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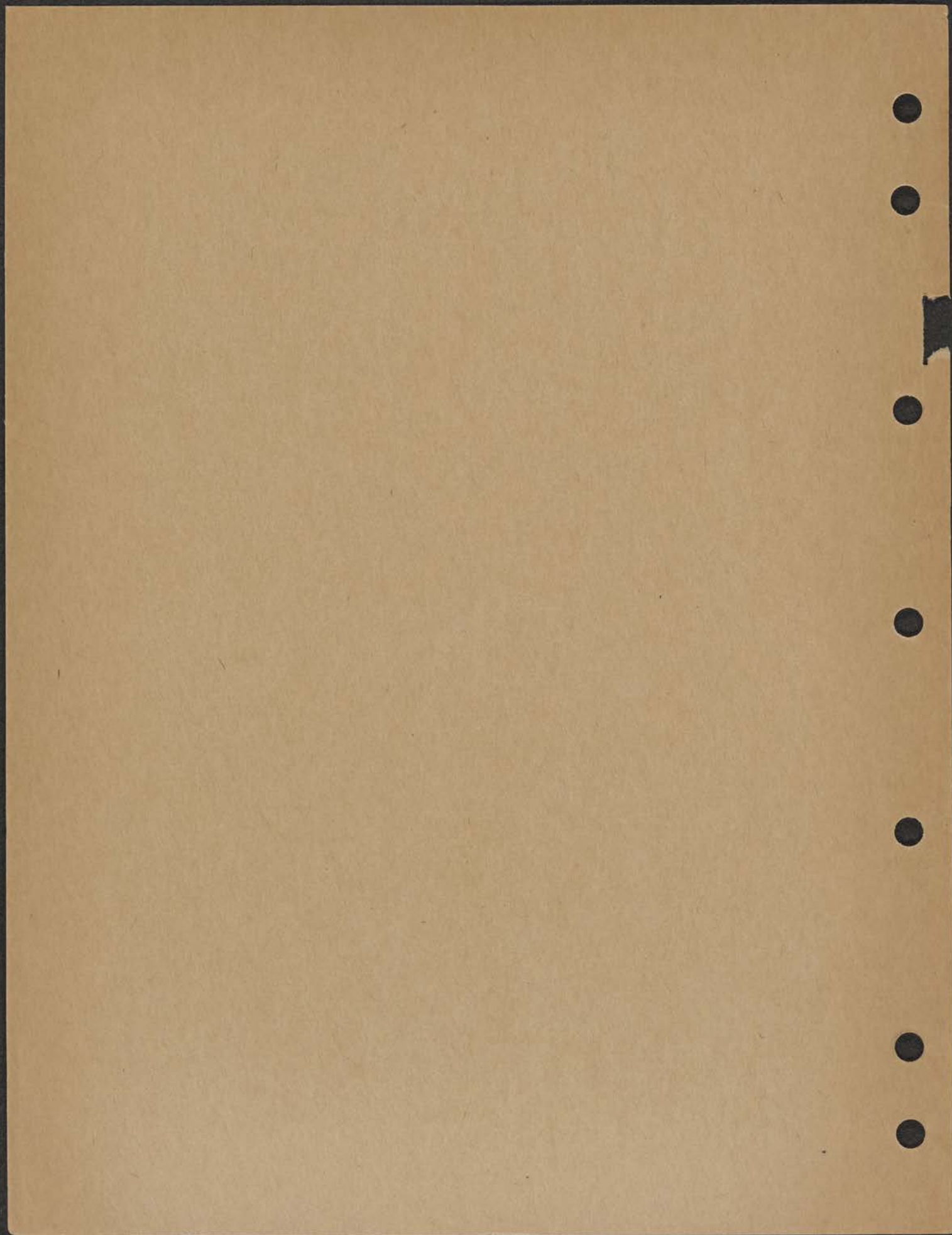
WAR DEPARTMENT TECHNICAL MANUAL

ADMINISTRATIVE
AUDIT PROCEDURES FOR
COST-PLUS-A-FIXED-FEE
SUPPLY CONTRACTS

WAR DEPARTMENT

JUNE 1946

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WAR DEPARTMENT TECHNICAL MANUAL
TM 14-1000

*This manual supersedes TM 14-1000, 1 May 1945; including C 1, 1 June 1945; C 2, 1 September 1945; C 3, 15 March 1946;
and C 4, 1 April 1946*

ADMINISTRATIVE
AUDIT PROCEDURES FOR
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SUPPLY CONTRACTS



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WASHINGTON 25, D. C., 30 June 1946

TM 14-1000, Administrative Audit Procedures for Cost-Plus-A-Fixed-Fee Supply Contracts, is published for the information and guidance of all concerned.

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BY ORDER OF THE SECRETARY OF WAR:

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FOREWORD

Changes to this manual will be supplied on a page basis, and will be published as required. As change pages are received they will be inserted in their proper places, and the replaced pages destroyed.

Each page of the manual bears a date in its upper inside corner. This date is the date of the publication. Pages which represent changes will carry the date of the change and the number of the change, for example, "C 1," "C 2," etc.

Paragraphs are numbered consecutively throughout the entire book. Paragraphs carrying decimal suffixes indicate newly added material; for example, a paragraph numbered 123.1 represents the first main paragraph following paragraph 123.

Pages are numbered consecutively throughout the book. If new pages are added within the book, the added pages will carry alphabetical suffixes—"A," "B," "C," etc. For example, if a new page is added between 102 and 103, the page will be numbered 102A. A second additional page in the same place would be numbered 102B, etc.

INTRODUCTION

TM 14-1000, Administrative Audit Procedures for Cost-Plus-A-Fixed-Fee Supply Contracts, is issued in accordance with the memorandum, 27 May 1942, approved by the Under Secretary of War. It is prescribed for use by all agencies of the War Department charged with the administration of cost and cost-plus-a-fixed-fee supply contracts, and is to be applied to existing as well as future contracts of this type.

In addition, audit staff instructions will continue to be issued by the Fiscal Division, headquarters of each of the services and by the Army Air Forces. The name of the service or the Army Air Forces will be prefixed to the title as, for example, "Ordnance Audit Staff Instructions." These instructions will be limited to reports of status of audit work, channels of correspondence, and, generally, instructions relating to the administrative supervision of the audit staff.

Because of varying procedural requirements in the individual services and Army Air Forces, some variation in the content of these instructions is permissible, but uniformity should be an objective. Only instructions of wide or general application are to be included and not those applying to a specific project or a relatively small number of projects. The latter instructions will be issued in letter form and are not to become part of the formal audit staff instructions.

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This manual supersedes TM 14-1000, 1 May 1945; including C 1, 1 June 1945; C 2, 1 September 1945; C 3, 15 March 1946; and C 4, 1 April 1946

CHAPTER 1

INTRODUCTION

Section I. GENERAL

1. Purpose of Administrative Audit

a. The purpose of the administrative audit of cost-plus-a-fixed-fee (CPFF) supply contracts is to ascertain that the claims for reimbursement made by the contractor are in accordance with the provisions of the contract, and that they are substantiated by his records and other supporting evidence. The auditor should consider the following aspects of every cost claimed: Is the item of cost allowable under the terms of the contract, has it been actually incurred, and, in the case of a direct charge to the contract, has it been paid by the contractor?

b. In carrying out his audit the auditor has the responsibility of developing an audit program which will protect the interests of the Government. At the same time, however, the auditor must not extend his procedures unnecessarily or needlessly duplicate the work of the contractor. He should cooperate in obtaining prompt reimbursement of the contract costs so that funds may be used effectively in the interests of production.

2. Major Divisions of Audit

The audit will consist of two major divisions:

a. A continuous review of the contractor's internal controls and procedures to determine their adequacy and effectiveness. If deficiencies are disclosed they will be brought to the attention of the contracting officer for consideration of the desirability of requiring the contractor to make adjustments, where practicable. If no adjustments are made, the extent of the auditing will be increased accordingly.

b. An audit of the accounts and records to determine whether the recorded transactions are authentic, are properly recorded, and that the

amounts claimed for reimbursement represent costs in accordance with the contract terms.

3. Purpose of Manual

a. The nature and extent of the audit and the applicable principles were covered in a directive issued 27 May 1942 by the Director, Fiscal Division, approved by the Lieutenant General Commanding and the Under Secretary of War. (See app.) This manual provides instructions and supplementary information for the application of selective audit procedures in accordance with the principles set forth in that directive. The manual is designed primarily for plants having more than one CPFF contract, or having a combination of CPFF and other work. In a plant devoted entirely to one CPFF contract, substantially all reimbursable expenditures will represent direct charges to the contract and will arise only from invoices and pay rolls.

b. The manual also applies to so-called "cost service contracts" which cover the cost of mechanics and specialists who are servicing certain products supplied on other contracts, and to fixed-price contracts which contain a provision for reimbursement of tooling, training, or plant rearrangement on a cost basis. It also applies to letters of intent which contain authorization for reimbursement on a cost basis.

4. Applicability to Subcontracts

The procedures described in this manual are applicable to cost-plus-a-fixed-fee subcontracts in the same manner as to cost-plus-a-fixed-fee prime contracts.

5. Allowability of Costs

a. Provisions of the contract which define cost must be carefully interpreted by the auditor.

Many contracts incorporate Treasury Decision 5000 in the definition of cost and in that event the provisions of the latter document must likewise be studied.

b. The more complex matters of allowability are likely to occur in connection with costs classified as overhead or miscellaneous direct charges, rather than in direct material or labor. By eliminating unnecessary detailed checking, it is the purpose of this manual to provide more time for a careful review of such costs.

6. Cost Interpretations

Cost interpretations, issued as chapter 6, prescribe instructions to be followed by War Department accounting personnel. They are also intended for the information and guidance of the contracting officer in determining whether or not costs are allowable.

7. Audit of Overhead

a. The effectiveness of the total audit depends upon an understanding of the relation of the audit of overhead to that of direct charges. Since overhead is made up largely of indirect materials and indirect labor, which differ from direct charges only in that they apply jointly to the contract and to other work, the same basic procedures which are applied to the audit of direct charges can be extended to include overhead. However, the audit of overhead requires one additional step—the determination of the acceptability of the methods and bases followed in proration.

b. It is important to emphasize that the audit of individual overhead items is to be performed currently. Certain phases of the examination cannot be performed on a post-audit basis, such as plant observations as to manufacturing processes, idle equipment, etc., floor checks, and witnessing pay-offs. The checking of time tickets and requisitions becomes more difficult as time elapses. The results of such audit activities and observations must be made of record in the audit working papers.

c. The extent of the detailed examination of overhead accounts will depend on the accuracy of the contractor's accounting and effectiveness of its internal controls and procedures. Consideration will also be given to the ratio of CPFF business to the total work done.

d. Where the CPFF business is small in proportion to the total, checks applied to overhead will ordinarily be less frequent. However, where the business, although small, is concentrated in certain departments, the more detailed examination of overhead items will be carried on currently in those departments along with the procedures involving direct charges. In any event, the general review of the overhead accounts and the examination of methods and bases of proration should be carried out regardless of the proportion of CPFF business.

8. Cooperation With Property Officer

The auditor, in an advisory capacity, should cooperate with the accountable property officer in every practicable way in developing required records and procedures in connection with property accounting.

9. Relations With Contractor

a. Care should be taken to explain to the contractor the necessity for documentary and other auditing requirements, and an effort should be made to enlist his full cooperation through a mutual understanding of the duties and responsibilities involved. The auditor also should cooperate with the contractor in showing him how to put his claims in proper form to expedite reimbursement. The auditor, however, should not prepare Standard Form 1034, Public Voucher for purchases and services other than personal.

b. Having agreed in his contract to keep an adequate accounting system, the contractor should be required to do so. At the same time, changes should be proposed by the auditor only when deficiencies clearly exist and after careful consideration and approval by higher fiscal authority and the contracting officer. The effect of the proposed changes on the over-all cost of the work, including the contractor's personnel, must be kept in mind. Every effort should be made to obtain the contractor's approval and cooperation.

10. Responsibility of Contractor

a. It is the responsibility of the contractor to submit promptly claims for reimbursement and to exclude all costs disallowed by the terms of the contract. There should be no interference with the contractor's right to claim reimbursement for

costs of doubtful allowability. Such costs, however, should be submitted as separate claims with full disclosure of facts.

b. In signing the "correct and just" certificate, the contractor is substantially in the same position as when he signs a Federal tax return. Heavy penalties are provided by law for false certification of facts in connection with all claims against the Government.

11. Need of Alertness

It is important that the auditor constantly seek out methods for achieving the objectives of his audit by more direct means. These possibilities will vary with the specific case. In addition, the auditor should always be alert to make his audit more effective by further inquiries and observations. The procedures set forth in this manual should be regarded as a general guide for the auditor to build a program which will achieve the desired results.

12. Other Governmental Regulations

It is not the auditor's responsibility to investigate violations of regulations issued by agencies other than the War Department. If the auditor discovers violations of these regulations in the course of his normal auditing procedures, he should report the matter to the contracting officer in writing.

Section II. REIMBURSEMENT POLICIES

13. Reimbursement of Costs

a. It is intended that the contractor be reimbursed promptly and thus be enabled to regain his capital for use in further production. Prompt reimbursement also minimizes the need of the contractor for advances from the Government.

b. For the purpose of reimbursement, costs normally will be considered as expended when—in the case of direct charges the cash has been paid out or the bank check drawn and placed in the mail and, in the case of overhead when the amounts of the liabilities for the items included therein have been definitely established or are based on reasonably accurate accruals. When adjustments in the amounts of the liabilities are developed in subsequent periods, the refunds or additional charges

involved should be prorated on the same basis as the original charges if the net amount of the effect on the contract is material.

c. As outlined in the sections dealing with overhead, monthly progress payments may be made for overhead on a tentative basis. These progress payments should be sufficiently less than the estimated overhead applicable to the contract to provide a suitable margin of safety. They do not constitute a reimbursement of costs but are advance payments against final overhead claims which will be presented by the contractor as a basis for the settlement of overhead. Care should be taken to avoid an excessive "hold back" of overhead during the year which would unnecessarily increase the contractor's capital requirements.

d. The total current reimbursements to the prime contractor are to be controlled by the auditor to avoid exceeding the maximum total cost stated in the prime contract and amendments. If it becomes apparent to the auditor that the prime contract will so exceed, he will notify the contracting officer. In the case of a CPFF subcontract, the auditor at the subcontractor's plant will notify his contracting officer and the auditor at the prime contractor's plant in any instances in which it becomes apparent that an overrun will occur on the subcontract.

e. Contractors, engaged either solely on CPFF work or on CPFF and other work, may be reimbursed for pay rolls on a gross basis in respect to deductions for social security taxes, victory tax, and all other pay roll deductions. However, in respect to deductions for bonds, the amounts deducted must be currently deposited in a special bank account to be used only for bond purposes.

f. A period of 90 days will be allowed for clearance of checks covering reimbursed direct charges as defined in paragraph 28 and deduction will then be made for any uncleared checks. Such deduction will not, however, include amounts covering taxes and bonds previously deducted from pay roll payments.

14. Payment of Fees

The contractor's fixed fee will be paid to him from time to time in accordance with the terms of the contract.

Section III. DOCUMENTARY EVIDENCE REQUIREMENTS OF GENERAL ACCOUNTING OFFICE

15. Introduction

The documentary evidence requirements set forth in this chapter represent the regular requirements of the General Accounting Office, and they apply whether the General Accounting Office audit is made at Washington or in the field. Other documents may, however, be required by the General Accounting Office when circumstances surrounding particular transactions indicate the necessity for further examination. In the case of settlement proposals submitted in connection with terminated CPFF contracts, the requirements in this section are subject to the modifications set forth in paragraphs 169 to 182, inclusive.

16. Original Invoices for General Accounting Office

a. General Accounting Office requires, as a general rule, the ribbon (first) copy of a typewritten invoice. When, in exceptional situations, for some valid reason the ribbon copy is not available, in lieu of it a legible carbon copy may be furnished, 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. If the receipted "freight bill" is furnished, no certification is necessary.

b. It is not necessary for the vendor (or the contractor) manually to sign and certify as the original a copy of an invoice reproduced by a hectograph or similar process, but there should be a printed or other designation by the *vendor* that it is the original invoice. All purchase orders issued by the contractor should require vendors using hectograph or similarly reproduced invoices to identify clearly one copy as the original. Invoices rendered under such purchase orders will not be acceptable unless these provisions are complied with.

17. Purchase Orders and Contracts

a. Copies of all purchase orders will be furnished except for those under \$5,000, not based on

an oral or written bid. In the case of General Accounting Office field audits, copies of all purchase orders will be retained in the Government files.

b. If the contract requires the approval of purchase orders by the contracting officer, the approval must be indicated on any copy furnished to the General Accounting Office.

c. Purchase orders furnished must bear reference to the applicable War Department contract number. They are to be furnished to the General Accounting Office as soon as available instead of being attached to Standard Form 1034.

d. Where shipments are covered by a contract, the original of which has been furnished to the General Accounting Office, no copies of purchase orders are required covering individual shipments under such a contract.

e. If the purchase order, irrespective of amount, has been issued based on a formal or informal written bid, that original bid, together with the originals of any accepted amendments to it which change the net delivered unit price, are to be furnished. In the case of the General Accounting Office field audit, such original accepted bids and amendments will be retained in the Government's files.

f. If no bid was obtained, the purchase order should so state. If oral bids were submitted, the purchase order should indicate "Oral bid of -----, ----- date."

g. Correspondence referred to in the purchase order must be furnished.

18. Vendor Invoices and Credit Memoranda

a. The original itemized receipted invoice should be furnished or the check number by which the vendor's invoice was paid by the contractor is to be shown on the invoices or on copies of remittance statements to which they are attached.

b. Invoices or credit memoranda are to show the purchase order number. If they apply to a numbered agreement, the number must be shown on the invoice or credit memoranda.

19. Pay Rolls

a. If separate pay rolls are maintained for each contract, the original pay roll is required.

b. If separate pay rolls are not maintained, only

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pay roll summaries in reasonable detail for each contract are required, showing at least the department names and total amount charged by departments. Such summaries are to be supported by a certificate of the auditor on Standard Form 1035, Public Voucher for purchases and services other than personal, as follows:

I certify that the above distribution of wages for the period indicated to be directly chargeable to the United States under the provisions of Contract No. _____ is true and correct and has been verified from the original records.

Auditor

c. A definite showing is required that the contracting officer has reviewed all salaries and salary increases chargeable directly to the contract, and has taken any necessary action. Each salary pay roll disbursed, representing direct charges to the contract and submitted in support of Standard Form 1034, will bear the following certificate:

This is to certify that this salary pay roll has been examined and the compensation, including increases in compensation, paid to the individuals has been approved.

Contracting officer

d. If separate pay rolls are maintained for each CPFF contract, the deposit slips from the depository designated by the Secretary of the Treasury covering pay roll withholding taxes should be obtained in duplicate, the original for the Internal Revenue Department and the duplicate copy to support the reimbursement voucher.

20. Travel Expense Reports

a. The original reports are required showing employee's name, purpose of trip, points of travel, details of expenses or per diem rates in accordance with the terms of the contract, executive approval of the contractor, the employee's receipt if paid in cash or the check number if paid by check. If the number of travel reports is voluminous, the executive approval may be in the form of a summary certificate.

b. Whenever it is customary in regular business practice to issue receipts, they should be obtained and attached to the expense reports.

21. Petty Cash Disbursements

a. Summary statements are required showing the date of expenditures, description of material or service, amount paid, and payee's name.

b. Each individual expenditure over \$10 is to be supported by a receipt.

c. Each petty cash summary statement will bear the following certificate signed by an executive competent to approve the expenditures:

The articles, commodities, or services procured for use of Contract No. _____ and listed hereon after payment, were used in connection with the performance of the contract, and reimbursement therefor has not been previously claimed from the Government.

Contractor

By _____

22. Withdrawals From Contractor Owned Stores

A statement is required showing the price and amount of the individual items withdrawn. If, however, transactions are voluminous, a reasonably detailed summary by classes and types of material is sufficient.

23. Tool and Other Work Orders

A statement is required listing the work orders in reasonable detail and showing material cost, labor cost, and applicable overhead.

24. Overhead

a. The first progress payment voucher for overhead will be supported by a statement detailing the major elements of cost included and showing the method of apportionment. If departmental rates are used, departmental analyses are to be submitted. A similar statement is required in support of a voucher which involves a change in rates. Other vouchers for progress payments should carry appropriate cross-reference to the voucher which carries the applicable detailed statement.

b. The contracting officer will append the following certificate to each progress payment voucher:

I certify that the amounts vouchered herewith as progress payments on account of overhead expense are less than the estimated amounts properly

chargeable to the contract. This payment does not constitute a final or partial settlement of overhead.

Contracting officer

25. Operation of Cafeterias, Commissaries, etc., in Plants Engaged Solely on CPFF Contracts

a. If a special working or imprest fund has been set aside to finance the operation of the cafeteria or similar facility, the contractor will submit, not less than once each month, a statement of operations for the period, certified by the contractor as correct. The fund may be reimbursed for losses, or the profits may be applied against reimbursement vouchers on the basis of this statement, and no further supporting documents will be required.

b. If such a working fund has not been established, it will be necessary to furnish all original invoices, pay rolls, etc., in support of the disbursements and receipts.

26. Corrected Invoices

a. Invoices will not be acceptable when the amount has been increased to correct for errors, greater quantities actually delivered, etc., unless such correction is instituted and approved by the claimant. Minor reductions in the amounts of invoices, however, will be acceptable when made to correct errors evident on the face of the invoice.

b. A corrected invoice will be acceptable, if the invoice first submitted is attached to it with appropriate cross-reference and explanation is made on both invoices. However, if the contractor returns the original invoice to the vendor for adjustment, and the vendor resubmits only a corrected invoice, the contractor should certify on the corrected invoice:

I hereby certify that the original invoice was returned to the vendor for adjustment. This corrected copy is to be considered as the original and only invoice covering this material, and will not be paid twice.

Contractor

By

27. Telegraph Charges

a. When telegraph charges are reimbursed as direct charges, an original and two copies of invoices

covering telegraph services is the maximum number that will be required from the telegraph company in any one case for governmental purposes. Any additional copies required by the contractor will be prepared by him. Distribution will be as follows:

Original—attached to the original Standard Form 1034 for General Accounting Office.

One copy—attached to Standard Form 1034a for finance officer.

One copy—attached to Standard Form 1034a for auditor's files.

b. When the General Accounting Office is auditing vouchers currently at the project, only the original invoice is required. This will be attached to the auditor's copy of the voucher.

c. The original invoice attached to Standard Form 1034 for General Accounting Office will be supported by one copy of each telegram, and no other copies will be required for governmental purposes. Where practicable, this copy will be supplied by the telegraph company. Where the General Accounting Office is auditing invoices currently at the project, the single copy of each telegram will be retained in the auditor's file. If the General Accounting Office is not auditing currently at the project, the auditor will not retain copies of telegrams in his files.

d. Pursuant to the provisions of Public Law 4, 78th Congress, approved 6 March 1943, cost-plus-a-fixed-fee contractors and subcontractors may no longer send telegraph, cable, or radio messages at Government rates. Effective 6 March 1943, commercial rates therefor will apply to all messages sent by CPFF contractors and subcontractors.

28. Evidence of Payment

a. In the case of *direct charges* to the contract as defined in (1) below, a form, "Certificate of Evidence of Payment" (illustration below), will be executed by field auditors or resident auditors coincident with each reconciliation of a bank account of a contractor, whether monthly or more frequently, observing the following procedures:

(1) All original purchase invoices, original (separate) pay rolls, and other documents submitted with public vouchers in support of *direct*

charges to the contract and represented by current check payments by the contractor are to show, either on the documents themselves or on attached remittance advices, the check numbers issued in payment. If the checks are entered in a solid numbered series on a pay roll sheet, only the beginning and ending check numbers are required. In mixed plants where materials or supplies are withdrawn from contractor-owned stores for the CPFF contract, it is not necessary to show the number of the check issued by the contractor in payment for such materials.

(2) When all of the checks listed by number on the applicable vouchers have been cleared by the bank as determined at the time of reconciliation of the account, the auditor will list such vouchers in the "Certificate of Evidence of Payment," and execute the following certificate in duplicate, sending the original to the Audit Division, General Accounting Office.

CERTIFICATE OF EVIDENCE OF PAYMENT

Audit Division _____ Contractor _____
General Accounting Office Contract No. _____

I certify that all checks issued by the subject contractor which are listed on documents supporting the public vouchers shown below have been audited by a Government representative, and that payment is evidenced by paid checks cleared through the contractor's bank account.

Date _____		(Title)	
Date of voucher	Bureau number	D. O. number	Amount of voucher

(3) When a check has been lost before clearance by the bank and a replacement check is issued, the voucher will not be listed until the replacement check has cleared.

(4) If any check is not cleared within a maximum period of 90 days from date of issuance, an appropriate deduction will be made from the next available voucher. The voucher on which the check was originally listed may then be included, if all other checks are cleared, in the "Certificate of Evidence of Payment" with a suitable notation indicating the check numbers and amounts which have been deducted from other vouchers, and the date and voucher number from which the deduction was made.

b. The above procedures are applicable regardless of whether the General Accounting Office audit is conducted in Washington or in the field.

29. Special Clothing and Equipment Purchased for Operation of Contract

In cases where reimbursement is claimed for special clothing, boots, metal gloves, equipment, etc., deemed necessary for the operation of a contract, each voucher covering reimbursements for such items should be supported by a certificate in the following form:

I hereby certify that the _____ for which payment is made on this voucher were deemed necessary for the operation of the contract. In accordance with the company's general policy, the above items were issued to employees without charge for use while on duty and remain the property of the Government.

