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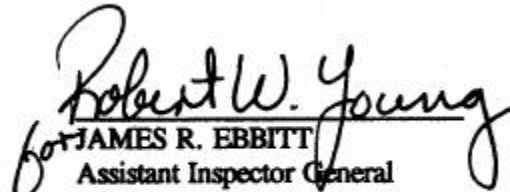
**Audit Guide**

**FOOD AND NUTRITION SERVICE**

**FNS - Audits of Multi-State Food Processors**

This guide is provided for use of nonfederal auditors in conducting audits of Multi-State Food Processors. Primary distribution to intended users will be by Food and Nutrition Service (FNS).

MATERIAL SUPERSEDED: Audit guide No. 27009d, dated June 25, 1996. Remove and destroy.

  
for JAMES R. EBBITT  
Assistant Inspector General  
for Audit

**AUDIT FIRMS WHICH DO NOT COMPLY WITH PROFESSIONAL AUDITING STANDARDS AND/OR FNS PROGRAM REQUIREMENTS COULD BE REFERRED TO THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AND CONSIDERED FOR SUSPENSION OR DEBARMENT FROM PERFORMING AUDITS OF FNS PROGRAMS.**

November 30, 1999

Date

## P R E F A C E

The audit guide has been revised to incorporate changes in the Food Distribution Program Regulations at 7 CFR part 250, and audit standards and procedures prescribed by the Office of Inspector General, USDA. This revised guide was prepared with participation of representatives of the Food and Nutrition Service and the Office of Inspector General.

This audit guide is designed to assist independent public accountants in conducting an attestation engagement of Multi-State Food Processors participating in the Food Distribution Program at the highest level of examination.

Comments and suggestions for improvement of this guide are encouraged.

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I. GENERAL

A. PURPOSE

This audit program is designed to assist independent public accountants in conducting an attestation engagement of Multi-State Food Processors (MSFP) participating in the Food Distribution Program (FDP) at the highest level of assurance (an "examination").

This program is not a substitute for knowledge of applicable laws, regulations, and operating procedures. The auditor must use professional judgment in tailoring the audit approach to incorporate variables encountered at the audit site. However, the minimum examination procedures provided in this program are necessary for uniform and consistent coverage.

The schedules (or similar ones) accompanying this program must be completed by the auditor and attached to the audit report. The auditor must use discretion to adapt the schedules to each processor's system. The data required on these schedules must be collected and any noted deficiencies must be included in the audit report. Deficiencies noted should be sufficiently explained in order to assess the impact on the program.

B. BACKGROUND

Section 416 of the Agriculture Act of 1949, as amended; Section 32 of Public Law 74-320, as amended; and Section 6 of the National School Lunch Act, as amended; authorized USDA to donate various agricultural commodities to eligible recipient agencies (RA) across the nation. These RA's include: schools, charitable institutions, summer camps, summer feeding programs, nutrition programs for the elderly, and nonresidential child care facilities.

Within each State, an agency has been designated the distributing agency (DA) for that State. This agency signs an agreement with USDA to distribute donated foods to those eligible outlets listed above. The DA or RA can enter into processing contracts with food processors to produce end products (e.g., pizza bread) utilizing USDA-donated foods as ingredients. In most instances the cost of the end product is reduced by the value of the donated foods contained in that end product. Only sales of approved end products to eligible RA's can be recorded by the processor for purposes of commodity inventory reductions. NOTE: A DA can also be a RA.

C. ACRONYMS AND TERMS

AICPA	American Institute of Certified Public Accountants
AMS	USDA's Agricultural Marketing Service
CA	Contracting Agency (either FNS, DA or RA)
CFR	Code of Federal Regulations
CPA	Certified Public Accountant
DA	Distributing Agency
EPDS	End Product Data Schedule

FDP	Food Distribution Program
FNS	Food and Nutrition Service
FSIS	USDA's Food Safety and Inspection Service
MSFP	Multi-State Food Processor
RA	Recipient Agency
RO	FNS Regional Office
USDA	United States Department of Agriculture
VPT	Value Pass Through

Definitions of standard terms used throughout this program can be found in 7 CFR 250.3.

Finally, for the purposes of this program the terms processing agreement and processing contract are synonymous.

#### D. PERTINENT REGULATIONS, INSTRUCTIONS, AND PUBLICATIONS

7 CFR Part 250 Food Distribution Program, Amended 12/7/94 (Overall Revision 1/1/96)

7 CFR Part 3015, Uniform Federal Assistance Regulations, January 14, 1986 (Subpart I)

Government Auditing Standards, 1994 Revision

U.S. Department of Treasury Circular 570

AICPA Statements of Standards for Attestation Engagement

The program regulations contain specific provisions concerning processing under the following citations with which the auditor should become familiar.

7 CFR 250.30, State Processing of Donated Foods

7 CFR 250.19, Reviews, Paragraph (b)(2)

7 CFR 210, Appendix C - Child Nutrition Labeling Program

Prior to beginning the examination, the auditor should obtain and review the key reference materials listed above. This review should provide a frame of reference as to how the program operates and what the auditor may reasonably expect from a processor that chooses to participate in DA or RA processing programs.

#### E. STANDARDS FOR CONDUCTING THIS ENGAGEMENT

The compliance attestation engagement must be performed as an examination-level engagement in accordance with AICPA Statement on Standards for Attestation Engagements - Compliance Attestation, and Government Auditing Standards issued by the Controller General of the United States (1994 Revision). Management's written assertions are the basis for the auditor's testing and therefore are an integral part of the

engagement. Such assertions normally should be obtained from management in a letter of representation to the auditor.

