classified information. If it is necessary to describe the nature of the supplies (or services) furnished under the contract, the auditor should use general terms such as “ordnance material”, “specialized equipment” and “contract item No.”.

7-2.005 Security Clearance of Military Department Auditors. As part of the employment procedure a security check is made on personnel

employed by the military departments in sensitive positions. Practically all audit positions fall in this sensitive category. Following the completion of the security check and determination of the classification which the individual may be called upon to handle, an authorization is issued stating specifically the classifications of military information for which the individual is cleared. In making audit assignments under classified contracts, it will be the responsibility of the district director to determine that personnel under his cognizance have been properly cleared prior to being given work which involves access to classified material. The mere fact that an individual has received authorization permitting access to classified information does not mean that discussion of classified matter should be freely indulged in; access to and discussion of such material should be limited to the extent actually required for proper performance of the work assigned.

7-2.006 Security Clearance of General Accounting Office Auditors. The General Accounting Office, Washington, D. C., keeps a complete listing of the names of field auditor personnel who are making audits of Department of Defense contracts. As auditors are cleared for access to Department of Defense classified military information through the "Top Secret" classification, the General Accounting Office transmits certified lists of cleared personnel to the Munitions Board. The Munitions Board approves and forwards the lists by memorandum to the three Military Departments. Audit Agency headquarters offices distribute copies of these lists to each of their district directors, who are then responsible for notifying the auditors under their supervision. Access to "restricted data" of the Atomic Energy Commission, to certain specialized equipment contracts, and to some highly restricted projects requires special and additional clearances. Before permitting General Accounting Office auditors, or persons representing themselves as such, access to contracts, files and records containing classified information, the military department auditor will carefully inspect their credentials and if there is any question as to the required clearance of the individual, access will be delayed pending confirmation of the individual's clearance. Ordinary General Accounting Office identification is acceptable only for access to non-classified contract information and documents.

7-2.007 Reports of Suspicious Actions. The auditor will immediately report to his supervisory office any action coming to his attention which, in his opinion, warrants a reasonable belief that any individual has attempted to secure access to classified information to which such individual is not entitled. This applies to Government personnel as well as others.

7-2.008 Transmission of Classified Matter. When classified matter is transmitted the means and methods employed must be in accordance with the regulations of the military department having audit cognizance.

7-2.009 Departmental Regulations. Each of the military departments has issued instructions concerning the security of military information of a classified nature: AR 380-5; AFR 205-1; United States Naval Security Manual for Classified Matter-1951 (OPNAV Instructions 551.1). Copies of these instructions are in possession of, or available to, district directors. The auditor should consult his supervisory office on security problems or matters not covered by the instructions.

APPENDIX A

DEFINITIONS OF ACCOUNTING, AUDITING AND
PROCUREMENT TERMS

The definitions in this Appendix will be of assistance to military department auditors engaged in the audit of procurement contracts and other similar work, and to contracting officers, technical inspectors and others who use the resultant audit reports and this Manual.

Accounting Policy. A settled course in the accounting area adopted or prescribed to be followed by a business entity which reflects the application of accounting principles.

Accounting Principles. Fundamental rules or laws of action relating to accounting and based upon desirable ends and objectives. Principles are more basic than policies and procedures and generally govern both.

Accounting Report. A formal statement, with or without narrative or exposition, showing financial condition at a given time or the results of transactions or operations for a given period, often presented in comparison with prior periods or with performance estimates. It serves the purpose of affording a basis of operating and policy decisions, or of furnishing information on the discharge of assigned responsibilities.

Accounting Review. A review of a contractor's cost or other financial representation without audit of the accounts and supporting evidence. Also referred to as "office" or "desk" review.

Accounting System Survey. An inspection, study and evaluation of a contractor's accounting policies, prescribed procedures, internal controls, and actual accounting and cost practices.

Agency Audit. The Army Audit Agency; the Cost Inspection Service, Bureau of Supplies and Accounts, Department of the Navy; Auditor General, USAF, or the audit staffs of any overseas commands.

Agreement, Supplemental. An amendment or change in the terms of a contract, which is not authorized under specific provisions thereof but which is found to be desirable or necessary during the life of the contract. A supplemental agreement must contain all the essential elements of an original contract including the signatures of the contracting parties.

Amortization. Gradual reduction, redemption or liquidation of the balance of an account according to a specific schedule of times and amounts.

Audit. The systematic examination of records and documents and the securing of other evidence by confirmation, physical inspection, or otherwise, for one or more of the following purposes: (a) determining the propriety or legality of proposed or consummated transactions, (b) ascertaining whether all transactions have been recorded, (c) determining whether all transactions are reflected accurately in the accounts, (d) determining the existence of recorded assets and the all-inclusiveness of recorded liabilities, (e) determining the accuracy of financial or statistical statements or reports and the fairness of the presentation of the facts therein, (f) determining the degree of compliance with established policies and procedures relative to financial transactions and business management, (g) appraising an accounting system and making recommendations for improvement therein. The performance of such an examination.

Audit, Assist. An administrative term used to identify audits requested by audit agency personnel as distinct from those requested by procurement personnel or others.

Audit, Continuous. An audit which is performed either continuously, or at short, regular intervals throughout the fiscal period.

Audit, Contract. The verification, through examination (usually on a selective basis) of accounts and supporting evidence, of the accuracy of a contractor's representations regarding costs incurred in the performance of a contract.

Audit, Detailed. A verification as to mathematical accuracy, accountability, documentary support and application of accounting principles of the details of certain or all accounts, vouchers, journal entries, checks, subsidiary and other records relating to a series of, or selected, business transactions occurring over a specified period of time.

Audit, Internal. The independent appraisal activity within an organization for the review of the accounting, financial, and related operations as a basis for protective and constructive services to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also deal incidentally with related matters of an operating nature (excluding military operations).

Audit, Limited. An audit in which one or more of the auditing procedures and tests considered necessary for the purpose of furnishing an unqualified opinion are omitted or restricted in certain specified respects.

Audit Status Date. The date which is (a) 60 days subsequent to the date of the receipt by the General Accounting Office of the Audit Status Notice, or (b) the date of the receipt by the procuring activity of the General Accounting Office Final Audit Status Letter, whichever is earlier. After the Audit Status Date, no formal exceptions, other than pro-forma exceptions, will be issued by the General Accounting Office. The term is used in connection with terminations of cost-type contracts.

Audit Status Notice. Also called "Notice of Audit Status Date." A prescribed form for use of disbursing officers in transmitting to the General Accounting Office a verified list of the "1034" vouchers paid in connection with any terminated cost-type contract and for establishing an Audit Status Date.

Auditor. As referred to in this manual, an employee of an audit agency of the military departments, engaged in or for the performance of audits. Sometimes referred to herein as "military department auditor."

Betterment. (1) An addition made to, or change in, a fixed asset which results in the prolongation of its life or in an increase in its efficiency or operating economy, over and above that arising from maintenance, and the cost of which is therefore added to the cost of the asset. *Note*—The term is sometimes applied to sidewalks, sewers and highways but these should preferably be designated as "improvements." (2) The amount of expenditure for such betterment.