Contracting officer

30. Disposition of Vouchers and Supporting Papers in War Department Audit Files at Field Projects

a. When a cost-plus-a-fixed-fee supply contract is terminated, either at the option of the Government or because of the completion of the contract, it will be necessary to make proper disposition of the vouchers and supporting papers which have been held in the files of the War Department auditor.

b. In cases where the General Accounting Office audit has been made in Washington, the files maintained by the War Department auditor will be disposed of in accordance with instructions issued by the individual technical services or the Army Air Forces.

c. In cases where the General Accounting Office audit is performed in the field and the contract has been completed, the vouchers and supporting documents, when not required for Government purposes at the project, will be forwarded to the General Accounting Office, Reconciliation and Clearance Subdivision, Army Audit Branch, Building 203, 4300 Goodfellow Boulevard, St. Louis 20, Missouri. In such cases the particular documents to be sent will be designated by the field representatives of the General Accounting Office

under the supervision of the chief cost auditor or the auditor in charge of the particular area station involved. To facilitate the handling and filing of the documents, the vouchers should be arranged in numerical order by D. O. voucher number under the name of each disbursing officer, and the contents of each box or package should bear a label indicating the contract number as well as the name of the contractor. Each box used for shipping project audit records will be plainly marked to show the contract number, the name of the contractor, and the number of the box in the shipment, such as "1 of 10," "2 of 10," etc.

31. Reclaim Vouchers

Reclaim vouchers, when submitted, must be certified and have attached all available and necessary

documentary evidence including questions raised by the informal inquiry and replies, if any; copy of Notice of Exception and replies; revisions to the exception and replies; and any additional evidence not theretofore submitted in support of the claim for reimbursement. However, original supporting documents are not to be withdrawn from the Government files after audit by the General Accounting Office. The documentary evidence supporting reclaim vouchers may consist of copies of such documents rather than the originals. There should appear in each such case an affirmative statement that the original documents are in the Government files and that the amount for which reclaim is now being made was deducted on D. O. Voucher No. -----, date -----, accounts of -----.

CHAPTER 2

REVIEW AND APPRAISAL OF CONTRACTOR'S PROCEDURES

Section I. GENERAL SURVEY

32. Purpose

a. As one of the initial phases of his work, the auditor should make a general survey of the contractor's organization, plant, products, and processes.

b. The purpose of the survey is to furnish a background of essential information so that an audit program can be intelligently formulated and effectively carried out. This background is particularly important in the appraisal of the contractor's methods of prorating overhead. The audit contemplated in this manual emphasizes the constant exercise of judgment in deciding, subject to procedures established by this manual, how much work is to be done, where it is to be directed, and how much reliance is to be placed upon the contractor's records and internal control procedures. Such decisions require a general familiarity and informed contact with actual operations and physical property. While the auditor necessarily devotes most of his time to the records, there must be sufficient contact with these activities so that the examination of records is not merely a mechanical process but is related to what is actually happening.

33. Scope

a. So far as practicable, the survey should involve first-hand observation by the auditor. These observations should be supplemented by information furnished by the contractor, submitted in form suitable for filing as part of the survey record. The survey should be made with the active cooperation of the contractor and in the spirit of gathering general information without an independent verification of the facts at this stage.

b. The main lines of inquiry hereafter enumerated are not necessarily separate and distinct. For example, the products manufactured will be

observed at the same time the plant and equipment are being inspected.

c. The general survey should include the following:

(1) *Organization.* The general structure of the organization in manufacturing and administrative divisions. An organization chart should be obtained preferably prior to the inspection of the plant. Inquiry should be made as to the existence, relationship, and operations of parent, subsidiary, and affiliated companies.

(2) *Financial policies.* The auditor should familiarize himself with the contractor's financial policies, including the financing of the operation of the contract and the acquisition of the necessary facilities. Copies of current financial statements should also be obtained.

(3) *Plant and equipment.* Inspection of the complete physical lay-out of the plant; the location of departments, and types of equipment used in the production and service departments.

(4) *Products.* The auditor should familiarize himself with the general specifications of the products manufactured, the general appearance, and the materials used, what parts and subassemblies are manufactured and what purchased. As soon as possible a copy of the bill of material should be obtained for reference purposes where bills of materials are used or required by the service.

(5) *Processes.* Observation of the manufacturing processes, the storage and handling of materials, accumulation and disposition of scrap, and the flow of production through the plant.

Section II. ACCOUNTING POLICIES OF CONTRACTOR

34. Introduction

The auditor should obtain from the contractor (with the assistance of the contracting officer) a

written statement setting forth its accounting and management policies which affect reimbursement claims under the contract. The statement should be signed by an authorized representative of the contractor. Through this statement the accounting policies may be appraised and questions of allowability determined on the basis of broad policy. Such a statement is essential to the review and evaluation of the contractor's internal control and for the determination of the allowability of costs through the application of auditing procedures. The statement of accounting policies required under this section is not to be confused with a description of the accounting system such as is dealt with in paragraphs 49 to 94 inclusive.

35. Consistency in Application

The contractor's accounting policies as stated should be followed consistently throughout the contract period. (See par. 200.) Changes in the contractor's organization and processes may occur which warrant or require a change in policy, in which case the stated policies should be amended by the contractor. However, consideration must be given, in each case where an amendment is proposed, to the soundness of the change and to the effect of its application to both current and previous periods. If changes are made in accounting policies, the statement of policies should be amended and the effective date of change shown. This does not necessarily require a complete rewrite and formal presentation of a completed statement of accounting policies. The original submission, plus properly signed amendments will be accepted by the auditor as constituting the contractor's statement of accounting policies.

36. Adjustment of Deficiencies in Accounting Policies

In correcting deficiencies in accounting policies, it may be necessary to adjust certain asset or liability accounts at the beginning of the contract period to reflect proper current charges to the contract for items such as supplies used, property taxes, etc.

37. Revision of Chart of Accounts

The contractor's classification of accounts should be revised to provide for the segregation of all

items of expense not allowable as costs under the terms of the contract.

38. Scope

The statement of accounting policies should cover all matters applicable to the particular contractor. The following, however, usually are to be included:

a. INVENTORY POLICIES. (1) Classes of materials and supplies inventories, how frequently inventories are taken, and the basis of pricing.

(2) To what accounts the adjustments of book inventories to physical are charged or credited.

b. PROPERTY-PLANT AND EQUIPMENT. (1) *General.* A general statement of the bases followed in determining the amounts carried on the books, or the amounts to which depreciation rates are applied if the book basis is not used.

(2) *Additions.* (a) Policies for distinguishing between charges to asset accounts or to repairs and maintenance—type, length of life, unit dollar amount, etc.

(b) Treatment of transportation and installation costs of new equipment.

(c) Allocation of overhead to items constructed by contractor for own use.

(3) *Disposition.* (a) How retirements or sales are reported.

(b) How handled in accounts and where resulting loss or gain is charged or credited.

(4) *Depreciation.* (a) How rates are determined.

(b) Application of rates to original cost or depreciated balance.

(c) When depreciation is started on new additions—month in which addition is made, middle of year, first of following year, etc.

c. DEFERRED CHARGES. (1) Types of items deferred.

(2) Basis of write-off.

d. ACCRUALS. (1) Types of items accrued.

(2) Bases of accrual.

e. WAGE POLICIES. Accounting policies based on administrative policies in respect to—

(1) Overtime payments—hourly and salaried employees.

(2) Group and other insurance.

(3) Vacations and sick leave.

(4) Bonuses.

(5) Christmas gifts.

(6) Pensions.

f. APPLICATION OF OVERHEAD. (1) Types of charges ordinarily included in overhead but which are to be charged directly to the contract on some basis of specific allocation.

(2) The propriety of the bases of overhead apportionment should be justified.

(3) If one over-all manufacturing rate is used instead of departmental rates, such a basis should be justified.

(4) If departmental factory rates are used, the bases of proration of the expense of all service and general departments to direct departments or burden centers should be clearly set forth and justified.

g. MISCELLANEOUS. (1) Reserves for self-insurance.

(2) Explanations of differences in policies followed in the preparation of tax returns and those reflected in the books.

(3) The policies with respect to intercompany and interdivision sales and transfers including the basis of pricing.

(4) Treatment of scrap.

(5) Policies for reimbursement of employees for travel expense.

(6) Treatment of miscellaneous revenue such as rental income, cash discounts on items charged to overhead, sale of waste paper, vending machine income, unclaimed wages, etc.

(7) Any other matters existing in the case of the particular contractor which involve to a substantial extent the costs or revenue applicable to the contract.

39. Approval of Accounting Policies

a. Upon presentation of the statement of accounting policies the auditor should determine that all essential matters have been stated in an adequate manner. The auditor may discuss acceptable alternatives with the contractor, but in all instances the contractor must choose the policy to be followed.

b. When the statement has been found to be satisfactory by the auditor he should obtain such further approvals as are required by the individual service before submitting his recommendations to the contracting officer. The auditor will then request the contracting officer to give him approval

of the policies governing the operations under the contract. Approval of the acceptable portion of the contractor's accounting policies need not necessarily be deferred until the questionable portions have been satisfactorily amended.

40. Application of Accounting Policies to Audit Functions

Each member of the Government audit staff should have a working knowledge of the contractor's approved accounting policies applicable to his particular audit functions. The audit staff member should consider transactions in the light of these policies and should report to his superior the situations which are not covered by the statement of policies or which do not conform thereto.

41. Preservation of Statements of Accounting Policies

When changes have been made in the accounting policies during the course of the contract, the auditor's working papers for each fiscal year should clearly indicate the accounting policies in effect during the year. The most satisfactory means of accomplishing this is to have a complete statement of accounting policies filed with each year's working papers. In instances where this is impracticable, superseded policies, together with notations as to their effective period, may be filed with each year's working papers.

Section III. GENERAL NATURE OF INTERNAL CONTROL

42. Introduction

a. The scope of the program of audit for a CPFF contract depends to a major extent on the contractor's system of internal control. The arrangement of internal procedures and creation of cross checks between individuals and activities provide the assurance that the accounting results are developed accurately, and it is this assurance which largely eliminates the necessity for duplicating the work of the contractor. The auditor should therefore study and appraise the system of internal control in the particular contractor's organization.

b. To do this efficiently the auditor first should understand the meaning of internal control and

the principles which relate to it. Second, he should have a plan by which he can review the particular system of internal control and determine its effectiveness. He then is able, through the exercise of judgment, to determine the nature and scope of his audit program.

c. The auditor should determine the effect of the contractor's methods of internal control on its claims submitted for reimbursement by a continuous review of all of its elements. If the contractor's claims require frequent adjustment due to the inclusion therein of items of a doubtful or unallowable nature, or lack the proper supporting evidence, or contain an undue number of clerical errors, it is a clear indication that some of the elements of its internal control are ineffective and need revision. Such conditions should be promptly brought to the attention of the contractor and, where necessary, the auditor should assist the contractor in accomplishing corrective action by recommending adequate or improved methods.

d. It is the purpose of the present section to discuss the nature of internal control and the general principles involved. The sections following will deal with the actual review of internal control.

43. Scope of Internal Control

Broadly speaking, internal control refers to the effectiveness of all of the internal procedures of an accounting and general financial nature. It includes both the procedures constituting the accounting system and also such internal auditing as may be carried on by the contractor. It is not restricted to procedures solely of a bookkeeping nature. Instead, internal control should be viewed as including all of the contractor's procedures having to do with the accuracy and general reliability of quantities or dollars as developed in the various forms and records.

44. Basic Principles of Internal Control

a. CHECKS AND BALANCES. (1) A basic principle of all internal control is the application of checks and balances. Two or more procedures are developed along different lines or carried on by separate persons or groups of persons. The result developed by each procedure then provides a check or basis of appraisal against the other. The effec-

tiveness of the cross check is in proportion to the degree of independence existing between the two procedures. It also follows that the greater the volume of transactions the greater the possibilities of developing the number and effectiveness of such checks.

(2) The system of checks and balances can be applied in many ways. In one of its more elementary and routine phases it may involve two operations of a single individual. Its greater effectiveness, however, comes when two or more individuals are involved in the operation, as for example, when one person prepares a voucher and a second person makes a comparison of it with the underlying papers. If the second individual obtains the information from a different source and uses this as a basis for the second check, then the cross check is made still more effective. At a still higher level the work of one department provides a check against the work of another department, as for example, where the distribution of the pay roll made by the cost accounting department is checked against the figures developed for payment purposes by the pay roll department. The term "check" is not limited to the fact of mathematical agreement; it may refer also to qualitative checks. The quality of the materials purchased by the purchasing department and inspected by the inspection department is, for example, subjected to a secondary check when put into production in that, if rejections are frequent because of defective material a general protest from the production department will be forthcoming.

(3) The internal auditing program further described in paragraph 47 is an important phase of internal control. It is essential to note that the internal audit is carried out on a "post" audit basis and hence serves only as a means of finding errors after the transactions involved have been consummated. An internal audit, if carried on by the contractor, serves as a check on the reliability of the other phases of internal control and should result in measures being taken to correct faulty procedures and means for eliminating clerical errors.

b. NO PERSON IN COMPLETE CONTROL OF IMPORTANT PART OF TRANSACTION. The desirability of checks and balances is commonly expressed as a principle that no one person should be in entire control of an important part of a business transaction. Where such is the case the possibilities of

fraud, carelessness, and errors in general are greatly increased. When the work of one person is subjected to review by a second under the normal routines, there is added assurance of accuracy up to that point. There is also greater probability that the first employee will function more efficiently when he knows that his work will be subject to review.

c. ACCOUNTING AND OPERATION SHOULD BE SEPARATED. The same plan of checks and balances is again often expressed in the special principle that accounting and operation should be separated. For example, a storekeeper should not be permitted to establish, without control, his own accountability for materials. Similarly a cashier should not receive cash and also work on or have access to ledgers or books of original entry other than those recording cash receipts. Such a situation might make it possible to manipulate the records to cover up the misappropriation of assets.

d. RESPONSIBILITIES SHOULD BE FIXED TO GREATEST PRACTICABLE EXTENT. Another important principle of internal control is that, so far as is practicable, responsibilities should be clearly fixed. In certain situations, as for example, in the case of cash, equipment, etc., the responsibilities can be fixed in terms of definite accountabilities. In other situations the responsibility is of a more general nature, such as the responsibility for making purchases. In all cases, however, the more precisely the responsibility can be fixed, the greater likelihood there is that personnel will function in an efficient and trustworthy manner and that fraud and error will be minimized.

45. Utilization of Physical Checks

The effectiveness of the accounting control depends to a major extent on the utilization of physical checks. It is important, therefore, that such checks be employed to the maximum extent practicable. For example, book inventory records should be checked at periodic intervals with physical inventories so that errors may be eliminated in the early stages and appropriate adjustments made.

46. Collusion

The auditor should realize that no system of internal control is infallible and he must be constantly alert for possible collusion and other conditions

which may lessen the effectiveness of particular phases of the accounting control. The system of internal control should be designed to make collusion difficult.

47. Contractor's Internal Auditing Program

a. The internal auditing program, when carried on by persons independent of the regular accounting procedures, represents an important means of improving and maintaining the system of internal control. Its function is to maintain a continuous independent check on the operation of the accounting and financial procedures.

b. To the extent such a program is carried out by the contractor, it should be given weight in determining the reliance to be placed on the system of internal control. It does not follow, however, that a contractor who does not have a separate internal auditing department cannot have a sufficiently adequate system of internal control to justify selective audit procedures.

48. Definition of "Independent Person"

In describing good internal procedures the term "independent person" frequently is used. It must be recognized that the status of such a person will vary depending on the particular circumstances. The independent person, however, should be at least one who is not subject to the same immediate superior as the person or operation with respect to which it is desired to establish independence, and he should not participate in the operation involved.

Section IV. OUTLINE OF PROCEDURE FOR REVIEW AND APPRAISAL OF INTERNAL CONTROL

49. Nature of Review

a. The importance of the internal procedures of the contractor's organization in providing a reliable record of accounting data can hardly be overemphasized. It is essential that the auditor investigate the operation of the internal procedures and appraise their adequacy at every point. He must realize that procedures are often established which appear to be adequate but which in practice are either never carried out or gradually break down over a period of time. The human element

is always to be considered, and the auditor must therefore determine first hand that given procedures are actually carried out.

b. The review of the internal control procedures should be made as the initial phase of the audit in order that the results obtained can provide a basis for developing the actual audit program. The initial review should then be supplemented by a continuous review, check and approval of the effectiveness of the system, since selective audit is predicated on an effective system of internal control.

50. Getting Facts Regarding System

Memoranda should be prepared by the auditor, with such assistance from the contractor as is practicable, describing the important aspects of the contractor's internal procedures. Each of the various paragraphs as described in sections V through VIII, will be covered in a separate memorandum and will deal with the handling of important accounting matters. These memoranda will include organization charts, names of persons responsible, approvals required, etc., and will give particular attention to controls or checks which tend to assure an accurate and reliable record. When completed in proper form they set forth the contractor's representations as to his system of internal control, and will become part of the auditor's working papers.

51. Determining How System Works in Practice

The auditor then should determine the extent to which actual practice conforms to the procedures stated to be in effect. This should be done by inquiries directed to the persons who are charged with carrying out the procedures and by actual observation of the manner in which the transactions are handled. In this phase of the review the auditor should set forth in his working papers the nature of his inquiries and observations and the findings made, following the same outline as used in the memoranda covering the procedure stated to be in effect.

52. Appraisal of System of Internal Control

a. With the above facts regarding the procedures being followed, the auditor is in a position to

appraise the adequacy of the internal control. For this purpose he should use the guides set forth in paragraphs 53 through 94 inclusive. The working papers should indicate the extent to which the given system varies from the preferred procedures and should set forth the auditor's opinion of the adequacy of the internal control resulting from the procedures actually being followed.

b. Where, in the judgment of the auditor, the contractor's internal procedures as to a particular phase are not adequate, the contractor should correct the deficiency. If, in unusual cases, such changes are not practicable, the auditor will extend his audit procedures as to that phase to the extent required to protect the interests of the Government. The auditor's decisions relative to the above questions will be recorded in the working papers and before action is taken will be referred to higher authority for approval in accordance with the standard procedure of the service involved.

Section V. INVOICES

53. Introduction

This section is applicable to invoices charged directly to the contract or to overhead accounts, stores, property, or other accounts which ultimately may affect the cost of the contract. The procedures set forth are those which the contractor preferably should follow, and are to serve as a guide for the auditor's review and appraisal of the procedures actually in effect.

54. Purchasing

a. Procedures should be in effect to avoid purchases of materials in excess of the contract requirements.

b. All commitments for materials and services, including utilities services, should be covered by written agreements or formal purchase orders, except for professional services such as legal, accounting, and medical.

c. Purchases should not be in contravention of Public Law 703, 76th Congress, Chapter 508, Act of 2 July 1940 relating to the Cost-Plus-a-Percentage-of-Cost system of contracting.

d. Purchase orders should be complete and definite as to specifications and quantities of material,

description of services, prices, discounts, transportation terms, f. o. b. point, delivery schedule, and terms of payment. They should be properly controlled and approved by a responsible executive of the contractor and, when required under the contract, approved by the contracting officer.

e. The purchase order should bear the number of the contract to which it applies.

f. Where the nature of the material is such that the trade practice is to permit some variation between the quantity ordered and the quantity shipped, the purchase order should specify the maximum plus or minus variation.

g. Changes in quantities, specifications, terms, etc., agreed to after issuance of the original order, should be covered by approved change orders.

h. Wherever possible, purchases applicable to CPEF contracts should be made free of sales or use taxes.

i. Transportation bills should be checked against the applicable purchase order, cross-referenced thereto, and be approved by qualified personnel. They should also be checked against invoices directly or through data posted on the purchase order. Transportation more expensive than that indicated on the purchase order must bear the approval of the contracting officer.

55. Receipt of Materials or Services

a. Receiving reports, covering both direct and indirect materials, should be prepared by receiving department personnel who are independent of employees in the purchasing department, and in the case of direct charges to the contract, should be approved by a Government representative as to quantities in accordance with TM 14-910.

b. Procedures should be in effect to assure that all contractor and Government inspection reports are being reviewed for rejections and that appropriate charges are made against vendors.

c. Wherever practicable, materials, after receipt in a receiving department, should be delivered to a storeroom and cleared through the stores record.

d. Invoices for utility services should be checked through independent meter readings, records of telephone calls, and other data.

56. Recording of Materials in Stores Records

The control of materials after purchase is not directly a part of the purchase invoice procedures.

However, stores control through inventory records provides a useful check on the actual receipt of the material and the accuracy of the accounting distribution. It is therefore an important internal control procedure and should be utilized. Stores control will be further treated in paragraphs 81 through 88 inclusive.

57. Invoice Payment Procedure

a. Vendors' invoices should be checked by independent persons with related purchase orders and receiving reports.

b. Where more than one invoice applies to a single purchase order, information should be shown on the purchase order giving the shipments to date and the balance to be billed.

c. All invoice additions, extensions, and deductions should be checked.

d. Special care should be exercised that debit memoranda for all shortages, overpricing, etc., are deducted from the invoices of the vendor.

e. All debit and credit memoranda should be cross-referenced to the applicable invoices.

f. The deduction of all cash and trade discounts, rebates, freight allowances, and quantity discounts should receive particular attention.

g. Invoices for outside service not supported by receiving reports should be approved by a qualified executive.

h. When invoices are ready to be paid, qualified independent personnel should review their validity and the accuracy of the accounting distribution. All unallowable costs should be eliminated from charges directly or indirectly affecting the contract.

i. Payment should be approved by an independent financial executive.

58. Invoices for Communication Charges

a. Ordinarily, in mixed plants, telephone and telegraph charges should be prorated to the contract through overhead. In such cases the procedures outlined below are not applicable.

b. When telegraph charges are handled as direct charges to each contract, the following procedures should be applied:

(1) Procedures should provide for showing the contract number on all telegrams directly chargeable to a contract at the time of transmission, so

that the telegraph company can bill the charges separately for each contract.

(2) When the invoice is received from the telegraph company covering telegrams directly chargeable to the contract, the contractor, after satisfying himself as to the applicability of the messages to the contract, should execute the following certificate on the auditor's copy of the invoice.

I certify that the messages which are listed on the attached invoice totaling \$----- are properly chargeable to the contract.

Contractor
By _____
(Name and title)

c. In unusual cases, where telephone toll and long distance charges are handled as direct charges to each contract, satisfactory records should be maintained for the identification of such calls.

59. Invoices From CPFF Subcontractors

CPFF subcontractors should submit to the prime contractor their commercial invoices for reimbursable costs. Such invoices should be subject to the same internal procedures as other purchase invoices.

60. Invoices From "Time and Material" Vendors

When purchase orders are issued for outside work on the basis of actual hours expended, to be billed at an agreed rate, the hours billed should be audited by the contractor. If material is furnished by the vendor, charges therefor will also be subject to audit and the provisions of paragraph 54c are applicable.

61. Travel Expense Reports

a. Procedures should be in effect for executive control over travel expense advances and for accounting controls to insure that the balances are cleared only through a proper expense report or refund of the balance of the advance. A claim for reimbursement can be made only after payment based on properly supported travel expense reports and the contractor's procedures should recognize this requirement. A system for the prevention of duplicate payments should be established.

b. The procedures should provide for the submission of expense reports in accordance with the

requirements listed in paragraph 20 in respect to documentary evidence.

c. In preparing claims for reimbursement, procedures should provide for excluding items such as entertainment, subsistence in excess of established limits etc., which are not in accordance with the terms of the contract.

d. The contractor should require receipted bills in support of expenses claimed by the traveler whenever it is customary in regular business practice to issue receipts.

62. Petty Cash Disbursements

a. The procedures should provide restrictions on the size and type of individual disbursements.

b. It is not desirable to make pay roll disbursements out of petty cash. These payments should be made either by drawing a pay roll check or from the paymaster's funds.

c. Rules for writing the petty cash voucher in ink or otherwise protecting against alteration should be enforced. The receipt of the payee and the written approval of an authorized executive should be obtained.

d. When a reimbursement check is drawn, the supporting documentary evidence should be reviewed by a responsible employee for validity, accuracy and correctness of distribution. The individual vouchers should be stamped or otherwise adequately canceled, but not destroyed.

63. Interplant or Interdivisional Charges

When work applicable to the contract is done in other plant or manufacturing divisions of the contractor in which separate books are maintained, interplant billings will be required. When work is started at one plant for another plant of the same contractor, a work order or similar method of controlling cost should be used. The invoices should be subjected to the same internal procedures as invoices from outside vendors and subcontractors.

64. Credits

a. Where a credit adjustment is covered by a credit memorandum or by a remittance from the vendor, controls should be maintained to assure that proper credit is made to the cost of the contract. Such controls should include requirements that all materials or other property leaving the plant be covered by authorized shipping orders.

b. Credit memoranda should show the following information:

- (1) Explanation of the nature of the refund.
- (2) Reference to the agreement, contract, or correspondence upon which such refund was based.
- (3) A statement of the period and the transactions or group of transactions involved.
- (4) Name of the company which made the refund.
- (5) Date refund was received by the CPFF contractor.
- (6) Total refund received and computation of resulting credit.

Section VI. PAY ROLLS

65. Introduction

a. This section is applicable to pay roll disbursements charged directly to the contract or to overhead accounts, work orders, or other accounts which may ultimately affect the cost of the contract. The procedures set forth are those which the contractor preferably should follow and they are to serve as a guide for the auditor's review of the procedures actually in effect.

b. Inasmuch as the procedures having to do with hourly rate or factory pay rolls are different in many respects from salary pay roll procedures, the two types will be treated separately.

HOURLY RATE PAY ROLLS

66. Personnel Records and Procedure

a. The hiring and dismissal of all hourly rate employees preferably should be cleared through a responsible individual or a centralized personnel department for the purpose of maintaining adequate personnel records.

b. Adequate records should be set up at the time of employment covering the employee's personal data, the rate, and other terms of his employment. These records should be maintained independently of the pay roll department.

c. The pay roll department should add names to the roll only on the basis of written advice from the executive responsible for the personnel records.

d. Rigidly enforced procedures should be established for immediately reporting to the pay roll department the dismissals or other separations of employees from the pay roll.

