



**Annual Review
Costs & Pricing Panel
Supplementary Materials**

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2018-2019

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June 7, 2019

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**Re: CASB Staff Discussion Paper on Conformance of the Cost
Accounting Standards to Generally Accepted Accounting Principles
(CASB Case 2019-01), 84 Fed. Reg. 9143 (March 13, 2019)**

Dear Mr. Wong,

On behalf of the American Bar Association (“ABA”) Section of Public Contract Law (“Section”), I am submitting comments on the staff discussion paper cited above. The Section consists of attorneys and associated professionals in private practice, industry, and government service.¹ The Section’s governing Council and substantive committees include members representing these three segments to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the ABA’s Board of Governors. The views expressed herein are presented on behalf of the Section. They have not been approved by the House of Delegates or the Board of Governors of the ABA and, therefore, should not be construed as representing the position of the ABA.²

¹ Kara M. Sacilotto, Section Chair, Mary Ellen Coster Williams, Section Delegate to the ABA House of Delegates, and Scott Flesch, Marian Blank Horn, and Kristine Kassekert, members of the Section’s Council, did not participate in the Section’s consideration of these comments and abstained from the voting to approve and send this letter.

² This letter is available in pdf format at http://www.americanbar.org/groups/public_contract_law/resources/prior_section_comments.html under the topic “Accounting, Cost and Pricing.”

I. INTRODUCTION

On March 13, 2019, the Office of Management and Budget (“OMB”) issued a Staff Discussion Paper prepared by the Cost Accounting Standards Board (“CASB” or “Board”) to invite public comment concerning the conformance of the Cost Accounting Standards (“CAS”) to Generally Accepted Accounting Principles (“GAAP”). The National Defense Authorization Act for Fiscal Year 2017 (Pub. L. No. 114-328, 130 Stat. 2273) amended 41 U.S.C. § 1501(c)(2) to require the Board to review CAS and conform them, where practicable, to GAAP. In addition, the amended 41 U.S.C. § 1502(e) requires the Board to submit an annual report to the Congressional defense committees, the House Committee on Oversight and Government Reform,³ and the Senate Committee on Homeland Security and Governmental Affairs describing the actions taken during the prior year to conform CAS with GAAP and to minimize the burden on contractors while protecting the interests of the Government.

The Section applauds the Board for thoughtfully undertaking the effort to conform CAS to GAAP. But the Section is concerned that the CASB’s detailed line-by-line analysis of each Standard relative to GAAP will not accomplish what Congress intended: to minimize the burden on contractors to the extent *practicable*.⁴

II. COMMENTS

A. Summary

We urge the CASB to revisit its charge from Congress in a broader sense. When established, GAAP did not fully address the measurement, assignment, and allocation of costs, which prompted creation of the CAS. Since that time, GAAP has evolved considerably. To the extent that GAAP now meets the CASB’s primary objective of achieving cost-accounting uniformity and consistency, and reflects no preference for contractors or the Government, certain CAS can and should be eliminated—even where GAAP and CAS currently differ.

The government procurement environment has changed significantly since the CASB promulgated the Standards in the 1970s. In recent years, Congress has emphasized that unnecessary and burdensome government-unique rules discourage commercial companies from selling to the Government, thus limiting the Government’s access to products and services that it needs. The Section accordingly encourages the CASB to approach conformance of CAS to GAAP with the objective of reducing government-unique rules unless necessary to protect the Government’s interest.

In this regard, the CASB should interpret the term “practicable” (as used by Congress in Section 820 of the FY17 NDAA) in a broad sense. Rather than requiring clear reasons to eliminate any CAS before proposing to do so, the CASB should instead be looking for clear reasons to keep each Standard. So long as CAS is maintained, detailed differences between CAS and GAAP will continue to create barriers to commercial participation in government procurement. Although

³ Now the Committee on Oversight and Reform.

⁴ See § B.2.b, *infra*, for additional discussion.

these detailed differences may indeed create different accounting outcomes, if GAAP accomplishes the CASB's primary objective of uniformity and consistency, without unduly advantaging either contracting party, then the corresponding Standard should be eliminated. Additionally, the Section encourages the CASB to approach the phrase "protecting the government's interests" within the scope of its authority: to achieve uniformity and consistency in cost accounting evenhandedly.

Regarding the term "practicable" used in the NDAA, the Section is concerned that the CASB's approach may be more in line with the term "practical." The Section acknowledges it may be "practical" to eliminate or conform CAS only when there is strong evidence that GAAP is substantially the same as CAS, whereas it is "practicable" to keep or conform CAS only when there is strong evidence that GAAP will not achieve the CASB's primary objectives of uniformity and consistency.

The Section appreciates the CASB's initial attempt to conform CAS 408 and 409 and we agree that these two Standards are ripe for conformance. However, because they are substantially similar to current GAAP and not a source of controversy, the Section urges the CASB to refocus its efforts on two recent GAAP changes (lease accounting and revenue) that could create acute, near-term challenges for contractors. The Section believes that if the CASB addresses lease accounting and revenue, then it can make immediate and impactful progress toward conforming CAS and GAAP, minimize burden on contractors, and protect the interests of the Government.