F. OBJECTIVES

The objectives of the examination are to ensure that the MSFP is in compliance with the terms of the contract for processing donated commodities, specifically to: (1) test and report on the reliability of the MSFP's monthly performance reports in conformity with applicable laws and regulations; (2) test and report if the MSFP is in compliance with laws and regulations which could have a direct and material effect on the financial-related data reported on the monthly performance reports; (3) detect with reasonable assurance, any irregularities, illegal acts, and other noncompliance that could have a direct and material effect on the financial schedules; and (4) to obtain an understanding of and assess the control risk relating to the MSFP internal controls that pertains to its ability to comply with the donated food processing contract, and in particular the MSFP's ability to record, process, summarize and report financial-related data on the monthly performance report in conformity with applicable laws and regulations. The objectives of the examination also include preparing a report showing the results of the examination including reports on compliance and a full discussion of all audit findings and conclusions. (See Section I - Reporting Requirements.)

G. SCOPE AND FREQUENCY OF EXAMINATIONS

All MSFP's shall have provided for a compliance attestation engagement depending on the value of the donated commodities received by the MSFP for each year as follows.

- Annual examinations are required for those MSFP's receiving more than \$250,000 in donated foods during the contract year.
- An examination is required every 2 years for those MSFP's receiving between \$75,000 and \$250,000 in donated foods each contract year.
- An examination is required every 3 years for those MSFP's receiving less than \$75,000 in donated foods each contract year.

Those multi-State processors which are in the two or three-year audit cycle shall move into the next audit cycle at the point in time in which the value of donated foods received reaches \$75,000 or \$250,000 in any year (See 7 CFR 250.18(b)).

If a processor exceeds \$250,000 in donated foods during the second year of its biennial cycle, one audit is required covering both years.

The thresholds apply to donated foods received in total from all States under the FDP. The examination cycle should be revised as the value of donated commodities received crosses the threshold levels.

The scope of the examinations should cover all FDP activities since the period covered by the prior examination. The extent of coverage must meet the minimum requirements of this program, and coverage should be expanded as necessary, to fully develop conditions noted, to enable the auditor to meet the examination and reporting objectives.

#### H. FIELDWORK REQUIREMENTS

In accordance with the AICPA's Attestation Standards, the examination should be adequately planned, and assistants, if any, should be properly supervised.

Plans for the audit should include a tour of the production facility to view the operations as they pertain to the contract. The auditor should plan to follow-up on any observations noted at this time; the auditor should also be aware of prior audits. Overall, the auditor must obtain sufficient evidence to provide a reasonable basis for the conclusions expressed in the attestation report.

In accordance with Government Auditing Standards, when laws, regulations, and other compliance requirements are significant to audit objectives, auditors should design the audit to provide reasonable assurance about compliance with them. Auditors should be alert to situations or transactions that could be indicative of illegal acts or abuse.

A sufficient understanding of the internal controls that pertains to the MSFP's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial-related items and to ensure compliance with applicable laws and regulations, is to be obtained to plan the examination, to determine the nature, timing, and extent of tests to be performed, and to assess associated procedures to provide reasonable assurance of detecting irregularities, illegal acts, and other noncompliance that could have a direct and material effect on the financial schedules. Auditors should exercise due professional care and caution in pursuing indications of illegal acts so as not to interfere with future investigations and/or legal proceedings.

Regarding testing for compliance with applicable laws and regulations, auditors should, at a minimum, perform the examination steps in sections II A - G of this bulletin. However, the auditor should use professional judgment in identifying and performing any additional coverage necessary to ensure material compliance with features contained in Title 7 CFR Part 250.30 that are applicable to MSFP's operations, and instances of material noncompliance should be adequately disclosed in the auditor's report.

Regarding internal controls, auditors should, at a minimum, obtain an understanding of, and assess the control risk for, internal controls necessary to provide reasonable assurance that:

- the MSFP's records support the data on the monthly performance reports;
- inventory reductions are only made for sales to eligible RA's;

- inventory reductions are only based on the actual number of approved units sold to eligible recipient agencies;
- inventory reductions are reconcilable to contracted yields under the FDP;
- book inventories of commodities are reconcilable to physical inventories;
- production and quality control records support yield claims on each End Product Data Schedule;
- appropriate value pass through has occurred;
- distributors do not over report sales to recipient agencies;
- the value of buy-back products and/or rework retained by the processor has been returned to the contracting agency (CA) at the established contractual rate or, if a contractual rate was not established, at the market value;
- the proceeds from the sales of containers, by-products, buy-backs or rework has been returned to the eligible RA;
- the value of by-products retained by the processor has been returned to the eligible RA via a reduction in the fee-for-service or sales price at the established contractual rate or, if a contractual rate was not established, at the market value; and
- the same amount of commercial purchases is made to replace operating losses of substitutable foods.

In accordance with Government Auditing Standards, the record of the auditor's work is to be retained in the form of working papers. Working papers must be maintained in accordance with the standard governmental records retention requirements (usually 3 years after the close of the fiscal year) and must be made available to USDA or its representatives upon request.

