

**AUDIT OF
CONTROL ENVIRONMENT AND OVERALL ACCOUNTING SYSTEM CONTROLS**

Version No. 5.0

July 2009

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
<p>1. INTEGRITY AND ETHICAL VALUES</p> <p>Management must convey the message that integrity and ethical values cannot be compromised, and employees must receive and understand that message through continuous demonstration of words, actions and commitment to high ethical standards.</p>	<p>Written codes of conduct address ethical business practices, conflicts of interest, and expected standards of ethical and moral behavior including dealings with customers, suppliers, employees and other parties.</p>	<p>a. Perform procedures to address the requirements in FAR 52.203-13, Contractor Code of Business Ethics and Conduct.</p> <p>1) Verify the existence of a written code of conduct and review the contents to ensure it addresses ethical business practices, conflict of interest, and expected standards of ethical and moral behavior. The code should cover dealings with customers, suppliers, employees, and other parties (See CAM 5-306.1). (FAR 52.203-13(b)(1))</p> <p>2) Obtain evidence that the code of conduct was made available to each employee (FAR 52.203-13(b)(1)).</p> <p>3) Verify that written codes of conduct (a) are periodically communicated to all employees, (b) are formally acknowledged, and (c) cite consequences for violations.</p>
	<p>Management places emphasis on establishing and maintaining an effective system of internal controls and self-governance and does not condone signs of inappropriate practices.</p>	<p>Perform procedures to address the requirements in FAR 52.203-13, Contractor Code of Business Ethics and Conduct, and FAR 52.203-14, Display of Hotline Poster(s).</p> <p>1) Verify that the contractor's policies and</p>

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		<p>procedures provide for a business ethics awareness and compliance program (FAR 52.203-13(c)(1)).</p> <ol style="list-style-type: none"> <li data-bbox="1493 367 2028 732">2) Verify that the business ethics awareness and compliance program includes an ethics training program for all principals and employees, and as appropriate, the contractor’s agents and subcontractors. Selectively test this control by evaluating training program materials and training records of completion (FAR 52.203-13(c)(1)). The training program should cover the contractor’s code of business ethics and conduct (see CAM 5-306.1). <li data-bbox="1493 773 2028 870">3) Verify that the manager responsible for the ethics program reports to a high level official (e.g., vice president/CFO). <li data-bbox="1493 911 2045 1341">4) Contractors should not appoint as a principal (e.g., officer, director, partner), an individual who previously engaged in conduct that conflicts with the contractor’s code of conduct (FAR 52.203-13(c)(2)(ii)(B)). Auditors should review the contractor’s policies and procedures and test the procedures to verify that they include steps for exercising due diligence in identifying such conduct (e.g., require background checks before appointing principals of the company) and that the steps have been taken when applicable. <li data-bbox="1493 1382 1955 1408">5) Verify that the contractor performs

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		<p>periodic reviews (i.e., at least annually) of company business practices, procedures, and internal controls for compliance with the contractor's code of business ethics and conduct and special requirements of Government contracting, including the specific requirements in FAR 52.203-13(c)(2)(ii)(C). Review the results of the recent reviews and assess any impact on this audit.</p> <p>6) Verify that the contractor has an internal reporting mechanism, such as a hotline, which allows for anonymity or confidentiality, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports (FAR 52.203-13(c)(2)(ii)(D)).</p> <p>7) Verify that the contractor's policies and procedures provide for appropriate disciplinary action for improper conduct, or failing to take reasonable steps to prevent or detect improper conduct (FAR 52.203-13(c)(2)(ii)(E)). Review the contractor's assessment of whether disciplinary action was needed related to the incidences of improper conduct, and the action that was taken (if applicable) and ascertain if reasonable (CAM 5-306.3).</p> <p>8) Verify that the contractor's policies and procedures provide for timely disclosure</p>

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		<p>to the agency OIG, with a copy to the contracting officer, when there is credible evidence of a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity, or a violation of the civil False Claims Act in connection with Government contracts (see CAM 5-306.3) (FAR 52.203-13(c)(2)(ii)(F)). Request a copy of any disclosures made and verify that the contractor complied with their policies and procedures. If deficiencies are identified related to the requirements in FAR 52.203-13(c)(2)(ii)(F), the DCAA Justice Liaison Auditor (DCAAHQJLA@dcaa.mil) will be included on the distribution for the audit report.</p> <p>9) Review any disclosures obtained in step 8 above. Ascertain if the contractor has taken the necessary corrective actions to protect the Government's interests. If the contractor has not taken the appropriate corrective action, the auditor should report this as an internal control deficiency.</p> <p>10) Verify that the contractor's policies and procedures provide for cooperation with any Government agencies responsible for audits, investigations, or corrective actions (FAR 52.203-13(c)(2)(ii)(G)). Confirm that there are no outstanding access to records issues or subpoenas that may indicate a lack of cooperation.</p>