The Section also believes the CASB can make rapid, significant progress toward achieving Congress's objectives by endorsing implementation of the Section 809 Panel's recommendation no. 30. This particular recommendation, contained in Section 4 of the June 2018 Report Volume 2, calls for Congress to, among other things, significantly increase the CAS applicability thresholds.⁵ As the Section 809 Panel researched and explained, doing so will meaningfully reduce the number of CAS-covered contracts and, thus, the number of contractors that must comply with CAS. Although CAS-GAAP conformance is an important undertaking, it appears likely to achieve smaller incremental reductions in compliance burdens relative to the Section 809 Panel's recommendations for attracting more commercial companies to the government marketplace.

Finally, the Section urges the Board to avoid changes to CAS and implementing regulations that may extend CAS administration to GAAP. Such an outcome would reduce the benefits of eliminating Standards by adding new burdens not contemplated by Congress. The Government does not need to expand CAS into enforcing GAAP because costs inconsistent with GAAP are unallowable by rule, which provides a method for the Government to ensure contractors comply with the relevant GAAP requirements. *See* FAR 31.201-2(a)(3). And CAS already provides for consistent cost estimating, accounting, and reporting (via CAS 401) regardless of whether cost accounting practices are governed by CAS or GAAP.

⁵ The report is available here: https://section809panel.org/wp-content/uploads/2019/01/Sec809Panel_Vol2-Report_JUN2018_012319.pdf.

B. The Government Contracting Environment and GAAP has Changed

1. Historical Environment

The 1970s marked a notable decline of the domestic industrial era. Information technology was nascent. Government contract spending was mostly defense-related and primarily for products (not services) from relatively few large industrial companies. These products tended to be government-unique items developed with government funding. Non-competitive firm-fixed price contracts were prevalent, which were negotiated using cost-based pricing.

The Department of Defense, particularly Navy Vice Admiral Hyman Rickover, testified before Congress about the lack of uniformity and consistency in contractor cost accounting, which frustrated the Department's ability to negotiate fair and reasonable contract prices. Congress chartered the then-named General Accounting Office ("GAO") to study the feasibility of "cost accounting standards." Because GAAP did not sufficiently address uniformity and consistency of cost accounting, and because the GAO's study suggested that cost accounting standards were both necessary and feasible, in 1970 Congress created the CASB and charged it with developing cost accounting standards applicable to defense contractors. The focus of the CASB, when evaluating the need for CAS, was on achieving a reasonable degree of cost accounting uniformity and consistency in:

- The measurement of costs
- The assignment of costs to cost accounting periods
- The allocation of costs to contracts

2. Current Practices

Over the past 40 years, the economy transitioned into the information technology/knowledge era. Although the Government still acquires industrial products, information technologies and knowledge-based services have become the focus of government procurement. The commercial marketplace rapidly develops new technologies, primarily at private expense. Service contracting has become highly competitive, and the Government negotiates comparatively fewer service-contract prices based on costs. Long-term traditional contract types (i.e., firm-fixed price, cost-type) have in many cases transformed into shorter-term hybrid and IDIQ contracts (with option periods) that provide for task orders or line-items of varying types.

The commercial marketplace has become the engine of innovation. Both Congress and the Section 809 Panel have amplified the importance of government access to this market. However, the Government's industrial-era procurement rules remain in effect and can deter commercial companies from participating in government procurements, which limits both competition and the Government's access to knowledge and technologies.

GAAP has also evolved since the 1970s, especially in measuring costs and assigning them to accounting periods. Although the CASB's original objectives remain relevant in the current market environment, the CAS themselves have remained relatively unchanged, and certain CAS

are no longer necessary to achieve cost accounting uniformity and consistency given developments in GAAP.

Although the nature of government contracting has evolved since the 1970s, the prevalence of cost-type contracting (to Congress's dissatisfaction) supports the continuing need for reliable and consistent contract cost accounting. But because GAAP now addresses cost measurement and assignment, fewer government-unique rules are needed to accomplish that consistency and reliability.

C. Guiding Principles

The Section generally agrees with the CASB's Guiding Principles for CAS-GAAP conformance but encourages the CASB to revisit its philosophical approach to the term "practicable" and phrase "protect the interests of the government." The Congressional record provides guidance in this regard, as detailed below.

With respect to the phrase "protect the interests of the government," the Section is concerned that the CASB may be interpreting it too broadly. In the context of CAS, consistent with the CASB's Statement of Objectives, Policies, and Concepts, "protecting the interests of the government" means achieving uniformity and consistency in cost accounting, without bias or prejudice to either contracting party. Any other interpretation of that phrase is a policy matter for each government agency and outside the CASB's scope, in the Section's reading.

D. Conformance of CAS to GAAP

1. *FY 17 NDAA*

The Section is concerned that the CASB may interpret the statutory language regarding CAS to GAAP conformance more narrowly than Congress intended. The Section notes that several passages from the FY17 NDAA committee and conference reports indicate Congress's desire for the CASB to act to reduce burdensome, government-unique rules:

The committee is concerned that the current cost accounting standards favor incumbent defense contractors and limit competition by serving as a barrier to participation by non-traditional, small business, and commercial contractors. To level the competitive playing field to access new sources of innovation it is in the government's interest to adopt more commercial ways of contracting, accounting, and oversight. The provision requires that cost accounting standards developed shall to the **maximum extent practicable** align with Generally Accepted Cost Accounting Principles, thereby **minimizing the requirement for government-unique cost accounting systems**.⁶

* * *

⁶ Senate Armed Services Committee Report, Section 811 (emphasis added).

