

Master Document – Audit Program

Activity Code 19403		Compliance Audit CAS 403
Version 6.11, dated June 2012		
B-1	Planning Considerations	
Purpose and Scope		
<p>1. The purpose of CAS compliance auditing is to determine if the contractor's policies, procedures, and practices used to estimate, accumulate, and report costs on Government contracts and subcontracts comply with the requirements of CAS. CAS 403 establishes criteria for the allocation of home office expenses to the segments of the organization on the basis of a beneficial or causal relationship. CAS 403 does not provide guidance for the allocation of IR&D/B&P costs of a home office. CAS 403.40(b)(5) states that IR&D/B&P costs shall be allocated in accordance with CAS 420. FAR 52.230-2, Cost Accounting Standards, requires the contractor to comply with the CAS 403 criteria.</p>		
<p>2. The scope of this audit should be limited to the last completed contractor fiscal year. For efficiency, CAS compliance testing, if possible, should be performed concurrently with tests for compliance with FAR and contract terms.</p>		
<p>3. This program is intended to provide for the proper planning, performance, and reporting on the contractor's compliance with CAS 403. The audit steps in the program should reflect a documented understanding between the auditor and supervisor as to the scope required to comply in an efficient and effective manner with generally accepted auditing standards and DCAA objectives. The program steps are intended as general guidance and should be tailored as determined by audit risk.</p>		
Other Planning Considerations		
<p>1. Before beginning any CAS compliance audit, the auditor should first determine whether the contractor is subject to the CAS standard. If the standard is not applicable to the contractor, the audit should be cancelled.</p>		
<p>2. Materiality (see 48 CFR 9903.305) and audit risk assessment (including Internal Control Audit Planning Summary (ICAPS) for major contractors, ICQ for nonmajors, and historical CAS problems) are integral parts of the planning process and should be considered in developing the extent of CAS compliance tests.</p>		
<p>3. Once it is determined that the standard is applicable, the auditor should assess which provisions of the standard are significant to the contractor; the extent reliance may be placed on the contractor's system of internal controls to ensure compliance; and the results of other relevant audits (e.g., results of prior compliance audits, Disclosure Statement examinations, etc.). The decision to not test whether the contractor is</p>		

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complying with specific provisions of the standard should be documented.
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B-1	Preliminary Steps	W/P Reference
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1. Research and Planning		
	a. Review the open MRD’s for guidance which may impact the audit and adjust the scope and procedures appropriately. Open MRDs can be identified using the link provided on the DCAA Intranet home page for “MRDs, AGMs, & AMGMs”	
	b. Read and become familiar with the criteria in CAS 403, CAM 8-403, and any recent Headquarters guidance not incorporated in CAM. Identify any changes in the CAS 403 standard since the last examination.	
	c. Evaluate Part VIII of the contractor’s disclosure statement to become familiar with the disclosed accounting practices. Determine if the contractor’s accounting practices have changed since the last CAS 403 compliance audit. If changes have occurred, document the file and adjust the audit scope accordingly.	
	d. Evaluate recent forward pricing or incurred cost proposals to determine whether total costs subject to CAS 403 are material. Consider contractor’s sales mix (i.e., CAS-covered Government contracts vs. non-CAS-covered and commercial). Materiality should be a consideration only in determining the extent of substantive testing.	
	e. Examine other FAO permanent file data (i.e.. relevant audit leads, MAARs Control Log, etc.) and prior relevant audit work packages to determine what data are available, what audit steps were done in the past, and the results from those steps. This will identify areas of high risk and/or areas where limited or no compliance testing is necessary. Document results.	
	f. If appropriate, coordinate with the FAO technical specialist, CAC, and/or regional specialist on matters of interpretation and policy.	
	g. Contact the contracting officer to ascertain any known concerns (including risk related to the contractor’s financial condition) that will impact the audit and adjust the audit scope and procedures accordingly. If information regarding the contractor’s financial condition is not available from the contracting officer, the auditor should perform the procedures addressed in CAM 2-302.1h. If	