67. Timekeeping

a. The preparation of the basic attendance record—usually time clock cards—should be properly safeguarded through adequate supervision by independent persons.

b. The attendance clock card, or similar record, will normally become the basic record for computing the earnings of the employee. In some plants it is feasible also to use the card for distribution purposes, although commonly a separate record is prepared.

c. The distribution tickets, or other record of worker's performance, should be prepared preferably by a timekeeper, but if prepared by the workman, time checkers should make adequate floor checks to check the accuracy of the distribution. In large plants, particularly where the men are changing jobs frequently, it is not practicable to have the foreman make out the distribution record.

d. The distribution record (time tickets or job cards) should be reconciled daily in the factory with the hours shown by the attendance clock record.

e. Where the employees are paid on a piece work or other incentive basis, controls should be maintained by having independent persons perform operations such as—

- (1) Checking production counts.
- (2) Approving allowances for nonstandard conditions (for example, shortages of materials or tools and delays due to machine break-downs).
- (3) Written authorization of piece rates or labor standards.

68. Accounting Distribution

a. The summarizing of the distribution records of charges directly to particular contracts, work orders, or to overhead classifications should be independently checked to detect erroneous sorting of tickets or errors in placing the contract numbers on tickets.

b. The summaries of pay roll distribution should be made preferably in a department other than the pay roll department, such as the cost department, and should be reconciled with the total pay rolls.

c. Procedures should be in effect for excluding from amounts claimed as reimbursable, either as direct charges or as part of overhead, any items which are not applicable to the contract.

69. Preparing Pay Roll

a. The individuals preparing the pay roll should have no part in the preparation of the basic time records, the time checking, or the actual pay-off.

b. All rates in effect should be supported by proper written authority.

c. Systematic routines should be maintained by the contractor to insure that proper deductions are made from wages.

d. Suitable cross checks should be maintained within the pay roll department with respect to the accuracy of hours, rates, extensions, and footings.

70. Making Pay Roll Disbursements

a. The distribution of the checks or cash to employees and the custody of the unclaimed wages should be under the charge of persons independent of the timekeeping, time checking, and pay roll preparation.

b. Preferably, signed receipts should be obtained if payment is made in cash.

c. At the time of pay-off, neither checks nor cash should be given to other than the worker. Unclaimed wages should be paid to other persons only on a properly authenticated written order.

71. Interim Pay-Offs

Pay-offs of employees between regular pay days should be recorded on pay roll records in the same manner as the regular pay roll and included in the distribution of the pay period to which they apply. It is not good procedure to make the accounting distribution of such pay-offs directly from the cash disbursements records.

72. General

The contractor's procedures should provide for continuous control over labor costs by which variations and trends in costs are studied and investigated currently. Such control may be through the use of labor standards set by time studies or by comparison with costs of previous periods or lots.

SALARY PAY ROLLS**73. Personnel Records**

Records should be available showing approvals of the engagement of salaried employees and their salary rates.

74. Timekeeping

It is a common and desirable practice to require the ringing of an attendance clock card or other evidence of attendance by all or most salaried employees.

75. Preparing Pay Roll

a. The pay roll, including both regular and overtime payments, should be approved in writing by department heads or other executives.

b. Procedures should be maintained to insure that all proper deductions are made.

c. Suitable cross checks should be maintained as to accuracy.

76. Accounting Distribution

a. The procedures should provide for a careful review of the salary pay roll distribution to eliminate from charges to the contract, either directly or through overhead, the salaries of any individuals whose services are not incident to and necessary for the performance of the contract.

b. All distributions should be approved by a responsible executive.

ALL PAY ROLLS**77. Limitations on Pay Rolls**

The contractor's procedures should provide for compliance with contract and administrative limitations on total compensation allowable for personal services.

78. Savings Bonds and Stamps

a. Before deduction for savings bonds and stamps can be made from wages, each contractor's employee will sign a pay roll Savings Authorization Card.

b. The contractor's pay roll should show the amount deducted for purchases of savings bonds or stamps.

c. The total withheld from employees will be deposited immediately with a bank insured by the Federal Deposit Insurance Corporation in a separate account so designated as to indicate its special character and purpose. It is not necessary to use a separate account for each contract.

d. Withdrawals from such accounts will be only for the purpose of purchasing savings bonds or stamps for delivery to employees or for refunding employees payments on subscriptions. Refunds may be made by a check drawn on the special bond account or the contractor's regular bank accounts. In the latter case, the contractor will reimburse his regular account from the special bond account.

e. The contractor will maintain appropriate records of all transactions involving employees' subscriptions including a periodic reconciliation of the total amount of employees' payments on unissued bonds with the balances in the special bank account.

79. The record maintained should be adequate to permit a check of vacation pay. In the case of a 100 percent CPFF plant the records must be such as to permit distribution in accordance with paragraphs 246, 247, and 248.

80. All overtime work performed in excess of the regularly established work schedule should preferably be preauthorized in writing.

Section VII. JOURNAL ENTRIES

81. Introduction

a. The internal procedures under invoices and pay rolls have dealt with items involving cash disbursements, many of which involve direct charges for which reimbursement can be immediately claimed. Other cash expenditures are made for overhead items, and monthly progress payments will ordinarily be made pending final annual settlements. Also, many cash expenditures affect stores accounts, deferred charges, property, and the like, in which case journal entries must provide for the distribution or write-offs from these accounts. If such journal entries result in direct contract charges, reimbursement can then be claimed. For the most part, however, the journal entries will involve items which will be reimbursed as a part of overhead.

b. The internal procedures under review in this section are those which deal with the validity and accuracy of these intermediate distributions and allocations so that when reimbursement for overhead is claimed the reliability of the content of the overhead will have been established.

c. The procedures following are those which the

contractor preferably should follow and serve as a guide for the auditor's review of the procedures actually in effect.

82. Materials and Supplies From Contractor-Owned Stores

a. A dollar control should be maintained over materials and supplies owned by the contractor which subsequently may be issued for contract use or chargeable to overhead.

b. Contractor-owned and Government-owned materials and supplies should be physically segregated and separately controlled. Requisitions from Government-owned stores should be of a distinctive color or otherwise distinguished to avoid possible confusion with requisitions covering contractor-owned materials.

c. All materials drawn from contractor-owned stores should be on a standard requisition form approved by a responsible employee and preferably showing evidence of receipt by the using department.

d. Cross checks should be maintained to insure the accuracy of clerical computations, distributions of charges, development of summaries, and ledger postings.

e. The contractor's procedures should provide for current checking of physical quantities against the book records.

83. Work Order Charges

Some contractors issue work orders to collect the costs of tools, major repair jobs, rearrangement of equipment, etc. Such work orders may serve as suspense accounts to be cleared eventually to overhead or other accounts. The charges thereto come from stores, invoices, and pay roll but the procedures of issuing and controlling work orders require separate review.

a. Work orders should contain an adequate description of the work to be performed.

b. Work orders should be numbered serially and issued only by authorized executives competent to determine the necessity for the work and the propriety of the proposed accounting distribution.

c. Work orders chargeable directly to the contract or to overhead should be cleared at least monthly to avoid an undue accumulation of undistributed costs.

d. Work orders cleared should be checked for accuracy of computations and distribution by competent independent persons. Summaries should be subjected to similar checks.

84. Write-Off of Deferred Charges

a. Write-offs should be checked as to computations, allocations, and conformance with established policies.

b. The accounting distribution of the write-off should be approved by a responsible executive.

85. Depreciation

a. Additions or betterments to property, plant, and equipment should be approved by responsible executives both before the acquisition, and later as to proper receipt of items involved and propriety of charges.

b. Procedures should be in operation to insure that retirements of all kinds are promptly reported and that the accounting clearances are accurately made.

c. Appropriate checks should be in effect with respect to depreciation charges, as follows:

(1) That rates are used in accordance with established policies.

(2) That rates are applied to a proper depreciable basis.

(3) That computations are accurate.

d. The accounting distribution of the depreciation charges should be reviewed and approved by a responsible executive.

e. Procedures should be in effect for recording idle plant and facilities and the depreciation applicable thereto in order that the exclusion of such costs will properly be made.

86. Accruals of Expenses

Appropriate checks should be in effect as to accuracy of calculation and distribution and conformance with established policies.

APPLICATION OF OVERHEAD

87. Introduction

a. The definition of overhead and the principles related thereto are set forth in paragraphs 189 to 203, inclusive, and should be followed by the con-

tractor in presenting his overhead claim. Reference should also be made to paragraph 13 wherein are set forth the principles applicable to the reimbursement of overhead.

b. The internal procedures and controls applicable to invoices, pay rolls, and journal entries apply whether the charges are direct or indirect. In addition the contractor must have special controls over direct charges of items commonly treated as overhead and for apportioning indirect costs.

88. Overhead Procedures

a. The contractor will submit in his statement of accounting policies, subject to the approval of the contracting officer, the bases and methods proposed for charging overhead costs to the contract. Such statement should include the basis for allocating overhead at the administrative head office, if allowable under the contract terms, and at other plants of the contractor performing work under the contract. Such policies may be subject to modification due to changes in operating conditions or other factors. The contractor's changes or amendments in this statement of accounting policies are also subject to the approval of the contracting officer.

b. PROGRESS PAYMENTS. The contractor may request progress payments for overhead using a tentative rate. Such requests must be prepared in the manner prescribed in paragraph 24.

c. FISCAL YEAR-END OVERHEAD STATEMENTS. (1) Fiscal year-end overhead statements must be prepared by the contractor as a basis for annual settlements. These statements should reflect the progress payments and should show the net balances represented by the contractor as amounts due from the Government. The statements should be prepared in reasonable detail supported by schedules, analyses and other relevant data in accordance with the directives of the service. A summary of each overhead account, burden center, or department should be presented by the contractor according to account classification in substantially the following manner:

- (a) Gross charges.
- (b) Less direct charges to contract.
- (c) Less direct charges to other work.
- (d) Net balances per general ledger.

- (e) Less nonreimbursable expenditures.
- (f) Balance to be prorated.
- (2) If monthly overhead settlements are made or if for any reason the overhead period is less than the fiscal year, the statement should be prepared in accordance with the procedure required for year-end statements.
- (3) In all overhead settlement statements the proration bases should be clearly shown and supported by reasonably detailed information and calculations.
- (4) If the contractor prorates overhead to the contract on a departmental basis, the claim should include a statement of the expenses in each department classified in reasonable detail. Charges to the overhead expenses from another department should be shown separately. When expenses of a department are prorated to other departments, the claim should show the basis used for the proration and the amounts charged to each department affected.

Section VIII. MISCELLANEOUS

CAFETERIAS, COMMISSARIES, CANTEENS, AND SIMILAR OPERATIONS

89. Introduction

The procedure outlined elsewhere herein, with respect to the review of the system of internal control is, in general, applicable to situations involving cafeterias, commissaries, canteens and similar operations, operated by contractors in connection with CPFF contracts. However, certain aspects of their operations are sufficiently different from the operation of the principal contract to require special treatment.

90. Invoices, Pay Rolls, etc.

a. The internal procedures outlined under invoices and pay rolls should be observed in the operation of cafeterias and similar units to the extent applicable.

b. Inasmuch as the purchase of many items—food and other perishable items used currently—require immediate decisions 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.

c. Receiving reports may not be prepared for cafeteria purchases but invoices are usually submitted with the merchandise and should be approved for receipt by a responsible person.

d. Purchases or expenditures of all kinds handled on a cash basis should be made from imprest funds and currently reimbursed according to regular procedures.

91. Control of Inventories

a. Food and supplies should be drawn from stores only by responsible personnel.

b. Physical inventories of food should be taken at least once a month and preferably weekly to permit determination of food costs.

92. Cash Receipts and Control of Revenue

a. Independent checks of cash receipts should be provided to the greatest practicable extent through cash registers, tickets or sales slips, inventory controls, etc.

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 suitably classified.

d. Statistical controls such as number of meals served, average sale, and operating ratios should be utilized to the maximum extent practicable to control 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 charges to guest accounts and collection of revenue to provide assurance that all revenue is being properly credited.

f. Provision should be made for the independent checking of commissions receivable from the operation of vending machines by reference to contracts with concessionaires and by appropriate checking of the receipts.

g. Where a concessionaire's contract provides for price adjustments, provision 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 if the income derived is in excess of that stipulated in the agreement.

93. General

Profit and loss statements on cafeterias, commissaries, dormitories, etc., should be prepared at least once each month.

SCRAP

94. General Requirements

The procedures for the control of scrap are set forth in TM 14-910. The contractor should familiarize himself with this manual and should develop his own procedures in accordance with the standards and requirements set forth therein.

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TM 14-1000

CHAPTER 3

APPLICATION OF SELECTIVE AUDIT PROCEDURES

Section I. INTRODUCTION

95. Preparing Audit Program

The audit program will be developed by the auditor in accordance with the procedures set forth in this manual after his reviews of the contractor's system of internal control and statement of accounting policies have been completed. Each part of the program will be based upon the effectiveness of the internal controls at the time the claimed cost items were incurred. It will be of such scope as is necessary to protect the interests of the Government in the light of the contractor's existing methods and system of internal control and should be based upon selective auditing to the greatest extent practicable. The program prepared by the auditor, together with the contractor's statement of accounting policies, will be submitted in accordance with the practice of the service involved to higher authority for review and approval. The audit program will be supported by such information relative to the system of internal control and other pertinent data as will enable the higher authority to pass on its adequacy.

96. Revision of Audit Program

a. The audit program will be currently revised and amended by the auditor, taking into consideration changing conditions and operational methods of the contractor, contractual relationships, periodic reappraisals of the contractor's system of internal control and the application of his announced accounting policies.

b. It is important that the auditor avoid a fixed and continuing pattern of procedure. By varying the application of selective audit procedures to different departments, shifts, and other sections of the work, a complete coverage of all sections can be accomplished over the life of the contract.

c. It is also important that the auditor constantly consider the adequacy of his program in the light of his day-to-day findings. Where given checks disclose errors or irregularities, the scope of the audit must be extended to protect the interests of the Government.

97. Nature and Use of Selective Audit Method

The selective audit method may be defined as a system of tests and checks similar to the methods used by public accounting firms. Generally speaking, selective auditing means the selection of particular transactions to which audit procedures are to be applied. One or more audit procedures may be applied to a selected group of transactions or documents, or different groups of transactions or documents may be selected for the application of various audit procedures, or a particular audit procedure may be applied by 100 percent to a specific claim. In some cases, it may be necessary to perform a particular audit routine in detail on all documents until such time as the contractor's procedures are properly established and applied. Selective auditing does not mean that certain vouchers will be selected for detailed audit while other vouchers will not be audited.

98. Direction of Audit Effort

a. In the case of certain classes of cost where there is ordinarily no question of allowability from a technical accounting standpoint, the selective method of audit can be employed to the greatest extent.

b. In the case of certain other accounts where the allowability may be less clear, there must be a more extensive review, and the working papers are to include analyses of such accounts sufficiently extensive to disclose their content. Examples of

these accounts are executive compensation, taxes, depreciation, repairs, insurance, subscriptions, memberships and dues, donations, and professional services.

c. Special attention should also be given to items which are large in amount or uncommon in nature, or which, because of other circumstances, appear particularly to concern the Government's interests. All unusual matters are to be followed through to a final conclusion, and any necessary action is to be taken.

99. Audit of Particular Portion or Phase of Transactions

In the audit of a given portion of the transactions or phase of the operations, there are certain important requirements to be observed:

a. The portion of phase examined is to be representative of the total group from which it is selected. The selection must be made without regard to convenience or availability of data or to difficulties involved.

b. The portion or phase selected must be checked out completely and without exception for the audit operations selected.

c. To be effective, the selective auditing procedures must be carried out only after the contractor has recorded the distribution of the transactions in such a manner and subject to such control by the auditor that changes cannot be made without detection subsequent to the selective auditing and prior to reimbursement. This can be accomplished, preferably, by the auditor retaining possession of the documents showing the accounting distribution or, where this is not practicable, by maintaining appropriate detailed lists until the given auditing procedures have been carried out.

d. If the portion audited indicates numerous errors, the scope of the examination must be extended to a detailed check of that phase of the accounts.

100. Representative Number

In this manual, the term "representative number" is frequently used in respect to selection of groups of transactions for auditing. The interpretation of the term is a matter of individual judgment and will depend upon the particular circumstances in each case. In general, however, the factors to be

considered in given situations will include: dollar amount of items, points of origin, classes of items, departments involved, etc. In all cases the objective is to obtain a sufficient cross section to justify reliance on the validity of the transactions of the group under examination. The extension of the auditing will then be based on the contractor's system of internal control and the results of previous audits.

101. Dual Responsibility of Auditor

It may be stated again that the auditor has a dual responsibility. He must extend his procedures so far as is necessary to safeguard the interests of the Government; at the same time, he must avoid an extension of procedures which is unnecessary and which unduly duplicates the work of the contractors.

102. Working Papers

a. GENERAL OBJECTIVES. (1) Working papers serve two major purposes: they are an essential historical record of the auditing procedures carried out and of all significant data and findings incident to and arising from the audit; and they are an important means of currently administering the auditing work. Working papers should therefore be prepared in such form as to achieve these objectives to the maximum extent.

(2) The papers should contain a clear and complete record of selective audit procedures carried out, by whom performed, and the results and findings. If the findings indicate the need for further action, the final disposition of such matters should be covered in the papers. However, extensive transcripts of the contractor's detailed records are usually unnecessary and are to be avoided wherever possible.

b. FORM OF PREPARATION. Each sheet must show the name of the contractor, the contract number, subject matter, the date, and the initials of the staff member who prepared it. No more than one type of subject matter should be covered on each sheet.

c. INDEXING OF PAPERS. So far as practicable, working papers and reimbursement vouchers should be cross-indexed.

d. CONTROL SHEETS OVER CURRENT WORK. In order that the auditor may properly control the

day-to-day auditing and administer it efficiently, he should, to the extent practicable, currently maintain appropriate control sheets setting forth the major auditing operations by departments and functions and dates.

e. IDENTIFICATION OF ITEMS EXAMINED. In applying selective audit procedures, rubber stamps or check marks should be placed on the specific documents examined to indicate the auditing procedures performed. Appropriate explanations of rubber stamps or check marks used should be placed on the documents or kept in a separate file so that it can be determined at any later time which documents or transactions were examined and the extent of such examination.

f. SUMMARIZATION OF AUDIT WORK. Summaries of the auditing procedures carried out and the results obtained on each voucher should be prepared and made a part of the auditor's working papers.

103. Audit of Costs Incurred Prior to Contract Date

The contract may provide for reimbursement of costs incurred in anticipation of the formal execution of the contract. Such costs should be scrutinized with special care.

104. Auditor's Certificate on Standard Form 1035

a. When the auditor has completed the administrative audit of each public voucher in accordance with the procedures set forth in this manual and has thus satisfied himself that the contractor's claim is reimbursable under the terms of the contract, he will complete the following certificate on the supporting Standard Form 1035 or its equivalent:

Approved in accordance with TM 14-1000-----

Date.

(Auditor)

b. When the above certificate is completed, it should not be modified or qualified in any way.

Section II. INVOICES

105. Introduction

a. The invoice audit procedure covers all vendors' invoices, transportation bills, travel expense

reports, and other miscellaneous bills, whether chargeable directly to the contract, to overhead, or to other accounts which may be partly applicable to the contract. The purpose of the audit procedures is to establish the credibility and allowability of all these invoices regardless of whether reimbursement is claimed immediately or at a later time through overhead.

b. The audit program will be based upon the review of internal procedures and will be adjusted to current findings.

106. Signatures

The auditor will obtain a list of the specimen signatures and titles of persons authorized to approve or sign purchase orders, receiving reports, invoices, etc.

107. Auditing Procedure—Direct Charges

a. MANNER OF SUBMITTING INVOICES BY CONTRACTOR. (1) The contractor will submit his claim for reimbursement on Standard Form 1034 supported by Standard Form 1035, or its equivalent, together with the invoices and related debit and credit memoranda listed thereon. The auditor will foot Standard Form 1035 and determine that the items listed thereon are supported by invoices or equivalent documents. The auditor will then carry out his administrative audit.

(2) Where the auditor takes exception to particular items, which cannot be immediately adjusted, he will strike out such items on Standard Form 1035 and adjust the totals on both Standard Forms 1034 and 1035 by drawing a single ink line through the incorrect amount and writing in the reduced amount immediately above. All changed totals should be initialed by the auditor. An extra sheet should also be prepared and attached to Standard Form 1035 detailing the downward changes made. A copy of this audit adjustment sheet, together with the rejected documents, will be returned to the contractor as formal notice of the rejections.

(3) Upon request by the contractor and when the contracting officer so authorizes, arrangements may be made for the contractor to submit revised Standard Forms 1034 and 1035 to replace the corrected forms which will be retained by the auditor. The resubmission of any of such rejected items

will be in accordance with the requirements of the individual service.

b. REVIEW OF ALL INVOICES SUBMITTED. (1) Invoices submitted as support to a public voucher should bear evidence in the way of initials and notations thereon that the contractor has performed certain procedures with respect thereto. The auditor will examine *all* invoices submitted for such evidence that the contractor has made the following determinations:

(a) That invoices for materials, supplies, and other property are covered by and checked to—

1. Purchase orders or agreements.
2. Receiving reports.

(b) That extensions and footings have been checked.

(c) That travel expense reports, petty cash reimbursements, and invoices for services are approved by a responsible executive.

(d) That applicable deductions have been taken or that control has been established for subsequent deduction.

(e) That check numbers are shown on the invoices or on attached remittance advices.

(f) That all tax exemptions applicable to CPFF contracts have been obtained, including sales and use taxes.

(2) In addition to the above, the auditor will review *all* invoices submitted to determine that the type of charge is allowable under the terms of the contract and that the amount does not appear to be unreasonable.

c. DETAILED CHECK OF REPRESENTATIVE NUMBER OF INVOICES SUBMITTED. Representative numbers of invoices, selected independently for each of the following operations, will be checked in detail in accordance with the principles set forth in paragraph 97 through 100 to determine in the case of—

(1) *Regular invoices.* (a) That extensions and footings are correct.

(b) That quantities billed do not exceed the permissible variations as stated on the purchase order or allowed by the particular service.

(c) That prices and terms on the invoice agree with applicable purchase order and also with the bid in those cases where a bid was obtained.

(d) That, when required under the contract,

purchase orders are approved by the contracting officer.

(e) That quantities billed are supported by receiving reports which agree with a copy of the receiving report forwarded directly to the accountable property officer.

(2) *Travel expense reports.* (a) That unallowable expenditures, because of type or amount, are not included.

(b) That amounts claimed are supported by documentary evidence as set forth in paragraph 20.

(c) That reports are accurate as to computations.

(3) *Petty cash summaries.* (a) That supporting evidence is adequate.

(b) That items are correctly listed.

(c) That petty cash slips are properly canceled.

d. AUDIT OF TRANSPORTATION BILLS. No audit is to be made of the rates in the case of transportation bills since such audit is the responsibility of the General Accounting Office. The collection of any overpayments arising from errors in rates or extensions will be processed by that office through the disbursing officer or directly with the carrier. However, the auditor should satisfy himself that payments made are in accordance with the terms of the purchase order and supported by receiving reports.

e. COORDINATION WITH OVERHEAD AUDIT. No item normally classified as overhead will be passed as a direct charge to the contract without coordination with the personnel charged with the audit of overhead costs.

108. Invoices From CPFF Subcontractors

CPFF subcontractors will submit to the prime contractors their commercial invoice for reimbursement. In addition, copies of Standard Form 1035 should flow directly to the auditor of the prime contract from the auditor of the subcontract.

109. Invoices From "Time and Material" Vendors

With respect to "time and material" invoices the auditor will assure himself that such charges have been appropriately audited by the contractor from the records of the "time and material" vendor. The audit program followed by the contractor

should be reviewed in a representative number of cases and, where deemed advisable, the auditor should determine, by actual visit to the vendor's plant, that the contractor is making adequate audits.

110. Interplant or Interdivisional Charges

To the extent practicable, the invoices covering interplant or interdivisional charges will be subjected to the same auditing procedures at the originating plant as are set forth in this manual for reimbursement vouchers, including the determination that the amount billed does not include any profit not provided for in the contract.

111. Government Inspection Reports on Material Received

Checks will be made to see that all Government inspection reports are being reviewed by the contractor for rejections. A representative number of such reports which indicate rejections will be examined and traced to ascertain that appropriate charges have been made against vendors.

112. Reclaim Vouchers

These vouchers cover costs originally paid on Standard Form 1034 but subsequently deducted from other reimbursements to the contractor or refunded by him because of a General Accounting Office exception, but which the contractor now wishes to reclaim. Such vouchers should be supported by documentary evidence in accordance with the requirements set forth in paragraph 31. The auditor should review reclaim vouchers in the light of the evidence submitted and other pertinent factors to determine whether audit approval should be given.

113. Receiving and Inspection Procedure Prescribed by TM 14-910

The procedure for the receiving and inspection of materials and other property by Government personnel is set forth in TM 14-910. The procedure set forth in that manual is for application by the accountable property officer. The auditor, however, should also familiarize himself with such procedure as a basis for effective cooperation with the accountable property officer.

114. Auditing Procedure — Invoices Other Than Direct Charges

a. Since reimbursement will not be claimed immediately, the auditor will have the alternative of examining the invoices from day-to-day as entered by the contractor or making the examination at the close of the month. Under the day-to-day basis, the auditor should maintain a daily accumulative record of the totals charged to overhead and trace the final monthly totals into the ledger accounts. If mechanical bookkeeping equipment is used, an additional copy of the distribution record may be obtainable for control purposes.

b. The day-to-day procedure ordinarily will be suitable when the bulk of the contractor's business is CPFF. If the CPFF business is not predominant, the examination of overhead invoices will be made normally after the close of the month.

c. The audit procedures for the general review of the invoices outlined in paragraph 107b with the exception of paragraph 107b (1) (e) and (f), will apply to overhead invoices with the provision that such review is to be applied only to a representative number of the overhead invoices.

d. Appropriate tests of the footings of the invoice distribution record (purchase journal, voucher record, or other form) should be made.