The provision also requires that cost accounting standards developed shall to the **maximum extent practicable** align with Generally Accepted Accounting Principles (GAAP), thereby minimizing the requirement for government-unique cost accounting systems.⁷

* * *

Additional language, though specific to the provisions addressing the CASB, further reflects the spirit of Congress to reduce the burden of government-unique rules:

The committee is frustrated by the continuous dependence of the Department of Defense on the use of cost type contracts. While there are some circumstances where cost-type contracts may be appropriate, the Department has over the years expanded the use of these types of contracts as a forcing mechanism to achieve absolute certainty in visibility over contractor costs. While this visibility has enabled the Department the ability to achieve some narrow cost reductions on certain contracts, it has come at the cost of reduced competition and innovation. The effect of the overuse of cost-type contracts is the narrowing of the industrial base **as commercial firms make a choice not to invest in the unique accounting and financial systems necessary to compete for a cost contract. This expensive barrier to entry has resulted in a smaller pool of defense unique companies that can comply with government unique requirements necessary to execute a cost contract. Commercial companies that choose not to invest in expensive government unique accounting systems are effectively precluded from doing business with the Department when DOD chooses to use cost contracts.** This provision, in combination with the preference for fixed-price contracts in a separate section of this Act, is designed to limit the use of cost contracts in the future and focus the Department on achieving greater value and innovation through accessing commercial, non-traditional, and small business contractors that are nimble enough to operate in a fixed-price environment.⁸

In light of Congress's expressed views, the Section urges the CASB to eliminate Standards where GAAP provides for uniformity and consistency in the measurement of costs and assignment of costs to accounting periods, and shows neither bias nor prejudice to either contracting party.

2. Conformance Alternatives

a. The Section's recommended alternative

To the extent GAAP provides for uniformity and consistency, the CASB should remove CAS related to the same area of cost even if doing so produces a transitory cost impact. The

⁷ Conference Report, Section 820 (emphasis added).

⁸ Conference Report, Section 826 (emphasis added).

Section urges the CASB to focus on this alternative in light of the GAAP developments and views of Congress described above.

Any cost impact associated with eliminating CAS is a separate matter addressable with a fair and equitable transition plan similar to when contractors initially adopted Standards as they became effective. The Section encourages the CASB to weigh the long-term benefits of fewer government-unique rules relative to the short-term transitory consequences of eliminating particular Standards. Congress has expressed that eliminating government-unique rules will be beneficial in the long term. The Section encourages the CASB to adopt that sense of Congress except when compelling evidence suggests otherwise.

The Section believes that this approach will protect the Government's interests through the uniformity and consistency provided by GAAP and, in Congress's view, by removing unnecessary barriers to entry and reducing government-unique burdens on commercial business. We note that FAR 31.201-2, Determining Allowability, will still apply, thereby requiring contractor compliance with GAAP. Moreover, the Section supports retaining CAS 401 to protect the Government's interests as it relates to the CAS objectives of uniformity and consistency (i.e., any cost accounting practice, whether covered by CAS or GAAP, is subject to the consistency requirements of CAS 401).

b. Other alternatives

- (1) To the extent GAAP aligns with CAS, keeping CAS unchanged

The Section believes that this option falls short of Congress's directions. Because certain CAS and GAAP can overlap in substantial part, CAS may for some contractors add limited accounting burdens (i.e., certain CAS do not currently require contractors to maintain both GAAP and CAS accounting methods). But even in these cases, other burdens remain such as CAS-specific audits and the duplication of GAAP and CAS reviews by external auditors (not to mention the possibility of disagreement between contractors' external and government auditors). The burdens of CAS administration also remain, which the Section believes are among the most significant barriers to entry for commercial companies.

- (2) To the extent GAAP aligns with CAS, conform CAS to GAAP

The Section has assessed this as the *least* desirable option given Congress's directions, yet it appears this is the CASB's current direction. This alternative would either:

- Align CAS and GAAP entirely, rendering CAS duplicative yet no less burdensome, or
- Eliminate certain elements of CAS that align with GAAP, but retain certain unique aspects of CAS that do not align with GAAP.

Both of these alternatives require a detailed line-by-line analysis that the CASB seems to be undertaking. The result of either will be, in the Section's view, short of what Congress desires.

Such a review will also require a significant investment of dedicated time and resources, which may be difficult to justify given the many competing priorities for both contractor and government resources.