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during the course of the audit the auditor becomes aware of unfavorable or adverse financial conditions, they should immediately communicate their concerns to the contracting officer, and appropriately adjust the scope of audit.	
h. Electronically transmit an acknowledgement/notification to the ACO/CAFO notifying them of the commencement of the risk assessment and that the expected completion date will be provided in the formal acknowledgement/notification once the risk assessment is complete. (CAM 2-303). The acknowledgement/notification process should be within the timeframe and in accordance with the procedures in CAM 4-104.	
2. Entrance Conference	
a. Arrange and conduct an entrance conference covering the areas highlighted in CAM 4-302 with particular emphasis on:	
(1) Confirming that cost accounting policies and procedures are current.	
(2) Requesting the contractor's explanation of the internal control structure as relates to CAS 403.	
(3) Any changes since the last audit.	
(4) The contractor's monitoring process for classifying costs.	
(5) Any identified weaknesses which may have been reported and related follow-up actions.	
b. If reliance is to be placed on the work of others, the file should contain the required documentation (see CAM 4-1000).	
c. Issue a notification letter to the contractor regarding the audit in accordance with CAM 4-302.3.	
3. Risk Assessment Steps	
a. Examine the ICQ or relevant ICAPS (whichever is applicable) to obtain information regarding accounting system adequacy, identify any known outstanding system deficiencies, and perform preliminary assessment of risk. Document results.	
b. Using the framework and the guidelines in WP B-2, obtain and document an understanding of the contractor's internal controls that are relevant to the audit. With the proper planning auditors	

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<p>should be able to obtain and document a major portion of this understanding during a walk-through of the contractor's assertion.</p>	
<p>c. Determine high-risk areas by performing the following limited testing. Using the most recent incurred cost or forward pricing proposal, or current operating results (financial statements):</p>	
<p>(1) Determine which pools are significant. (For immaterial pools/rates, discuss with technical specialist and/or supervisory auditor prior to performing additional effort.)</p>	
<p>(2) Compare the pools/bases to the disclosure statement to determine if any changes have been made to any accounting practices.</p>	
<p>(3) For each significant pool, determine that actual major functions and cost elements included in each pool and allocation base are consistent with Disclosure Statement.</p>	
<p>(4) Determine provisions of the standard that are material.</p>	
<p>d. Hold a planning meeting with the audit team (e.g., RAM, Manager, Supervisor, Auditors) to discuss the risk of fraud and other noncompliances with applicable laws and regulations that could have a material effect on the assertion. The discussion should include relevant prior audit experience (e.g., questioned cost, relevant reported estimating or accounting system deficiencies), relevant aspects of the contractor’s environment (e.g., the extent of incentives, pressures and opportunities to commit fraud and the propensity to rationalize misstatements), other known risk factors, and the audit team’s understanding of relevant internal controls (see W/P B-2). The team should also review and discuss the general and other relevant sections of the IG Handbook on Fraud Indicators for Contractors as well as the relevant fraud indicators in CAM Figure 4-7-3. See “Principal Sources of Fraud Indicators” below.</p> <p>Based on the team discussion and other risk assessment procedures the team should document on W/P B, Section 4 the risk factors/indicators identified and design audit procedures to meet the audit objectives and provide reasonable assurance of detecting fraud and other noncompliances with applicable laws and regulations that could have a material effect on the proposal (i.e., tailor (add/delete/modify) the audit steps). GAGAS 6.13(a)</p> <p>Communication among audit team members about the risk of material misstatement due to fraud should continue as needed throughout the audit.</p> <p>Principle Sources of Fraud Indicators:</p>	