115. Bank Accounts and Proof of Payment

a. Whenever the contract requires it, and preferably in all other cases, the contractor should maintain a special bank account or accounts for CPFF contracts, and in such cases the auditor should obtain periodic statements directly from the bank and have all reconcilements made under his control.

b. If special bank accounts are not maintained, a similar reconciliation should be made at intervals, depending on the extent of CPFF business in relation to the total activity of the account.

c. Check numbers covering all direct charges should be shown on Standard Form 1035 (or an equivalent form) submitted by the contractor for audit. The auditor should satisfy himself as to the clearance of such checks and the general credibility of the expenditures by means of the reconciliations of the bank accounts involved and by actual tests of the paid checks to the items listed on Standard Form 1035. For purposes of proof of

payment, the auditor should also take special care that checks disposed of by any other method than being cashed by the payee are not treated as being paid.

116. Contractor's Insurance Program

The auditor should determine that the contractor's insurance program is in accordance with applicable regulations, and that costs claimed for reimbursement do not include either premiums on Government-owned property, premiums on contractor-owned property not used for the performance of the contract, or premiums not authorized by War Department plans which are prescribed for CPFF contractors.

117. Contributions

a. Contributions meeting the tests of paragraph 221 to 224 inclusive should be submitted to the contracting officer for written approval as to amount. While it is not the auditor's responsibility to pass upon the amount of allowable contributions he should furnish the contracting officer any available information which might assist him in determining the reasonableness of the amounts claimed.

b. As stated in PR 398-A, a separate voucher should be prepared covering the item involved inasmuch as a separate certification is required of the contracting officer, and, after the usual audit procedures and certification has been completed the voucher is to be returned to the contractor instead of being submitted to the disbursing officer.

118. Attorney's Fees

When the contractor's claim for reimbursement includes attorney's fees, the auditor should refer the matter, together with all available information to the contracting officer for a decision as to the amount, if any, which should either be reimbursed as a direct charge or included in the overhead pool. The auditor should keep in his files a written statement from the contracting officer in respect to any such fees.

Section III. PAY ROLLS

119. Introduction

a. The pay roll audit procedure covers all pay roll disbursements charged directly to the contract

or to overhead and other accounts which may ultimately affect the cost of the contract. The purpose of the pay roll audit procedure is: to establish the credibility of the record of all pay roll expenditures at the time of original entry; and to determine that claims for reimbursement are in accordance with the terms of the contract. The audit program will be based upon the results of the review of the internal procedures and will be adjusted to current findings.

b. The audit procedures include two main phases—

(1) Those procedures concerned with the day-to-day preparation of the basic pay roll records.

(2) Those procedures dealing with pay roll records and distribution summaries prepared at the close of each pay roll period. The two groups of procedures are closely related and combine to accomplish the total audit objective.

c. Pay roll audit procedures are set forth separately for hourly rate and salary pay rolls in accordance with the plan followed under internal procedures.

HOURLY RATE PAY ROLLS

120. Procedures—Daily Pay Roll Records

a. From time to time the auditor will witness the ringing in and out of time cards of employees in each department and for each shift.

b. In departments working both on CPFF contracts and other work, and particularly when the men frequently shift between these classes of work, a check of the distribution of the time becomes especially important. Floor checks will be made from time to time in each department and on each shift to determine that the men ringing in are actually on the job and are charging their time to the correct job or contract. In addition to the floor checks, in such cases, a representative portion of the labor tickets should be traced to production control records or such other independently maintained records as are available.

c. In making floor checks the following requirements will be observed:

(1) The floor check is to be on a surprise basis.
(2) A list of all men assigned to the department or group to be checked will be prepared and *all* names on it will then be accounted for.

(3) At the time the employees are contacted

the auditor will determine from time tickets, when used, and by observation the job on which the employee is working and whether the occupational rate of the employee is applicable to the work being performed.

(4) The names of all employees not on the job will be checked to the clock record and satisfactory explanations will be obtained for all absences. All such absentees should also be checked at work at a later date.

(5) The daily distribution will be checked to the record of the floor check as soon as the former record is available, and such distribution will be traced into the summary for the pay period.

(6) The names of employees on the final pay roll will be checked to the record of the floor check to check out the employees listed in it for the departments covered by the floor checks.

d. The agreement of the total hours as shown by the distribution record for the day on which the floor check was made will be checked with the total of the hours shown by the clock cards or other attendance record.

e. The auditor will witness from time to time, on a surprise basis, the pay-off in each department and for each shift, observing the following requirements:

(1) The amounts on the envelopes or checks will be checked against the pay roll before the pay-off. Employee numbers on checks or envelopes will be checked against badge numbers as pay-off is made.

(2) The control over the pay-off will be maintained jointly with contractor's paymasters.

(3) A list of the unclaimed wages will be prepared by the auditor and subsequent disposition of the items witnessed. In lieu of witnessing disposition, a copy of such list may be given to the contractor with the instruction that signatures be obtained at the time the wages are claimed. Such signatures should then be test checked by the auditor to authorized signatures in the personnel department.

(4) Special inquiry should also be made of all checks not claimed within a period of 90 days.

121. Auditing Pay Roll

a. The auditor will obtain a list of the signatures and titles of persons authorized to establish rates, approve pay rolls, sign checks, etc.

b. A representative portion of the names on the pay roll will be checked to personnel records to determine authority for employment and rates used.

c. A representative portion of the hours will be checked to basic attendance records (usually clock cards).

d. Extensions will be reviewed and checks made of a representative number of individual computations.

e. The totals of all pay roll sheets will be traced to summaries and the footings of the summaries proved. The footings of a representative number of the individual pay roll sheets will be verified.

122. Use of Cross Checks

The auditor, to the extent practicable, should utilize cross checks between the pay roll department and other departments. Examples of such cross checks are as follows:

a. Comparison of the final pay roll total compiled by the pay roll department with the total pay roll distribution as developed by the cost department.

b. Comparison of the final pay roll total with the total developed by the extension and footing of pay rolls by wage block groups.

123. Auditing Distribution Record

a. The summary distributions involving the contract will be checked to intermediate summaries or totals of individual lots of time distribution tickets.

b. A representative portion of the intermediate summaries or lot totals of tickets will be checked for accuracy of footings.

c. A representative portion of supporting tickets will be reviewed as to extensions, description of work, and accuracy of accounting distribution.

d. The auditor will determine that the summary distribution is approved by a responsible executive and agrees with the total shown on the pay roll.

SALARY PAY ROLLS

124. Audit of Pay Roll and Distribution Record

a. The auditor will obtain a list of the signatures and titles of persons authorized to establish rates, approve pay rolls, sign checks, etc.

b. A representative portion of the names on the pay roll will be checked to personnel records for authority of employment and salary rates.

c. In small companies the attendance of personnel may have been properly established through the review of internal control. Where this is not true it will be necessary to make a modified form of floor check.

d. The auditor will determine that the pay roll, including both regular and overtime payments, has been approved by one or more qualified executives and that overtime is being paid in accordance with established policies.

e. The auditor will review the distribution of the pay roll to determine that it is based upon proper facts and is approved by responsible executives.

f. Specific claims for reimbursement of salaries on a direct charge basis in plants having other than CPFF business will be traced to the pay roll distribution.

g. As a general rule, the accuracy of all footings will be proved and a representative number of extensions checked. However, in cases involving very large pay rolls, and where there are reliable internal checks, substantial tests of footings may be adequate.

h. All footings will be traced to summaries and the summaries proved.

i. In connection with the audit of salary pay roll charges to overhead the auditor will submit to the contracting officer for his review and approval, a complete list of executive compensation and, with respect to other salaries, any specific instances of apparently excessive salary rates or rate increases. The audit working papers will include a record of instances brought to the contracting officer's attention and, in the case of disapproval, the action taken.

ALL PAY ROLLS

125. General

a. (1) In plants where separate pay roll bank accounts are maintained covering CPFF operations, the monthly reconciliations will be made by or under the control of the auditor. A representative portion of names and indorsements will be examined.

(2) In plants where separate pay roll bank accounts are not maintained covering CPFF opera-

tions, a similar reconciliation should be made at intervals depending on the extent of CPFF business in relation to the total activity of the accounts.

b. Where the contractor has been reimbursed on a gross pay roll basis, and the proportion of CPFF business is substantial, the auditor should determine, by reference to appropriate disbursement records and paid bank checks, that the amounts withheld are subsequently paid to the proper parties by the contractor.

c. Where the contractor has been reimbursed on a gross pay roll basis for deductions covering the purchase of bonds and the proportion of CPFF business is substantial, the auditor should—

(1) Determine that amounts deducted from pay rolls have been properly deposited and recorded.

(2) Ascertain that checks issued against the bank account are supported by lists of employees receiving the bonds, stamps, or refunds.

(3) Review the reconciliation of contractor's bond bank account with the control account.

(4) Check the trial balance of individual subscribers' accounts to the control account and make appropriate tests to determine that the amounts shown are in agreement with the individual accounts.

(5) In a representative number of cases, determine that amounts deducted on pay rolls and amounts shown on lists of bonds, stamps, and refunds received by employees are properly posted to individual subscribers' accounts.

d. The auditor will determine that all contract and War Department administrative limitations on compensation have been observed.

e. No item normally classified as overhead will be approved by the auditor as a direct charge to the contract without coordination with the personnel charged with the audit of overhead costs.

Section IV. JOURNAL ENTRIES

126. Introduction

a. The invoice and pay roll audit procedures have dealt with the authenticity of all cash disbursements. Where these disbursements are charged to asset accounts such as contractor's stores, property, etc., journal entries are made by which the amounts originally charged are allocated directly to the contract or to accounts such as overhead which may subsequently affect the

contract. While these charges to overhead do not immediately constitute the basis of a claim for reimbursement, it is necessary that the auditor establish their authenticity. The auditor is then in a position to deal properly with the application of overhead and the associated claims for reimbursement.

b. The audit procedures carried out will be based upon the review of internal control modified in the light of current findings.

c. Before beginning the audit of the various sections which follow, the auditor will obtain a list of signatures and titles of all persons authorized to sign or approve the individual entries and supporting papers.

127. Materials and Supplies From Contractor-Owned Stores

a. A representative portion of invoices covering items charged to stores will be checked to the stores' records to determine accuracy of the postings of quantities and prices. In those cases where the withdrawals applicable to the CPFF contract are not substantial, these tests should be restricted to items of the type being withdrawn for CPFF work.

b. A representative number of requisitions will be examined to determine—

(1) That pricing is consistently applied on the basis of an acceptable method such as first in—first out, last in—first out, or average cost.

(2) That the requisitions have been posted to the stores records.

(3) That the using department is indicated by receipt or other designation.

(4) That computations are accurate.

(5) That requisitions are authorized by responsible personnel.

(6) That the accounting distribution is proper.

(7) That quantities have been approved by a Government property officer in the case of direct charges to the contract.

c. Summaries of requisitions will be examined to determine—

(1) By addition to the requisition totals that the summary footings are correct and the requisitions correctly listed.

(2) That the total distribution is approved by a responsible executive.

d. The requisitions will be reviewed to disclose the inclusion of items similar to those charged directly from purchase invoices. Any such items will be investigated to disclose possible duplication.

128. Work Order Charges

a. The auditor will determine that all work orders have been authorized by responsible executives.

b. The auditor should make periodic inspections in the plant to determine that work order descriptions clearly designate work to be performed and that orders are completed in accordance therewith.

c. A representative portion of the detailed charges appearing on work orders are to be traced to originating sources.

d. Accuracy of totals of postings on the work order form, or its equivalent, will be proved.

e. The auditor will determine that clearance is being made at least monthly.

f. The auditor will review for correctness all accounting distributions involved in clearing the work orders and determine that they are approved by a responsible executive.

g. Where work orders are summarized, the accuracy of summarization will be checked and the auditor will determine that the summary distribution is approved by a responsible executive.

129. Write-off of Deferred Charges

a. The auditor will examine a representative number of items charged to deferred accounts and determine that the basis of deferment and method of write-off are sound and in accordance with established policies.

b. Reasonable checks will be made to determine the accuracy with which the method of write-off is being applied.

c. The auditor will determine that distributions involving the contract, both directly and indirectly, have been approved by a responsible executive.

130. Depreciation

a. The auditor will determine that capitalizations prior to activation of the contract and included in the base for depreciation are consistent with approved policy followed during contract operation. Charges to property accounts during

the contract period and included in the base for depreciation will be at cost as determined by accepted accounting policies and as approved by a responsible executive.

b. The auditor should review the depreciation charges for any evidence that such charges relate to idle plant or facilities, not reasonably required as stand-by equipment. This review should also be supplemented by such physical observation of the operations as is practicable and should be coordinated with the contracting officer who is ultimately responsible for determining the portion of the plant and facilities to be classified as idle.

c. The auditor will determine that retirements and sales are being properly handled—

(1) That sales, items scrapped, etc., are being promptly reported.

(2) That retirements are being properly cleared from property and reserve for depreciation accounts.

d. Depreciation charges will be reviewed and a representative number of individual calculations examined to determine—

(1) That rates used are in accordance with established policies and are reasonable.

(2) That rates are being applied against correct asset balances.

(3) That computations are accurate.

e. The auditor will determine that depreciation charges directly to the contract, or to overhead accounts which may affect the contract, are based on proper facts, and approved by responsible executives.

131. Accrued Expenses

a. The auditor will determine that the basis for accrual in each case is sound and in accordance with established policies.

b. Periodic checks will be made of a representative portion of the detailed calculations to determine their accuracy.

c. Supplementary checks will be utilized to the extent available. For example, accruals for unemployment taxes can be checked to pay rolls and to reports rendered to taxing authorities.

d. The auditor will determine that distributions affecting the contract, both directly and indirectly, have been approved by a responsible executive.

e. Checks should be made currently and at least

once a year to determine whether the liability accrued is accurately stated and whether adjustment of previous charges to the contract is necessary.

OVERHEAD

132. Introduction

a. In making his audit of overhead the auditor will be governed by the principles and guides set forth in paragraphs 7 and 13.

b. The audit of overhead claims must include determination that the charges applied to the contract are consistent with the statement of accounting policies submitted by the contractor and approved by the contracting officer. The scope of the audit should take into consideration the applicable internal controls and procedures of the contractor as appraised by the auditor. Continuous check must be made on the effectiveness of these internal controls and procedures.

c. It is essential that the overhead be audited currently both to avoid an accumulation of audit work and also to be sure that a proper margin of safety exists over amounts currently paid as progress payments.

d. In reviewing the overhead charges the auditor will find it helpful to have on hand some or all of the following papers which he may request of the contractor:

(1) Contractor's organization chart.

(2) Plant layout chart showing arrangement of departments and facilities.

(3) Copy of independent public accountant's report (detailed and condensed report).

(4) Copy of, or excerpts from the contractor's applicable Federal income tax return including supporting schedules.

(5) Copies of or excerpts from special reports filed with other Federal and State Government agencies such as the Securities and Exchange Commission.

(6) Copy of the contractor's final financial statements with pertinent schedules for each fiscal year or portion thereof during which operations were conducted under the contract.

(7) Copies of schedules used to control reserves and related expense accounts.

(8) Copies of reconciliations of differences between the contractor's Federal income tax return and his closing trial balance.

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133. Audit of Contractor's Overhead Accounts

a. The auditor should audit the contractor's overhead accounts currently. Such audit will include floor checks of indirect labor as well as current examination of invoices, credits, journal entries, inventory records, stock ledgers, cost records, analyses of depreciation, insurance, and other overhead accounts before the contractor's records have been closed for a particular accounting period. However, no approval of a final overhead claim will be made until the contractor's general ledgers, cost ledgers, and other subsidiary records show that—

(1) The ledgers have been formally posted, including general ledgers, cost ledgers, and other subsidiary ledgers. Entries made in pencil or analyses on working papers will not be considered a formal posting.

(2) The accounting statements have been prepared from the ledgers covering the particular period (monthly, quarterly, etc.) and have been approved by the contractor's accounting representative.

b. The auditor ordinarily will be provided with interim statements by the contractor setting forth the accounts which are to be included in the overhead pool and ultimately prorated to the contract. The auditor will use these statements as a guide to the analysis of the contractor's accounts.

c. In establishing the audit program for the audit of the contractor's overhead accounts, the auditor should develop his program in a manner which will enable the auditor to comply with the principles and standards set forth in paragraphs 189 to 203, inclusive.

d. In making analyses of individual accounts the auditor should indicate in his working paper schedules the items in the account actually checked and reconcile the audited and unaudited portions with the total of the account.

e. The auditor should review all miscellaneous income accounts to assure himself that credits which should be made directly to the contract are being made, and that all income attributable to the operations as a whole is being credited properly to overhead.

f. Comparisons will be made between Federal

tax returns and the books to ascertain major differences in accounting policies.

g. After the books have been closed, the auditor will obtain an analysis of the changes in surplus during the year to determine whether any credits should be applied to the cost of the contract.

h. The auditor should examine the minutes of the stockholders', directors', and executive committee meetings.

i. (1) When the contractor has followed a policy of charging items ordinarily treated as overhead directly to the contracts, the auditor should make sufficient tests to satisfy himself that the contractor has followed the principles and standards set forth in paragraphs 189 through 203, inclusive. The fact that these tests were made, together with their results should be included in the working papers.

(2) If the contractor has made direct charges to the contract or used a basis of allocation, which is not in agreement with the principles outlined in paragraphs 189 through 203 inclusive, the auditor must determine that the amounts approved do not exceed the amounts which could be claimed by the contractor through the application of approved principles. He should record his evidence in the working papers. Such deviations from cost interpretations require advance approval in accordance with the requirements of the service involved.

j. The auditor should investigate all major physical changes in the product, in plant lay-out, and in manufacturing methods during the performance of the contract. The results of the investigation should be recorded in the working papers together with conclusive evidence that, irrespective of the physical changes, the basis of allocating overhead results in charges to the contract consistent with the general principles referred to in paragraphs 189 to 203, inclusive, or that appropriate changes have been made in the basis to give effect to the changes.

k. In currently auditing the overhead accounts, it may be found that the approved accounting policies are not being followed. Other errors of procedure and general deficiencies may be discovered which should be corrected immediately. The auditor should inform the contractor through the contracting officer of these matters in writing. In

no instance should he allow the contractor to shift to him the burden of establishing allowable overhead charges.

l. When the contractor has included in the overhead pool an account containing expenses which cannot readily be segregated by the auditor between allowable and unallowable costs but a substantial portion of which appears to be unallowable, the auditor should disallow the entire amount and require the contractor to present those he considers to be allowable items.

m. In the audit of overhead, it is necessary that the results obtained in the audit of claims covering other types of costs be utilized. This is essential both because certain procedures of these other audits deal directly with charges which are included in the overhead pool and also because the overhead auditor must be familiar with the types of items being claimed as direct charges. It is the responsibility of the overhead auditor to coordinate these audit results and to trace them into the contractor's records. (See pars. 107e and 125e.)

134. Progress Payments

a. The auditor should determine that requests for progress payments on overhead are supported in the manner set forth in paragraph 24.

b. All requests for progress payments of overhead will be reviewed to determine that amounts requested are sufficiently under the amount of actual overhead to provide a proper margin of safety. In making this review, the auditor should utilize his current audit findings. (See par. 133.) However, as stated in paragraph 13c, these progress payments do not constitute a reimbursement of costs.

c. Before a progress payment rate for a current period based on cost information for a prior period can be approved, the contractor's books and records for such prior period must have been formally posted so that a reasonably accurate determination of the overhead rate may be based thereon. The auditor must have made sufficient examination of the records to determine a satisfactory margin of safety.

135. Audit of Overhead Claims

a. If settlements of overhead are made on a basis shorter than a fiscal year, the audit of such

claims presented by the contractor will be conducted in the same manner as that for year-end claims. If settlements are not made on the basis of the shorter periods but progress payments only are made, the year-end claims prepared by the contractor are the basis for settlements. These claims should reflect the progress payments and show the net balances which the contractor represents as amounts due from the Government.

b. The audit work on the overhead accounts carried out during the year provides the major basis for establishing the validity and accuracy of the year-end claim. The individual procedures should, however, be supplemented as necessary to satisfy the auditor as to the results for the entire year and as to compliance with the standards and principles set forth in paragraphs 189 to 203, inclusive.

c. The auditor will also determine that progress payments previously made are properly listed in the year-end statement.

d. The auditor should determine that physical inventories of supplies and indirect materials on hand in storerooms or on the floor are taken at the end of the fiscal year and the relative overhead accounts appropriately adjusted. If such inventories have not been taken, or, adjustment of accounts has not been made by the contractor, the auditor must consider the necessity of a suitable adjustment in the year-end overhead settlement.

e. An item may properly be included in overhead, if otherwise acceptable, when the amount of the liability for such an item has been definitely established or is based on a reasonably accurate accrual. The auditor should, however, utilize every means practicable to determine whether the obligation was stated with reasonable accuracy and should, where he deems it necessary, determine that actual payment was made in the amount stated.

f. Appropriate checks will be made to determine the accuracy and uniformity with which amounts or quantities used as the basis for proration of the final overhead claim (as, for example, direct labor dollars) are developed. Where possible, such amounts will be tied into results obtained through other audit procedures.

g. The accuracy of the overhead proration computations set forth in the claim will be established.

h. The auditor will determine that all distributions of overhead affecting the contract have been approved by responsible executives.

i. It is not the auditor's responsibility to make a calculation of the overhead for the contractor. However, the auditor may delete unallowable items of cost and approve the contractor's claim in accordance with paragraph 107a(2) when he feels that the contractor has made a conscientious effort to file a proper claim.

j. If the auditor finds that the contractor's presentation of overhead deviates so materially from the prescribed form and principles that it is wholly unacceptable, he should return the claim to the contractor through the contracting officer with a written statement of his specific objections to bases, methods, and related matters. The auditor should discuss the objections and acceptable alternatives with the contractor in order to avoid useless work by the contractor and to expedite the overhead settlement.

Section V. MISCELLANEOUS

CAFETERIAS, COMMISSARIES, CANTEENS, AND SIMILAR OPERATIONS

136. Introduction

a. The purpose of the auditing procedures relating to cafeterias, commissaries, canteens, and similar operations is to establish the credibility of the accounts, to ascertain that proper controls are in operation with regard to inventories and cash, and to determine that the net income from operations has been applied against the costs of the contract. These procedures may also be applied to the audit of cafeterias operated by concessionaires.

b. The procedures specified in this manual with respect to cash disbursements for pay rolls, invoices, etc., will, in general, be applicable. Those instructions will be followed to the extent practicable in conjunction with the special procedures set forth in this chapter.

c. The audit program will be based upon the findings made in the review of the internal procedures, and will be adjusted to current findings.

137. Invoices, Pay Rolls, etc.

a. A representative number of invoices will be examined to determine that they are approved for

prices and receipt of merchandise by responsible persons.

b. A representative number of pay rolls will be examined to check the number of employees, rates of pay, and approval by responsible persons.

c. A representative number of cash disbursement entries will be supported by paid invoices, petty cash vouchers, pay rolls, etc.

138. Control of Inventories

a. Where perpetual inventories are maintained, the auditor will determine that the inventories are being properly relieved of the cost of items withdrawn and losses through spoilage.

b. The auditor will check the physical inventories at appropriate intervals. This may be accomplished through supervision of the taking of inventories by contractors' employees.

139. Cash Receipts and Control of Revenue

a. The auditor will determine that receipts are being properly recorded at time of sale.

(1) A representative number of sales checks or tickets should be compared with cash register tapes.

(2) If a food checker is maintained, a representative number of day's cash receipts, as recorded, will be reconciled to the food checker's control totals.

b. Cash receipts as recorded at time of sale will be traced to book records.

(1) Compare totals of cash register tapes or other records with daily cash receipts recorded for a representative period.

(2) Check daily receipts to bank deposits for a representative period.

(3) Reconcile bank account if a separate bank account is maintained.

c. Compare statistics such as percentages of food costs to sales, expense ratios, etc., with ratios for previous periods.

d. In the event that costs of food and service appear to be excessive, explanations thereof should be obtained.

e. Where dormitories are operated, the rental charges and the collection of revenue should be compared with records of occupancy of rentable rooms for representative periods to determine that all revenue is properly credited.

f. Appropriate checks will be made to ascertain

that commissions from concessionaires are being received in accordance with the terms of the concessionaire's contract and are being applied according to approved accounting policies.

140. General

a. The auditor will trace the postings from cash receipts and cash disbursements records to the general ledger for representative periods.

b. The individual items shown on the contractor's summary reports will be traced to the general ledger.

c. The accuracy of the summary statements will be checked and the application of the net balance to the cost of the contract will be verified.

d. The operation of facilities under a service or management agreement which provides for payment of a fee on a percentage basis should be checked for the accuracy of the basis and calculation of the fee.

e. If the contractor pays to the Defense Plant Corporation any part of the net profits from the operation of a facility for the reason that the space or equipment used is owned by that corporation, such payment should be in accordance with a contract or agreement.

f. Check should be made of the control maintained on meals furnished to employees as part of compensation.

SCRAP

141. Introduction

The general responsibility for the control of scrap is that of the accountable property officer. However, the auditor should cooperate with this officer and should bring to his attention any findings with respect to scrap which result from the auditor's regular audit procedures.

142. Receipts From Sale of Scrap

a. All sales or other disposition should be reconciled by the auditor with the records of the account-

able property officer and checked to determine that credits therefrom are properly applied as a reduction of the cost of the contract.

b. In cases where it is not practicable physically to segregate scrap applicable to the contract, the bases of allocation should be reviewed to determine whether they are acceptable and accurately applied.