The Section is concerned that pursuing this alternative will not relieve the burden of government-unique rules on commercial companies. Rather it will make the rules more nuanced and detailed, without conforming CAS to GAAP to the *maximum extent practicable* as directed by Congress

E. CAS-GAAP Conformance Roadmap

The Section generally agrees with CASB's categorization of the Standards relative to their ripeness for conformance to GAAP:

- Regarding Category 1 (CAS 404, 407, 408, 409, 411, 415, 416), the Section encourages the CASB to eliminate all of these Standards, to the *maximum extent practicable*, unless clear, compelling, and significant evidence exists to either keep or conform them.
- Regarding Category 2 (CAS 403, 410, 418, 420), the Section agrees that GAAP generally does not address cost allocation to contracts and, thus, conformance of these Standards is not yet practicable.
- Regarding Category 3 (CAS 412, 413, 414, 417), the Section encourages the CASB to evaluate CAS-GAAP conformance as it relates to the measurement and assignment of pension costs (i.e., CAS 412, 413). Although the measurement and assignment of costs differs between CAS and GAAP, GAAP has evolved to provide a greater degree of uniformity and consistency since the 1970s. The Section agrees that CAS 414 and 417 are necessarily unique to government contracting unless the Government, as a matter of procurement policy, decides to make interest an allowable contract cost.
- Finally, regarding Category 4 (CAS 401, 402, 405, 406), the Section generally agrees that GAAP does not address the cost accounting concepts in CAS 401, 402, and 405. However, the Section encourages the CASB to consider reassigning CAS 406 to Category 1 because GAAP provides for the determination of accounting periods.

F. Applicability of CAS clauses to GAAP compliance

The Section encourages the CASB not to extend CAS administration rules to GAAP compliance. These regulations currently do not apply to GAAP compliance.

If the CASB eliminates certain Standards where GAAP provides sufficient uniformity and consistency, then the CAS administration rules would no longer apply to those areas. Congress's statutory direction for this exercise did not contemplate expanding the Government's CAS administration burden or the Government's access to contractor records. The FAR cost principles and CAS 401 will sufficiently protect the government's interest without the added layer of CAS administration.

III. CONCLUSION

The Section encourages the CASB to align its activities with Congress's desire to reduce government-unique regulatory burdens on, and eliminate barriers to entry for, commercial companies. While CAS-GAAP conformance is an important task, it will not produce immediate beneficial results like those available by implementing the Section 809 Panel recommendation no. 30. Because increasing the CAS applicability thresholds would greatly reduce the number of commercial companies that must comply with CAS, CAS-GAAP conformance becomes less critical. For those companies that must still comply with CAS after increasing the applicability thresholds, the CASB should next address the emerging CAS-GAAP issues concerning leases and revenue. The CASB can take these actions without waiting for further direction from Congress.

When undertaking CAS-GAAP conformance, the Section encourages the CASB to eliminate CAS where GAAP now addresses uniformity and consistency (even if CAS and GAAP do not closely align) so long as GAAP shows neither bias nor prejudice to either contracting party. Implementation plans can adequately address any transient cost impacts associated with adopting GAAP for contract costing purposes (a required change). In addition to FAR 31.201-2, which requires compliance with GAAP, future changes in GAAP necessitating cost accounting changes will be covered by CAS 401, which the Section agrees should be retained. Finally, the CASB should avoid using the CAS administration regime as a GAAP-enforcement mechanism. The CAS administration rules, beyond those invoked by CAS 401, do not currently, and should not in the future, apply to GAAP compliance.

The Section appreciates the opportunity to comment and would be happy to provide any further information or insights that your office might require.

Sincerely,

Linda T. Maramba

Linda Maramba
Chair-Elect, Section of Public Contract Law

cc:
Susan Warshaw Ebner
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Cost Accounting Standards Board

Staff Discussion Paper (SDP) – Conformance of CAS to GAAP

Case Number CASB 2019-01

I. Introduction

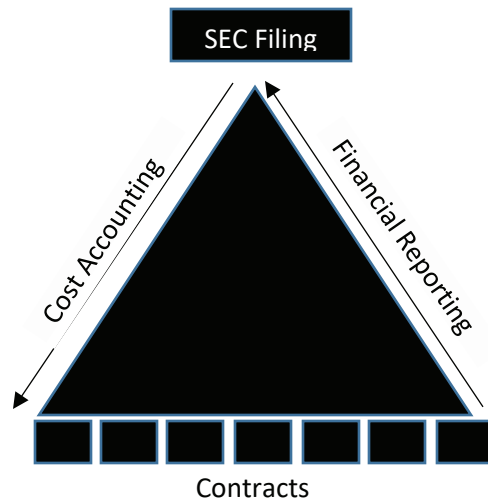
In evaluating where and how Cost Accounting Standards (CAS) may be conformed to Generally Accepted Accounting Principles (GAAP), the Board believes it is important, as a preliminary matter, to take note of differences and similarities in the purpose and application of these overlapping, but distinct, accounting standards. This comparison is driven, in large part, by differences between cost accounting and financial accounting.