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<ul style="list-style-type: none"> • Handbook on Fraud Indicators for Contract Auditors, Sections I and III, (IGDH 7600.3, APO March 31, 1993) located at: http://www.dodig.mil/PUBS/igdh7600.doc. • CAM Figure 4-7-3. <p>(To access the fraud handbook, copy and paste the web address shown above into the address block in Internet Explorer.)</p>	
<p>e. From the information gathered in the preceding steps and using the materiality criteria in 48 CFR 9903.305, assess the audit risk and determine the scope of audit and extent of compliance testing to be performed. Transaction testing should be increased when the contractor allocates a material amount of home office expenses through indirect pools (e.g., homogeneous and residual expense pools.)</p>	
<p>f. Update the information in the permanent files as needed. (MAAR 3)</p>	

C-1	Evaluation of the Organization and Operations	W/P Reference
Version 6.11, dated June 2012		
1.	Identify all segments directed or managed by the home office by referring to organizational charts and financial statements.	
2.	Review permanent files and prior audit assignments (e.g., forward pricing, incurred cost and financial capability audits) to determine whether the contractor is involved in any off-balance sheet financing activities. If the contractor has off-balance sheet activity, determine the impact of the activity on the home office allocation bases (see CAM 9-703.4d).	
a.	If the contractor is publicly held, off-balance sheet financing activities will be identified in the “Management’s Discussion and Analysis” (MDA) section of the contractor’s quarterly and annual SEC filings (see CAM 14-306a(1)). If a review of the SEC filings has not been performed in a prior audit for the period(s) covered by the CAS audit, review the SEC filing. Quarterly and annual SEC filings can be assessed via the Securities and Exchange Commission website at http://www.sec.gov .	
b.	If the contractor is not publicly held, review the contractor’s last financial capability audit to determine if the contractor has provided written confirmation that its financial statements include disclosure of all off-balance sheet arrangements and related party transactions. If the contractor has not provided written	

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confirmation, request the contractor to provide this documentation (See CAM 14-306a(2)).	
Note: A proforma letter requesting contractor confirmation of the financial statements is included in the APPS for Financial Capability Audits (17600), Other Audit Guidance section, entitled ConfirmLtr – Financial Statements.	
3. Coordinate/compare understanding of benefiting segments with the auditor cognizant of segments.	
4. Understand functions, services, and responsibilities of various contractor operations by evaluating the organizational charts, descriptions of functional departments and operations, etc.	

D-1	Classification of Home Office Expenses (MAAR 16)	W/P Reference
Version 6.11, dated June 2012		
1.	From the contractor’s most recent incurred cost submission, forward pricing rate proposal, or other supporting documentation, obtain a detailed breakdown of the contractor’s home office expenses.	
2.	Analyze the data obtained in step 1 above and determine if home office expenses are properly classified within the following three categories: (CAS 403.40(a)(1) and CAS 403.50(a)(1))	
	a. Directly allocated to segments.	
	b. Separately grouped in logical and homogeneous pools.	
	c. As residual for those managing the organization as a whole.	
3.	For any unusual classification of significant functions or cost centers, request the contractor to provide the rationale for the classification.	
4.	Evaluate indirect allocation of selected home office expenses to ensure no costs are allocated through a homogeneous pool or a residual pool if costs incurred for the same purpose have been allocated directly to a segment(s). (CAS 403.40(a)(2))	

E-1	Directly Allocated Cost (MAAR 18)s	W/P Reference
Version 6.11, dated June 2012		
1.	Evaluate the contractor’s direct allocation policies and practices to determine if they allow direct allocation to segments to the maximum extent practical. (CAS 403.40(a)(1))	