Bill of Material. A qualitative, quantitative, and descriptive listing of all materials and equipment (except processing materials and production equipment) required to produce a completed procurement item or a structure.

Common Item. Any raw material, purchased part, component, or tool which is usable on more than one Government contract or on a Government contract and any commercial work of the contractor.

Completed Portion of Contract. That portion of a contract which relates to work or articles completed and accepted prior to a specified date (in the case of a terminated contract, the effective date of termination).

Continued Portion of Contract. That portion of a partially terminated contract which is not already completed at the effective date of termination, and which the contractor must continue to perform.

Contract, Construction. A contract for the construction, alteration or repair of buildings, bridges, roads, or other kinds of real property. The term does not include a contract for the manufacturing, producing, furnishing, construction, alteration, repair, processing or assembling of vessels, aircraft or other kinds of personal property.

Contract, Cost. A contract which provides for payment to the contractor of allowable costs to the extent prescribed in the contract, incurred in the performance of the contract.

Contract, Cost-Plus-a-Fixed-Fee. A type of contract similar to the cost contract in that it provides for payment to the contractor of all allowable costs as defined in the contract and establishes an estimate of the total cost. It differs from the cost contract in that it also provides for payment of a fixed fee based on the estimated cost of the contract.

Contract, Cost-Plus-a-Percentage-of-Cost. A form of contract formerly used but now illegal for use by the military departments, which provided for a fee or profit at a specified percentage of the contractor's actual cost of accomplishing the work to be performed. Sometimes referred to as a "cost-plus" or "percentage-of-cost" contract.

Contract, Cost-Sharing. A cost contract which provides for payment to the contractor of a portion of allowable costs, to the extent prescribed in the contract, incurred in the performance of the contract.

Contract, Cost-Type. A general term used for contract cost audit purposes in referring to cost, cost-plus-a-fixed-fee, cost-sharing, and time-and-materials contracts. Although Armed Services Procurement Regulation (ASPR 15-101) states, in part, that a cost-reimbursement-type contract includes the cost-reimbursement portion of a time and material contract, it is intended for contract cost audit purposes that the entire contract, rather than only the cost-reimbursement portion, be construed as a cost-type contract.

Contract, Fixed-Price. A type of contract which generally provides for a firm price or prices for the supplies or services which are being procured. It is used when contracts are let by competitive bidding; and, in negotiated contracts, when costs can be estimated with reasonable accuracy and a fair price negotiated. It may include provision for price escalation or adjustment.

Contract, Fixed-Price, With Provision for Redetermination of Price. A fixed-price contract which includes a special provision for redetermining upward or downward, and retroactively or prospectively, the price or prices in the contract. It is used to assure to the Government the benefit of reduced costs of performance and, in some instances, to the contractor,

recovery in whole or in part of increased costs, and to obtain reasonable prices whenever contingency charges otherwise would be included in a contract price due to such factors as prolonged delivery schedules, unstable market conditions for material and labor, or uncertainty as to cost of performance.

Contract, Incentive-Type. A contract of either a fixed-price or a cost-plus-a-fixed-fee nature, with a special provision for redetermination of the fixed price or fixed fee. It provides for a tentative base price or target price (called the "contract price") and a maximum price or maximum fee, with price or fee redetermination after completion of the contract for the purpose of establishing a final price or fee based on the contractor's actual costs plus a sliding scale of profit or fee which varies inversely with the cost but which in no event shall permit the final price or fee to exceed the maximum price or fee stated in the contract. Use of the incentive-type contract is usually restricted to instances when the procurement of supplies or services involves a reasonably long production run, when the contractor has an acceptable accounting system and adequate manufacturing experience, and when a reasonably close "contract price" can be negotiated.

Contract, Prime. A contract entered into directly by any military department or procuring activity of the Department of Defense.

Contract, Research and Development. A contract for experimental, developmental or research work.

Contract, Task-Type. A master contract for research and development or other work, consisting of two parts, one of which sets forth general provisions and the other of which is represented by one or more task orders issued thereunder. (Navy term.)

Contract, Time-and-material. A contract for the purchase of supplies or services on the basis of (a) direct labor hours at specified hourly rates (which rates include direct labor, overhead, and profit) and (b) material at cost.

Contract, Type C. A cost-plus-fixed-fee contract for the repair, alteration, and construction of naval vessels, aircraft and vehicles. These contracts are awarded by Navy shipyards and other local activities. They provide for performance of work only in accordance with job orders issued thereunder. (Navy term.)

Contract, Type D. A contract generally similar to the Type C contract except that it provides for the negotiation of fixed prices before or after commencement of the work. (Navy term.)

Cost. (1) A measure of something sacrificed to gain something. (2) The total outlay in cash or its equivalent for the purchase, construction, or production of an item of physical or intangible property, or the total outlay for a group of such items. (3) The total outlay in cash or its equivalent applied (a) in carrying out a specific program, function, or project; (b) in the manufacture of a specified product; (c) in the rendering of a specific service.

Note—Strictly speaking, the cost of any program, function, project, product, or service in any given fiscal period must be stated on the *accrual basis of accounting*, such a cost may also involve allocation of joint costs. (4) To determine the cost of an item of property or of performance during a fiscal period, of a specific program, function, or project.

Cost Accounting. A system of accounting, analysis and reporting on costs of production of goods or services, or of operation of programs, activities, functions, or organizational units. The system also may embrace cost estimating, determination of cost standards based on engineering data, and comparison of actual and standard costs for the purpose of aiding cost control. The system may deal in non-financial (statistical) measures in lieu of or to augment financial measures.

Cost, Actual. A cost based on an historical transaction as opposed to a standard, predetermined, or estimated cost.

Cost Allocation. A method, usually mathematical, of assigning direct or indirect costs equitably to each of several objectives for which the costs were jointly incurred.

Cost Center. A control unit selected for the purpose of accumulating costs. It usually: (1) consists of a natural grouping of machines, methods, processes, or operations; (2) is identified with management responsibility for the control unit; and (3) is made up of elements which have common cost characteristics.

Cost, Direct. Any item of cost (or the aggregate thereof) which may be identified specifically with any objective, such as product, service, program, function, or project; usually, but not necessarily, limited to items of material and labor. The distinction between direct and indirect costs is often arbitrary or is based upon convenience and cost accounting simplicity without sacrifice of reasonable accuracy in overall costs of specific objectives.

Cost, Estimated. (1) A calculated amount, as distinguished from an actual outlay, based upon related cost experience, prevailing wages and prices, or anticipated future conditions, usually for purposes of contract negotiations or budgetary control or reimbursement, (2) The amount stated in a cost-type contract as the estimated cost thereof.

Cost, Historical. The cost of any objective based upon actual dollar or equivalent outlay ascertained after the fact.