ADVANCE PAYMENTS

143. Introduction

a. The objective of the audit procedure with respect to advance payments is to determine that funds representing advance payments under the usual advance payment clause of supply contracts are used by the contractor exclusively as a revolving fund to carry out the purposes of the specific contract and not for other purposes.

b. The audit program will be based upon the findings made in the review of—

(1) The advance payment clause in the contract.

(2) The procedure prescribed by the service to be followed in effecting withdrawals from the advance payment bank account.

144. Control of Advance Payments and Reimbursements

The auditor will determine through maintenance of controls that the unliquidated balance of the advance payments outstanding under the contract, together with funds received by the contractor as reimbursement of costs, does not exceed the total estimated cost of the contract, exclusive of fixed fee.

145. Bank Account

The auditor will obtain monthly statements directly from the bank and have all reconcilements of the advance payment bank account made under his control.

CHAPTER 4

AUDIT PROCEDURES FOR COMPLETED COST-PLUS-A-FIXED-FEE
SUPPLY CONTRACTS

Section I. GENERAL

146. Applicability of Chapter

a. This chapter applies to cost-plus-a-fixed-fee supply contracts upon which all work on the contract, as called for by the original agreement and supplements or changes thereto, has been completed. This chapter is also applicable to cost-plus-a-fixed fee supply contracts terminated because of default on the part of the contractor.

b. The term "cost-plus-a-fixed-fee" contract as used in this chapter is applicable to the following:

- (1) Cost and cost-plus-a-fixed-fee war contract.
- (2) That portion of a fixed-price war contract which is on a reimbursable cost basis.
- (3) Letter orders, letter contracts, letters of intent, and letter purchase orders which provide for current reimbursement of allowable costs.

147. General Plan of Settlement

a. During the period which follows the cessation of the regular operations under the contract, the contractor should continue to present his claims in the regular manner for audit by the War Department auditor. The auditor should cooperate in every way practicable in effecting the prompt presentation and audit of such claims.

b. Amounts collected by the contractor for the Government, including those amounts received from sources referred to in paragraphs 151 to 168, inclusive, should be deducted from public vouchers. If this is not practicable, such amounts should be forwarded to the disbursing officer through channels in accordance with the instructions of the service involved.

c. During this period, the auditor should keep the contracting officer fully advised of both the

unliquidated balance of all advance payment funds and the estimates of reimbursed costs, to the extent reasonably available, in order that the contracting officer may authorize appropriate offsets as a means of reducing the unliquidated balance of such advance payment funds.

d. When substantially all determinable costs have been presented and the contracting officer and contractor have agreed upon a settlement date, the auditor, upon notification in writing by the contracting officer, will prepare a closing statement as a basis for the settlement agreement. This closing statement should be prepared in the form outlined in paragraph 168. The closing statement, together with supporting schedules and other data should be prepared in sufficient number to include at least two copies for Governmental purposes.

e. In some cases, it will be desirable to close the field audit office at the contractor's plant prior to the settlement date and transfer the audit records to area or district offices. In that event, the closing statement and the procedures set forth in this chapter may also properly be used as a guide for an interim report covering the status of the audit at such an interim date.

f. It is recognized that particular types of claims not yet determinable may be excluded under the terms of the settlement agreement. When claims of these types subsequently arise, they should be presented in accordance with the requirements of the individual service involved.

148. Contractor's Statement of Accounting Policies Covering Settlement Expenses

a. It is recognized that, after the items or services called for under the supply contract have been manufactured or furnished, certain further ex-

penditures may be incurred by CPFF contractor in completing the contract. Such expenditures will represent chiefly the cost of taking inventory, disposing of scrap, salvage, and excess materials, removal of Government-owned equipment from the plant, and preparation of final reimbursement vouchers.

b. In order that a proper audit of such costs can be made, a supplementary statement of accounting policies should be obtained from the contractor as the contract nears completion, covering the types of costs which it is expected will be incurred after the items called for under the contract have been completed and covering the methods proposed by the contractor for recording, computing, and allocating such costs. Such a supplementary statement of policies is particularly essential where there is continuing work other than CPFF contracts.

c. The contractor's supplementary statement of accounting policies should be studied and reviewed by the auditor in the light of the provisions of the contract, accepted accounting principles, requirements of TM 14-1000, and the requirements of the service involved. The auditor should bring to the attention of the contracting officer all aspects of the contractor's statement which are not in accordance with these principles and requirements. The contracting officer should be requested to secure from the contractor the necessary amendments to the statement of policies and should then be requested to approve in writing to the auditor the contractor's statement as amended. The contractor's statement of policies, as approved by the contracting officer, should then be used by the auditor as a basis on which to formulate a program for the audit of costs incurred after the items called for under the contract have been completed.

149. Settlements of Subcontractor Claims

a. Settlements of fixed-price subcontracts terminated or canceled in whole or in part for any reason except the default of the subcontractor will be audited and reimbursed in accordance with the provisions of the Joint Termination Accounting Manual and paragraph 180 of this manual.

b. Settlements of completed CPFF subcontracts under CPFF prime contracts will be made in accordance with the provisions of this chapter.

150. Auditing Procedures for Completed CPFF Contracts

The applicable auditing procedures as set forth in the preceding chapters of the manual will be followed in auditing all claims presented by the contractor relating to the completion and settlement of the contract. In addition, the special procedures outlined in paragraphs 151 to 168, inclusive, will be applied in connection with the preparation of a closing statement. These special procedures may also be utilized as a guide in connection with the preparation of any interim settlement report.

Section II. SPECIAL PROCEDURES FOR AUDIT OF COMPLETED COST AND CPFF CONTRACTS

151. Advance Payment Fund

a. The auditor should determine that the unliquidated balance of the fund (the outstanding obligation of the contractor) is accurately reflected in the closing statement set forth in paragraph 168. As a part of this verification, the balance should be supported by schedules (to the extent such schedules have not been submitted for prior periods) showing all advances made and other increases and all reductions resulting from offsets of approved claims or repayments. The auditor should also verify the balance directly with the disbursing officer.

b. The contractor should present a schedule accounting for the unliquidated balance of the advance payment fund. This schedule will show the bank accounts, unreimbursed expenditures, or other elements making up the total unliquidated balance.

152. Closing of Restricted Bank Accounts

a. The procedures set forth in this paragraph are to be followed by the auditor in closing restricted bank accounts containing funds advanced for the use of the contractor. They are also recommended as a guide for the closing of other separate bank accounts containing funds advanced by the Government but not controlled by the contracting officer.

b. Activities normally carried out by the auditor during the operation of the contract with re-

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spect to the restricted bank accounts should be continued after the cessation of regular operations. In general, these activities include:

(1) Periodic reconcilments of the bank accounts.

(2) Determination that all funds have been deposited to the credit of the restricted bank accounts as required by the advance payment fund agreement.

(3) Determination that all withdrawals have been approved by the contracting officer or the fiscal officer.

c. Preparations should be made for the closing of restricted bank accounts sufficiently in advance of the settlement date referred to in paragraph 147 that the closing will have been completed by that date. In this connection, the following procedures are applicable:

(1) A date should be agreed upon after which no further checks will be issued.

(2) Every effort should be made to locate the holders of outstanding checks and determine why the checks in question have not been cashed.

(3) After a reasonable period of time, the contractor should send formal notices to all payees of checks issued which have not cleared the bank stating that payment will be stopped on *all* checks not presented for payment by the designated date.

(4) On the designated stop payment date, the contractor should formally notify the bank to stop payment on all checks not yet cleared and the holders of checks should be advised as to the procedure of the particular service involved for obtaining payment.

(5) A final reconciliation of each bank account should then be completed.

(6) The balance per the bank should ordinarily be transferred to the disbursing officer and applied as a reduction of the contractor's advance payment obligation, except in those cases where such application is not needed or where for other reasons the contracting officer authorizes other action.

153. Unclaimed Wages and Unclaimed Checks Other Than for Pay Roll

Upon agreement by the contractor to release the Government from all future claims in connection

with unclaimed wages or unclaimed checks other than pay roll, the contracting officer is authorized to negotiate a lump sum settlement therefor. In the unusual situation where an agreement between the contracting officer and the contractor as to settlement for unclaimed items cannot be reached, the applicable procedures set forth below will be followed.

a. In the case of a mixed plant where some costs are reimbursed on a distribution basis, the overhead pool, for the final period will be reduced by the amount of such unclaimed wages as the contracting officer determines will not be claimed. Similar treatment should be given unclaimed checks other than pay roll when the unclaimed checks resulted from transactions occurring during the operation of the contract. However, if it can be shown that the unclaimed check resulted from a transaction that was a direct charge to the contract or to the contractor's other work, the amount of the check should be credited in full accordingly.

b. The following actions will be taken in the case of a Government-owned, contractor-operated plant engaged solely on CPFF work, as well as a 100 percent CPFF contractor-owned plant. A 100 percent CPFF contractor-owned plant, for this purpose, is a division or plant which engaged exclusively on CPFF work and for which separate basic accounting records were maintained.

NOTE: The determination as to whether the unclaimed items shall be handled under *a* or *b* above will depend upon the status of the plant at the time of the incurrence of the charges in question.

c. UNCLAIMED WAGES. Unclaimed wages will include pay roll checks or cash undelivered to employees, as well as pay roll checks delivered to employees but outstanding at the time of the final closing of the pay roll bank account on which payment will be stopped in accordance with paragraph 152c(4).

(1) A pay roll will be prepared covering all unclaimed wages under the completed contract. This pay roll will be known as the "Unclaimed Wages Register," and the heading thereof will include the name and location of the establishment, the name of the contractor, the contract number, and the name and location of the bank on which the checks were drawn.

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(2) The detailed information furnished in the Unclaimed Wages Register and the alignment thereof will be in accordance with instructions issued by the individual service. However, the information will include, as a minimum, the period covered by the pay roll, pay roll number, page number, line number, bureau voucher number, D. O. voucher number, date paid by disbursing officer, name of employee, badge number, occupation, social security number, hours worked straight time, hours worked overtime, total pay hours, rate, gross earnings, pay roll deductions in detail, net amount paid, check number, and date of check.

d. UNCLAIMED CHECKS OTHER THAN PAY ROLL. This category will include all checks outstanding at the time of final closing of the bank accounts, other than pay roll checks and checks issued to refund employees' savings deposits.

(1) A statement will be prepared covering all outstanding checks, as described above, under the completed contract. This statement will be known as the "Final Statement of Outstanding Checks Other than Pay Roll Checks and Savings Deposits Refund Checks," and the heading thereof will include the name and location of the establishment, the name of the contractor, and the contract number.

(2) The detailed information furnished in the statement and the alignment thereof will be in accordance with the instructions issued by the individual service. However, the information will include, as a minimum, the name of the payee, brief description of the material furnished or service rendered, references to the contractor's related documents, bureau voucher number, D. O. voucher number, date paid by the disbursing officer, contractor's check number, amount of check, and name and location of bank on which drawn.

e. If unclaimed wages or unclaimed checks other than pay roll and savings refunds were deducted from a subsequent reimbursement voucher, there should be shown: the bureau voucher number, the D. O. voucher number, and the date on which payment was made of the reimbursement voucher from which the deduction was made. Unclaimed reimbursed items which were not subsequently recouped from the contractor should be charged to the contractor in the closing statement (par. 154), and pertinent references thereto included alongside the applicable items in the above lists.

f. The total amount of the unclaimed and unpaid items will be set up in the reserve for settlement of claims account under the applicable appropriation in accordance with the provisions of chapter 7, TM 14-702. In connection with these particular items, no further credits of unclaimed amounts will be set up in the trust fund receipt account 218990 after 15 March 1946.

g. The officer or civilian regularly certifying vouchers for reimbursement to the contractor will execute on the above lists a certificate in the following form:

I certify that the above is correct and just to the best of my knowledge and belief; that neither (name of contractor) nor any of the individuals named hereon has received reimbursement for these amounts; that the amounts set forth hereon are due the persons listed; that the amounts due are for settlement by the General Accounting Office under Section 305 of the Budget and Accounting Act.

The above certificate also should be signed by a duly authorized official of the contractor whose title should appear under his signature.

h. After preparation and payment of the final Standard Form 1034, vouchers as provided in paragraph 168, the original and two copies of the lists of unclaimed wages and checks will be forwarded to the disbursing officer designated to make payment under the contract completed. The designated disbursing officer will certify on the lists that "Payment has not been made and will not be made of the amount of unclaimed and unpaid items shown hereon." The disbursing officer will retain one of the copies in his files and will transmit the original and the remaining copy to the Office of the Chief of Finance, Attention: Receipts and Disbursements Division, Washington 25, D. C., together with evidence of the establishment in the reserve for settlement of claims of the amounts involved as required by TM 14-702. A copy of the lists will be furnished the contractor and a copy retained in the Government auditor's files for permanent War Department storage with other contract files. Such other copies of the lists will be furnished as desired by the individual service.

i. In connection with the closing of a completed contract, the preparation of the lists should be one of the last acts, so that no changes or corrections thereon will be necessary. Any claims for unpaid wages or checks after the procedures in *h* above

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have been carried out will be forwarded directly to the Claims Division, General Accounting Office, Washington 25, D. C., for settlement.

154. Certificates of Evidence of Payment

a. Under the provisions of paragraph 28a (4), deduction will currently have been made for checks covering direct charges not cleared within 90 days from date of issuance. At the settlement date, care must also be exercised that any other uncleared checks covering direct charges as indicated either by the reconciliation of the restricted bank accounts, or of bank accounts controlled by the contractor, have been deducted from vouchers or charged to the contractor in the closing statement. It should also be ascertained that no amounts included in the list of outstanding checks for which the contractor has not been reimbursed are included as costs in the closing statement. If the contractor is later required to make payments to the State under an escheat law, he will present his claim for reimbursement at that time.

b. After carrying out the procedures set forth in a above, Certificates of Evidence of Payment should be completed on all vouchers covering direct charges for which such certificates have not previously been issued.

155. Fixed Fee

The amount of the fixed fee earned is determined by the contracting officer in accordance with the terms of the contract and supplements or change orders thereto. The auditor should assist the contracting officer in every practicable manner and should ascertain that the total fee determined to be earned does not exceed the terms of the contract. The auditor should also summarize the fee payments previously made and calculate the balance to be included in the closing statement.

156. Summarization of Costs

The auditor will have currently summarized all costs presented and reimbursements made thereon, in accordance with such classifications as are prescribed by the particular service. Where offsets have been made against Standard Form 1034, reimbursement vouchers to recover amounts due for such items as scrap sales, disallowances, etc., and information with respect to such offsets was not

currently maintained, it normally will be satisfactory for closing statement purposes to use the net reimbursement figures without identifying and restating the deductions.

157. Interest on Advance Funds

Where the contract provides for interest to be paid for funds advanced by the Government, it should be determined by the auditor that such charges have been calculated by the office preparing the expenditure voucher (the fiscal component or the disbursing officer) and recovered from the contractor. If there is an unliquidated balance of the advance payment fund at the settlement date, the final amount will be calculated by the disbursing officer at the time of payment of the voucher on which final recoupment is made and the interest due will be deducted on that voucher by the disbursing officer.

158. Penalties Applicable to Contractor

When the contractor has defaulted in the performance of the contract and under the terms of the contract a penalty has been established by the contracting officer, it should be determined by the auditor that this charge is incorporated in the closing statement.

159. Government - Owned Property Connected with Contract

a. Instructions in regard to accounting for Government property at contract completion are set forth in TM 14-910. The auditor should cooperate with the accountable property officer and render him accounting counsel if requested by the contracting officer. In accordance with TM 14-910, the responsibility for the property records and the property inventories is that of the accountable property officer and therefore the auditor's responsibilities in this connection will be advisory in character.

b. The auditor should determine that credit is given to the Government for the amount of sales of Government property approved by the contracting officer.

c. In the case of every settlement, the auditor should request the contracting officer to advise him in writing whether there are any unsettled charges outstanding against the contractor for loss, dam-

age, or destruction of property under the provisions of TM 14-910. The auditor should then ascertain that the amount of such charges, as determined by the contracting officer and reported to the auditor in writing, is reflected in the closing statement.

160. Outstanding General Accounting Office Informal Inquiries and Exceptions

a. Prior to the settlement date, every effort should be made to answer satisfactorily all informal inquiries and exceptions raised by the General Accounting Office. If informal inquiries are still outstanding as the settlement date approaches, it is desirable that a decision be obtained from the General Accounting Office in the way of clearance.

b. In accordance with existing instructions to disbursing officers, exceptions, other than pro forma, will normally have been offset against other vouchers. In the event, however, that there should be any uncleared formal exceptions at the settlement date, such exceptions should be included in the closing statement as a charge to the contractor.

161. Materials Received or Services Rendered and Not Billed

a. Every effort should be made by the contractor prior to the final settlement to secure invoices from vendors for materials received or services rendered and not billed.

b. Where billing is not obtainable, a list should be prepared by the contractor showing the date the material or service was received, receiving report number (where applicable), vendor's name, and other pertinent information.

162. Uncompleted Purchase Orders

Wherever possible, all uncompleted purchase orders pertaining directly and solely to the contract should be settled by waiver or other appropriate means and releases in writing obtained by the contractor. All other uncompleted purchase orders pertaining directly and solely to the contract should be listed by the contractor showing the date; purchase order number; vendor's name; quantities, description and prices of each item on which delivery is incomplete; quantities received; and reasons or explanations, if any, as to why the purchase order was not completed. This list

should be supported by copies of purchase orders bearing the usual approvals by contractor personnel.

163. Additional Liabilities

Where the settlement agreement excludes particular items or types of items which are contingent in nature or for any other reason are indeterminable at the settlement date, it is essential that a complete statement be prepared by the contractor covering all available information which is pertinent to the items excluded and which may be of value to the Government in determining proper payment at any later date.

164. Insurance Premiums Charged to Contract

a. Where insurance has been written under the War Department Rating Plan, the War Department Group Insurance Plan, or other plans under the general supervision of the Office of the Chief of Finance, the auditor should determine that settlements made with carriers, or under self-insurance plans, are approved by the contracting officer and reflected in the closing statement.

b. In the above cases and with respect to other insurance not so supervised, the auditor should determine that all refunds, dividends, premium adjustments or any other premium credits set forth in the insurance settlements, or otherwise due, have been reflected in the closing statement, and where rights exist covering any future amounts, that such rights have been assigned to the Government.

165. Miscellaneous Credits to Contract

a. It should be determined that all credits, refunds, etc. applicable to the contract have been properly recognized and credited to the Government. Every effort should be made to bring to a conclusion all unsettled items but in cases where that result is not possible, assignments should be secured covering the interests of the Government in such credits.

b. The following are illustrative of the types of credits to which the auditor should direct his attention:

(1) Refunds from or charges against vendors and other subcontractors for items returned for credit, shortages, defective items, rework-vendor-responsibility, substitutions, etc.

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(2) Collections from or charges against insurers and carriers for lost or damaged property, cost of repairs, etc.

(3) Discounts.

(4) Miscellaneous income required to be applied as a reduction in contract cost; for example, scrap, income from vending machines, cafeterias, etc.

(5) Amounts received from vendors representing distributions to eliminate excess profits made pursuant to their renegotiation agreements with Government agencies or otherwise.

(6) Other credits to the contract such as over reimbursements on taxes, vacation pay, etc., which have not been otherwise recovered by the Government.

(7) All possible refunds from any reimbursement which may have been made out of Government funds as, for example, in the case of deposits on containers and unexpired portions of prepaid expenses.

166. Special Procedures Where All Work at 100 Percent Plants Is Completed

a. In cases where all work is completed at 100 percent CPFF plant, certain special procedures are applicable at the date of settlement. A 100 percent CPFF plant for this purpose is a division or plant engaged exclusively on CPFF work immediately prior to the date of completion and for which separate basic accounting records are maintained.

b. Any deposits unclaimed by separated employees for tools, clothing, badges, etc., should be listed showing the date and nature of the deposit, the amount, and the employee's name and badge number. Such deposits should then be properly credited to the Government in the closing statement and any obligations with respect thereto will be assumed by the Government.

c. Final reports should be prepared covering social security and other taxes and payment properly transmitted to the Governmental office involved.

d. Unclaimed savings deposits and bonds of separated employees should be disposed of as follows:

(1) Upon agreement by the contractor to release the Government from all future claims in connection

with unclaimed savings deposits, the contracting officer is authorized to negotiate a lump sum settlement therefor. In those instances where an agreement between the contracting officer and the contractor as to settlement for unclaimed savings deposits cannot be reached, the contractor should prepare a list of the unclaimed deposits, draw a check payable to the Treasurer of the United States for the total amount thereof, and transmit the check to the Government auditor, who will forward the check to the disbursing officer with the request that the amount be credited to the reserve for settlement of claims under the applicable appropriation. The statement of unclaimed savings deposits will be prepared in the same manner as prescribed for unclaimed wages in paragraph 153d., except that the information furnished on the statement will be limited to the following: item number, employee, occupation, social security number, badge or pay roll number, latest known address, and amount of unclaimed deposit. The statement will be certified, and copies thereof distributed, as outlined in paragraph 153. Any claims for unrefunded savings deposits after the procedures set forth above have been carried out will be forwarded directly to the Claims Division, General Accounting Office, Washington 25, D. C., for settlement.

(2) The contractor should prepare a list of all bonds not delivered to the contractor's separated employees showing the name of the bondholder and co-owner or beneficiary, serial number, and description of bond and any information developed in tracing nondelivery of the bond. Five copies of this list with the bonds attached should be forwarded through the contracting officer to:

Section of Investments
Bureau of Accounts
Treasury Department
Washington 25, D. C.

It should be requested that two copies of the list be receipted and returned, one to be retained by the contractor and one by the contracting officer.

e. Final reports should be obtained from the contractor covering all operations of cafeterias, canteen, commissaries, guest houses, etc., and final credits therefrom, as determined by final audit, incorporated in the closing statement.

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167. Overhead Settlements in Mixed Plants

a. The general standard is that all overhead accounts should be closed as of the end of the month in which production under the contract is completed. However, it is recognized that by the time a settlement date has been reached the results of the overhead audit of the year in which the contract was completed will ordinarily be available and the use of such results will generally be acceptable, provided the tests of accuracy set forth in paragraphs 189 to 203, inclusive, are observed. Where such annual rates are not acceptable and it is therefore necessary that the overhead accounts be closed at the end of the month in which production under the contract is completed, the overhead audit should be carried out and

settlement made in accordance with the general procedure for year-end overhead settlements as outlined in paragraphs 95 to 145, inclusive.

b. In respect to refunds, dividends, premium adjustments, or other premium credits of a material nature under insurance settlements, referred to in paragraph 164, the auditor should determine that the participation of the Government is in the same proportion as the Government's contribution to the original premium for the policy from which the return premium results.

168. Form of Closing Statement

a. The closing statement should be prepared by the auditor in substantially the following form:

CLOSING STATEMENT

Date Prepared.....		19....
Contractor.....		
Work covered by contract.....		
Contract No.....	Date of contract.....	19....
If contractor is a subcontractor show:		
Prime contractor.....	Prime contract No.....	19....
Figures from inception of contract to.....		
A. COMPUTATION OF BALANCE DUE CONTRACTOR.		
1. Total fixed fee earned as determined by contractor officer (par. 155)	\$.....	
2. Fee payments previously made (par. 155)		\$.....
3. Unpaid balance of fixed fee (1-2)		\$.....
4. Total reimbursable costs under contract (par. 156)	\$.....	
5. Cost reimbursement received		\$.....
6. Add progress payments on unsettled overhead		
7. Total payments on costs (5+6)		
8. Balance due on cost (4-7)		\$.....
9. Total (3+8)		\$.....
10. Proceeds from sales of Government property, including allowance for that retained by contractor (par. 159)	\$.....	
11. Property not accounted for to Government accountable property officer (par. 159)		
12. Miscellaneous charges against contractor (pars. 154, 158, 159, 164, 165, and 166)		
13. Unliquidated balance of advance payment fund as of date of payment (par. 151)		\$.....
14. Total deductions (lines 10 through 13)		\$.....
15. Balance payable to the contractor or balance due Government at settlement date (9-14), exclusive of additional interest on advance payment fund, if any		
16. Interest due on advance payment fund (par. 157)		\$.....
17. Balance payable to the contractor (by disbursing officer) (15-16)		\$.....
B. SUPPLEMENTARY INFORMATION.		
1. Other known liabilities (pars. 154, 161, 162, and 163)		\$.....

The various items in the closing statement should be supported by schedules and other data in accordance with the requirements of the particular services.

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b. Separate public vouchers will be prepared by the contractor for fixed fee, overhead settlement claims and for balances due on other unreimbursed costs in accordance with the requirements of the service involved. On the overhead voucher, overhead progress payments will be deducted on the applicable Standard Form 1035. Credits due the Government for items included in lines 10 to 12 inclusive of the above closing statement will be deducted on Standard Form 1035 of any public voucher or vouchers. The unliquidated balance of the advance payment fund *will not* be deducted on Standard Form 1035 but will be indicated on the

face of Standard Form 1034 in such a manner that it will be clear to the disbursing officer that a recoupment is to be made to liquidate the advance payment fund. In the event the advance payment agreement calls for interest, Standard Form 1034 should likewise indicate that interest due on the advance fund is to be recouped by the disbursing officer.

c. The original copy of the closing statement and supporting schedules in connection therewith should be attached to the last Standard Form 1034 voucher covering an amount due the contractor in the settlement.

CHAPTER 5

AUDIT PROCEDURES FOR TERMINATED COST AND
COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS**169. Purpose and Application**

a. The purpose of this chapter is to set forth the principles and procedures for the presentation and audit of costs and settlement proposals arising out of the termination of:

(1) Cost and cost-plus-a-fixed-fee prime contracts and cost and cost-plus-a-fixed-fee subcontracts thereunder.