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2. Verify from the detailed breakdown of directly allocated costs that expenses that benefit only one segment are allocated directly to that segment. (CAS 403.40(a)(1))	
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F-1	Homogenous Expense Pools (MAARs 16 & 18)	W/P Reference
Version 6.11, dated June 2012		
1.	Evaluate the service and management functions performed by each pool and determine if the pool is grouped in logical and homogeneous expense pools.	
2.	For significant cost centers, determine and document which segments benefit from the cost (or cause the cost to be incurred). For example, if the contractor groups several accounts into a cost center described as “Payroll Processing”, determine if all payroll is processed through this center or just certain segments (such as the home office and the smaller segments).	
3.	Obtain contractor’s rationale for excluding any segments from the base.	
4.	Identify the contractor’s homogeneous expense pools by categories specified in CAS 403.40(b) for the purpose of evaluating allocation methods in accordance with the criteria provided therein:	
a.	centralized service functions,	
b.	staff management,	
c.	line management,	
d.	Central payments or accruals,	
e.	IR&D/B&P, and	
f.	staff management not identifiable with specific segments.	
5.	Centralized Service Functions Verify that the selected allocation base complies with the hierarchy of preferable allocation techniques. (CAS 403.50(b)(1)).	
a.	Activity Resource Consumption – Ensure that this allocation base (e.g., labor hours, machine hours, or square footage) is used unless unavailable or impractical.	
b.	Units of Output – Determine that this measurement base (units of end product; for example, number of printed pages for a print shop) is used only if an activity resource consumption base is unavailable or impractical.	

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c. Surrogate Measure of Consumption – Confirm that this allocation base is used only if (1) and (2) are impractical or unavailable. An example is head count of the segment receiving the benefit.	
6. Staff Management Functions	
a. Confirm that the costs of staff management functions of specific activities such as personnel management, engineering policies, etc., that are significant in total and in relation to total home office expenses are segregated from the residual cost pool. (CAS 403.40(b)(2) and (b)(6)).	
b. Verify that the allocation base includes all segments receiving more than a minimal benefit and represents the total specific activity being managed such as number of personnel managed. (CAS 403.40(b)(2)).	
7. Line Management Functions	
a. Evaluate the organizational charts and management hierarchy and responsibilities and determine which segments are managed or supervised. Line management costs are allocated only to segments which are being managed or supervised. (CAS 403.40(b)(3)).	
b. Evaluate the allocation base to determine if it represents the total activity of these segments (for example, total cost input). (CAS 403.40(b)(3)).	
8. Central Payments or Accruals	
a. Evaluate the details of each pool for indirect allocation to determine that the pooled costs do not include central payments or accruals (e.g., group insurance, state taxes, etc.) that can be identified specifically with individual segments. (CAS 403.40(b)(4))	
b. For those payments/accruals that cannot be identified specifically with individual segments, confirm that the allocation base is representative of the factors on which the total payment/accrual is based. (CAS 403.40(b)(4)).	

G-1	Residual Expenses (MAARs 16 and 18)	W/P Reference
Version 6.11, dated June 2012		
1. Verify that the expenses included in the residual pool are expenses incurred for managing the organization as a whole and have no readily measurable relationship to segments and cannot be allocated using one of the other CAS 403 methods. (CAS 403.40(c)(1).		

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2. Determine if the contractor is required to use the three-factor formula. (CAS 403.40(c)(2)).		
a. Identify the amount of residual expenses in the contractor’s previous fiscal year.		
(1) Verify that all unallowable costs are excluded.		
(2) Verify that all residual expenses to be allocated using a “special allocation” (see d. below) are included.		
b. Identify the total operating revenue for all segments for the previous fiscal year and apply the following formula:		
	<i>Operating Revenue</i>	<i>Percentage</i>
<i>First</i>	<i>\$100M</i>	<i>3.35</i>
<i>Next</i>	<i>\$200M</i>	<i>.95</i>
<i>Next</i>	<i>\$2.7B</i>	<i>.30</i>
<i>Over</i>	<i>\$3.0B</i>	<i>.20</i>
c. Compare the previous residual expense value obtained in step 1 above to the calculated value in step 2. If the residual value exceeds the step 2 calculated value, the three-factor formula must be used. <i>If the contractor is not required to use the three-factor formula and does not voluntarily elect to use it, skip to Step 3 or 4 below.</i>		
d. Verify the calculation of the three-factor formula. Generally, the validation of the segment information used in the formula should be done via an assist audit with the cognizant auditor at the segment level. (CAS 403.50(c)(1))		
e. Determine that the allocation base correctly includes the appropriate amounts for the three-factor formula.		
(1) The percentage of the segment’s payroll dollars to the total payroll dollars for all segments.		
(2) The percentage of the segment’s operating revenue to the total operating revenue of all segments. Verify that only net interdivisional purchases are included (amounts charged to other segments reduced by any amounts charged by other segments for purchases.)		
(3) The percentage of the average net book value of the sum of the segment’s tangible capital assets plus inventories to the total average net book value of such assets of all segments.		
(a) Verify that property held primarily for leasing to others is excluded.		