Government Cost Accounting Standards (CAS) promulgated pursuant to 41 U.S.C. § 1502 are designed to provide protections to the Federal Government by achieving uniformity and consistency in the cost accounting practices used by contractors for measurement, assignment and allocation of costs to contracts with the United States Government. Uniformity of the standards used across contractors provides the Government the ability to compare contract proposals and performance. Consistency provides the Government protection from the effects of inconsistent or improper contractor cost accounting, which could result in entities shifting costs incurred in one segment to another segment or on one contract to another contract, e.g., between private sector and the government contracts. Pursuant to 41 U.S.C. § 1502(b)(1)(B), each CAS standard establishes principles, practices to be applied, or criteria to select from alternative principles and practices in estimating, accumulating, and reporting costs under contracts subject to the rules of the Board (generally contracts other than for commercial items valued over \$7.5 million that are cost-reimbursement or certain negotiated fixed-price where price reasonableness is established through the use of certified cost and pricing data. *See* 41 U.S.C. § 1502(b)(1)(C)). The principles in each standard generally give Government contractors implementation flexibility. However, the contractor must select and, depending upon the value of contract awards

subject to CAS, disclose its CAS accounting practices in compliance with CAS. Once a CAS Disclosure Statement is filed with and approved by the Government, the contractor is required to consistently apply its disclosed CAS accounting practices accordingly. If the contractor intends to change its disclosed practices, the contractor is required to notify the Government of the accounting changes and their cost impact on its CAS-covered contracts. In this way, CAS serves to ensure the Government is not harmed by changes to the contractor's disclosed practices.

GAAP is a set of financial accounting standards established by the Financial Accounting Standards Board (FASB) for recording and reporting financial information. The financial statements produced using GAAP focus on the financial performance of segments of the company and the entity as a whole. These financial statements are used internally to operate the business and externally by interested parties, such as shareholders (owners of the company), investment firms, banks and other stakeholders. For example, the Securities and Exchange Commission requires publicly traded entities to file certain statements, which are made available to the public, including financial statements that are published in compliance with GAAP.

While CAS and GAAP record and present the same costs, they do so with different perspectives and for different purposes. CAS is focused at the contract level with a strong focus on the method of cost allocations to contracts to achieve the right recognition of costs for each contract for the benefit of the Government. In contrast to CAS, GAAP is focused on reporting at a product line, segment or entity level, not by individual contract. Costs measured and assigned according to GAAP are consolidated into financial reports at these higher levels.



When considering the need for CAS in 1970, Congress concluded that GAAP and other financial accounting standards could not satisfy the Government’s requirements for evaluating contract costing and pricing because “unlike financial accounting, which concentrates on a company’s total operations for a given period, cost accounting is concerned with allocating a part of a company’s total expenses to a specific product or service.” Senate Report No. 91-890, May 21, 1970. See also House Report No. 91-1330, July 27, 1970.

Over time, since CAS was initially promulgated, changes in GAAP have been driven by the need for improved uniformity and consistency, including in the measurement and assignment of costs, to achieve greater comparability, reliability and transparency of financial reporting used by investors and other users. This need has been the result of growing complexity in business transactions and stakeholder demands for accountability.

Despite the differences in purpose and focus of CAS and GAAP, there appear to be some areas of overlap that have arisen since CAS was first promulgated. This overlap has arisen as GAAP has evolved with the addition of a number of requirements related to the measurement and assignment of costs. Today, in practice, Government contractors follow concurrently a mixed blend of GAAP and CAS. Where there is conflict between CAS and GAAP, the requirements of CAS supersede those of GAAP for Government contract costing and pricing purposes.

The growth in GAAP content presents potential opportunities to modify or eliminate overlapping CAS requirements where GAAP standards may be applied reasonably as a substitute for CAS to support contract cost and pricing. Such reductions might help to reduce overall burden in the procurement process by allowing contractors to more heavily rely on GAAP, which they are already using to report on their daily business activities. Examples of benefits might include fewer unique records and/or processes that contractors must maintain, fewer Government oversight activities required by unique CAS requirements and opportunities for reliance on financial audits being performed by commercial firms for GAAP compliance. At the same time, rolling back CAS and relying on GAAP may create challenges where the standards are similar, but not the same, and leave the Government vulnerable to future GAAP changes that, as explained above, are implemented with a purpose that differs from the goals of CAS.

Accordingly, to effectively analyze where CAS-GAAP conformance may be beneficial, this SDP proposes (1) guiding principles that can serve as guardrails in evaluating the benefits and drawbacks of any proposed action and (2) a global roadmap to help the Board prioritize where it should focus its attention from among the 19 CAS that are currently in effect. The SDP then provides a preliminary comparison of CAS to GAAP for two standards identified in the roadmap as early candidates for analysis: CAS 408, *Accounting for Costs of Compensated Personal Absence*, and CAS 409, *Cost Accounting Standard Depreciation of Tangible Capital Assets*. The requirements of each cost accounting standard are delineated in a chart that shows corresponding coverage in GAAP, if any, and initial Board observations. Finally, the SDP discusses recent changes in GAAP that may require changes to CAS.

The Board welcomes comment on any part of this SDP, including reactions to:

- (1) the cited examples of potential benefits and drawbacks of CAS-GAAP conformance described in the introduction, above;

- (2) the guiding principles proposed for evaluating benefits and drawbacks of actions to conform CAS to GAAP;
- (3) the prioritization for action, and initial thinking on where action may not be beneficial, as outlined in the global roadmap;
- (4) views on the initial analysis of CAS 408 and 409, including the Board's preliminary observations and specific questions for public feedback; and
- (5) the Board's preliminary thinking on where CAS may need to be modified to conform to GAAP.