Cost, Indirect. An item of cost (or the aggregate thereof) which is incurred for joint objectives, and, therefore, cannot be identified specifically with a single final objective, such as a product, service, program, function, or project. An indirect cost usually is allocated to the several cost objectives. A cost may be direct with respect to some specific service or function which in itself is indirect with respect to the end-product, service, program, function, or project. In practice the distinction between direct and indirect costs is sometimes arbitrary or is based upon convenience and practicality without sacrifice of reasonable accuracy in overall costs of specific objectives.

Cost, Standard. Advance estimates of cost, of a complete product or part of a complete product, which may be attainable under specified conditions, determined from existing cost experience or from engineering estimates of requirements for labor, material, equipment and other manufacturing facilities, and overhead expenses.

Depreciation. (1) The decline in value of physical assets due to such causes as wear and tear, inadequacy, action of the elements and obsolescence, but without loss of substance. (2) The portion of cost of

capital assets calculated to have expired for any accounting period due to such causes.

Disposal Credits. (1) The agreed upon price for any part of the termination inventory sold to the contractor by the contracting officer. (2) The proceeds of the sale of any material sold to third parties which has not otherwise been paid or credited to the Government.

Escalation Clause. A contract clause in a fixed price contract which provides for adjustment of prices by prescribed formulae or by negotiation to compensate for changes in labor or material costs.

Expenditure. The amount of a liability incurred (whether or not paid) for goods and services received or assets acquired.

Improvement. (1) A building, other structure, or other attachment or annexation to land which is intended to remain so attached or annexed, such as sidewalks, trees, drives, tunnels, drains, and sewers.

(*Note*—Sidewalks, curbing, sewers and highways are sometimes referred to as “betterments” but the term “improvements” is to be preferred.) (2) The amount of expenditures therefor.

Independent Person. One not subject to the influence of, or administrative control of, the person responsible for the activity under consideration.

Internal Check. An element of internal control arising from the division of employees’ duties in such a manner that automatic checks and balances are maintained in the handling and recording of transactions and in the care and protection of assets.

Internal Control. The plan of organization and all of the coordinate methods and measures adopted within an entity to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

Letter Contract or Letter of Intent. A preliminary contract with or without a tentative price or specific amount agreed to therein, and with such other basic terms set forth therein as can be agreed to at that time. It authorizes the contractor to commence work, incur costs, and make commitments pending negotiation and execution of the final definitive contract. It obligates the Government to either make a final definitive contract within a specified time, or to reimburse the contractor for costs incurred under the letter of intent or letter contract.

Maintenance. (1) Upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life, but keeps it in efficient operating condition. Includes repairs. (2) The cost thereof.

Obsolescence. (1) The decrease in utility of an asset due to economic, social, or technological changes which have brought about development of something new to meet new demands or which have increased efficiency in production or use (also see depreciation). (2) The cost applicable thereto.

Overhead Cost. Synonymous with “Cost, Indirect.”

Overhead Cost, Idle Plant. The amount of overhead costs applicable to a plant, or the portion of a plant, which is not operated, or which is operated below its rated capacity (includes the cost of maintaining plants in stand-by condition).

Overhead Cost, Overabsorbed. The excess of overhead charged to production upon a normal or standard basis, over corresponding actual overhead. Usually arises because the actual overhead cost is less than was anticipated when the overhead rate for contemplated production was established or actual production was greater than that contemplated.

Overhead Cost, Underabsorbed. The excess of actual overhead over corresponding overhead charged to production on a normal or standard basis. Usually arises because the actual overhead cost is greater than was anticipated when the overhead rate for contemplated production was established or actual production was less than that contemplated.

Overhead Costs, Fixed An item of overhead cost (or the aggregate thereof) which is not considered to vary with less than extreme changes in the volume of production; as opposed to variable and semi-variable overhead costs.

Overhead Costs, Semi-Variable. An item of overhead cost (or the aggregate of such items) the amount of which varies in the same direction with changes in production but in a lesser proportion than such changes.

Overhead Costs, Variable. An item of overhead cost (or the aggregate of such items) the amount of which varies directly (or in a greater proportion) with changes in production.

Payment, Advance. A payment made by the Government to a contractor in the form of a loan or an advance prior to and in anticipation of complete performance under a contract and in accordance with terms agreed upon by the parties to the contract. Advance payments are to be distinguished from "partial payments" and "progress payments" and other payments made because of performance or part performance of a contract.

Payment, Partial. A payment authorized under a contract made by the Government to a contractor upon completion of the delivery of one or more complete units called for under the contract, or upon completion of one or more distinct items of service called for thereunder.

Payment, Progress. A payment made to a contractor as work progresses. Amounts usually are based upon actual expenditures, work performed, or a particular stage of completion.

Payment, Provisional. A payment made under a cost-type contract to a contractor approval of which is based on an office review prior to an audit to be made after payment.

Property, Contractor-acquired. Property procured or otherwise provided by the contractor for the performance of a contract, pursuant to the terms of which title is vested in the Government.

Property, Contractor-furnished. All property used by the contractor in the performance of a contract other than contractor-acquired and Government-furnished property.

Property, Government-furnished. Property in the possession of or acquired directly by the Government and delivered or otherwise made available to the contractor.

Purchase Order. (1) An executed document authorizing a vendor to deliver materials, equipment or perform services, which document, upon acceptance, constitutes a purchase contract. (2) A form intended for such use.

Reasonable. No more or less than reason dictates within due and just limits, having in mind all of the circumstances involved in a particular case. Syn. equitable, moderate, fair.

Repair. (1) The restoration or replacement of parts or components of property as necessitated by wear or tear, damage, failure of parts or the like in order to maintain it in efficient operating condition. (2) The cost thereof. See maintenance.

Representative Number. The number of transactions selected from an aggregate, at random or by design, as circumstances warrant, which will comprise a cross section of the aggregate sufficient to justify reliance on the results of an examination of the selected number as representing the condition of the whole.

Salvage. (1) Property that is in such worn, damaged, deteriorated, or incomplete condition, or is of such a specialized nature that it has no reasonable prospect for sale or use as a unit, or is not usable as a unit without major repairs or alterations. Salvage may have some value in excess of its basic material content because it may contain serviceable components or may have value to a purchaser who may make major repairs or alterations. Salvage property is composed of condemned, discarded, abandoned, or captured property, including scrap and waste material, non-repairable property, and abandoned private property. (2) The amount realized or realizable from disposition of such property. (3) The saving or rescuing of such property or material contained therein for reuse, refabrication, or scrapping.

Scrap. Property which has no value except for its basic material content.

Scrap Warranty. A written warranty by a buyer that property purchased as scrap will in fact be sold or used only as scrap.

Settlement Expenses. Reasonable accounting, legal clerical, and other expenses necessary in connection with the termination and settlement of the contract and subcontracts and purchase orders thereunder, including expenses incurred for the purpose of obtaining payment from the Government but only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith. Settlement expenses include reasonable storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.

Settlement, Partial. A settlement of a severable portion of a termination claim or settlement proposal, evidenced by a partial settlement agreement.