(2) That portion of a fixed-price war contract which is on a reimbursable cost basis, where the estimated cost of that portion exceeds 50 percent of the fixed-price portion, if the cost portion is terminated either in whole or in part, or if the fixed-price portion is terminated in whole.

(3) Letter orders, letter contracts, letters of intent and letter purchase orders which provide for current reimbursement of allowable costs. (See JTR 560.1.)

b. The term "cost-plus-a-fixed-fee contract" as used in this chapter includes the various types of contracts listed in *a* above.

170. General Policies for Settlement of Terminated CPFF Contracts

a. JTR 560-569 sets forth the basis for settlement of terminated cost-plus-a-fixed-fee contracts. As stated in JTR 562.1 (1), it is the policy of the War Department that settlements be complete and final. Settlements should be by agreement to the maximum extent feasible, but to the extent that contracts cannot be settled by agreement they must be settled by determination as provided in JTR 515.3 and 568.

b. As stated in JTR 562.1 (2), each complete and final settlement, either by agreement or determination, should include not only unreimbursed costs and fixed fee but also, for the purpose of

finality, reimbursed costs under the contract. "Reimbursed costs" is defined in JTR 560.3 (3) as payments on Standard Form 1034 cost vouchers to a war contractor for costs, audited and allowed by the War Department up to the time of payment of the last Standard Form 1034 cost voucher under the contract, whether or not subsequently recovered from the contractor as the result of a General Accounting Office exception. It is also specifically stated that progress payments on unsettled overhead will not be regarded as reimbursed costs.

c. In those instances where a negotiated settlement cannot be reached between the contracting officer and the contractor for unclaimed wages, unclaimed checks other than pay roll, and unclaimed savings deposits, the same respective procedures will be followed as are outlined in paragraphs 146 to 168, inclusive, except that where reference is made in paragraphs 146 to 168, inclusive, to the "closing statement," the words "termination settlement" will be used.

171. General Procedures for Submitting Costs After Termination

a. As provided in JTR 563.2, upon the effective date of complete termination, or in the case of a partial termination, upon receipt of notice from the contracting officer that performance is complete or that performance on any continued portion is only on subsidiary items or spare parts, or is otherwise not substantial, the contractor shall promptly discontinue the presentation of Standard Form 1034 cost vouchers, except reclaim vouchers, and except as provided in *c* below.

b. After the discontinuance of Standard Form 1034 cost vouchers, the contractor will begin to submit his costs on the form set out in JTR 965 designated "Settlement Proposal for Use on Terminated Cost and Cost-Plus-A-Fixed-Fee Con-

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tracts" (War Department Form 70 (Settlement Proposal)). These settlement proposals will not be sent to the disbursing officer inasmuch as no payments will be made directly on the basis of these proposals. Payments to the contractor will be made only on Standard Form 1034 vouchers for the following:

(1) Reclaim vouchers covering items previously disallowed by the General Accounting Office and for which collection has been made from the contractor by deduction or refund, but now authorized for payment by the General Accounting Office and the Office of the Chief of Finance. (See JTR 561.3.)

(2) Partial payments. (See JTR 340-369.)

(3) Partial settlements. (See JTR 515.3, 562.3, and 564.2.)

(4) Final settlements. (See JTR 563 and 564.)

c. As provided in JTR 563.2, a contractor otherwise entitled to use settlement proposals may elect to continue presenting all costs on Standard Form 1034 cost vouchers but he may at any later time elect to discontinue the use of such vouchers. A contractor who elects to discontinue Standard Form 1034 cost vouchers will not be permitted to resume the use of such vouchers. However, a contractor will not be permitted during the same period of time to use both Standard Form 1034 cost vouchers and settlement proposals in presenting his costs.

d. The auditor will be guided by the determination of the contracting officer in writing as to the point at which the use of the settlement proposals is to be made effective.

172. Treatment in Settlement of General Accounting Office Informal Inquiries and Exceptions

a. In those cases where the final settlement includes reimbursed costs, JTR 563.4 provides for an audit status date at or before which the General Accounting Office will give a final report on the status of its audit. As stated in JTR 563.5, it is essential that every effort be made by the contracting officer to answer promptly any informal inquiries and exceptions from the General Accounting Office issued with respect to reimbursed costs up to the audit status date, and to forward

reclaim vouchers as promptly as possible. The auditor should assist the contracting officer in every way practicable in answering General Accounting Office exceptions.

b. JTR 563.6 provides that the final settlement may include all claims of the Government and the contractor under the terminated contract whether or not audited by the General Accounting Office except reimbursed costs which are the subject of a General Accounting Office exception outstanding on the audit status date and remaining uncleared; a General Accounting Office exception cleared by deduction or refund and as to which the contractor has not presented a reclaim voucher; or a reclaim voucher not authorized for payment by the General Accounting Office. The contracting officer may, however, if the contractor so requests, refer any costs not authorized for inclusion in the settlement to the Readjustment Branch, Director, Service, Supply, and Procurement, W. D. General Staff, who may apply to the Under Secretary of War for instructions.

c. JTR 563.6 also provides that in negotiating the settlement no unreimbursed cost will be allowed which is identical in nature to an item of cost required to be excluded from the settlement because of the restrictions set forth in b above.

173. Preparation of Partial Settlement Proposals by Contractor

a. Costs should be presented on the partial settlement proposal (see illustration in JTR 965) in a similar manner to that followed in preparing Standard Form 1034. The use of the item classification on each partial settlement proposal is optional with the services. As a minimum, the total of the partial proposal must be shown on line 19, column 3, supported by a second sheet prepared in the same form as was previously followed in preparing Standard Form 1035.

b. The documentary evidence requirements set forth in section II, chapter 1, except paragraph 28, and except as set forth in paragraph 175d, are also applicable to partial and final settlement proposals but the required documentary evidence is presented and maintained for War Department administrative purposes only. Only one copy (the original) of each required supporting docu-

ment will be submitted, irrespective of previous practice.

c. Partial settlement proposals containing final overhead settlements will be supported by appropriate schedules and analyses as set forth in paragraph 88. In these cases, as a minimum, the gross amount of the overhead represented to be applicable to the contract for the period involved should be shown on the proposal, and the progress payments previously made on Standard Form 1034 shown in line 15, column 3 of the same form.

d. The contractor will number each partial settlement proposal serially, beginning with the number "1" and will maintain a separate number series for each cost-plus-a-fixed-fee contract. (See JTR 565.) A minimum of two copies of each proposal will be furnished to the auditor by the contractor.

- | | | |
|---|---------|---------|
| 1. Costs claimed (excluding fee). | | |
| a. Reimbursed on public vouchers before adoption of settlement proposal (War Department Form 70) procedure (excluding progress payments on unsettled overhead)—(see line 8c below). | \$----- | |
| b. Partial settlement proposals (War Department Form 70) submitted covering costs. | ----- | |
| c. Reclaim vouchers for which reimbursement has not been received. | ----- | |
| 2. Total costs claimed (1a through c). | | \$----- |
| 3. Total fixed fee claimed. | | |
| 4. Gross proposal (2+3). | | \$----- |
| 5. Less: Deductions not reflected in amounts shown under item 1. | | |
| a. Property not accounted for to Government accountable property officer. | \$----- | |
| b. Proceeds from sale of Government property including allowance for that retained by contractor. | ----- | |
| c. Miscellaneous charges. | ----- | |
| 6. Total deductions (5a through c). | | \$----- |
| 7. Net settlement cost. | | \$----- |
| 8. Less payments previously received. | | |
| a. Fixed fee public vouchers. | \$----- | |
| b. Progress payments on unsettled overhead. | ----- | |
| c. Other public vouchers, before adoption of settlement proposal (War Department Form 70) procedures. (See 1a.) | ----- | |
| d. Partial payments. | ----- | |
| e. Partial settlements. | ----- | |
| 9. Total payments previously received. | | ----- |
| 10. Balance (7-9). | | ----- |
| 11. Less advanced payment funds. | | |
| 12. Balance. | | \$----- |
| 13. Interest due on advance payment fund, if any, as of final settlement date. | | ----- |
| 14. Net termination claim. | | \$----- |

d. In preparing the exhibit set forth in c above, the following guides are applicable.

(1) The amounts shown on each line should be supported with schedules or other data in accordance with the requirements of the particular service.

174. Preparation of Final Settlement Proposal by Contractor

a. When the contractor has submitted all his partial proposals for settlement, he will present his final proposal for settlement, including a summary and recapitulation of such partial proposals, supported by other appropriate information.

b. A final settlement proposal should be prepared on the regular settlement proposal form (JTR 965) with the "final" space checked as provided on that form. The amount of the total settlement proposals for the entire contract should then be shown on line 19, column 4 of the proposal.

c. The final settlement proposal should be supported by an exhibit in substantially the following form:

(2) Where offsets have been made against Standard Form 1034, reimbursement vouchers to recover amounts due for such items as scrap sale credits, disallowances, etc., it normally will be satisfactory to use the net reimbursement figures without identifying and restating the deductions.

175. Auditing Procedures for Partial and Final Settlement Proposals

a. The auditing procedures to be carried out in connection with partial and final settlement proposals under terminated CPFF contracts are the same as those set forth in the chapters of this manual covering going and completed CPFF contracts, except so far as special procedures are set forth in this chapter.

b. JTR 563.6(3) provides that in negotiating the settlement, the provisions of the particular contract governing the types of reimbursable costs shall constitute the basis of negotiation. In his audit of partial settlement proposals, the auditor will therefore be guided, in general, by the same principles and standards as would have been applicable to the contract had it not been terminated. If costs are submitted which have previously been disapproved by the auditor because they were considered to be ineligible types of cost, they will be recommended for nonacceptance unless additional written evidence is presented by the contractor which establishes eligibility of the item to the satisfaction of the auditor.

c. In the audit of costs covering direct charges to the contract presented on partial settlement proposals, the procedure applicable in the case of Standard Form 1034 voucher that payment must have been made by the contractor, is no longer a mandatory requirement. An item of cost which is otherwise acceptable may therefore be recommended for acceptance if, in the opinion of the auditor, a definite liability exists on the part of the contractor. This same principle has been applicable in the case of costs included in overhead on going contracts and continues to be applicable in the case of overhead settlements presented on partial settlement proposals.

d. In making the determination that a definite liability exists, reliance will be placed on the documentary evidence which, except for paragraph 28, is required to be submitted by the contractor. However, those documentary requirements may be waived with respect to particular items of costs in specific vouchers when, in the opinion of the auditor, the effort of obtaining the regular documentary evidence is not warranted by the amount involved and there is other satisfactory evidence

to support the contractor's representation that a cost has been incurred.

e. It is the auditor's responsibility to identify and disclose costs presented on partial and final settlement proposals which are identical in nature to other items of cost under the contract covered by exceptions or reclaim vouchers and not allowed by the General Accounting Office. Such costs should be recommended for nonacceptance if the auditor concurs in the exception and for further consideration if the auditor disagrees with the exception. In those cases where partial proposals have been audited prior to the issuance of exceptions or presentation of reclaim vouchers, it will be necessary to reexamine such partial proposals to determine that costs of an identical nature are properly disclosed.

f. The auditor will not indicate audit approval on the partial and final settlement proposals and supporting exhibits. Deletions will not be made on the forms, and audit adjustment sheets as such will not be prepared. The auditor will currently advise the contracting officer of his findings in a partial settlement report covering each partial proposal to be prepared in the manner set forth in paragraph 176. The auditor will also maintain a register covering partial settlement proposals which is separate from his register of public vouchers and which will be in such form as is prescribed by the individual service.

g. In auditing contractors' partial or final proposals for settlement, it is the function of the Government auditor to audit and analyze facts relative to the proposal, make reports, and render accounting counsel to the contracting officer for this officer's assistance in negotiating a settlement. While the auditor makes his determination independently of the contracting officer as to whether the costs claimed were incurred and are in accordance with the terms of the contract, the auditor's findings are advisory in nature and the responsibility of making the settlement is that of the contracting officer.

176. Reporting Procedure—Partial Settlement Proposals

a. The form and content of the report covering a partial settlement proposal may properly vary, depending upon the amount involved and the com-

plexity of the settlement proposal being reviewed. However, the following plan of arrangements will serve as a general guide to be followed:

(1) The heading will conform to the requirements of the particular service involved. Ordinarily, it will contain the date, name of the contractor, number of the contract, partial settlement proposal number, and the name of the contracting officer to whom it is addressed.

(2) A statement that the partial settlement proposal has been audited in accordance with TM 14-1000.

(3) Summary schedule of contractor's partial proposal for settlement with the items classified in accordance with the requirements of the individual service. This schedule, together with the auditor's findings, should be presented in the following form:

<u>Item</u>	<u>Per contractor's settlement proposal</u>	<u>Auditor's recommendations</u>	<u>For non-acceptance</u>	<u>For further consideration</u>

(4) Comments with respect to the individual items of cost which have been recommended for nonacceptance or for further consideration.

(5) Signature in accordance with the procedures of the individual service.

b. When an item which was not previously approved on a Standard Form 1034 cost voucher is now recommended for acceptance or further consideration, the auditor should state the reasons for his action.

c. When an item is recommended for nonacceptance, the auditor should state clearly the grounds upon which such recommendation is based and the extent of any verification which has been made by him.

d. The "for further consideration" column will be used in those cases where:

(1) The amount of a particular item applicable to the contract is not susceptible of an accounting determination, or where such determination can only be made at a later date, where otherwise the type of item is acceptable to the auditor.

(2) Further approvals are necessary on the part of the contracting officer or other designated authority, where otherwise the type of item is acceptable to the auditor.

(3) There is evidence as to the existence of a definite liability but such evidence is not sufficiently complete that the auditor can report the item as recommended for acceptance.

e. When the "for further consideration" column is used, the auditor should include in his report all pertinent facts and observations relative to the item as may assist the contracting officer in negotiating the settlement.

f. The original copy of the auditor's report will be attached to the copy of the partial settlement proposal forwarded to the contracting officer. A copy of the report will be attached to the original copy of the partial settlement proposal retained by the auditor. This original partial settlement proposal, together with the required documentary evidence furnished by the contractor, will be filed by the auditor separately from the files of Standard Form 1034 cost vouchers.

177. Preliminary Overhead Reports

a. Partial or final settlement proposals involving overhead costs allocable to terminated CPFF contracts should be audited in accordance with the standards set forth in paragraph 167 and the general procedure for year end settlements as outlined in paragraphs 95 to 145, inclusive.

b. In certain cases, after the contractor has submitted his overhead proposal, the auditor may be requested to make a preliminary report as a basis for the contracting officer to initiate negotiations. In that event, the auditor may properly report upon the findings of fact which have been made up to that time together with a presentation of the various matters still unsettled because of the incomplete stage of the audit or because of lack of agreement with the contractor as to allowability as costs. Any preliminary report thus rendered, however, should clearly indicate its preliminary nature inasmuch as such a report does not take the place of the final report required by JTR 567.3 to be furnished as the basis for final negotiation.

c. As stated in paragraph 199, the amount of overhead included in a negotiated settlement in no way affects the determination of the amount of overhead allocable to other CPFF contracts on which there was performance during any part of the period involved.

177. Preliminary Overhead Reports

a. Partial or final settlement proposals involving overhead costs allocable to terminated CPFF contracts should be audited in accordance with the standards set forth in paragraph 167 and the general procedure for year end settlements as outlined in paragraphs 95 to 145, inclusive.

b. In certain cases, after the contractor has submitted his overhead proposal, the auditor may be requested to make a preliminary report as a basis for the contracting officer to initiate negotiations. In that event, the auditor may properly report upon the findings of fact which have been made up to that time together with a presentation of the various matters still unsettled because of the incomplete stage of the audit or because of lack of agreement with the contractor as to allowability as costs. Any preliminary report thus rendered, however, should clearly indicate its preliminary nature inasmuch as such a report does not take the place of the final report required by JTR 567.3 to be furnished as the basis for final negotiation.

c. As stated in paragraph 199, the amount of overhead included in a negotiated settlement in no way affects the determination of the amount of overhead allocable to other CPFF contracts on which there was performance during any part of the period involved.

178. Reporting Procedure—Final Reports

a. When the contractor has submitted a final settlement proposal in substantially the form set forth in paragraph 174, the auditor will complete his audit and will prepare a final report for the contracting officer to assist him in negotiating a final settlement with the contractor.

b. In general, the arrangement of the final report should conform to the plan of the partial settlement report although it will necessarily include comments covering the additional items set forth in the final settlement proposal and the exhibit attached thereto. It will also normally be desirable to provide for an appendix to include supporting detailed schedules, using schedules prepared by the contractor, wherever practicable.

c. The partial settlement proposals previously submitted should be summarized normally by types of costs involved in order that the contracting officer can deal with a particular type of cost as a single item regardless of the number of partial proposals involved. In making his comments with respect thereto, the auditor should make reference to, so far as practicable, comments and data included in the partial settlement reports previously submitted to the contracting officer.

d. In dealing with items set forth in the supporting exhibit to the final settlement proposal, reference should be made to paragraphs 146 to 168, inclusive, inasmuch as the principles and guides set forth there for settlements of completed CPFF contracts are substantially applicable to the settlements of terminated CPFF contracts.

e. The report should clearly set forth the current status of all General Accounting Office exceptions and reclaim vouchers outstanding, so far as information is available in his office, together with any comments or other pertinent data. Any amounts of an identical nature to the costs covered by either exceptions or reclaim vouchers not allowed by the General Accounting Office and now included in the settlement proposal, should be clearly disclosed.

179. Auditing Procedures for Public Vouchers After Termination Date

a. **COST VOUCHERS.** Standard Form 1034 cost vouchers submitted prior to the date that settlement proposals are used for presenting costs, will be subject to the same audit procedures and docu-

mentary evidence requirements as Standard Form 1034 vouchers undergoing CPFF contracts. These requirements will include the preparation of certificates of evidence of payment covering such vouchers. After either partial or complete termination, however, no actual deductions will be made for uncleared checks although such items will be reported to the contracting officer for appropriate consideration in the final negotiated settlement.

b. **RECLAIM VOUCHERS.** Standard Form 1034 vouchers covering amounts previously recouped from the contractor because of exception thereto on the part of the General Accounting Office, should also be audited in accordance with the procedures provided for reclaim vouchers undergoing CPFF contracts. (See par. 112.)

c. **PARTIAL PAYMENTS, PARTIAL SETTLEMENTS, AND FINAL SETTLEMENTS VOUCHERS.** (1) Vouchers of the types indicated will be supported as follows:

(a) Vouchers for partial payments will be supported only by the appropriate certificate required by JTR 354 through 366.2, depending on the type of partial payment involved.

(b) Vouchers for partial settlements will be supported only by the partial final settlement agreement substantially in the form set forth in JTR 983.2. (See JTR 564.2. (2).)

(c) The voucher for a final negotiated settlement will be supported only by the final settlement agreement or final determination by the contracting officer, and evidence showing that the provisions of the agreement or determination have been complied with. (See Form in JTR 983.1.)

(2) The auditor's responsibilities in connection with these vouchers will be as follows:

(a) Furnishing the contracting officer with such accounting information and advice as may be requested.

(b) Ascertaining that the documentation set forth in c (1) above has been submitted.

(c) Recording the amount of the public voucher in an appropriate voucher register.

(d) Determining, when requested, the proper project and allotment account to be charged with the payment and indicating the symbol therefor in the accounting distribution block of the public voucher.

(e) Recording the amount of the voucher in a contract allotment control ledger where such procedure is required by the service involved.

(3) The auditor should affix the usual audit certificate provided in paragraph 104a as evidence that the procedures required in c(2) above have been complied with.

d. **SUPPLEMENTAL SETTLEMENT VOUCHERS.** The voucher for a supplemental negotiated settlement covering a claim excluded in the final settlement agreement will be processed in the same manner as a voucher for a final negotiated settlement.

180. Audit Procedures Applicable to Terminated Fixed-Price Supply Subcontracts

a. The functions of the auditor in connection with negotiated settlements of fixed-price supply subcontracts are set forth in the Joint Termination Accounting Manual. The procedural guides contained in that manual will be used by the auditor when performing accounting reviews of termination settlement proposals of fixed-price subcontractors requested by the contracting officer.

b. When such settlements are submitted for audit by the CPFF contractor on either a Standard Form 1034 voucher or a settlement proposal, the auditor will have the responsibility to make the following determinations:

(1) That the claim is supported by a negotiated final settlement agreement between the CPFF contractor and his fixed-price subcontractor, approved by the contracting officer (except where authority to negotiate final settlement is delegated to the contractor in accordance with JTR 642 or 643).

(2) That the nature of the item or service covered by the terminated subcontract is an allowable type of cost under the terms of the CPFF contract.

(3) That there is evidence of compliance by the CPFF contractor with the minimum office accounting review requirement on subcontractor claims exceeding \$1,000. (See JTR 633.1.)

181. Procedures at CPFF Subcontractor's Plant After Termination Procedures Become Effective

In general, the provisions of the other sections of this chapter apply to terminated CPFF subcon-

tracts as well as CPFF prime contracts. However, except in those cases where direct settlement has been authorized, the following special features exist in the case of terminated CPFF subcontracts where the negotiated settlement procedures have been put into effect:

a. Partial final settlements and final settlements are negotiated between the prime and subcontractor. Such settlements are subject to the approval of the contracting officer having jurisdiction and become a part of the settlement between the Government and the prime contractor.

b. The reports of the auditor at the subcontractor's plant with respect to costs submitted for audit on partial settlement proposals, together with copies of the proposals, and his final audit report will be submitted to the contracting officer having jurisdiction. The contracting officer will determine the manner in which the prime contractor is to have access to the proposals and audit reports and may, where he so desires, request additional copies for transmittal by him to the prime contractor. The auditor at the prime contractor's plant will not be furnished copies of the proposals or reports.

c. Subcontractors will present commercial invoices to the prime contractors for payments of the same types of items and supported in the same manner as public vouchers submitted by the prime contractor. (See par. 179.) The responsibility of the auditor at the subcontractor's plant in connection with such commercial invoices is as provided in paragraph 179c(2). Copies of such approved commercial invoices should be forwarded to the auditor at the prime contractor's plant in accordance with the procedures of the individual service.

182. Processing of Subcontractor's Commercial Invoices at the Prime Contractor's Plant After Termination of the CPFF Subcontract

a. Commercial invoices of terminated CPFF subcontractors covering costs, partial payments, partial settlements or final settlements will be presented by the CPFF prime contractor either on his own partial settlement proposals or Standard Forms 1034, depending on whether the prime con-

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tract has been terminated and if so, depending on the manner in which he is submitting his costs.

b. In all cases, the responsibility of the auditor at the prime contractor's plant will be as follows:

(1) Determining that the commercial invoices have been properly approved by both the auditor

at the subcontractor's plant and the contracting officer having jurisdiction.

(2) Determining that commercial invoices covering partial settlements and final settlements are supported by agreements signed by the parties involved and approved by the contracting officer.

CHAPTER 6

COST INTERPRETATIONS

Section I. SCOPE, PURPOSE, AND APPLICATION (Originally issued 30 Nov 42)

183. These cost interpretations are intended to provide a basis for uniformity with respect to the interpretation of accounting terms and their application to CPFF contracts. They prescribe instructions to be followed by War Department accounting personnel. Although the auditor personally may not entirely agree with a particular cost interpretation, he must apply the principles contained therein. The cost interpretations are issued also for the information and guidance of the contracting officer, but are not intended to control or direct the exercise of the authority given him by the contract to determine what costs are reasonable and are incident to and necessary for the performance of the contract.

184. In all instances the specific terms of the contract will govern, and these cost interpretations may be given consideration only where the contract is silent, vague, or ambiguous as to their subject matter. It should be noted that, as a general rule, contracts covering Government-owned, contractor-operated facilities do not provide for reimbursement of home office overhead on a cost basis. Some of the cost interpretations therefore are not appropriate to such operations, but to the extent that they are appropriate, they should be applied.

185. These cost interpretations are not intended to provide factual yardsticks for the computation of costs incident to and necessary for the performance of any particular contract. They deal essentially with the meaning of terms of a technical or commercial nature relating to costs and indicate the usual interpretation of such terms where used in contracts, subject to consideration by the contracting officer of the specific facts before him in the light of the terms of the particular contract involved. They are intended to be consistent with

the principles for determination of costs contained in Treasury Decision 5000, paragraph 26.9, as approved by the Secretary of War, 6 August 1940, and are interpretations of the cost provisions of cost-plus-a-fixed-fee contracts embodying such principles or principles substantially similar thereto.

186. As a general rule these cost interpretations express basic principles, the application of which requires the exercise of judgment. In certain cases, however, such as in paragraphs 233 and 234, where definite procedures and limitations in regard to the allowance of Federal capital stock tax are expressed, the exercise of judgment on the part of the auditor is necessarily restricted.

187. It is intended that the contractor adhere to the principles and procedures expressed in this chapter. However, other principles and procedures may be employed by the contractor, provided it is clearly demonstrated by tests, evidence of which will be included in the auditor's working papers, that deviations from cost interpretations result in no increase in the amount computed by the contractor as reimbursable cost or the submission of claims for reimbursement which at any time exceed in the aggregate the total cost, through the period covered by such submission, which would be arrived at by application of cost interpretations.

188. When a cost interpretation is issued it applies to all unreimbursed costs unless otherwise specified in the cost interpretation.

Section II. APPLICATION OF OVERHEAD TO CONTRACT COSTS (Originally issued 30 Nov 42)

189. Definitions

a. Overhead costs are defined for the purpose of this cost interpretation as those costs which in the contractor's accounts are charged first to depart-

mental, burden center, or other overhead unit accounts and subsequently apportioned to a particular CPFF contract and to other such contracts, fixed-price contracts and civilian work. Overhead as used in this section includes factory indirect expenses, engineering indirect expenses, and administrative expenses.

b. Direct costs are defined as those costs which in the contractor's accounts are charged directly and finally to the contract without any intermediate apportionment through an overhead unit.