II. Guiding Principles

The Board has provisionally identified the following set of guiding principles to help identify actions that can simultaneously reduce burden on contractors while continuing to protect the interests of the Federal Government:

- 1. Reduce CAS requirements where practicable to minimize the burden on contractors while protecting the interests of the Federal Government.
- 2. Consider whether the proposed action would result in a net burden reduction (e.g., would the benefits of eliminating a requirement in one cost accounting standard be outweighed by the burdens made by changes required in other CAS) .
- 3. Consider whether other CAS requirements may protect the Government's interests when evaluating the potential risk of any gaps created by relying on GAAP instead of CAS. In addition, consider whether existing requirements in other relevant rules (e.g., Federal Acquisition Regulation (FAR)) may protect the Government's interests while not infringing on the Board's exclusive authority over the measurement, assignment, and allocation of costs for Government contracts.

4. Monitor future changes to GAAP and FAR to identify and evaluate their impact to CAS and revise CAS, as necessary, through the rulemaking process.
5. Monitor future significant disputes related to the elimination of any CAS requirements in conformance to GAAP, evaluate whether the Board should address them through clarifying guidance or the rulemaking process, and take action as necessary.

III. Global CAS-GAAP conformance Roadmap

The Board has developed a global roadmap for CAS-GAAP conformance. The roadmap includes three activities. The first activity is to organize the standards into groupings relative to their anticipated opportunity for conformance with GAAP. The second activity is to perform an assessment of each of the standards for potential conformance to GAAP and revise CAS, where practicable, using the prescribed rulemaking process. The third activity is to perform an assessment of changes that have occurred in GAAP to assess the impact to CAS and evaluate the need for revision to CAS to conform to the changed GAAP.

A high-level initial assessment of the standards was performed by the Board and the standards were aligned into four groupings based on their anticipated opportunity for conformance with GAAP. The groupings are as follows:

1. Standards focused primarily on cost measurement and assignment of costs to accounting periods. This group includes CAS 404 *Capitalization of tangible assets*, CAS 407 *Use of standard costs for direct material and direct labor*, CAS 408 *Accounting for costs of compensated personal absence*, CAS 409 *Cost accounting standard depreciation of tangible capital assets*, CAS 411 *Cost accounting standard—accounting for acquisition costs of material*, CAS 415 *Accounting for a the cost of deferred compensation*, and CAS 416 *Accounting for insurance costs*. GAAP contains significant requirements for cost measurement and assignment of costs to accounting periods,

so the standards with content focused primarily on cost measurement and assignment are anticipated to offer the most opportunity to conform CAS to existing content in GAAP.

2. Standards focused primarily on allocation of costs. This group includes CAS 403 *Allocation of home office expenses to segment*, CAS 410 *Allocation of business unit general and administrative expenses to final cost objectives*, CAS 418 *Allocation of direct and indirect costs*, and CAS 420 *Accounting for independent research and development costs and bid and proposal costs*. GAAP contains little content on the allocation of costs to cost objectives, such as intermediate pools and contracts, so the standards focused on cost allocation are anticipated to offer much less opportunity to conform CAS to existing content in GAAP.
3. Standards with complex rules satisfying unique needs of Government contracting. This group includes CAS 412 *Cost accounting standard for composition and measurement of pension cost*, CAS 413 *Adjustment and allocation of pension cost*, CAS 414 *Cost accounting standard—cost of money as an element of the cost of facilities capital*, and CAS 417 *Cost of money as an element of the cost of capital assets under construction*. CAS 412 and CAS 413 requirements include features which mitigate the significant volatility of the defined benefit pension cost measurement, which are beneficial to both the Government and contractors, while GAAP tolerates the market volatility in its measure of the pension costs. In addition, CAS 413 requirements include a specialized mathematical mechanism to achieve a settling up of cumulative pension costs for Government contracts when certain events occur. CAS 414 and CAS 417 provide contractors with an imputed cost of capital, which allows some cost recovery for financing of capital assets, in lieu of interest costs, which are an expressly unallowable cost under the Federal Acquisition Regulation (FAR) and not recoverable on Government contracts. These standards serve very unique purposes in Government contracting and are anticipated to offer little if any opportunity to conform CAS to GAAP.

4. Standards that are generally foundational principles of Government contracting. This group includes CAS 401 *Cost accounting standard—consistency in estimating, accumulating and reporting costs*, CAS 402 *Cost accounting standard—consistency in allocating cost incurred for the same purpose*, CAS 405 *Accounting for unallowable costs*, and CAS 406 *Cost accounting standard—cost accounting period*. GAAP contains limited content in some of these areas, so these standards are anticipated to have limited opportunity to conform CAS to existing content in GAAP.

For the reasons stated above, the Board intends to limit the scope of the project to focus on the standards in the first group. The Board plans to prioritize work beginning with the standards with the most anticipated opportunity for conformance. For each of these standards, a detailed analysis will be performed that will include developing a side-by-side comparison of the CAS requirements with the corresponding GAAP requirements, identifying any potential gaps between CAS and GAAP, evaluating the potential risk of any gaps identified in context of coverage by other CAS requirements and related regulations (e.g., FAR), determining if there is a history of compliance issues, and reviewing the need for the initial promulgation of the Standard with an assessment of the extent to which these needs in the current regulatory environment continue to protect the interests of the Federal Government.