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		11) Verify that the contractor includes the substance of FAR 52.203-13 and 52.203-14, when appropriate, in its subcontracts (FAR 52.203-13(d)(1) and FAR 52.203-14(d)). Review a sample of subcontracts that should contain the clause to determine if the FAR clauses are included in the subcontracts.
<u>2. EXTERNAL AUDITOR'S REPORT</u>		
Management should take timely corrective action on any deficiencies noted by the external auditor.	External evaluations influence and heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations. They may prompt management to establish specific internal control structure policies or procedures, and prompt management's correction/disposition of deficiencies noted.	<ul style="list-style-type: none"> a. Obtain the external CPA's report of material weaknesses of internal controls and/or management letter for the most recently audited year. For identified weaknesses of internal control, determine that corrective action has been taken to correct the item(s). b. Review the annual report for SEC registrants for an internal control report. This report includes an assessment of the effectiveness of the internal control structure and procedures for financial reporting, and the individual auditor must attest to and report on the contractor's assessment. <ul style="list-style-type: none"> i. Auditors located at segments or divisions of SEC Registrant companies will need to coordinate this effort with the CAC or Corporate auditors. ii. Determine whether corrective action has been taken in response to internal control weaknesses. c. Determine the reason for any recent changes in external auditors. Review the associated SEC filing by predecessor auditors for corroborating

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		evidence.
3. <u>BOARD OF DIRECTORS/AUDIT COMMITTEE</u>		
<p>The Board of Directors and the Audit Committee should be sufficiently independent enough from management to constructively challenge management's decisions and act effectively on external audit communications and recommendations. The Board and Audit Committee should take an active role to ensure an appropriate upper management's commitment to ethical business practices and behavior. Auditors at contractor segments should request an assist audit from the corporate auditors to accomplish the audit steps associated with this control objective. If auditors at contractor segments observe indications of possible weaknesses in internal controls that relate to corporate functions, they should refer them to the auditor cognizant of the corporate office. Examples include controls involving the Board of Directors and Corporate Internal Audit.</p>	<p>The Board of Directors and/or Audit Committee are composed of independent members and are actively involved in significant decisions.</p>	<p>a. Obtain a list of Board of Director and Audit Committee members. Determine their relationship to the business and assess their independence.</p> <p>b. Evaluate the minutes of the Board of Directors' meetings and all communications with the Audit Committee or body of similar authority to determine if the Board is taking an active role in significant management decisions.</p> <p>c. Evaluate the minutes of the Audit Committee meetings to determine if the committee (and/or Board of Directors) is acting effectively on all audit matters, including internal and external audit recommendations.</p>
	<p>The internal audit department is functionally and organizationally independent and is sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report their findings, opinions, and conclusions without fear of repercussion.</p>	<p>d. Verify that the internal audit department is functionally and organizationally independent to achieve objectivity in the conduct of its audits.</p>
4. <u>BASIC STRUCTURAL ORGANIZATION</u>		
<p>The organization structure provides the overall framework for planning, directing and</p>	<p>This structure defines the form and nature of the organization as well as the management functions</p>	<p>a. Complete or update the contractor's basic organizational structure questionnaire.</p>

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
controlling operations.	and reporting relationships.	
	Authority and areas of responsibility should be appropriately assigned.	b. Review the current organization chart to determine whether it delineates clear lines of authority.
5. <u>ASSIGNMENT OF AUTHORITY AND RESPONSIBILITY</u>		
Management ensures that appropriate responsibility and delegation of authority is assigned to deal with goals and objectives, operating functions, regulatory requirements, information systems and authorization for changes. The delegation of authority ensures a basis for accountability and control and sets forth individual respective roles.	Written policies and procedures adequately address delegations of authority and clearly delineate duties and responsibilities so that there is an adequate segregation of duties.	a. Verify that policies and procedures exist which specifically state the limitation or delegation of authority.
	Written policies and procedures require evaluation of current financial conditions in order to anticipate and avoid adverse conditions.	b. Verify that there is a clear assignment of responsibility and delegation of authority to deal with such matters as goals, objectives, operating functions, and regulatory requirements.
6. <u>FINANCIAL CAPABILITY</u>		
Management must ensure that the contractor has adequate financial resources to perform on Government contracts.	The contractor conducts periodic assessments of accounts payable and accounts receivable including analysis of accounts payable aging and the collectibility of accounts receivable.	<p>a. Verify that management regularly conducts financial analyses and monitors contract cost performance. Observe that procedures are in place and appropriate management and the Board of Directors is being informed of adverse conditions.</p> <p>b. Evaluate notes to financial statements, management certifications, and SEC filings (including Management Discussion & Analysis) for any indication of potential adverse financial conditions and discuss these conditions with the controller or other financial managers.</p>