As specifically set forth in Government Auditing Standards, working papers should contain:

- standards the auditors determine do not apply;
- the objectives, scope, methodology, including any sampling criteria used;
- documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records, and
- evidence of supervisory review of the work performed.

Auditors should document in their working papers all communications to the auditee about irregularities, illegal acts, and other noncompliance.

All communications to the auditee about deficiencies in internal controls should be documented in the working papers.

## I. REPORTING REQUIREMENTS

The overall report should include:

- a report identifying the monthly performance reports being reported on, stating that the engagement consisted of an examination of the processor's monthly performance reports and the auditor's opinion on whether the processor's donated food operations, as represented by the monthly performance reports taken as a whole, are in conformity with Title 7 Code of Federal Regulations (CFR), Parts 250.30 and 252.1-6 (see Statement on Attestation Engagements at Section 100.53-55, for an illustration of an examination report);
- a report of all audit findings, conclusions, causes and recommendations for all material instances of noncompliance and reportable internal control conditions presented in accordance with Government Auditing Standards, as amended (See Chapter 5, "Reporting Standards for Financial Audits," Part 23, 27, and Chapter 7, Reporting Standards for Performance Audits, Parts 17 through 26 and 55 through 69);
  - a list of the procedures contained within this audit program that were not conducted;
- the monthly performance reports that were tested or a summary, which includes a description of the monthly performance reports, tested. If the number of tested reports exceeded the minimum number cited in this audit program, please contact FNS officials for guidance on submission procedures. If statistical sampling was used, provide the following information:
  1. A statement that statistical sampling was used and the reason for its use.
  2. A statement identifying the components of the audit where statistical sampling was used.
  3. The universe of the sample.
  4. The sampling method used.
  5. The confidence level.
  6. The maximum tolerable margin of sampling error (precision).
  7. The acceptable level of beta risk assigned by the auditor.

If different sampling procedures are used for different components of the audit, these should be disclosed, as well.

Any nonmaterial instances of noncompliance and internal control weaknesses should be communicated to the MSFP's management in a management letter, which should be referred to in the overall report and submitted to FNS with the report.

In accordance with Title 7 CFR Part 250.18(b)(4), audit findings relative to those elements associated with the processing of donated food shall be submitted to the processor and to FNS concurrently. Audit reports should be submitted no later than 180 days after the final date of the processor's contract year (December 31).

According to the Government Auditing Standards, auditors are required to report irregularities or illegal acts directly to parties outside the auditee in two circumstances: (1) If auditors have communicated such irregularities or illegal acts to the auditee, and it fails to report them, then the auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditor's communication with its governing body, then the auditors should report the irregularities or illegal acts directly to the external party specified in the law or regulation; (2) when an irregularity or illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statements or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then if the auditee does not report the irregularity or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the irregularity or illegal act directly to that entity.

NOTE: Amendment No. 1 to the Government Auditing Standards (1994 version) amends the section entitled "Internal Control" (paragraphs 4.21 through 4.33) in chapter 4. It establishes a new fieldwork standard requiring documentation in the planning of financial statement audits in certain circumstances (paragraphs 4.21.1 through 4.21.4). Specifically, this new standard requires auditors to document in the working papers the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent on computerized information systems. It also requires auditors to document their consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

## II. AUDIT PROCEDURES

When terms such as "evaluate, ascertain, verify, and determine" are used within this audit program, the procedure may be done on a test basis, unless the auditor has reason to believe more extensive testing is needed.

### A. CONTRACT ADMINISTRATION

In order to participate in the FDP, MSFP must make application and meet eligibility criteria which include: (1) the ability to meet the terms and conditions of applicable regulations and contracts; (2) the ability to distribute end products to eligible RA's; (3) a satisfactory record of integrity, business ethics, and performance; and (4) the ability to prove marketability of end products. These processors also agree to comply with specific program requirements as described below.

A processor is required to maintain records, i.e., bills of lading, invoices, production records, quality control records, inventory records, records of commercial purchases to replace production losses, and documentation to substantiate performance reports submitted as outlined in the regulations and the approved contract, for a period of 3 years past the current Federal fiscal year except when notified that they must be maintained longer. Contracts cannot exceed 1 year in duration and may be extended twice (two additional one-year periods). The appropriate company officials as designated in the regulations must sign the agreements.

If the processor subcontracts for any aspect of the end products manufactured, the subcontract must be in written form and approved in advance by the DA or FNS.

Program regulations require processors to provide each CA with a performance supply and surety bond, irrevocable letter of credit, or escrow account that is, at the minimum, sufficient to protect the contract value of all donated food inventory on hand or on order. The performance bond must be obtained from a surety company listed in the most recent U.S. Department of Treasury Circular 570.

For audits of processors using donated meat and poultry, there are several unique aspects of meat and poultry processing. These commodities are nonsubstitutable and must be processed under the supervision of an AMS grader with the exception of limited waivers granted by State DA's (in writing). Generally, meat and poultry commodities are processed under fee-for-service contracts, which do not involve the deduction of the value of the donated food from the gross price. The commodity value becomes a factor when replacement for losses is necessary or byproducts are produced.

In addition, the processors often contract to provide a guaranteed minimum number of units or yield in cases of finished products for the quantity of raw commodity they are provided. However, the CA is entitled to all of the end products produced including any cases produced above the contracted guarantee. Production of end products below the contracted guarantee must be replaced with commercial product or paid for based on the quantity of donated food contained in each case multiplied by the commodity value.