In addition to this SDP which includes a preliminary analysis of CAS 408 and CAS 409, the Board plans to issue the next SDP on CAS-GAAP conformance with a preliminary analysis of two other standards in the first group. The Board welcomes comments on the approach to conformance, groupings of standards, the assignment of each standard to a particular grouping, the proposed limited scope of the project to only the first grouping of standards and the considerations the Board anticipates using as the basis for the conformance assessments.

The Board is also considering whether revision to the CAS contract clause found at 9903.201-4 *Contract clauses* may be necessary as a result of the elimination of any requirements in the standards.

This contract clause applies to compliance with CAS but does not apply to compliance with GAAP. The clause requires that a contractor agree to an adjustment, with interest, payable to the Government if it fails to comply with an applicable Standard in CAS. The calculation of this adjustment for the impact of the non-compliance to Government contracts includes years in which the non-compliance existed and may include years for which indirect costs have been settled. Elimination of any requirements in CAS with reliance on GAAP may result in the adjustment for a noncompliance identified in the current period to being limited to flexibly priced contracts in the current and future periods, because the clause at CAS 9903.201-4 does not apply to a non-compliance with GAAP. The Board welcomes public comments that consider whether this clause should be revised if any requirements in CAS are eliminated to protect the interests of the Government and contractors.

IV. Initial Assessments of CAS and GAAP

The Board has performed a preliminary detailed analysis of CAS 408, *Accounting for costs of compensated personal absence*, and CAS 409, *Cost accounting standard depreciation of tangible capital assets* using the considerations described in the *Global CAS-GAAP Conformance Roadmap* section above. The analyses are included as Appendix 1 to this SDP. The Board welcomes public comment on the analysis.

V. Recent changes in GAAP that may require revision in CAS

As part of the activities to conform CAS to GAAP, the Board recognizes that changes to GAAP may have an impact and require revision to CAS for the standards to remain clear and relevant to those responsible for applying them. The Board recognizes that failure to take action may lead to disputes. Therefore, consistent with the guiding principles described above, the Board plans to monitor and review changes in GAAP more diligently and respond through the prescribed rulemaking process to revise CAS when necessary.

The Board has identified two changes to GAAP that require an assessment of their impact to and the potential need for revision of CAS. The two changes in GAAP are the new lease accounting guidance and revenue recognition rules.

FASB Accounting Standards Update No. 2016-02 requires lessees to report most operating leases as assets and liabilities on the balance sheet effective January 1, 2019. The new accounting for these “right of use” assets may impact areas of CAS which rely on property, plant and equipment asset balances, such as the allocation of residual costs based on the three factor formula in CAS 9904-403-50(c)(1) and the calculation of cost of money in accordance with CAS 9904.414.

FASB Accounting Standards Update No. 2014-09 requires revenue to be recognized when control of promised goods or services transfers to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The GAAP definition of “revenue” has, accordingly, been revised in ASC 606-10-20. This new revenue definition may impact areas of CAS, such as the definition of “operating revenue” in CAS 9904.403-30(a)(3).

The Board is in the process of performing a preliminary assessment of the impact of these GAAP changes to CAS to determine the appropriate action to be taken by the Board. As part of the CAS-GAAP conformance activities, the Board welcomes public comments on recommended actions, if any, the Board needs to take regarding these two GAAP changes. The action suggested by respondents may include, but are not limited to, specific revisions to standards or interpretive guidance about specific CAS requirements related to the GAAP changes. The Board is also interested in any other changes to GAAP and their impact to CAS which merit the Board’s action.

A. *Initial Assessment of CAS 408, Accounting for costs of compensated personal absence***Initial promulgation**

CAS 408 was initially published September 19, 1974 at 39 FR 33681. The preamble for the original publication of CAS 408 stated that “[t]his Standard deals primarily with the amount and time recognition of costs of compensated personal absence...Detailed criteria for the allocation of costs of compensated personal absence are not included in this Standard.”

The preamble identified the following needs for the initial promulgation of the Standard. “The most significant problems and issues relate to the amount and timing of recognition of costs of compensated personal absence appear to stem from the reliance of existing procurement regulations on the Internal Revenue Code (IRC) and income tax regulations to govern accounting for these costs.” The primary disadvantage identified in the initial preamble was in the reliance on the IRC accrual accounting for vacation pay that permitted, but did not require, the accrual of the costs and the lack of rules identifying the amount to be accrued. The preamble made no mention of GAAP rules related to compensated personal absences.

Regulatory developments after initial promulgations

GAAP has been revised significantly with additional content since the original promulgation of CAS 408 in 1974, while CAS for the most part has remained static subsequent to the initial promulgation. A comparison of the requirements in CAS 408 with pertinent GAAP content are provided below.

CAS 408 Compared with GAAP ASC-710-10

For each requirement in CAS 408, the Board identified if a comparable requirement existed in GAAP, FAR or other Standard. There appears to be at least one potential gap on which the Board especially appreciates comments.

The potential gap is the GAAP requirement (see ASC 710-10-25-1) to record both absences for which “the obligation relates to rights that vest or accumulate” [emphasis added]. CAS 408-40(a) requires that the costs “shall be assigned to the cost accounting period or periods in which the entitlement was earned,” where entitlement is considered earned when an employer would be required to pay the employee for the benefit in the event of employee termination on a basis of other than disciplinary action.