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		<ul style="list-style-type: none"> c. Consider the impact of any off-balance sheet arrangements disclosed (CAM 14-306). d. Consider the impact of severe financial distress on the ability of the contractor to perform on Government contracts. e. Determine that policies and procedures require the preparation of an accounts payable aging schedule and that results are elevated to appropriate levels of management. f. Evaluate procedures for analyzing the collectibility of receivables.
	The contractor conducts periodic assessments to ensure that it is meeting debt payment schedules and is in compliance with other loan covenants.	g. Evaluate procedures and verify that the contractor monitors loan covenants and sets up payment schedules.
	The contractor regularly performs short and long term cash flow projections.	h. Verify that the contractor periodically prepares and evaluates cash flow projections.
<u>7. ACCOUNTING SYSTEM AND CONTROLS</u>		
The accounting system is well-designed and is operating effectively to provide reliable accounting data and prevent misstatements that would otherwise occur.	The contractor's accounting system consists of methods and records established to identify, assemble, analyze, classify, record and report an entity's transactions and to maintain accountability for the related assets and liabilities. The system will be designed so that the supporting documentation is complete (i.e., included purpose), accurate (e.g., includes credits where applicable), and readily available for examination.	<ul style="list-style-type: none"> a. Determine that the contractor maintains a current description of the accounting system, including books of original entry, general and subsidiary ledgers, and any statistical and/or supporting records which demonstrate the initiation of transactions, the flow of documents, and the identification of all points where correcting, adjusting or other cost transfers can be entered into the system. b. Determine if the contractor maintains a chart of accounts which is updated in a timely manner.

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		<ul style="list-style-type: none"> c. Verify that adequate written policies and procedures exist for approving and documenting, correcting, adjusting, closing, credit, and transfer entries. d. Verify that adequate procedures exist for reconciling all subsidiary cost ledgers and cost objectives to the general ledger accounts. If this is a computerized function, the auditor should document how this is accomplished and selectively test to verify that it is occurring properly. e. Verify that a trial balance is prepared on regular basis and reconciles to the financial statements. f. Verify that adequate procedures exist for controlling monthly accrual calculations and that an adequate approval process is used. g. Verify that there is adequate segregation of duties and responsibilities in such areas as access to accounting records, check-signing authority, recording disbursements in cash journal, performance of bank reconciliations, etc. h. Determine whether policies and procedures require identification of systemic problems or trends based on error reports. Verify that corrections are processed in a timely manner.
	Policies and procedures provide guidance on the situations and frequency of management intervention or overrides, approvals and	<ul style="list-style-type: none"> i. Evaluate management intervention and/or overrides. <ul style="list-style-type: none"> 1) Determine whether policies and

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
	documentation required, and the strict prohibition of manager overrides.	<p>procedures address the situations and frequency of management intervention, require documentation and approval of intervention, and the strict prohibition of any management overrides.</p> <p>2) If applicable, selectively evaluate documentation of management interventions or overrides for compliance with policies and procedures.</p>
8. <u>COST ALLOCATIONS</u>		
<p>Management ensures that an item of cost or a group of items of cost are assigned to one or more cost objectives in accordance with rules, regulations, and standards for proper distribution of direct cost and allocation of indirect costs. Management ensures the proper allocation of both the direct assignment of cost and the reassignment of a share from an indirect cost pool.</p>	<p>The contractor maintains a current disclosure statement.</p>	<p>a. Determine that the contractor's disclosure statement is current and adequately describes its accounting practices.</p> <p>b. Document, if applicable, any CAS noncompliances that may impact the internal control structure.</p> <p>c. Verify that adequate written policies and procedures exist for the identification and exclusion of unallowable costs. Determine that the detail and depth of records required as backup support for proposals, billings, or claims are adequate to establish and maintain visibility of identified unallowable costs (CAS 405).</p>
	<p>Written procedures prescribe approvals required in establishing contract charge numbers.</p>	<p>d. Verify that adequate written procedures exist to ensure that charge numbers are based on contractual requirements and are under management control and authorizations.</p>
	<p>Written procedures ensure that the Government receives its share of any income, rebates, refunds, allowances or other miscellaneous credits.</p>	<p>e. Verify that adequate written procedures exist for adjusting costs charged to the Government for any income, rebates, allowances or miscellaneous credits and that appropriate</p>

<u>Control Objectives</u>	<u>Example Control Activities</u>	<u>Audit Procedures</u>
		approvals are required.