Settlement Proposal. A termination claim submitted by a contractor or subcontractor in the form and supported by the data, required by departmental regulations.

Subcontract. Any contract, agreement, or purchase order, and any preliminary contractual instrument, other than a prime contract calling for the performance of any work, or for the making or furnishing of any material, required for the performance of any one or more prime contracts. The term also includes any such contract, agreement, purchase order, or other instrument, placed under any one or more subcontracts as herein defined.

Supplies. (1) Personal property which after issue is immediately consumed in use or which, while having continuing life, becomes incorporated in other property, thus losing its identity. (2) A procurement term. All property except land or interests in land. It includes, by way of description and without limitation, public work, buildings, facilities, ships, floating equipment, and vessels of every character, type and description, together with parts and accessories thereto; aircraft and aircraft parts, accessories and equipment; machine tools; and the alteration or installation of any of the foregoing.

Task Order. A supplementary contractual and obligating document issued under a master or basic task-type contract for research and development or other work. (Navy term.)

Terminated Portion of Contract. That portion of a terminated contract which does not relate either to completed work or material delivered and accepted under the contract, or to any continued portion of the contract.

Termination Claim. Any claim or demand by a prime contractor or subcontractor for compensation because of the termination before completion of any contract or subcontract, at the convenience of the Government.

Termination Inventory. Any items of physical property purchased, supplied, manufactured, furnished or otherwise acquired for performance of the terminated contract which are properly allocable to the terminated portion of the contract. Termination inventory may comprise (a) Government furnished property and (b) contractor acquired or contractor furnished property. The term does not include any facilities, machinery, material, special tooling or equipment which are subject to a separate contract or a special provision governing the use and disposition thereof.

Termination, Partial. The termination of a portion of the uncompleted work under a contract.

Test-Check. The examination of a representative number of transactions.

Variance Labor. The difference between the standard hours priced at the standard rate and the actual hours priced at the actual rate.

Variance, Labor Rate. The difference between the actual hours at standard rates and the actual hours at actual rates.

Variance, Labor Time. The difference between the standard hours priced at the standard rate and the actual hours priced at the standard rate.

Variance, Material. The difference between the standard quantity of materials priced at the standard rate and the actual quantity used and priced at the actual rate.

Variance, Material Price. The difference between the standard cost and the actual cost of the actual quantity of materials used.

Variance, Material Use. The difference between the standard quantity of materials priced at the standard rate and the actual quantity of materials used and priced at the standard rate.

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Variance, Overhead. The difference between the overhead charged to production at standard rates and the actual overhead allocated to production. (Overhead variance may be divided into scrap variance, stores inventory variance, calendar variance, budget variance, efficiency variance, idle plant variance and such other subdivisions for the analysis of efficiency factors as may be desired and which the refinements of the cost system permit.)

APPENDIX B

ABBREVIATIONS USED WITHIN THE MILITARY DEPARTMENTS

The abbreviations included in this Appendix are included only for information purposes. They are not to be used in audit reports or correspondence.

AAG	Air Adjutant General	AF
AGB	Auditor General's Bulletin	_____
AGI	Auditor General's Instruction	_____
AGL	Auditor General's Letter	_____
AGM	Auditor General's Memorandum	_____
AI	air inspector	AF
AIC	Accountant-in-charge	_____
AMC	Air Matériel Command	AF
AMC	Army Medical Center	A-N
ANAF	Army-Navy-Air Force	_____
ANG	Air National Guard	A-AF
APM	Air Provost Marshal	AF
AR	Army Regulations	A-N-AF
ARDC	Air Research and Development Command	AF
ASOFA	Assistant Secretary of the Army	A
ASofAF	Assistant Secretary of the Air Force	AF
AstSecNav	Assistant Secretary of the Navy	N
ASPR	Armed Services Procurement Regulation	AF
Aud Gen	Auditor General	AF
AWCO	Area Wage and Classification Office (Navy title)	_____
BAGR	Bureau of Aeronautics General Representa- tive	N
BAR	Bureau of Aeronautics Representative	N
BLADING	Bill of Lading	N
B/L	Bill of Lading	A-N
BUAER	Chief, Bureau of Aeronautics	N
BuAer	Bureau of Aeronautics	N
BUDOCKS	Chief, Bureau of Yards and Docks	N
BuDocks	Bureau of Yards and Docks	N
BUMED	Chief, Bureau of Medicine and Surgery	N
BuMed	Bureau of Medicine and Surgery	N
BUORD	Chief, Bureau of Ordnance	N
BuOrd	Bureau of Ordnance	N
BUPERS	Chief, Bureau of Naval Personnel	N
BuPers	Bureau of Naval Personnel	N
BUSANDA	Chief, Bureau of Supplies and Accounts	N
BuSandA	Bureau of Supplies and Accounts	N
BUSHIPS	Chief, Bureau of Ships	_____
BuShips	Bureau of Ships	_____
CAM	Contract Audit Manual	_____
CE	Corps of Engineers (Army)	A-N-AF

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CIS	Cost Inspection Service	
	Bureau of Supplies and Accounts	N
CMLC	Chemical Corps	A
CO	Commanding Officer	A-N
CO	commanding officer	AF
COFENGRS	Chief of Engineers	A
COFF	Chief of Finance	A
CofF	Chief of Finance	AF
COFS	Chief of Staff	A
CofS	Chief of Staff	N-AF
COMPT	Comptroller	A
compt	Comptroller	AF
ConUS	Continental United States	A
DA	Department of the Army	A-AF
DAF	Department of the Air Force	AF
DCS/M	Deputy Chief of Staff, Matériel	AF
DD	Department of Defense	A
DOI	Directorate Office Instruction (AMC)	AF
EUCOM	European Command (Army)	-----
FC	Finance Corps	A
FEAF	Far East Air Forces	AF
FEAF	Far Eastern Air Forces	N
FEAMCOM	Far East Air Matériel Command	AF
FECOM	Far East Command (Army)	-----
FOUSA	Finance Office (r), United States Army	A-AF
GAO	General Accounting Office	A-N-AF
GB/L	Government Bill of Lading	A-AF
GFE	Government Furnished Equipment	N
GFP	Government Furnished Property	AF
GO	general orders	A
GO	General Order	N
G-1	Assistant Chief of Staff, G-1 Personnel	A
G-2	Assistant Chief of Staff, G-2, Intelligence	A
G-3	Assistant Chief of Staff, G-3, Operations	A
G-4	Assistant Chief of Staff, G-4, Logistics	A
GSC	General Staff Corps (Army)	A-N
GSC	General Staff Corps	AF
HOI	Headquarters Office Instruction	AF
hq	headquarters	AF
HQ	Headquarters	A-N
IG	Inspector General (Army)	A-N
IG	inspector general	AF
IndMan	Industrial Manager	N
InsAir	Inspector Naval Aircraft	N
InsGen	Inspector General (Naval)	N
InsMach	Inspector of Naval Machinery	N
InsMat	Inspector of Naval Material	N
InsOrd	Inspector of Ordnance (Naval)	N