190. Content of Overhead Pool

a. As a general rule, individual items of overhead need not be separately allocated to the contract and other work. Instead, overhead costs may be accumulated in one or more overhead "pools" for proration between the contract and the contractor's other work.

b. Included in each overhead pool will be the types of overhead cost suitable for inclusion by reason of their nature and their relationship to the basis to be used for proration. The basis selected for proration, of a particular type of expense should be the one which most satisfactorily measures the portion of the expense attributable to the contract and other work.

c. There must be excluded from each overhead pool all types of cost specified as unallowable by the terms of the contract and those which have no relation to the performance of the contract. The latter exclusion does not apply to types of cost which are of a general nature in that they relate to the business as a whole, rather than to any specific work or contracts.

191. Standards for Direct Charging of Types of Costs Ordinarily Treated as Overhead

a. When costs of the type usually charged to overhead are charged directly to the contract, it is essential that a thoroughly reliable basis exist for determining the amount of the charge and its applicability to the contract. Such direct charges must be susceptible to satisfactory current check. This requires that adequate records of such direct charges both to the contract and to other work be maintained by the contractor and that documentary evidence as required for other types of direct charges be provided. If direct

charges can be made in accordance with these standards and if direct charges for costs similar in nature have been made on a uniform basis for both the CPFF work and the other work (fixed-price Government work and civilian work) the remainder of the expense may be allocated on an overhead basis. However, the fact that only a small portion of a particular type of cost can properly be handled on a direct basis is evidence that the entire amount of such cost should be treated as overhead. It is not acceptable procedure with respect to any type of expense to segregate direct charges only for the contract and to treat the entire balance as overhead.

b. Where the Government furnishes property for the operation of the contract, such as equipment, tooling, or supplies, the Government in effect absorbs direct charges for such costs as depreciation, insurance and property taxes related to such property. In such cases the corresponding costs related to contractor-owned property not used in connection with the CPFF contract must be treated as direct charges to the contractor's other work and not included in overhead.

c. As a general rule direct charges cannot be made for the compensation of supervisory personnel or for telephone expense since such charges would not be susceptible to satisfactory check.

d. No attempt should be made to charge directly relatively small items of cost which are ordinarily charged to overhead. Such a procedure is economically unsound since the cost of the clerical work involved is disproportionate to the apparent gain in accuracy.

192. Overhead Rates

a. As a general rule, overhead will be charged to contract costs through the use of rates applied to appropriate bases.

b. Rates computed on the time factor are the most accurate method of applying factory overhead. Such rates may be based on machine hours or direct labor man hours. Machine hour rates are ordinarily essential only when more than one direct worker operates a machine and the size of the crew varies with the type of work or when one operator handles more than one machine and varying numbers of machines are operated. Ma-

chine hour rates are particularly appropriate where direct labor is a relatively minor part of cost and where depreciation, repairs, supplies, and maintenance of machinery are relatively large. Rates based on direct labor dollars are a convenient substitute for labor hour rates when direct labor dollars reflect the time factor with reasonable accuracy. The use of an overhead rate per direct labor hour, as contrasted with a percentage of direct labor dollars, is usually necessary only when there are wide variations in rates of pay for the same kind of work or other variations which have no significance in relation to the incidence of overhead. The use of machine hour rates or labor hour rates does not obviate the necessity of a proper departmental classification as described in paragraph 194.

c. When overhead is distributed on a direct labor dollar basis, overtime and shift premiums are not properly includible in the base.

d. The overhead rate used is to be computed from fiscal and statistical data covering the period involved. An overhead rate based on data of a previous fiscal period may not be acceptable when applied to current costs.

e. The bases selected for application of overhead should not be arbitrary and are to be susceptible of audit.

193. Differential Method of Charging Overhead

It is not acceptable procedure to determine the amount of overhead applicable to other work on the basis of a "normal" overhead rate based on previous operations and to charge the remainder of the costs in the overhead pool to the contract.

194. Departmental Rates

a. Whether departmental rates (or burden center rates) are necessary for the correct application of overhead as contrasted with the use of one over-all plant rate is a matter to be determined in individual cases. The variety of products and processes in the mixed plant, the proportion of work done on each product in the various sections of the plant and variations in rates of production are factors which should be taken into consideration. Departmental rates are ordinarily preferable; however, an over-all plant rate may be sufficiently

accurate in certain cases. The decision to accept an over-all rate should be reexamined from time to time in the light of changing conditions.

b. It may be necessary to allocate overhead on several different bases in order to obtain an acceptable charge to the contract. For example, direct labor hours or dollars may not be a suitable basis for the allocation of freight-in. This item is closely related to material, and a material basis might be necessary to obtain an accurate allocation of freight-in when such cost is of importance. Credits applicable to overhead costs such as scrap sales may, in some cases, be similarly allocated to obtain greater accuracy.

c. The departmental classification existing prior to engaging in CPFF work may become inadequate because of changed conditions. For example, parts for the contract may be processed entirely by bench work in a department having expensive machinery. In such a case a further subdivision of the department may be necessary.

d. Changes in floor space, departmental investment in machinery and equipment, power consumption, and other proration factors may require current revisions in departmental rates.

e. No attempt is made herein to outline in detail the principles to be followed in prorating particular types of expense to departments or the expenses of indirect or general departments to direct departments. However, the fundamental requirement is that the bases used must result in a proration which measures with reasonable accuracy the services or benefits received by the department to which the proration is made. Proration should not be made on the basis of "normal", "readiness to serve" or other arbitrary factors. Ordinarily, the allocation of *all* indirect or general factory expenses to direct departments on the basis of direct labor pay rolls is not acceptable. General factory expenses may include, for example, depreciation of machinery and equipment which is not necessarily related to the amount of direct labor in the various departments.

195. Overhead Period

a. In most cases, rates computed on an annual (or quarterly or semiannual) basis will be acceptable and it will not be necessary to compute monthly rates. However, if the proportion of

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CPFF work to the total work is not substantially constant during the period and there are *at the same time* appreciable fluctuations in the rates of overhead from month to month, consideration will be given to the necessity of computing overhead on a monthly basis. In no case should rates be computed for a period longer than 12 months or for a period which overlaps the end of the contractor's fiscal year.

b. Whatever periods are used, the rates must accurately reflect accruals of costs. The contractor's accounting procedures must assure that overhead items are charged to the accounts in the periods to which they apply and that inventory records measure with reasonable accuracy the supplies consumed during such periods. Where the period is less than one year, year-end adjustments should be reflected with reasonable accuracy in the rates.

c. The choice between monthly rates and rates computed for a longer period should be considered separately for each plant of the contractor. It is not necessary that all plants use the same basis.

d. Monthly rates need be used only as long as their use is considered essential. As soon as it can be demonstrated that sufficient accuracy will be obtained by the use of rates based on a longer period, they may be used, despite the fact that monthly rates have previously been used. The propriety of using rates based on a period longer than a month should be reexamined from time to time, and if it is demonstrable that changed conditions make the use of monthly rates essential, the use of other rates should be discontinued.

e. When a contract is in effect for a portion of a fiscal year, the overhead rates will be based on the period including the first month and the last month in which charges of the type which are used as a basis for the proration of overhead were incurred on the contract. If two or more fiscal years are involved, an overhead determination will be made as of the end of each fiscal year. If rates are computed for a fractional fiscal period as a whole rather than month by month, the preceding provisions of this paragraph apply to the fractional period in the same manner as if it were a whole year. For example, if a 14-month period is involved which includes the last 8 months of one fiscal year and the first 6 months of the following

fiscal year, two average overhead rates may be used, one for the first 8 months and another for the succeeding 6 months. These overhead rates will be subject to applicable adjustments at the end of each fiscal year. Consideration will also be given to the use of monthly rates for either or both overhead periods.

f. The references in TD 5000, paragraph 26.9(j), to "the period within which the contract or sub-contract is performed" are not to be interpreted as permitting the use of a single overhead rate for the entire period. They are intended only to exclude consideration of periods prior or subsequent to performance under the contract in the determination of overhead charges. However, it may be necessary in the determination of rates to use a slightly longer or shorter period than the exact period of performance to avoid fractional parts of months at the beginning or end of performance. Within the period of performance, monthly, annual or other periodic rates are to be used in accordance with the principles set forth above.

196. Application of Fixed Charges

In the case of existing contractor-owned plants and facilities, the application of fixed charges such as depreciation and property taxes may commence with the date when conversion of the plant is started or production begins. In the case of new facilities furnished by the contractor, depreciation may be charged from the date of completion or purchase of buildings or the date of installation of machinery. Property taxes on new facilities may be charged on a pro rata basis from the date such taxes become a lien.

197. Idle and Excess Facilities

a. Care should be exercised to exclude any costs resulting from idle and excess facilities which are not necessary and will not become necessary for the performance of the contract, after considering reasonable stand-by requirements. When departmental rates are used, the prorations of general factory expense as well as direct departmental costs should exclude such costs.

b. Widely, varying monthly production volumes tend to produce wide fluctuations in monthly overhead rates because of fixed charges. A study of such variations over an annual period constitutes

an important basis for the determination as to whether idle, excessive, and unnecessary capacity exists in relation to the volume of production, requiring the exclusion of the related fixed charges.

198. Fixed Payment for Overhead

Where a contract stipulates that a fixed amount or fixed rate will be allowed in payment for all or any part of overhead costs, an allocation of costs should nevertheless be made to such contract in order to assure a proper allocation to other concurrent contracts under which overhead is to be reimbursed on a cost basis.

199. Effect of Negotiating Overhead on Terminated Contracts

The amount of overhead included in a negotiated settlement of a terminated CPFF contract in no way affects the determination of the amount of overhead allocable to other CPFF contracts on which there was performance during any part of the period involved.

200. Consistency

a. Consistency in the application of accounting policies is necessary to the accurate determination of costs.

b. The basis selected for prorating overhead in a particular department, burden center, or plant should be used for all contracts (including fixed-price and other work) performed within such department, burden center, or plant.

c. The basis selected should not be modified or changed after it has been accepted for previous fiscal periods unless it is found to be inadequate because of major changes in operating conditions or unless improved methods of cost determination have been adopted.

d. The elements in the proration base should be developed in a uniform and consistent manner. For example, where direct labor is used as a base and inspectors are classified as indirect labor for commercial work, they must not be classified as direct labor for CPFF work.

e. It is essential that the same types and classes of costs be treated as direct charges or as overhead uniformly throughout the entire performance of the contract. Exceptions to this rule may be made only in cases in which either changes in

operational conditions require or justify changed treatment of certain costs, or improved and refined methods of cost determination have been adopted which make possible the treatment of certain types of cost as direct charges which were formerly included in overhead. After such changed methods of cost determination have been adopted, they should be maintained throughout the balance of performance under the contract, unless further changes are justified in light of the previously stated exceptions. The contractor may independently make his choice as to whether recovery of particular types of cost will be sought as a direct charge or through overhead proration, and must consistently follow his election, except as stated above.

f. Consistency is also essential in the choice of the cash, or accrual basis for the recognition of certain costs, where the use of either basis might be acceptable. The basis chosen must be uniformly adhered to in all plants of the contractor and all years of the contract.

201. Engineering Overhead (Indirect Expenses)

a. The engineering overhead referred to consists of supervision, drafting supplies, maintenance and repair of engineering equipment, etc., relating to the engineering direct labor involved in work directly chargeable to the contract, such as the designing of tools and preparation of routing sheets and working drawings.

b. Engineering costs such as are involved in research work and development of new products are not includible in the engineering overhead described in the preceding paragraph.

202. Administrative Overhead

a. TD 5000 provides that administrative expenses will ordinarily be allocated or distributed to the cost of performing a contract on the basis of the proportionate manufacturing, installation, and construction cost. This basis is acceptable only if it is appropriate in the particular circumstances and any other basis may be used if it is in accordance with sound accounting principles.

b. Where the total manufacturing cost basis is used, the following interpretations apply:

(1) "Total manufacturing cost" refers to all manufacturing costs incurred (including those unaudited) during the accounting period, exclusive of the cost of facilities purchased. If administrative overhead is treated as a cost of facilities constructed or manufactured by the contractor under a facilities contract or for his own account, the total manufacturing cost base will include the cost of such facilities.

(2) In determining total manufacturing cost no allowance will be made for the hypothetical cost to the contractor of Government-furnished, free-issue materials, parts, or equipment.

(3) Disallowed items of substantial amount will be excluded from manufacturing cost of the CPFF contract for purposes of applying administrative expense. Whether disallowed items should be included in the total manufacturing cost base depends on whether they may properly be considered to be manufacturing costs of the contractor's other work.

c. A policy of making direct charges to the contract in mixed plants for items of cost customarily treated in commercial practice as a part of administrative overhead should generally be avoided.

203. Facilities Contracts

a. Some facilities contracts contain a clause to the effect that the contractor will be reimbursed a stated percentage of labor costs as an allowance for all overhead and administrative expenses. In these instances, proper allocation of costs nevertheless should be made to such contracts when there is concurrent performance of the facilities contract with a supply contract in order to assure a fair allocation to the supply contracts under which overhead is to be reimbursed on a cost basis.

b. Other facilities contracts contain clauses restricting the reimbursement of overhead on such contracts. Where there is no provision in concurrent CPFF supply contracts for reimbursement through the supply contracts of the overhead allocable to the facilities contracts but not reimbursable thereon, it is necessary to make a proper allocation of all costs to the facilities contracts in order that no overcharge will be made to the supply contracts. If the CPFF supply contracts do provide for reimbursement of any part of overhead allocable to but not reimbursable under facilities

contracts, only so much overhead need be allocated to the facilities contracts as is not reimbursable under the supply contracts.

Section III. DIRECT LABOR OVERTIME AND SHIFT PREMIUMS (Originally issued 30 Nov 1942)

204. Overtime premiums do not apply solely to the work done in the overtime hours, but rather to the work done within the entire period which is the basis for determining the amount of overtime worked.

205. Similarly, shift premiums apply to all work done in a particular department or other overhead unit within the pay roll period, since they arise because of the total number of daily hours operated including all shifts.

206. The provisions of paragraphs 204 and 205 are met if the overtime and shift premiums are included in factory overhead.

207. In some cases a policy is followed of charging overtime and shift premiums directly to the work performed during the overtime and shift premium periods. In such cases the auditor should make studies to determine whether an undue proportion of the CPFF work in relation to other work is performed during overtime and premium shift hours and advise the contracting officer of his findings. Such a policy is acceptable if it is approved by the contracting officer. The auditor will, from time to time, make additional studies of the proportion of overtime and shift premium time worked on CPFF contracts and advise the contracting officer of his findings for the purpose of determining whether such policies continue to be acceptable.

Section IV. ENTERTAINMENT (Originally issued 30 Nov 1942)

208. Expenses which are solely in the nature of entertainment are not allowable.

209. Meals purchased and expenses incident to group meetings of a business nature for employees are allowable, provided information is submitted as to the purpose and nature of the meeting including the number of employees present.

210. Expenses of events which are designed to stimulate the efforts of employees toward increased production or similar objectives, such as celebrations in connection with "E" awards, are allowable.

Section V. FEES OF PROFESSIONAL ACCOUNTANTS (Originally issued 30 Nov 1942)

211. Fees of professional accountants incurred in connection with normal and customary accounting services, including the periodic audits of the contractor's accounts, the preparation of regular stock exchange and S.E.C. reports and income tax returns represent reimbursable costs.

212. Fees are not reimbursable when incurred in connection with reorganizations, security issues, capital stock issues, negotiation of contracts with the Government, prosecution of claims against the Government, and prosecution of income tax matters.

Section VI. COMPENSATION OF DIRECTORS (Originally issued 30 Nov 1942)

213. Compensation of directors and reimbursement for their traveling expenses are allowable as a general rule.

Section VII. DEPRECIATION AND AMORTIZATION OF FACILITIES (Originally issued 9 Dec 1942)

214. For the purpose of reimbursement the rates of depreciation and amortization will, as a general rule, not be in excess of those claimed in the Federal income tax returns of the contractor.

215. Amortization of emergency facilities covered by certificates of necessity will not be allowed on the basis established for income tax purposes but depreciation on such facilities at appropriate rates will be reimbursable. The rates used must be justified by the contractor and should be compared with those taken on similar facilities not covered by certificates of necessity. If such a comparative basis is not available, the rates published by the Bureau of Internal Revenue in Bulletin F will be used as a guide by the auditor in considering the propriety of the rates claimed, but consideration

may be given to the effect of multiple shifts and other pertinent conditions.

216. If the rates claimed in the current year's tax return have been increased over the approved rates in the return for the most recent year which has been closed, such increases must be specifically justified by the contractor. Unless the justification is clear, consideration will be given to the disallowance of part or all of the depreciation due to the increased rates.

217. In any special situation, where depreciation in excess of the rates used in the Federal income tax return is claimed by the contractor and it appears that limitation to the tax rates would not be equitable, the facts will be submitted for the information of higher authority of the service involved or Army Air Forces who, in important cases will advise the Fiscal Branch, Washington, of Army Air Forces or the service involved.

Section VIII. EMPLOYEE BONUSES (Originally issued 9 Dec 1942)

218. Bonuses to employees represent a part of their total compensation and are a reimbursable cost subject to the following conditions:

- a. The bonuses must not be restricted to officer or other employee stockholders and the basis of distribution must have no relation to individual or group stockholdings.
- b. The contractor's policies in respect to payment of bonuses must be presented in writing to the contracting officer.
- c. The bonuses must not be based upon the amount of profits made by the contractor.
- d. The bonuses must be for services rendered.
- e. Limitations on total compensation must be complied with.

219. The bonus payments may include production incentives, prizes for suggestions, safety awards, and Christmas gifts and may be paid either in cash or merchandise.

220. The fact that an employee bonus plan or employment agreement was in effect prior to the securing of CPEF contracts does not make expenditures allowable which would otherwise be unallowable. Regardless of the date of origin of

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the plan, if the payments fail to meet the tests outlined above the expenditures are not allowable costs.

Section IX. CONTRIBUTIONS TO CHARITABLE OR COMMUNITY ORGANIZATIONS (Originally issued 9 Dec. 1942)

221. The contractor will normally be called upon to make contributions to charitable and community organizations.

222. Such contributions will constitute reimbursable costs when made to charitable, religious, scientific, or educational organizations which are "recognized" as such by the Treasury Department.

223. In determining whether a contribution is reasonable in amount, the contracting officer should give consideration both to past policies of the contractor and the expanded scope of the contractor's current activities.

224. Contributions to so-called "national" organizations are allowable if the organization either solicits its funds locally or the local area receives funds or benefits therefrom.

Section X. INTERDIVISIONAL TRANSFERS (Originally issued 9 Dec. 1942)

225. In the performance of a CPFF contract by the contractor, certain materials or parts will frequently be obtained from one division of the contractor to be used in another division. Such divisions may operate much like separate companies and transfers between them may be handled through interdivisional billings. Any billings of this kind are not to include a profit for the originating division unless otherwise specifically provided by the terms of the contract.

Section XI. PREMIUMS AND CONSIDERATIONS PAID TOWARD AN EMPLOYEE RETIREMENT PROGRAM (Originally issued 30 Nov 42)

226. Premiums and considerations paid by a contractor in respect of a retirement program which provides for pensions or annuities to employees upon retirement are reimbursable provided:

a. The contracting officer has approved the contractor's costs of an acceptable employee retire-

ment plan and the basis of reimbursement, subject to compliance with the conditions below.

b. The retirement program has received the approval of the Chief of the Technical Service concerned, or his duly authorized representative, and the Office of the Chief of Finance, Washington, D. C., as to the reasonableness of benefits and payments required and the basis of reimbursement therefor. These approvals will signify that the basis of reimbursement conforms to the following standards.

(1) Substantial credits may revert to a contractor or to a retirement fund upon the release of employees prior to the time when the contractor's payments toward his employee retirement program become vested in the employees. In general, reimbursement will be limited to a portion of the contractor's payments toward his employee retirement program after considering the estimated proportion of the number of employees now performing CPFF operations who will terminate their employment during or within a reasonable period subsequent to the completion of such operations, and no sums will be repaid to the War Department. Where, owing to unusual circumstances, it is not feasible to determine reimbursement on the above principle, returns payable to the contractor or to a retirement fund upon the withdrawal of employees within a reasonable period following completion of the CPFF contracts will, to the extent that they have been previously reimbursed by the War Department, be repaid to the War Department or an equivalent amount will be repaid.

(2) When the retirement program is initiated while CPFF work is in progress, premiums or considerations applicable to services prior to the effective date of the retirement program, are not allowable.

(3) When the retirement program was in effect prior to the date of the CPFF contract, only those premiums or considerations are allowable which are based upon services coincident with the performance of the contract. In other words, no portion of the premiums or considerations applicable to services prior to the incidence of the CPFF work can be applied to the contract.

227. Premiums or considerations paid with respect to an employee are part of his total compen-

sation and are therefore subject to any limitations on compensation which may be specified by the contract or by the service involved.

Section XII. ATTORNEYS' FEES (Originally issued 16 June 43)

228. AR 410-5 requires contractors in certain cases to utilize the services of The Judge Advocate General's Department or the Department of Justice. The contracting officer in other cases may require the contractor to utilize such services.

229. In cases other than those referred to above and in the absence of a specific contract provision to the contrary, a cost-plus-a-fixed-fee contractor may be reimbursed for attorneys' fees to the extent the services are necessary and relate to the performance of the work under the contract, provided the services are in a matter where there is no conflict of interest between the contractor and the Government.

230. Such services include, but are not limited to—

a. Services in connection with a tax or wage claim against the contractor which, if proved and paid, would be reimbursable in whole or in part by the Government.

b. Services in defense against a claim arising from injury to persons or damage to property in connection with the performance of the contract and directly attributable thereto, which claims, if proved and paid, would be reimbursable in whole or in part by the Government.

c. Services in connection with the procurement of supplies, services, and facilities directly related to the work under the contract.

d. Counsel concerning laws, rules, and regulations which are or may be applicable to the performance of the contract, when such counsel benefits the Government.

231. When reimbursement for such fees is claimed, a brief description of the nature of the services should be attached to the voucher.

232. Fees incurred by the contractor for his sole benefit, such as for the negotiation of contracts with the Government and for prosecution of claims against the Government, are not reimbursable. Similarly, fees incurred in connection with

such general matters as capital stock issues and corporate reorganizations are not reimbursable. Retainer fees of a general nature, including those where it is not practicable to identify the extent to which the interests of the Government are served, are also not reimbursable.

Section XIII. FEDERAL CAPITAL STOCK TAX (Originally issued 25 Aug 43)

233. The capital stock tax has been held to be an excise tax for the privilege of doing business as a corporation. As a necessary cost of doing business it is a proper reimbursable cost.

234. The maximum amount of capital stock tax reimbursable is to be determined as follows:

a. The amount of tax paid will be prorated in equal amounts per month over the contractor's first income tax year ending subsequently to the last day of the capital stock tax year. For example, if the contractor's income tax year ends on 31 December 1943, the capital stock tax referred to is the tax payable on 31 July 1943.

b. The amount prorated under *a* above will not exceed the amount of tax calculated on 10 times the net income for declared value excess-profits tax computation for such income tax year.

c. Any allocation of capital stock tax to the contract and to other work will be made on the same basis as other general administrative expenses.

d. The amount allocable to the contract for the contractor's income tax year will not exceed the lower of:

(1) The amount of tax calculated on 10 times the profit on the contract for such income tax year. For example, if the contractor's income tax year ends on 31 December 1943, and the profits on the contract for such year is \$100,000, the amount of Federal capital stock tax which would be an allowable cost for such year cannot exceed \$1,250 ($\$100,000 \times 10 \times .00125$).

(2) The proportion of the tax paid that the profit on the contract for the income tax year bears to the net income for declared value excess-profits tax computation for such income tax year.

e. In the determination of the foregoing limitations any subsequent change in the applicable statutes will be reflected in the rates used for capitalizing the earnings and for the calculation of the tax thereon.

f. The amount of profit applicable to the contract for the income tax year is to be determined on a basis consistent with that used by the contractor in the determination of his net income for declared value excess-profits tax computation. The profit applicable to the contract will be considered to be the amount of fee taken into income for income tax purposes less any charges attributable to the contract which are not reimbursable under the particular terms of the contract.

g. The applicability of the limitations prescribed herein is to be determined in connection with the audit of the year-end overhead statements prescribed in paragraph 135.

Section XIV. ADVERTISING (Originally issued 20 Oct 43)

235. Advertising expense as used herein includes the salaries and expense of advertising departments as well as the agency fees and cost of media.

236. As a general rule advertising is not a reimbursable cost.

237. Advertising of an institutional character (as contrasted with the advertising of products for sale), placed in technical journals, primarily for the purpose of offering financial support to such journals because they are of value for the dissemination of technical information for the industry, is a reimbursable cost. The cost of the design and processing of plates, etc., for illustrations used in advertisements will in no instance be considered reimbursable inasmuch as they are unnecessary in extending financial support to technical journals.

238. This cost interpretation does not apply to expenditures for newspaper space, radio time, and other media in connection with employment and other personnel activities.

Section XV. PROFIT OR LOSS FROM CAFETERIAS, DINING ROOMS, SALES STORES, VENDING MACHINES, AND SIMILAR OPERATIONS (Originally issued 1 Apr 44)

239. Subject to the specific terms of the contract, profits accruing to the contractor from the operation of cafeterias, dining rooms, soda fountains,

sales stores, vending machines, and similar operations, operated by the contractor or by a concessionaire will be treated as a credit to costs of the contract except for activities from which the profit is irrevocably set over to a company welfare organization in amounts reasonably usable for the benefit of the employees at the particular location.

240. Subject to the approval of the contracting officer, losses in reasonable amount incurred on any of such activities may be reimbursable provided—

a. The operation is not primarily for the benefit of a limited group, such as an executives' dining room.

b. That any profits from the operation are credited to costs.