Inventory records must indicate raw commodity received, finished product produced, and finished product returned to RA's. Meat and poultry processing often involves byproduct credits for unused parts (necks, wings, tails, carcasses, etc.) or commodity left in ingredients remaining after production, and broken or misshapened patties. Processors must clearly account for these credits.

For all nonsubstitutable donated foods the processor utilizes in the manufacture of contracted end products, those end products must bear the following legend:

"Contains Commodities Donated by the United States Department of Agriculture.  
This product Shall Be Sold Only to Eligible Recipient Agencies."

At the CA's discretion, the processor may either apply as credit against the processing fee or return to the CA any funds received from the sale of donated food containers and the market value or the price received from the sale of any byproducts of donated foods or commercial foods which have been substituted for donated foods.

Protecting the value of USDA-donated foods is also a processor responsibility. These commodities should be stored in clean, safe, secure locations and be utilized in a manner, which maximizes the quality of the commodities. A processor may utilize another firm to process donated foods into end products via a subcontract with written approval from the DA or FNS. At times, a processor may also act as a subcontractor to another donated food processor. The prime contractor remains fully liable for the actions of the subcontractor with respect to donated food processing. The monthly performance report submitted by the processor incorporates the results of the subcontractor activities. As a result, in situations where subcontracting occurs, the processor must maintain adequate controls over the subcontractor in order to submit accurate monthly performance reports.

#### Required Management Assertion

[Processor] complied with eligibility criteria, including (1) meeting the terms and conditions of applicable regulations and contracts; (2) distributing end products to eligible RA's; (3) maintaining a satisfactory record of integrity, business ethics, and performance; and (4) demonstrating marketability of end products.

#### Purpose:

To determine whether the MSFP complied with the provisions stated in the contract in processing donated foods.

#### Audit Procedures

1. Follow-up on known material findings and recommendations from previous audits and determine whether the auditee has taken timely and appropriate corrective action. The auditor's report should disclose the status of uncorrected material findings and recommendations.

2. Obtain the processing contracts in force for both contractors and subcontractors (by CA) and the commodities utilized. Complete Schedule A, identifying all donated food subcontracts held by the processor during the contract year. Determine, through discussion and tests, whether records are maintained as prescribed by regulations and agreement.
3. Examine, on a test basis, the compliance of donated food subcontracts with 7 CFR Part 250.30c.
4. Examine, on a test basis, actual end product case labels if nonsubstitutable foods are used to determine whether the required label statement is in use.
5. Interview appropriate officials and test review sales records to determine if donated food containers are sold by the processor. If so, test review processor records to determine whether the value from the sales has been credited (or returned) to the CA. If the processor does realize a gain through the disposal of these containers but has not complied with the regulations in returning the value, report on the number sold and receipts generated by each CA.
6. Through discussion and record review on a test basis, determine if the processor has provided credit for buy-back products, byproducts and/or other saleable products to CA's. Byproducts can be tails, mechanically deboned product, carcasses and others. The value of any byproduct credit must be a mutually agreed value based on published price information. Credit for rework (misshapened patties, over breaded items and other usable products) remaining at agreement close should be documented according to the CA's designation. If the value of the credit is not stated in the contract, the processor must be able to demonstrate that the value derived from the use or sale of the buy-back products, byproducts, rework, or other saleable products has been returned to the CA. (Complete Schedule D-3).

B. MONTHLY PERFORMANCE REPORTS

Processors report sales and inventory information to the DA on a monthly basis by way of the monthly performance report (monthly activity report). This report contains:

- A list of all RA's purchasing end products in that month.
- Beginning commodity inventory (lbs.).
- Commodity received (lbs.).
- Number of units of approved end products delivered to each eligible RA.

- Number of pounds of each commodity represented by delivered end products.
- Ending commodity inventory (lbs.).

Additionally, under FDP the following items must be submitted along with the performance report:

- When sales verification responsibilities have been delegated to the processor by the DA, a list of findings (attached to the December and June reports only).
- A certification statement regarding the adequacy of inventory records.

The amount of sales the processor reports determines the amount deducted from the commodity inventory. Two methods are used to reduce inventories. For substitutable food items, the number of pounds represented in documented sales to eligible RA's form the basis for inventory reductions. For a fee-for-service arrangement utilizing substitutable commodities, the processor must meet the 100 percent return requirement. For nonsubstitutable food items, raw inventory is reduced by the number of pounds of commodity used in production. However, the processor must document compliance with the contracted yield, i.e., guarantee 25 percent on breast meat in white turkey rolls from a 36,000-pound shipment of whole birds.

Under Part 250 if a discount through the distributor VPT system is utilized, some form of sales verification by either the processor or DA is required. Processors which have been delegated this responsibility must maintain records documenting their efforts in this area and, as stated earlier, must report their findings to the DA four times each year.

If it is determined that the value of the donated food has not been passed on to RA's or if the end products have been improperly distributed, FNS may assess a claim against the processor. The claim may include a projection of the verification sample to the total sales reported by the processor. The statistical sampling performed by the DA or food processor on discount sales made by distributors without dual billing should have a 95 percent confidence level, and a .05 precision level.

#### Required Management Assertion

[Processor] complied with requirements for submitting to the DA monthly performance reports, and when applicable a list of findings (attached to the December and June reports only) when the processor has been delegated sales verification responsibilities, and a certification statement regarding the adequacy of inventory records.