JAG	Judge Advocate General	A-N-AF
JCS	Joint Chiefs of Staff	A-N-AF
JPR	Joint Procurement Regulation	AF
MAP	Military Assistance Program	AF
MATS	Military Air Transport Service	A-AF
MB	Munitions Board	AF
MC	Medical Corps (Army)	A-AF
MDAP	Mutual Defense Assistance Program	AF
MRPRB	Military Renegotiation Policy and Review Board	-----
MSTS	Military Sea Transport Service	A-AF
NCI	Navy Cost Inspector	N
ND	Navy Department	N-AF
NG	National Guard	A-AF
NGB	National Guard Bureau	A-AF
NRAO	Navy Regional Accounts Office	-----
NSRB	National Security Resources Board	AF
OCA	Office, Comptroller of the Army	-----
OIC	Officer-in-Charge	N
OIC	officer in charge	A-AF
OICC	Officer in Charge of Construction (Navy)	-----
OIR	Office of Industrial Relations	N
ONR	Office of Naval Research	-----
ORD CORPS	Ordnance Corps	A
OSA	Office of the Secretary of the Army	AF
OSAF	Office of the Secretary of the Air Force	AF
OSD	Office of the Secretary of Defense	AF
OS/D	over, short and damaged report	A-N
OSN	Office of the Secretary of the Navy	AF
QMC	Quartermaster Corps (Army)	A-N-AF
QMG	Quartermaster General	A-N-AF
RDB	Research and Development Board	A-AF
RInsMat	Resident Inspector of Naval Material	N
ROinC	Resident Officer-in-Charge	N
SA	Secretary of the Army	A-AF
SAF	Secretary of the Air Force	AF
SCI	Supervisory Cost Inspector	N
SD	Secretary of Defense	AF
SG	Surgeon General (Army)	A-N-AF
SIGC	Signal Corps	A-AF
SN	Secretary of the Navy	AF
SecNav	Secretary of the Navy	N
SR	Special Regulations	A
SupInsMat	Supervising Inspector of Naval Material	N
SupShip	Supervisor of Shipbuilding	N
TAG	The Adjutant General (Army)	A-N
TC	Transportation Corps (Army)	A-N-AF
TIG	The Inspector General	AF

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TJAG, USAF	The Judge Advocate General, United States Air Force	AF
TWX	teletypewriter exchange service	AF
TWX	Commercial Typewriter Exchange System	N
USA	United States Army	A-N-AF
USAF	United States Air Force	A-AF
USN	United States Navy	A-N-AF
USOFA	Under Secretary of the Army	A
USofAF	Under Secretary of the Air Force	AF
USS	United States Ship	N

APPENDIX C

Pro Forma Audit and Accounting Reports

(To be published at a later date)

APPENDIX D

**Administrative Forms and Reports, Including Instructions for
Preparation and Use**

(To be published at a later date)

APPENDIX E

Other Forms

(To be published at a later date)

APPENDIX F

Working Papers

(To be published at a later date)

APPENDIX G

Publications, Regulations, and Other Reference Material

(To be published at a later date)

APPENDIX H

SECTION XV—ARMED SERVICES PROCUREMENT REGULATION
CONTRACT COST PRINCIPLES

(Revised 1 March 1952)

15-000 Scope of Section. This section sets forth, in general, standards for the determination and allowance of costs in connection with the performance of cost reimbursement type contracts.

15-001 Effective Date of Section. This section shall be complied with on and after 1 March 1949, although compliance is authorized from the date of its issuance (but see Part 6 as to effective dates of Cost Interpretations set forth therein).

Part 1—Applicability

15-101 Types of Contracts. Subject to the requirements of paragraph 15-102, the provisions of Part 2, Part 3, or Part 4 of this section (whichever part is applicable) shall be followed in connection with all cost-reimbursement type contracts (including cost-reimbursement sub-contracts thereunder), except that in the case of such contracts having predetermined overhead rates the applicable provisions of this section shall be used only as a basis for negotiating such rates but shall be followed for all other items of cost. The provisions of Part 2 shall be followed for all cost-reimbursement type contracts other than those covered in Parts 3 and 4, the provisions of Part 3 shall normally be followed for all research and development cost or cost-sharing contracts with educational or other nonprofit institutions, and the provisions of Part 4 shall normally be followed for all construction contracts (as defined in said Part 4) and for all contracts for architect-engineer services related to construction; however, when deemed by the head of the procuring activity concerned to be more suitable for a particular contract, Part 2 may be followed in place of Part 3 or of Part 4. The term "cost-reimbursement type contract," as used throughout this section, includes cost or cost-sharing contracts, cost-plus-a-fixed-fee contracts, and the cost-reimbursement portion of time-and-materials contracts.

15-102 Contract Provisions. In order for the principles for determination of costs outlined in Part 2, Part 3, or Part 4 of this section to be binding upon the Government and upon a contractor, the applicable principles must be (a) set forth in the contract or appended thereto, or (b) specifically incorporated by reference in the contract. The cost principles outlined in Part 2, Part 3, or Part 4 of this section (whichever is applicable) shall be made a part of every contract of the type referred to in paragraph 15-101 executed as of a date on or after 1 March 1949, except that any such contract (i) may, to the extent necessary in a particular case, expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this section unless any such kind of costs is expressly excluded under Part 2, Part 3, or Part 4 (whichever is applicable), and (ii) may exclude any item of allowable cost set forth in Part 2, Part 3, or Part 4.

Part 2—Supply and Research Contracts With Commercial Organizations

15-200 Scope of Part. This part sets forth principles for the determination of costs in connection with cost-reimbursement type contracts (which term, as used in this part, includes cost-reimbursement subcontracts thereunder) other than (i) research and development cost or cost-sharing contracts with educational or other nonprofit institutions, and (ii) construction contracts and contracts for architect-engineer services related to construction.

15-201 General Basis for Determination of Costs. The total cost of a cost-reimbursement type contract is the sum of the allowable direct costs incident to the performance of the contract, plus the property allocable portion of allowable indirect costs, less applicable income and other credits. The tests used in determining the allowability of costs also include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, and (iii) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable. The use of normal or standard costs (with appropriate adjustments for variances, unallowable costs and the other provisions of this part) is acceptable in determining amounts of provisional or interim payments, but final allowable costs must represent actual costs. Income and other credits arising out of operations under the contract, where the related cost was reimbursed or accepted as an allowable cost, will be credited to the Government.

15-202 Allowable Direct Costs.

15-202.1 Materials. The cost of materials includes the cost of all items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product. In computing material costs, consideration will be given to reasonable overruns, spoilage, and defective work. Withdrawals from a contractor's stock will be charged in accordance with the pricing system used by the contractor, *provided* such system is in accordance with sound accounting practice and is consistently followed. Reasonable charges arising from differences between periodic physical inventory quantities and related material-control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material-control records shall be taken into account. In calculating the cost of materials, there shall be deducted all cash discounts, trade discounts, rebates, and other allowances and credits taken by the contractor, including (a) credit for any materials returned to stock or to vendors, and (b) credit for the value of scrap resulting from performance of the contract, whether or not such scrap is sold. Such discounts, rebates, allowances and credits may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs.