241. The terms "profit" and "loss" as used herein refer to the profit or loss of a particular activity for the contractor's fiscal year or portion thereof in which the activity is involved. The accounting records are to be maintained in such a manner that the loss of executive or other restricted patronage operations (which are not reimbursable under the terms of par. 240) can be readily determined.

242. If profits are irrevocably set over to a company welfare organization, such organization will be charged with its proper share of expenses related to the activities from which the profit is obtained. These charges will include a rental charge for Government-owned equipment and a charge for any space occupied in a Government-owned facility.

243. In the case of plants which are "mixed" in character, that is, having work other than CPFF contracts, the profit or loss will be reflected in appropriate overhead accounts of the contractor. In the case of plants having only CPFF contracts, the profit or loss will be allocated directly to the contracts involved.

Section XVI. PLANT NEWSPAPERS

244. The cost of plant newspapers and similar publications is reimbursable if such publications are expressly for the purpose of the dissemination of information to employees and the creation and maintenance of good employee relationships.

245. The circulation of the publication must be preponderantly to employees. If an appreciable portion of the circulation is to others than employees, a proportionate part of the cost must be excluded.

Section XVII. VACATION PAY

246. In order that vacation pay may be reimbursable, the contractor must be *unconditionally* required to make such payments by statute, by an explicit agreement, or by the operation of an established policy in effect during the period of performance of the contract which has the effect of an implicit agreement.

247. In a mixed plant, the contractor may include vacation pay in overhead on a cash or an accrual basis. If the cash basis is used, vacation pay should be included in the overhead periods in which it was earned and vacation pay earned in other plants should be excluded. In computing the accrual proper recognition should be given to the probability of employee separations prior to becoming entitled to vacation pay. If vacation payments are made on the basis of the employee's wage or salary rate at the time of taking the vacation, pay increases may have the effect of increasing the accrual retroactively. In such a case, the entire effect of such a pay increase on the accrual may be included in the overhead of the period in which the increase is paid.

248. In a plant in which no costs are reimbursed on an overhead basis, reimbursement of vacation pay should be made on a cash basis, provided that the portion of the vacation pay applicable to other work is excluded.

Section XVIII. DIFFERENTIAL COSTS

249. It is not acceptable procedure for the contractor to determine the amount of overhead applicable to other work on the basis of a "normal" overhead rate based on previous peacetime operations and charge the balance of the costs in the overhead pool to the contract.

250. Costs of a nature not regularly incurred in peacetime operations but which nevertheless apply

jointly to other work and the contract cannot be charged exclusively to the contract.

251. Similarly, where costs of a type incurred to a limited extent in peacetime operations are increased because of wartime conditions, the increase over a "normal" level of such costs cannot be charged entirely to the contract.

Section XIX. EXPENSES OF PAY ROLL DEDUCTIONS FOR BOND PURCHASES

252. The expense incurred by CPFF contractors in complying with the Government's request to make authorized deductions from the wages of their employees for the purchase of U. S. Savings Bonds and stamps is a reimbursable item under the provision made in such contracts for reimbursement of the cost of administering pay roll systems, but the cost of the services of their employees and other costs in promoting the sale of such bonds and stamps to the public are not reimbursable.

253. Reimbursable expenses will include the cost of inscribing the bonds and making delivery direct to the individual employee, and, subject to the approval of the contracting officer, the contractor may make arrangements to accomplish the inscription and delivery in the most practicable manner, including arrangements with authorized banking institutions.

Section XX. EXPENSES OF PERSONNEL SERVING EMPLOYEES IN RATIONING MATTERS

254. Subject to the provisions of this section, the expense incurred by CPFF contractors in rendering service to their personnel to comply with Government regulations pertaining to rationing is a reimbursable cost under CPFF contracts.

255. Consideration will be given to the necessity for expenses incurred by CPFF contractors in rendering this service and particularly the accessibility of Government operated offices for the processing and issuance of ration documents, coupons, etc. It must be determined that personnel of CPFF contractors do not have convenient access

to Government operated offices established for this purpose. Evidence must be furnished by the CPFF contractor proving the necessity for the operation and assignment of personnel to render service of this nature to employees, such as the elimination and prevention of absences caused by conditions over which CPFF employees have no control.

256. All such expenses and arrangements are subject to prior approval or ratification by the contracting officer.

Section XXI. EXPENSES OF PRETERMINATION PLANNING

257. The expense incurred by CPFF contractors in pretermination planning is a reimbursable cost in connection with the performance of CPFF contracts. However, in those cases where a contractor is also engaged on war prime or subcontracts other than CPFF, a proper apportionment of such expense should be made. Such planning includes advance plans and preparations for prompt discontinuance of work by the contractor and his subcontractors and the preparation of pretermination agreements with the Government and other contractors concerning plant clearance, interim financing, disposition of termination inventories and production equipment and the settlement of termination claims. Pretermination planning expense does not include any costs connected with reconversion of the contractor's organization or facilities to peacetime work.

Section XXII. SEVERANCE PAY

258. The term "severance pay," as used herein, refers to amounts due to employees solely by reason of their involuntary separation (ordinarily termed "lay-off") from the employ of the contractor other than for cause. It should be distinguished from pensions, bonuses, vacation pay, and similar payments, which involve different accounting treatment.

259. a. A reasonable amount of severance pay is reimbursable under CPFF contracts provided

the contractor is required to make payments therefor: (1) by statute, (2) by written agreement, or (3) by the operation of an established policy which constitutes an implicit agreement.

b. No amount of severance pay is reimbursable where payment is contingent upon recovery from the Government.

c. Severance pay should be considered as applicable to the entire period of employment with the contractor.

260. In plants or departments commonly referred to as 100 percent CPFF plants or departments, severance payments may be charged directly to particular contracts to the extent that reimbursements of pay roll costs have been made on the basis of separate pay rolls.

261. In plants engaged on both CPFF contracts and other work, any method of allocating severance pay to a contract may be used, provided the amount so allocated is reasonable and the method is consistent with the principles set forth in this section.

a. It will usually be acceptable to allocate severance pay to contracts by applying a rate based on the relation of the total severance payments of the contractor during the period indicated in *b* below to any suitable base for the same period, such as pay rolls of classes of employees covered by the severance pay plan, total pay rolls of all employees, direct labor, etc. Where there have been substantial interplant transfers of employees or classes of employees, appropriate adjustment of the total severance payments should be made for that portion of the payments applying to employment at the other locations. The rate should be applied to the corresponding element of base cost claimed to arrive at the reimbursable amount of severance pay.

b. The period used in the determination of the rate will necessarily vary with different contractors, but it should cover the approximate average period of employment of those classes of employees covered by the severance pay plan, up to and including the date of substantial completion of mass lay-offs resulting from cessation of war production.

Section XXIII. PAYMENTS TO EMPLOYEES FOR 15 AND 16 AUGUST 1945

262. In a memorandum dated 25 August 1945, the President of the United States instructed contracting agencies that contractors paying war workers for time off taken during the period 15 and 16 August 1945 should be reimbursed by the Government to the extent that the Government is compensating these contractors on a cost basis.

263. Payments to employees for work done on 15 and 16 August 1945, including premium payments required by the applicable provisions of law or Executive Order, are to be treated in the same manner as other similar types of payments for work done under the contract.

264. Payments to employees for time off on 15 and 16 August 1945 are reimbursable costs under CPFF contracts. Such payments will not exceed pay for a normal shift at straight time rates.

265. In plants or departments commonly referred to as 100 percent CPFF plants or departments, payments to employees for time off on 15 and 16 August 1945 may be charged directly to particular contracts to the extent that reimbursements of pay roll costs have been made on the basis of separate pay rolls.

266. In plants engaged on both CPFF contracts and other work, these payments for time off will be included in the appropriate overhead accounts of the contractor and allocated between the CPFF contract and other work in accordance with the applicable accounting principles and procedures in effect under the contract. In no case will these payments be allocated on the basis of an overhead period of less than 1 month.

Section XXIV. STATE FRANCHISE AND INCOME AND EXCESS PROFITS TAXES

267. State franchise taxes levied for the privilege of doing business, including those computed on a net income base, are reimbursable costs under CPFF contracts. However, state income and excess profits taxes are not reimbursable costs.

268. The tax will be prorated in equal amounts per month over the period to which the privilege applies, namely, the privilege year. When it is necessary to allocate a franchise tax between CPFF contracts and other work, the basis for the allocation of general administrative expenses will be used.

269. Taxes imposed by the following states and statutes have been classified below as (1) franchise taxes which are reimbursable as costs and (2) income and excess profits taxes which are not reimbursable:

List of States and statutes imposing (1) Reimbursable franchise taxes and (2) Nonreimbursable income and excess profits taxes

State	Reimbursable	Not reimbursable*	Statute
Alabama	1	2	Code of Alabama 1940, Title 51, Ch. 15, Art. 3, Secs. 347-364. Code of Alabama 1940, Title 51, Ch. 17, Secs. 373-424.
Arizona		2	Arizona Code Annotated, 1939, Ch. 73, Art. 15, Secs. 73-1501 to 73-1551.
Arkansas	1	2	Pope's Digest of the Statutes of Arkansas, 1937, Ch. 158, Art. II, Secs. 13488-13517. Pope's Digest of the Statutes of Arkansas, 1937, Ch. 158, Art. XXII, Secs. 14024 et seq.
California	1	2	California Bank and Corporation Franchise Tax Act, Deering's California General Laws, Volume 3, Act. 8488, Secs. 1-38. California Corporation Income Tax Act, Deering's California General Laws, Volume 3, Act 8494a, Secs. 1-30.
Colorado	1	2	Colorado Statutes Annotated, 1935, Ch. 142, Secs. 93-106. Colorado Stats. Ann. 1935, 1944 Cum. Supp., Ch. 84A, Secs. 1-56.
Connecticut	1		Corporation Business Tax Act of 1935, Cum. Supp. to Connecticut Gen'l. Stats., Ch. 66b, Secs. 416c-441c.
Delaware	1		Delaware Revised Code of 1935, Ch. 6 Article 8, 95 to 111 (Secs. 61-77).
District of Columbia		2	D. C. Code, Title 47, Ch. 15, Sec. 1502 (b).
Florida	1		Florida Statutes, Ann., 1943, Title XXXIV, Ch. 610, Sec. 8.
Georgia	1		Code of Georgia Annotated, Ch. 92, Secs. 92-2401 to 92-2409. Code of Georgia Annotated, Ch. 92, Secs. 92-3001 to 92-3317.
Idaho	1	2	Idaho Code and Supplement Annotated, Title 29, Ch. 6, Secs. 29-601 to 29-613. Idaho Code and Supplement Annotated, Title 61, Ch. 24, Sec. 61-2401 et seq., especially sec. 61-2425.

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List of States and statutes imposing (1) Reimbursable franchise taxes and (2) Nonreimbursable income and excess profits taxes—Continued

State	Reim- bursable	Not reim- bursable	Statute
Illinois	1		Smith-Hurd Illinois Annotated Statutes, Ch. 32, Sec. 157.131 (d) and 157.138 (d).
Iowa		2	The Property Relief Act, Iowa Code (1939), Title XVI, Ch. 329.3, Sec. 6943.065 et seq.
Kansas	1	2	General Statutes of Kansas Ann., Ch. 17, Article 7, 17-701 to 17-712. General Statutes of Kansas Ann., Ch. 79, Article 32, Sections 79-3201 to 79-3241.
Kentucky	1	2	Kentucky Revised Statutes (1944), Ch. 136, Section 136.070. Kentucky Revised Statutes (1944), Ch. 141, Sections 141.010 to 141.990.
Louisiana	1	2	Louisiana General Statutes (Dart), Title 57, Ch. 37, Sections 8722-8733. Louisiana General Statutes (Dart), Title 57, Ch. 22, Sections 8587.1 to 8587.104.
Maine	1		Maine Revised Statutes 1930, Ch. 12, Secs. 21-27, as amended by Chapters 225 and 242, of Laws of Maine 1931.
Maryland	1	2	Maryland Annotated Code (Flack), Art. 81, Secs. 144 and 148. Maryland Annotated Code (Flack), Article 81, Secs. 222 et seq.
Massachusetts	1		Mass. Excise (Income) Tax Annotated Laws of Massachusetts, Ch. 63, Secs. 30 to 52.
Michigan	1		Michigan Statutes Annotated, Vol. 15, Title 21, Ch. 196, Sec. 21-205 et seq.
Minnesota	1	2	Minn. Statutes (1941), Ch. 290, Sec. 290.02. Minnesota Statutes (1941), Ch. 290, Section 290.03.
Mississippi	1	2	Miss. Franchise Tax Laws of 1934, Miss. Code Annotated 1942, Vol. 7, Title 37, Ch. 2, Secs. 9312-9340. Income Tax Act of 1934, Miss. Code Ann. 1942, Title 36, Ch. 1, Secs. 9220-9261.
Missouri	1	2	Missouri Revised Statutes Annotated, 1939, Ch. 33, Article 1, Section 5113 et seq. Missouri Revised Statutes Annotated, 1939, Ch. 74, Art. 21, Secs. 11343 to 11377.
Montana	1		Revised Codes of Montana (1935), Ch. 205, Secs. 2296 to 2304.
Nebraska	1		Revised Statutes of Nebraska (1943), Ch. 21, Art. 3, Secs. 21-301 to 21-327.
New Hampshire	1		Revised Laws of New Hampshire (1942), Ch. 274, Sec. 116.
New Jersey	1		Present Law: New Jersey Annotated Statutes, Title 54, Subtitle 4, Part 2, Ch. 13, Secs. 54: 13-1 to 54: 13-3 and Title 54, Subtitle 4, Part 6, Ch. 32A, Secs. 32A-1 to 32A-53.
	1		Corporation Franchise Tax Act of 1945, New Jersey Laws of 1945, Chapter 162, which repeals foregoing corporate franchise tax law on and becomes effective as of 1 January 1946.
New Mexico	1	2	New Mexico Statutes Annotated (1941), Ch. 54, Art. 12, Secs. 54-1201 to 54-1212. New Mexico Statutes Annotated (1941), Ch. 76, Art. 12, Secs. 76-1201 to 76-1247.
New York	1	2	Consolidated Laws of New York, Ann. Book 59, Tax Law, Part 1, Art. 9-A, as amended by Ch. 415 of the N. Y. Laws of 1944. Temporary Emergency Tax on Net Incomes of Unincorporated Businesses, Consol. Laws of N. Y., Ann., Book 59, Tax Laws, Pt. 2, Art. 16-A, Secs. 386-386K.
North Carolina	1	2	General Statutes of North Carolina, 1943, Ch. 105, Art 3, Schedule C, Sec. 105-122. General Statutes of North Carolina, Ch. 105, Art. 4, Schedule D, Secs. 105-130 to 105-163.
North Dakota		2	North Dakota Revised Code of 1943, Title 57, Ch. 38, Secs. 57-3802 et seq., especially 57-3811.
Ohio	1		Page's Ohio General Code, Annotated, Sec. 5495 et seq.
Oklahoma	1	2	Oklahoma Corporation License Law, Oklahoma Statutes Annotated, Title 68, Ch. 17, Secs. 634-643. Oklahoma Income Tax Law of 1935, Oklahoma Statutes Annotated, Title 68, Ch. 21, Secs. 871-915.
Oregon	1		Oregon Compiled Laws, Annotated, Sec. 110-1506.
Pennsylvania	1		Oregon Compiled Laws, Annotated, Secs. 77-205 and 77-206. Corporate Net Income (Franchise) Tax Act. Purdon's Pennsylvania Statutes, Title 72, Ch. 2, Secs. 3420a-3420n.
Rhode Island	1		Purdon's Pennsylvania Statutes, Title 72, Ch. 2, Sec. 1871 et seq.
	1		Corporate Excess Tax, General Laws of Rhode Island, 1938, Ch. 37, Secs. 1-13.
	1		Annual Franchise Tax on Domestic Corporations. Gen. Laws of Rhode Island 1938, Ch. 39, Secs. 1-4.
South Carolina	1	2	Code of Laws of South Carolina, 1942, Civil Code, Title 25, Ch. 108, Art. 8, Secs. 2678 to 2690-2. Code of Laws of South Carolina, 1942, Civil Code, Title 25, Ch. 107, Art. 1, Secs. 2435 et seq.

List of States and statutes imposing (1) Reimbursable franchise taxes and (2) Nonreimbursable income and excess profits taxes—Continued

State	Reim- bursable	Not reim- bursable	Statute
Tennessee	1		Williams' Tennessee Code Annotated, Title 5, Ch. 1, Art. 12, Secs. 1316 to 1328.
	1		Williams' Tennessee Code Annotated, Title 5, Ch. 1, Art. 6A, Secs. 1248.143 to 1248.149.
		2	Williams' Tennessee Code Annotated, Title 5, Ch. 1, Art. 5, Secs. 1123.1 to 1123.30.
Texas	1		Vernon's Texas Civil Statutes, Title 122, Ch. 3, Art. 7084-7097.
Utah	1		Utah Code Annotated, 1943, Title 80, Ch. 13, Secs. 80-13-1 to 80-13-65.
Vermont	1		Public Laws of Vermont, 1933, Title 8, Ch. 43, Secs. 989 et seq.
		2	Public Laws of Vermont, 1933, Title 8, Chapters 39, 40 & 41, Secs. 872-919.
Virginia	1		Franchise Tax and Registration Fee. Virginia Code of 1942 Annotated, Tax Code, Ch. 15, Secs. 210 and 211.
		2	Income Tax. Virginia Code of 1942 Annotated, Tax Code, Ch. 6, Secs. 23-67.
Washington	1		Remington's Revised Statutes of Washington, Annotated, Title 25, Ch. 1, Secs. 3836-4 and 3836-5.
West Virginia	1		West Virginia Code of 1943, Annotated, Ch. 11, Art. 12. Secs. 933 and 935.
Wisconsin		2	Wisconsin Statutes, 1943, Ch. 71, Secs. 71.01-71.37 and 71.61.
Wyoming	1		Wyoming Revised Statutes, 1931, and Wyoming Suppl. 1940, Ch. 28, Art. 10, Secs. 28-1001 and 28-1004.

APPENDIX

WAR DEPARTMENT,
WASHINGTON, MAY 27, 1942.

SPBFA-6A.

Memorandum for:

The Chief Chemical Warfare Service,
The Chief of Engineers,
The Chief of Ordnance,
The Quartermaster General,
The Chief Signal Officer,
The Surgeon General,
The Chief of the Transportation Service,
The Commanding Generals of all Corps Areas,
The Chief of the General Depot Service,
The Commanding General, Matériel Command,
Army Air Forces,

Copies to:

The Chief of Administrative Services,
The Judge Advocate General,
The Chief of Finance,
The National Guard Bureau,
The Inspector General,
Subject: Administrative Audit of Cost-Plus-A-Fixed-Fee Contracts.

Introduction

1. The auditing procedures being followed by the various services for auditing cost-plus-a-fixed-fee contracts are now burdensome and with the imminent increase in expenditures are likely to prove unworkable. If this situation can be remedied, much needed manpower will be made available for other duties, costs will be reduced and reimbursement of contractors will be accelerated. It is believed that the remedy lies in the adoption of modified procedures which nevertheless will adequately protect the interests of the Government.

2. The basic philosophy of the auditing manuals of the Services has been a detailed check of every item in support of the contractors' costs. The

rigid procedures now prescribed may result in spending as much time and effort on a small item of cost as is spent on a large and important item; the records of a contractor with a complete and efficient accounting system, of proven general accuracy, are subjected to the same amount of detailed checking as the records of contractors having unsatisfactory and poorly maintained accounting systems. While these rigid and detailed procedures can be carried out in normal times, the present large volume of contracts to be audited and the limited supply of competent manpower make some modification imperative.

Elimination of Duplication

3. The objective of an audit of a cost-plus-a-fixed-fee contract is to ascertain that the contractor's invoices, certified as correct by him, are in accordance with the provisions of the contract and are substantiated by his accounting records and other supporting evidence. To achieve this objective it is not imperative to make a complete and detailed examination of all transactions. An adequate and more practical method, suitable in cost cases, is the selection of representative sections of the transactions or phases of the procedures for auditing after considering the individual circumstances in each situation.

4. Where the contractor maintains a satisfactory system of internal control, under which, for his own protection, all expenditures on account of the contract are audited by his own organization, it is apparent that the interests of the Government can be protected, without duplicating the work performed by the contractor, by instituting a selective and flexible method of audit by a relatively small number of experienced auditors.

5. A satisfactory system of internal control requires a separation of activities and responsibilities within the contractor's staff and an application of accounting controls so that all important phases of the transactions are subject to cross-checks. Such

a system minimizes the possibility of errors and fraud and justifies considered departure from rigid detailed audit procedures.

6. The extent of the application of the selective audit procedure, where an effective internal control is present, will be determined, in accordance with certain principles enunciated hereinafter, by the Chief Auditor of the project subject to review by the Chief Auditor of the Service involved. The auditing manuals of the Services will be revised to incorporate therein regulations governing the application of these principles.

7. The adoption of a selective method of auditing does not reduce in any way the necessity of a review of documents and schedules in support of all vouchers. By the elimination of unproductive detailed checking more time is available for such a review by the experienced auditor predicated on a carefully predetermined audit program and the knowledge of its consummation by his staff.

Principles Governing Extent of Selective Audit Procedure

8. The Chief Auditor of the project will first review the system of internal control and prepare a thorough report thereon which will include answers to a specific list of questions designed to disclose the adequacy of the internal control. If the internal control should not be adequate and if it is practicable to correct the deficiencies the contractor should be required to do so.

9. Upon approval of the system of internal control, the problem then becomes one of determining the extent to which the selective procedures will be applied. In the case of certain classes of costs as to which there is ordinarily no question of allowability from a technical standpoint, the problem is to substantiate their authenticity and mathematical accuracy. Where there is a considerable volume of individual transactions of these classes, a selective method of auditing may be appropriately applied.

10. Certain other accounts, which are more likely to include costs of doubtful allowability, will be subjected to more extensive review and in many cases to a complete detailed examination. Examples of such accounts are executive salaries and bonuses, traveling expense, taxes, depreciation and amortization, insurance, subscriptions,

memberships and dues, donations, and professional services.

11. In carrying out a program of selective auditing, it is important to avoid a fixed and continuing pattern of procedure and to revise the scope and extent of the program currently. Care should also be taken to select a representative group of each of the various classes of transactions such as material purchases, supply purchases, store requisitions, pay rolls, etc., but emphasis should be placed on examination of the larger items. An audit of a relatively small number of material purchase transactions, for example, may cover the greater part of the dollar total of such transactions.

12. When the review of the internal control procedures discloses that as to certain phases of the accounts the internal control is not entirely adequate a wider range of transactions should be checked and where the selective audit discloses numerous errors, a complete check must be made of that phase of the accounts.

13. These rules are stated as a guide and the auditor should always consider the necessity of expanding his program in the light of the surrounding conditions. He must be sure that the contractor's system of accounting adequately protects the interests of the Government, and he must carry his checking far enough to satisfy himself as to the credibility of the accounting records and the supporting data.

14. The project auditor will include in his files a complete record of:

a. The extent and nature of his periodic review of the established system of internal control and his conclusions upon which the program of selective auditing is based.

b. The extent of the selective auditing done, by whom performed, and the results of such auditing.

15. Selective auditing in those cases where there are satisfactory internal controls will not only reduce the cost of auditing but will result in more satisfactory audits. Reimbursement of cost-plus-a-fixed-fee contractors will be accelerated.

Certification of Vouchers by Contracting Officers

16. Contracting officers are authorized to certify vouchers for payment when, through the field au-

ditors, they have carried out the procedures outlined herein, provided that:

a. The contractor has certified that the bill is correct and just; that payment therefor has not been received; that all statutory requirements as to American production and labor standards, and all conditions of purchase applicable to the transactions have been complied with; and (if applicable) that State and local taxes are not included in the amounts billed.

b. The expenditures as described in the supporting documents are determined to be properly reimbursable under the contract.

c. All required documentary evidence is attached to the voucher.

Responsibility of Disbursing Officers

17. AR 35-180 states in paragraph 3:

Responsibility in connection with certificates of fact,

a. Disbursing officers are not responsible for the correctness of statements of fact appearing on pay rolls of which they can have no knowledge but which are certified to by the proper administrative officers; they are, however, responsible for the correct application of laws and regulations to the statement of facts certified and for the sufficiency of the facts stated. (25 Comp. Dec. 437.)

b. The financial responsibility for an improper certification will be determined by a board of officers convened by the commanding officer at the request of the disbursing officer who made erroneous disbursements thereon. Board proceedings, with appropriate recommendations, will be forwarded to The Adjutant General for final action of the Secretary of War. (See AR 35-1040.)

18. Disbursing officers are hereby authorized to

accept the certification of facts by contracting officers executed pursuant to the modified auditing procedures outlined in this directive. In the event of any disallowance in any disbursing officer's account resulting from the improper certification of facts by a contracting officer predicated on the administrative auditing procedures outlined herein, and in the absence of fraud or negligence on the part of the disbursing officer involved, the War Department will take appropriate steps to effect clearance of or relief from such disallowance.

Revision of Auditing Manuals of the Services

19. A committee will be formed, representing the interested services, to coordinate a revision of the manuals providing for the application of the principles governing the use of selective auditing procedures outlined in this directive. Each of the services interested in cost-plus-a-fixed-fee auditing will appoint a representative at the earliest possible moment to serve on this committee.

BY COMMAND OF

LIEUTENANT GENERAL SOMERVELL:

(S.) A. H. CARTER,
A. H. Carter,
Brigadier General,
Director, Fiscal Division.

APPROVED:

(S.) BREHON SOMERVELL,
Brehon Somervell,
Lieutenant General, Commanding.

APPROVED:

(S.) ROBERT P. PATTERSON,
Robert P. Patterson,
Under Secretary of War.

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