### Purpose

To determine whether (1) the Monthly Performance Reports are maintained as required in accordance with the provisions in the contract for processing the commodities, and (2) the reports reflect the processor's activity accurately, and documentation maintained to support that activity.

### Audit Procedures

1. Determine, on a test basis, if monthly performance reports are on file for a sampling of contracting agencies (based on volume and dollar value of total commodity).
2. Review, on a test basis, for those contracting agencies sampled, if they were prepared in a timely manner (dated 30 days past the end of the month to which they pertain).
3. For those contracting agencies selected in Step 1 above, sample a representative number of months out of the audit period for review (the months should be selected based upon sales and production). Review the processor's supporting records to test the accuracy of the monthly reports. This can be done by comparing sales information (refund applications, bills of lading, grading certificates, shipping and delivery documents, sales invoices, and/or distributor's sales reports) with information contained on the monthly performance reports. Test supporting documents to determine that only approved end products have been claimed (as contained in the processor's contract). Complete Schedules B and C.
4. If the processor uses distributors, determine on a test basis, whether internal controls provide reasonable assurance that the distributors' reported sales are not in excess of the end product actually available to them for resale.
5. Steps taken by the processor to ensure that sales are only reported for eligible RA's should be noted, as well as, the number of cases of end products sold and the number of pounds of donated food each sale represents.
6. Perform adequate tests to determine the effectiveness of the processor's internal control system based on information submitted by subcontractors which is reported on the processor's monthly performance reports, or;
7. If the processor acts as a donated food subcontractor to another donated food processor, perform adequate tests to determine the accuracy of the information submitted to the prime processor.

8. For the months selected in Step 3 above, test for accuracy and validity the sales verification process conducted by the processor if this responsibility is delegated to the processor. The audit should conduct sufficient tests (such as confirmations) to assure that verifications are authentic.

### C. PRODUCTION YIELD RETURN

Regulations require that processors describe each end product in terms of the quantity of each ingredient, which is needed to yield a specific number of end products. This information is contained on the End Product Data Schedule (EPDS), and is part of every contract. The processor must maintain adequate production records to substantiate the appropriate use of commodity products. Processors utilizing substitutable donated foods are required to provide a 100 percent yield return. USDA recognizes that, generally speaking, it is physically impossible for a processor to return an actual 100 percent yield on donated foods for a variety of production reasons. However, this rule does encourage efficient use of donated foods in that any shortfall in donated ingredients must be replaced by the processor with commercially acquired food of like identity and equal or better quality.

In accordance with Part 250, the processor shall substitute only like quantities of domestically produced commercial food of the same generic identity (i.e., cheddar cheese for cheddar cheese, BHW flour for BHW flour, etc.) and of equal or better quality. Those foods, which can be substituted, are listed in Part 250.30(f)(i).

The 100 percent yield return requirement does not apply to the processing of nonsubstitutable foods. Processors of nonsubstitutable foods (primarily comprised of meat and poultry items) must meet or exceed the yield contained on the EPDS, which has been approved by the CA. This yield represents a minimum guaranteed return for the raw commodities provided. Production above the minimum yield must be returned to the eligible RA.

Beginning in School Year 1987, all processing of USDA-donated meat and poultry under DA or RA contracts by regulation must be processed under AMS grading certification. (Some DA's required this in previous years as well.) The AMS grader completes a certificate for all end products produced including the in and out weights as well as the number of units produced. Those grading certificates should support figures stated on the production records. Waivers of grading services granted by State DA's must be in written form.

#### Required Management Assertion

[Processor] complied with requirements for maintaining adequate production records to substantiate the appropriate use of commodity products.

Purpose

To determine whether (1) the end product represents the quality of donated foods utilized, and (2) substitutable quantities of commercial foods represent a 100 percent yield return of donated foods.

Audit Procedures

1. Sample, on a test basis, the accuracy of the processor's production records according to program requirements. If production records are not available, or are inadequate, cite this as an audit finding. Grading certificates for meat and poultry processing may be used in lieu of production records to substantiate production yield.
2. Using the months selected in Section B, Step 3, compare, on a test basis, the EPDS yield information to the processor' production records to determine whether required amounts of ingredients were used to prepare the end products. If the processor is found to be producing end products not in conformance with the contracted yields, determine the pounds of commodities, which were short of meeting the specified yields per the EPDS. Complete Schedule D-1 for substitutable foods, Schedule D-2, Part 1 for nonsubstitutable foods, and Schedule D-2, Parts 1 and 2 and Schedule D-3 for meat and/or poultry. For end products containing a combination of substitutable, nonsubstitutable, and/or donated meat and poultry, complete all of the applicable Schedule D's. Attach copies of the applicable end product data schedules for each product tested.
3. For substitutable foods only, review records to determine whether the processor has made adequate commercial purchases to replace commodity operating losses, as well as, to meet its regular commercial needs according to regulations.
4. For commercial foods which have been substituted for donated foods, have the processor provide documentation to test or to document that substituted commercial foods are of equal or better quality and of domestic origin as required in the regulations.
5. From a review of production records selected in Step C-2, determine on a test basis, if any substitution has occurred for reasons other than meeting the 100 percent yield return requirement for commodities other than those specifically listed as substitutable in the regulations.