15-202.2 Labor. Direct labor cost consists of salaries and wages properly chargeable directly to the performance of the contract. Generally

such salaries and wages will be charged at the actual rates paid by the contractor. However, if it is the contractor's consistent accounting practice to make such charges on the basis of average rates, this practice will be acceptable if it is demonstrated by the contractor that the Government will not be prejudiced thereby.

15-202.3 Other Direct Costs. There are numerous items of cost which are generally classified as indirect costs but which may, in particular cases, properly be chargeable directly to the contract, where the contractor demonstrates that such costs are specifically related to the contract.

15-203 Allowable Indirect Costs. For accounting purposes indirect costs usually fall into the following three categories, although for purposes of allowability any such costs are subject to the limitations of this part:

- (a) manufacturing and production expenses, which are the indirect costs incurred in the operation of production departments;
- (b) selling and distribution expenses, which are costs incurred in connection with the marketing of the contractor's products;
- (c) general and administrative expenses, which are costs incurred in the general management, supervision and conduct of the business as a whole.

In establishing a method of equitably apportioning the indirect costs, consideration should be given to such factors as charges of subcontractors, fixed asset improvement programs, and any unusual circumstances involved in the contractor's operation; and such factors should be carefully reviewed from time to time, particularly when there is a change in the nature or volume of production, to determine whether the method of apportionment continues to be equitable. Whenever items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs apportioned to the contract.

15-204 Examples of Items of Allowable Costs. Subject to the requirements of paragraph 15-201 with respect to the general basis for determining allowability of costs, and irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of costs are considered allowable within the limitations indicated:

- (a) Advertising in trade and technical journals, *provided* such advertising does not offer specific products for sale but is placed for the purposes of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry (but see paragraph 15-205 (a)).
- (b) Bonds and insurance, including self-insurance (but see paragraph 15-205 (p)).
- (c) Compensation of corporate officers, executives and department heads. (The term "compensation" includes all amounts paid or set aside, such as pension and retirement benefits in accordance with the interpretation set forth in paragraph 15-601, salaries, royalties, license fees, bonuses, and deferred compensation benefits. The total compensation of an individual may be questioned and the amount allowed may be limited; and in connection therewith, consideration will be given to the relation of the total compensation to the services rendered).
- (d) Depreciation and depletion, based on cost of acquisition (but see paragraph 15-205 (b) and (o)).

(e) Directors and executive committee fees and expenses; the expenses of stockholders meetings, annual reports, and reports and returns prepared for governmental authorities; and registry and transfer charges resulting from changes in ownership of securities issued by the contractor.

(f) Freight, transportation, and material handling.

(g) Improvement of working conditions, employer-employee relations, and standards of performance.

(h) Jigs, dies, fixtures, patterns, drawings and special tools.

(i) Legal, accounting, and consulting services and related expenses (but see paragraph 15-205 (d) and (l)).

(j) Manufacturing and production engineering, that is, engineering related immediately to manufacturing and production as distinguished from research, experimentation, and development.

(k) Materials and supplies.

(l) Memberships in trade, business and professional organizations.

(m) Miscellaneous office and administrative services and supplies, including communication expenses.

(n) Overtime compensation for direct or indirect labor, to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Government.

(o) Patents, purchased designs, and royalty payments, to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Government.

(p) Pension and retirement plans in accordance with the interpretation set forth in paragraph 15-601 and group health, accident and life insurance plans (but see paragraph 15-205 (p)).

(q) Plant maintenance and protection.

(r) Recruiting (including "help wanted" advertising) and training of personnel.

(s) Research and development specifically applicable to the supplies or services covered by the contract.

(t) Salaries and wages, direct and indirect (but see paragraph 15-204 (c)).

(u) Subcontracts and purchase orders.

(v) Taxes (but see paragraph 15-205 (i) and (r)).

(w) Traveling expenses.

(x) Vacation, holiday and severance pay, sick leave and military leave, to the extent required by law, by employer-employee agreement or by the contractor's established policy.

15-205 Examples of Items of Unallowable Costs. Irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of cost are considered unallowable, except as indicated:

(a) Advertising, except "help wanted" advertising, and advertising in trade and technical journals (see paragraph 15-204 (a) and (r)).

(b) Amortization or depreciation of (i) unrealized appreciation of values of assets, or (ii) assets fully amortized or depreciated on the contractor's books of account.

(c) Bad debts (including expenses of collection) and reserves for such debts.

- (d) Commissions and bonuses (under whatever name) in connection with obtaining or negotiating for a Government contract.
- (e) Contingency reserves.
- (f) Contributions and donations.
- (g) Dividend payments.
- (h) Entertainment.
- (i) Federal taxes on income and excess profits.
- (j) General research, unless specifically provided for elsewhere in the contract.
- (k) Interest on borrowings (however represented), bond discount and expenses, and financing charges.
- (l) Legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation, defense of anti-trust suits, and the prosecution of claims against the United States.
- (m) Losses from sales or exchanges of capital assets, including investments.
- (n) Losses on other contracts.
- (o) Maintenance, depreciation and other costs incidental to excess facilities (including machinery and equipment) other than reasonable standby facilities.
- (p) Premiums for insurance on the lives of directors, officers, proprietors or other persons, where the contractor is the beneficiary directly or indirectly.
- (q) Selling and distribution activities not related to the contract products.
- (r) Taxes and expenses in connection with financing, refinancing, or refunding operations, including the listing of securities on exchanges.

Part 3—Research Contracts with Nonprofit Institutions

15-300 Scope of Part. This part sets forth principles for the determination of costs in connection with cost or cost-sharing contracts (which term, as used in this part, means cost-reimbursement type contracts where no fee or profit is involved, and includes such cost-reimbursement type subcontracts thereunder) for research and development entered into with educational or other nonprofit institutions.

15-301 General Basis for Determination of Costs. The total cost of a cost or cost-sharing contract for research and development with nonprofit institutions is the sum of the allowable direct costs incident to the performance of the contract, plus the properly allocable portion of allowable indirect costs. The tests used in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted institutional accounting principles and practices, and (iii) any limitations as to types or amounts of cost items set forth in this Part 3 of Section XV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable.

15-301.1 Cost-Sharing Methods. Cost-sharing may be accomplished by one of the following methods:

- (a) by providing in the contract for the percentage of the total

allowable cost of the project which will be borne by the Government;

(b) by agreeing that, for the purpose of the particular project, reimbursement for indirect expense of the institution will be limited to some rate or dollar amount less than the indirect expense otherwise applicable and computed in accordance with the principles set forth in this part;

(c) by providing in the contract that certain items of cost will not be considered reimbursable;

(d) by such other method as may be agreed upon.