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(b) Verify that inventories are net of progress payment billings.	
(c) Verify that inventories include work-in-process on fixed price contracts.	
(4) Determine that there are no double entries in the three factor formula (e.g., unbilled costs classified as revenue and inventory).	
f. Verify the mathematical accuracy of the three factor formula (arithmetical average of the three percentages computed above).	
g. Verify that any residual expenses allocated via a special allocation method (step d. below) are removed from the residual pool and that the applicable segment’s data are excluded from the base.	
3. Verify that the residual expenses are allocated over a base that represents the total activity of the segments (CAS 403.40(c)(1)). Do not perform this step if the three-factor formula is used (step 2 above).	
4. Special Allocation of Residual Expenses (CAS 403.40(c)(3) and 40(d))	
a. Obtain the agreements between the contractor and the contracting officer allowing the use of a “special allocation” of residual expenses, if any.	
b. Verify that the contractor’s allocation is consistent with the agreement.	
c. Verify that the special allocation method is needed because a particular segment may receive significantly more or less benefit from residual expenses than would be reflected by the normal allocation methods. Be especially cognizant of changing conditions that may make previous determination inapplicable to the current year.	
d. Verify that the special allocation base represents the cost of estimated or recorded efforts devoted to the segment. (CAS 403.50(d)(3))	
e. Verify that the amount of such a special allocation is excluded from the pool of residual expenses and such segment's data are excluded from the allocation base.	

A-1	Concluding Steps	W/P Reference
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1.	Summarize the results of audit.	

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<p>2. Discuss the audit results with the supervisor or the Technical Specialist/supervisory auditor. The auditor should only report those noncompliances which are considered material (see CAM 8-302.7). Coordinate significant or unusual issues with the CFAO, FAO Manager, and if applicable, with the CAC, CHOA, or GAC network (see CAM 8-302.4, 8-302.6). Coordination should be both before and after discussion of audit results with the contractor. The ACO should be apprised of noncompliance matters at the earliest possible date. If a noncompliance is considered immaterial, recommend to the CFAO that the contractor be notified to correct the noncompliance and if the noncompliance is not corrected, that the Government reserves the right to make appropriate contract adjustments should the cost impact become material (see FAR 30.602).</p>	
<p>3. Prepare draft audit report. If the audit scope was limited to a certain area(s) of the contractor’s accounting practices, modify the scope and opinion statements, as necessary, so that they clearly identify the limited areas audited.</p>	
<p>a. If no instances of noncompliance are found, prepare a draft audit report in accordance with CAM 10-807 (activity code 19403).</p>	
<p>b. If instances of noncompliance are found, open an assignment under activity code 19200, prepare an audit report in accordance with CAM 10-808, and close this 19403 assignment with an MFR.</p>	
<p>4. If an internal control system deficiency is detected during the course of this audit, draft a flash internal control report and submit it to the contractor for comment in accordance with CAM 10-413.</p>	
<p>5. Conduct an exit conference with the contractor in accordance with CAM 4-304.</p>	
<p>6. Finalize audit report incorporating the contractor’s response and rejoinder, if applicable.</p>	
<p>7. Update the permanent files. <i>Ensure that a copy of DMIS Report No. CAS 3 entitled “CAS Compliance Testing (Activity Code 194XX)” is included in the permanent file after the assignment has been closed in DMIS.</i></p>	