D. QUALITY CONTROLS

By contract, each processor is required to maintain quality control (QC) records to further substantiate their use of donated foods and to help ensure the production of end products containing consistent amount of ingredients, as set forth in the end

product schedule. Those QC records are completed during the production and, for the most part, document individual portion weights at different points on the production line. These records will indicate the average amount of commodity applied to, or contained in, a portion of end product and serve as a management tool in enduring uniform product quality. A detailed QC plan, approved by USDA is required of those processors participating in the Child Nutrition (CN) Labeling Program.

#### Required Management Assertion

[Processor] complied with requirements to maintain QC records to further substantiate their use of donated foods, and to help ensure the production of end products containing consistent amounts of ingredients, as set forth in the end product schedule.

#### Purpose

To perform an overall evaluation of the processor's quality control system to determine whether the system adequately accounts for donated foods.

#### Audit Procedures

1. Obtain the processor's QC plan. Verify that records are being maintained as outlined in the plan.
2. Evaluate whether the processor has documentation to show that corrective actions were taken when QC tests indicate that end products are not meeting the requirements of the contract.

### E. INVENTORY CONTROLS

Program regulations require processors to maintain accurate and complete records pertaining to the receipt, disposal, and inventory of donated foods.

Processors receive donated foods in a variety of ways. Generally, the DA submits a food requisition to the RO for direct delivery of one or more carloads of a commodity to the processor's plant during a specific shipping period. Ideally, the processor has had some input in the decision to order the product. The Farm Service Agency then arranges for shipments to the processor.

Sometimes RA's under both States and local agreements, arrange to have commodities backhauled from their location by the processor.

Also, on some occasions, one DA may have an excessive book inventory and may desire to transfer all or part of that inventory to another DA. This type of transaction can only occur with the concurrence of each DA and the appropriate RO's. Written authorization from FNS is required.

Regardless of the receipt method, regulations allow no more than a 6-month inventory level except with written DA authorization. In order to perform the following steps, the amount of commodities for all CA's must be included in the calculation since food processors generally commingle similar commodities in inventory. If separate inventories are maintained for each CA, the CA's can be analyzed separately.

NOTE: Processors must maintain adequate purchases of commercial product to meet commercial needs. In addition, processors must maintain adequate supplies of commercial product to meet the 100 percent yield requirement for production losses of substitutable foods. In cases where the processor has insufficient physical inventories of raw substitutable donated foods, verification of adequate commercial purchases and existing physical inventories of nondonated foods to meet the need for commercial and donated foods will be necessary.

#### Required Management Assertion

[Processor] complied with requirements to maintain accurate and complete records pertaining to the receipt, disposal, and inventory foods.

#### Purpose

To determine whether controls are in place to adequately and accurately account for donated foods, including delivery, storage, usage and disposal.

#### Audit Procedures

1. Test receipt of commodities by reviewing the accuracy of documentation supporting the receipt, disposal and inventory of donated foods. Complete Schedule E for each CA, by State, for the previous 12 months and complete Schedule F in summary. Schedule E must be completed for all States where contracts were taken, whether or not a specific CA with the State has been selected for testing within other aspects of the audit program.
2. For processors utilizing the nonsubstitutable foods, use a physical inventory count of all donated foods completed within the contract period being audited, and reconcile the year end adjusted book inventory to the physical inventory, including the number of pounds of nonsubstitutable foods represented in sales to a distributor. Reconcile the nonsubstitutable foods using Schedule G-1. For processors employing distributors under the rebate/refund system, obtain documentation to attest to the processor's monthly certification that the required quantities of donated foods are on hand.

**NOTE: The schedule may need to be adjusted to relate to the processor's system. Footnote any differences.**

3. Determine, on a test basis, whether each CA's inventory is within the 6-month limit. (See Schedule E.)

F. COMMODITY VALUE PROTECTION

Value Pass-Through (VPT) is the system by which the value of donated foods which are either contained in an end product, when utilizing substitutable foods, or used to produce an end product, when utilizing nonsubstitutable foods, flows from the processor to the purchasing RA in the form of a refund or discount against the full cash price. There are three primary VPT methods: refunds, direct discount and indirect discount. In addition, fee-for-service arrangements are commonly used for meat and poultry (nonsubstitutable) processing. The VPT methods are described below:

Refund

The processor pays a refund (rebate) to the RA upon proof of end product purchase for the commodity value. From point of purchase to point of payment no more than 70 days should elapse by regulation. This method can be used under both direct sales by processors and indirect sales through distributors. The refund application serves as the source sale document along with the cancelled check or other accounting documents.

Direct Discount

The processor sells the end product to the RA at a price instantly discounted for the commodity value. The processor's sales invoice serves as the source sale discount.

Indirect Discount

The processor sells the end product to a commercial distributor at the full price without credit. The distributor sells the end product to the RA at the discounted price plus a percentage markup to cover service costs and normal profit. The distributor submits proof of RA purchase to the processor to request commodity credit. The processor, upon determining that an appropriate discount was given the RA, remits payment for the commodity value to the distributor. The distributor's proof-of-purchase documents serve as the source sale documents. Depending on the source document, the distributor may be required to submit sales invoices (or similar documentation) to substantiate its sales claims.

Fee-For-Service

The processor provides a finished end product at a cost per case or unit. This price represents the processor's costs for other ingredients (not donated commodities), labor, packaging, overhead and other costs incurred in the conversion of donated commodities into end products.