15-302 Allowable Direct Costs.

15-302.1 Materials. The cost of materials includes the cost of all items purchased, supplied, manufactured or fabricated, which enter directly into the project or which are used or consumed directly in connection therewith. Withdrawals from stock will be charged in accordance with the pricing system used by the contractor, *provided* such system is in accordance with sound institutional accounting practice and is consistently followed. In calculating the cost of materials, there shall be deducted all cash discounts, trade discounts, rebates, and other allowances and credits taken by the contractor, including (a) credit for any materials returned to stock or to vendors, and (b) credit for proceeds or value received by the contractor for any scrap resulting from performance of the contract. Such discounts, rebates, allowances and credits may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs.

15-302.2 Salaries and Wages. This type of cost consists of salaries and wages properly chargeable directly to the performance of the contract. Generally, such salaries and wages will be charged at the actual rates paid by the contractor. Where faculty members paid on a salary basis work part-time on a Government research or development project, reasonable estimates of such time may be used in lieu of exact time records.

15-302.3 Other Direct Costs. There are numerous items of costs which are ordinarily classified as indirect costs but which may, in particular cases, properly be chargeable directly to the contract where the contractor demonstrates that such costs are specifically related to the contract.

15-303 Allowable Indirect Costs. For the purposes of this part, institutional indirect costs include the following:

(a) all costs customarily classified by institutions as "general administration" and "general expense";

(b) the cost of operation and maintenance of the physical plant, exclusive of expenses relating to the library;

(c) expenses relating to the library;

(d) any other allowable indirect costs.

"General administration" and "general expense" include all expenses of the general executive and administrative offices of an institution, and all expenses of a general character which do not relate to any specific division of the institution.

15-303.1 Apportionment. Where apportionment is necessary and prior to allocation to the contract, the aforementioned kinds of indirect costs shall first be apportioned as between (i) instruction and research activities and (ii) noneducational activities, as follows:

(a) "general administration" and "general expense," on the basis of total expenditures, except that any such expense relating to group insurance or to annuity premiums and pensions shall be so apportioned on the basis of total salaries and wages;

(b) operation and maintenance of the physical plant, on the basis of total square or cubic footage of the buildings;

(c) library expenses (including the total library expenses plus a use charge of four cents per volume per year), on the basis of the institution's total population (including students), *provided* that apportionment on the basis of either total salaries and wages or direct department charges may be used when, by comparison with apportionment on the basis of population, the result is equitable;

(d) other allowable indirect costs, on the basis of total expenditures.

15-303.2 Allocation. After determination of the total amount applicable to instruction and research activities, such amount shall in turn be allocated to the contract.

15-303.3 Use Charge in Lieu of Depreciation. In connection with the cost of operation and maintenance of the physical plant, a charge for the use of buildings and equipment may be included as an allowable indirect cost in lieu of depreciation. The use charge for buildings (excluding grounds, and also excluding buildings paid for out of Federal funds) shall be computed at the rate of two percent of original cost. The use charge for equipment (excluding library books) shall be computed either (i) at a rate not exceeding ten percent of the actual or estimated cost of equipment where the institution's records reflect only the cost of the original complement of equipment for the present functions, or (ii) at a rate not exceeding six and two-thirds percent where the records reflect cost of usable equipment on hand. In cases where the use charge for administration buildings is substantial, the cost item representing such charge shall be included in general expense.

15-304 Examples of Items of Allowable Costs. Subject to the requirements of paragraph 15-301 with respect to the general basis for determining the allowability of costs, and irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of cost are considered allowable within the limitations indicated:

(a) Bonds and insurance, including self-insurance (but see paragraph 15-305 (k)).

(b) Freight, transportation, and material handling.

(c) Library expenses (but see paragraph 15-303.1 (c)).

(d) Materials and supplies.

(e) Miscellaneous office and administrative services and supplies, including communication expenses.

(f) Patents, purchased designs, and royalties, to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Government.

(g) Pension and retirement plans in accordance with the interpretation set forth in paragraph 15-601 and group health, accident and life insurance plans (but see paragraph 15-305 (k)).

(h) Protection and maintenance of Government-owned or of rented equipment.

- (i) Salaries and wages, direct and indirect (but see paragraph 15-305 (l)).
- (j) Subcontracts and purchase orders.
- (k) Taxes (but see paragraph 15-305 (e)).
- (l) Traveling expenses.
- (m) Vacation and sick leave pay, to the extent required by law, by employer-employee agreement or by the contractor's established policy.

15-305 Examples of Items of Unallowable Costs. Irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of cost are considered unallowable, except as indicated:

- (a) Bad debts (including expenses of collection) and reserves for such debts.
- (b) Commissions, bonuses and contingent fees (under whatever name), in connection with obtaining or negotiating for a Government contract.
- (c) Contingency reserves.
- (d) Equipment (including books) purchased or rented, except to the extent specifically approved in writing by the Contracting Officer or authorized by the terms of the contract.
- (e) Federal taxes on income or excess profits.
- (f) Interest on borrowings (however represented), bond discount and expense, and financing charges.
- (g) Losses from sales or exchanges of capital assets, including investments.
- (h) Losses on other contracts.
- (i) Museum expenses and expenses of similar activities, except to the extent demonstrated by the institution to be directly related to the work under the contract.
- (j) Noneducational activities expenses (including auxiliary activities, off-campus and other extension services, and organized activities relating to instructional and research departments, except to the extent that the research contracted for is to be performed by or in such activities).
- (k) Premiums for insurance on the lives of executives or other persons where the contractor is the beneficiary (but see paragraphs 15-304 (a) and (g)).
- (l) Salaries and expenses of deans of schools and heads of instructional departments, and their offices, *provided* that salaries of such persons may be included as a direct charge where research and development work is undertaken directly by them and is authorized in the contract or approved in writing by the Contracting Officer.

Part 4—Construction Contracts

15-400 Scope of Part. This part sets forth principles for the determination of costs in connection with cost-reimbursement type contracts (which term, as used in this Part, includes cost-reimbursement subcontracts thereunder) for construction or for architect-engineer services related to construction.

15-401 Definition of Construction Contract. The term "construction contract" as used in this part means any contract for the construction,

alteration or repair of buildings, bridges, roads, or other kinds of real property. It does not include a contract for the manufacturing, producing, furnishing, construction, alteration, repair, processing or assembling of vessels, aircraft, or other kinds of personal property, regardless of the terms of any such contract as to payment or title.

15-402 General Basis for Determination of Costs. The total cost of a cost-reimbursement type contract for construction or for architect-engineer services related to construction is the sum of the allowable costs incident to the performance of the contract, less applicable income and other credits. The tests used in determining the allowability of costs also include (i) reasonableness and (ii) any limitations as to types or amounts of cost items set forth in this Part 4 of Section XV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable. Income and other credits arising out of operations under the contract, where the related cost was reimbursed or accepted as an allowable cost, will be credited to the Government.