Alternative Value Pass-Through Systems

With the publication of the June 5, 1988, regulations, States are permitted to use alternative VPT systems with the written approval of FNS. Instances occasionally arise where systems not approved or prescribed by regulation are in use. Please note any instances where a processor has been found using a system, which does not conform to current regulation.

Required Management Assertion

[Processor] complied with the requirements to ensure that the value of donated foods flows from the processor to the purchasing RA in the form of a refund or discount against the full case price.

Purpose

To determine whether the value pass-through system activity is properly controlled and recorded.

Audit Procedures

1. It is the processor's responsibility to ensure that VPT has occurred, regardless of the method of sale. Obtain a description of the VPT used for the contracting agencies in Section B, and compare this with the VPT method approved by the CA.
2. Review the supporting data (sales and price information), which the processor used to establish the VPT. Evaluate this information and determine if the value of the donated foods was properly determined and passed on to the RA's.
3. If the processor utilizes a refund VPT method, determine on a test basis, whether payments are made to the requesting RA on a timely basis (within 30 days of receipt by the processor for State processing). Using the same sample in Section B, Step 3, examine, on a test basis, cancelled checks to determine whether payment has actually been received by the RA's.

G. BONDING AND INSURANCE

Each processor must maintain adequate insurance to protect against insurable losses in addition to maintaining a performance bond, escrow account or irrevocable letter of credit to protect contracting agencies against performance failures by the processor.

Required Management Assertion

[Processor] complied with the requirements to maintain adequate insurance to protect against insurable losses.

Purpose

To determine whether the MSFP is in a position to ensure the protection of all donated foods processed from financial loss.

Audit Procedures

1. Obtain copies of the certificates of insurance, bonds, escrow account balances, or letter of credit.
2. For letters of credit, determine if the letters are irrevocable and payable on demand to the appropriate contracting agencies; and for escrow accounts, determine if the account is payable to the contracting agencies.
3. Determine if the contractual and regulatory amounts of performance-based protection have been met by the surety documents for the duration of the audited period.
4. Identify any surety document, which would not cover losses resulting from the year-end reconciliation report or this audit report, either by amount or expiration date.
5. Determine if the processor maintains adequate insurance coverage to protect the maximum amount of donated foods on hand at any time, including raw, in production and finished goods, from an insurable loss.

PROCESSOR NAME:  
SUMMARY OF SUBCONTRACTS  
FOR THE PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

A. DONATED FOOD SUBCONTRACTS USED BY THE PROCESSOR

Name of Subcontractor	Donated Foods Used	Deficiencies Not Noted Elsewhere in Report

B. DONATED FOOD SUBCONTRACTS HELD BY THE PROCESSOR

Name of Prime Contractor	Donated Foods Used	Deficiencies Not Noted Elsewhere in Report

(NOTE: CAUSE FOR DEFICIENCIES NOTED HEREIN SHOULD BE DETERMINED AND REPORTED.)

SCHEDULE B  
of 27009e  
(AUDIT PROCEDURE II,B 3)

PROCESSOR NAME:

MONTHLY SALES:

BY END PRODUCTS FOR THE MONTHS OF: \_\_\_/\_\_\_/\_\_\_/\_\_\_/ AND \_\_\_/\_\_\_/

CONTRACTING AGENCY:

REPORTING MONTH/YEAR	END PRODUCT CODE	SALES REPORTED TO DA (CASES)	DOCUMENTED SALES (CASES)	=	UNDOCUMENTED SALES
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EXPLAIN DIFFERENCE IN FOOTNOTES:

SCHEDULE C  
of 27009e  
(AUDIT PROCEDURE II,B 3)

PROCESSOR NAME:  
SUMMARY OF SALES FOR THE MONTHS OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

CONTRACTING AGENCY:

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END PRODUCT CODE	UNDOCUMENTED SALES	X	DONATED FOOD PER CASE	EXCESS INVENTORY REDUCTIONS	X	DONATED FOOD VALUE PER POUND	=	VALUE UNDOCUMENTED CASES
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SCHEDULE D-1  
of 27009e  
(AUDIT PROCEDURE II,C 2)

PROCESSOR NAME:  
SCHEDULE OF AUDITED PRODUCTION - SUBSTITUTABLE FOODS  
RECORDS FOR THE PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

CONTRACTING AGENCY: \_\_\_\_\_

	COMMODITY 1 (NAME) Item #	COMMODITY 2 (NAME) Item #
A. TOTAL POUNDS ACTUALLY PUT INTO PRODUCTION PER THE PRODUCTION RECORDS		
B. NUMBER OF CASES PRODUCED PER PRODUCTION RECORDS		
C. POUNDS OF DONATED FOOD REQUIRED TO BE PUT INTO PRODUCTION PER CASE (FROM THE END PRODUCT DATA SCHEDULE)		
D. POUNDS OF DONATED FOOD REQUIRED TO BE CONTAINED IN THE CASE OF END PRODUCT (FROM THE END PRODUCT DATA SCHEDULE)		
E. "B" X "C"		
F. "A" "E"		

(NOTE: CAUSE FOR DEFICIENCIES NOTED HEREIN SHOULD BE DETERMINED WHEN REVIEWING QUALITY CONTROL RECORDS UNDER THIS GUIDE.)

SCHEDULE D-2  
of 27009e  
(AUDIT PROCEDURE II,C 2)

PROCESSOR NAME:  
SCHEDULE OF AUDITED PRODUCTION - NONSUBSTITUTABLE FOODS  
RECORDS FOR THE PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

CONTRACTING AGENCY: \_\_\_\_\_

	COMMODITY 1 (NAME) Item #	COMMODITY 2 (NAME) Item #
PART 1		
A. TOTAL POUNDS ACTUALLY PUT INTO PRODUCTION PER THE PRODUCTION RECORDS (FOR MEAT & POULTRY, AMS GRADING CERTIFICATES, IF AVAILABLE, MUST BE USED)		
B. NUMBER OF CASES PRODUCED PER PRODUCTION RECORDS		
C. POUNDS OF DONATED FOOD REQUIRED TO BE PUT INTO PRODUCTION PER CASE (FROM THE END PRODUCT DATA SCHEDULE)		
D. "B" X "C"		
E. "A" "D"		
PART 2 FOR DONATED MEAT AND POULTRY ONLY		
F. GUARANTEED MINIMUM RETURN FROM THE END PRODUCT DATA SCHEDULE		
G. POUNDS OF END PRODUCT PRODUCED (FROM THE AMS GRADING CERTIFICATE OR PRODUCTION RECORDS IF CERTIFICATE IS NOT AVAILABLE)		
H. "A" X "F"		
I. "G" "H"		

(NOTE: NEGATIVE ENTRIES ON LINE E AND/OR NON ZERO ENTRIES ON LINE I SHOULD BE CROSS CHECKED WITH APPLICABLE QUALITY CONTROL RECORDS AND ANY DEFICIENCIES NOTED.)

SCHEDULE D-3  
of 27009e  
(AUDIT PROCEDURE II,C 2)

PROCESSOR NAME:  
SUMMARY OF BYPRODUCTS - MEAT & POULTRY ONLY  
FOR THE PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

CONTRACTING AGENCY: \_\_\_\_\_

	BY PRODUCT 1 (NAME)	BY PRODUCT 2 (NAME)
A. TOTAL POUNDS OF SALEABLE PRODUCT RESULTING FROM DONATED FOOD PROCESSING		
B. CONTRACT VALUE PER POUND  OR		
C. MARKET VALUE PER POUND AS OF JUNE 30		
D. TOTAL VALUE OF SALEABLE PRODUCT RETURNED TO RECIPIENT AGENCIES		
E. "A" X "B" <del>OR</del> "A" X "C"		
F. "D" "E"		

(NOTE: CAUSE FOR DEFICIENCIES NOTED HEREIN SHOULD BE DETERMINED AND REPORTED.)

SCHEDULE E  
of 27009e  
(AUDIT PROCEDURES II,E, 1 AND 3)

PROCESSOR NAME:  
INVENTORY ACTIVITY FOR THE  
PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

CONTRACTING AGENCY: \_\_\_\_\_

	COMMODITY 1 (NAME)	COMMODITY 2 (NAME)
A. BEGINNING BOOK INVENTORY (AS OF ___/___/___)		
B. COMMODITY RECEIVED		
C. TRANSFERS IN AND OUT		
D. INVENTORY REDUCTIONS		
E. ENDING BOOK INVENTORY (AS OF ___/___/___)		
F. AVERAGE MONTHLY USAGE (LINE D ) 12)		
G. MONTHS' INVENTORY ON HAND (LINE E ) LINE F)		

(NOTE: CAUSE FOR DEFICIENCIES NOTED HEREIN SHOULD BE DETERMINED AND REPORTED.)

SCHEDULE F  
of 27009e  
(AUDIT PROCEDURES II,E 1)

PROCESSOR NAME:  
COMBINED INVENTORY ACTIVITY  
SUMMARY FOR THE  
PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_  
(IN POUNDS)

	COMMODITY 1 (NAME)	COMMODITY 2 (NAME)
A. BEGINNING BOOK INVENTORY (AS OF ___/___/___)		
B. COMMODITY RECEIVED		
C. TRANSFERS IN AND OUT		
D. INVENTORY REDUCTIONS		
E. ENDING BOOK INVENTORY		
F. AVERAGE MONTHLY USAGE (LINE D ) 12)		
G. MONTHS' INVENTORY ON HAND (LINE E ) LINE F)		

(NOTE: CAUSE FOR DEFICIENCIES NOTED HEREIN SHOULD BE DETERMINED AND REPORTED.)

SCHEDULE G  
of 27009e  
(AUDIT PROCEDURES II,E, 2)

PROCESSOR NAME:  
INVENTORY RECONCILIATION SCHEDULE - NONSUBSTITUTABLE FOODS  
FOR THE PERIOD OF: \_\_\_/\_\_\_/\_\_\_ THROUGH \_\_\_/\_\_\_/\_\_\_

CONTRACTING AGENCY \_\_\_\_\_

	COMMODITY 1 (NAME)	COMMODITY 2 (NAME)
A. TOTAL BOOK INVENTORY AS OF (AUDIT DATE)		
B. TOTAL RAW PHYSICAL INVENTORY AS OF (AUDIT DATE)		
C. COMMODITY IN END PRODUCTS AT PROCESSOR ON (AUDIT DATE)		
D. COMMODITY IN END PRODUCTS AT DISTRIBUTORS ON (AUDIT DATE)		
E. TOTAL PHYSICAL INVENTORY ON (AUDIT DATE) (B + C + D)		
F. DIFFERENCE		

(NOTE: CAUSE FOR DEFICIENCIES NOTED HEREIN SHOULD BE DETERMINED AND REPORTED.)