15-403 Examples of Items of Allowable Costs. Subject to the requirements of paragraph 15-402 with respect to the general basis for determining allowability of costs, the following items of cost are considered allowable within the limitations indicated:

- (a) Bonds and insurance, including self-insurance, to the extent authorized by the Contracting Officer.
- (b) Camp operations (but see paragraph 15-404 (h)).
- (c) Freight, transportation, and material handling.
- (d) Land and structures, temporary use thereof.
- (e) Materials and supplies, including inspection, storage, salvage, and other usual expenses incident to the procurement and use thereof.
- (f) Patents, purchased designs, and royalty payments, to the extent authorized by the Contracting Officer.
- (g) Plant and equipment, purchase or rental thereof.
- (h) Recruiting of personnel (including "help wanted" advertising).
- (i) Restoration and cleanup of site and facilities, as directed by the Contracting Officer.
- (j) Structures and facilities of a temporary nature.
- (k) Subcontracts.
- (l) Taxes, fees or charges, except those imposed upon, by reason of, or measured by the contractor's fee.
- (m) Traveling expenses, to the extent authorized by the Contracting Officer.
- (n) Utility services, such as communication, power, gas, and water.
- (o) Vacation, holiday and severance pay, sick leave and military leave, to the extent required by law or specifically provided for elsewhere in the contract.
- (p) Wages and salaries.
- (q) Pension and retirement plans in accordance with the interpretation set forth in paragraph 15-601 and group health, accident and life insurance plans (but see paragraph 15-404 (b), (d), and (m)).

15-404 Examples of Items of Unallowable Costs. The following items of costs are considered unallowable, except as indicated and then only subject to the requirements of paragraph 15-402:

- (a) Advertising (including advertising in trade or technical journals), except "help wanted" advertising.
- (b) Central office expenses of the contractor, such as supplies, equipment, rent or any other expenses incident to its maintenance and operation, except to the extent authorized by the Contracting Officer.
- (c) Commissions and bonuses (under whatever name) in connection with obtaining or negotiating for a Government contract.
- (d) Compensation and traveling expenses of any officer or employee in the central office organization of the contractor, except to the extent authorized by the Contracting Officer.
- (e) Contingency reserves.
- (f) Contributions and donations.
- (g) Dividend payments.
- (h) Entertainment, except for on-site recreational activities for the contractor's employees as authorized by the Contracting Officer.
- (i) Interest on borrowings (however represented), bond discount and expense, and financial charges.
- (j) Legal, accounting and consulting fees and related expenses, except to the extent authorized by the Contracting Officer.
- (k) Losses on other contracts.
- (l) Memberships in trade, business and professional organizations.
- (m) Premiums for insurance on the lives of directors, officers, proprietors or other persons, where the Contractor is the beneficiary directly or indirectly.
- (n) Storage of contract records after completion of contract operations, irrespective of contractual or statutory requirements regarding the preservation of records.
- (o) Taxes, fees or charges imposed upon, by reason of, or measured by the contractor's fee.

Part 5—Subjects Affecting Cost Which May Require Special Consideration

15-500 Scope of Part. This part enumerates certain subjects affecting cost which may require special consideration in connection with the negotiation or performance of cost-reimbursement type contracts and which are not specifically covered in Part 2, Part 3, or Part 4 of this section.

15-501 Consideration Required. It is important that Contracting Officers and their negotiators consider the subjects enumerated in paragraph 15-502, and any other subjects not precluded by the provisions of Part 2, Part 3, or Part 4 of this section (whichever part is applicable), for the purpose of (i) determining which subjects if any should be expressly provided for in a particular cost-reimbursement type contract, and (ii) incorporating appropriate clauses in the contract. Action taken with respect to any such subjects shall be reflected either in the contract or in the record of contract negotiations.

15-502 Examples of Subjects Requiring Special Consideration. The following examples are illustrative of subjects affecting cost which may require special consideration:

- (a) Costs incurred incidental to work covered by the contract but prior to the execution of the contract, with specific identification of the types thereof and the period involved.
- (b) Government-furnished property, general nature and extent.
- (c) Indirect cost basis (i) actual, (ii) predetermined rate or amount, or (iii) other.
- (d) Insurance.
- (e) Intracompany and intercompany transactions.
- (f) Liability to third persons.
- (g) Operation of restaurants and cafeterias.
- (h) Overtime compensation.
- (i) Patents, purchased designs, and royalty payments.
- (j) Personnel movement of a special or mass nature.
- (k) Plant facilities fully depreciated or amortized on the contractor's books of account or acquired without cost (possible compensation for utilization in the form of a use or rental charge.
- (l) Rearrangement or relocation of facilities or plant sites.
- (m) Research programs of a general nature.
- (n) Security measures of a special nature.
- (o) Sharing of cost of research projects of the type which an educational or other nonprofit institution might undertake as a part of its own educational or research program.
- (p) Subcontracting, nature and extent thereof and relation to fee or profit.
- (q) Subsistence and housing of employees.
- (r) Termination expenses.
- (s) Tooling and equipment.
- (t) Traveling expenses of a special or unusual nature.
- (u) Wages or salaries of partners or sole proprietors.

Part 6—Cost Interpretations

15-600 Scope of Part. This part sets forth interpretations of certain cost principles contained in other parts of this Section.

15-601 Pension and Retirement Plans.

15-601.1 Effective Date and Applicability. This cost interpretation pertains to paragraphs 15-204 (c), 15-204 (p), 15-304 (g), and 15-403 (q) and applies to contracts, executed as a date on or after 1 January 1952, of which the provisions of any such paragraphs are made a part.

15-601.2 Interpretation.

(a) Costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent they are determined to be unreasonable or unallowable under any other provision of this cost interpretation. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent they are determined to be unreasonable or unallowable under any other provision of this cost interpretation.

(b) Pension or retirement plans of a contractor which are subject

to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be accepted as charges to Government contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue—when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will, as a general rule, be the only approval required by the Departments; however, the right is reserved to require submission of any plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are acceptable under the provisions of this cost interpretation and other provisions of this Section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly, are subject to the provisions of this Section with respect to reasonableness of the total compensation paid to the individual for the services rendered.

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

(g) The allowability of costs of lump sum purchases of annuities or of periodic cash payments made to provide pension or retirement benefits for retiring or retired employees, other than incurred under approved pension or retirement plans, will be subject to consideration on an individual case basis.

(h) Credits which became available or are foreseeable must be taken into account in an equitable manner in determining pension and retirement costs subject to apportionment to a military contract. In some instances, this may require adjustments to costs in anticipation of the realization of credits. For example, such action would normally be appropriate where contractors' organizations are substantially expanded for the performance of military contracts and there is a reasonable expecta-

tion that, upon completion of the contracts, the services of practically all or a large number of the additional employees will be terminated with the result that contractors will benefit from contributions made on behalf of these employees, because such personnel will not acquire vested rights under the terms of the plans.

(i) In any current or future contract no cost allowance will be made which would duplicate, in whole or in part, an allowance previously made under a prior contract.

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