ASC 710-10-25-1(b) reads in part, “[v]ested rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee’s future service.” By comparison, CAS 408-50(b)(1), reads in part, “compensated personal absence is earned at the same time and in the same amount as the employer becomes liable to compensate the employee for such absence if the employer terminates the employee’s employment.”

GAAP includes rights that accumulate, not just those which vest. ASC 710-10-25-1(b) defines accumulated rights as “earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.” ASC 710-10-25-3 adds, “[i]f unused rights do accumulate and increase the benefits otherwise available in subsequent years, a liability shall be accrued at year-end to the extent that it is probable that the employees will be paid in subsequent years for the increased

benefits attributable to the accumulated rights and the amount can be reasonably estimated.” The Board is interested in public comments about whether the GAAP requirement of generally assigning the cost of benefits in the year the employee performed services upon which the benefit was earned would result in a materially different result than the requirement in CAS 408-40(a) to accrue only vested benefits earned.

Although GAAP is more permissive in allowing accumulated rights to be assigned to the year in which the employee services were performed it also requires that anticipated forfeitures be considered, thereby potentially reducing the risk of recognizing costs that may not be paid in a future cost accounting period. ASC 710-10-25-2 reads in part, “[a] liability for amounts to be paid as a result of employees’ rights to compensated absences shall be accrued, considering anticipated forfeitures, in the year in which earned.” Thus, the amount accrued would be reduced by estimated forfeitures in the year the recorded.

The Board encourages respondents to identify the magnitude of compensated personal absence costs that accumulate but don’t vest, as described in GAAP, taking into consideration the reduction for estimated forfeitures.

Are there any other gaps between CAS 408 and GAAP that the Board did not identify but should consider?

Compliance history

The Board is interested in public comments with facts and data of the history of CAS 408 non-compliance issues raised and how they were resolved. In particular, what is the frequency and magnitude of the issues identified on Government contracts? Furthermore, could the issue raised have been considered non-compliant with GAAP, other CAS or FAR?

Detailed comparison

A detailed comparison of the current requirements in CAS 408 and corresponding GAAP requirements is provided below. The Board is interested in public comments and especially recommendations of any changes to the Standard to conform it to GAAP.

CAS 408 Requirements Comparison with GAAP

CAS 408 Requirement	GAAP Requirement	Queries
CAS 408-40 Fundamental Requirement		
<p>(a) The costs of compensated personable absence shall be assigned to the cost accounting period or periods in which the entitlement was earned.</p>	<p>ASC 710-10-25-2 A liability for amounts to be paid as a result of employees' rights to compensated absences shall be accrued, considering anticipated forfeitures, in the year in which earned... Furthermore, the definition of a liability does not limit an employer's liability for compensated absences solely to rights to compensation for those absences that eventually vest. The definition also encompasses a constructive obligation for reasonably estimable compensation for past services that, based on the employer's past practices, probably shall be paid and can be reasonably estimated.</p> <p>ASC 710-10-25-1 An employer shall accrue a liability for employees' compensation for future absences is all of the following conditions are met:</p> <ol style="list-style-type: none"> The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered. The obligation relates to rights that vest or accumulate. Vested rights are those for which the employer has an obligation to make payment even if an employee terminated; thus, they are not contingent on an employee's future service. Accumulate means 	<p>"Entitlement" is defined in CAS 408-30(a)(2) – an employee's right, whether conditional or unconditional, to receive a determinable amount of compensated personal absence, or pay in lieu thereof.</p> <p>CAS requires the cost to be accrued in the year that an employee becomes entitled to payment. GAAP requires an employee to have rights, either vested or accumulated, to the compensated absences, less those anticipated to be forfeited, to be recorded in the year earned.</p> <p>QUERY: Are these equivalent requirements?</p> <p>QUERY: If these are not equivalent would FAR 31.201-5 – Credits further mitigate the risk to the Government?</p>

CAS 408 Requirement	GAAP Requirement	Queries
	<p>that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.</p> <p>c. Payment of the compensation is probable.</p> <p>d. The amount can be reasonably estimated.</p>	
(b) The costs of compensated personal absence for an entire cost accounting period shall be allocated pro-rata on an annual basis among the final cost objectives of that period.	<p>No equivalent content for allocation.</p>	<p>QUERY: Do other CAS for cost allocation address this?</p>
CAS 408-50 Techniques for Application		
(a) Determinations. Each plan or custom for compensated personal absence shall be considered separately in determining when entitlement is earned. If a plan or custom is changed or a new plan or custom is adopted, then a new determination shall be made beginning with the first cost accounting period to which such new or changed plan or custom applies.	<p>ASC 710-10-25-3, Individual facts and circumstances must be considered in determining when nonvesting rights to compensated personal absences are earned by services rendered. The requirement to accrue a liability for nonvesting rights to compensated absences depends on whether the unused rights expire at the end of the year in which earned or accumulate and are carried forward to succeeding years, thereby increasing the benefits that would otherwise be available in those later years. If the rights expire, a liability for future absences shall not be accrued at year-end because the benefits to be paid in subsequent years would not be attributable to employee</p>	<p>In order to apply the GAAP, each compensated absence plan (e.g., vacation time, sick time, military leave) would need to be evaluated separately.</p> <p>QUERY: Are these CAS and GAAP requirements equivalent?</p>

CAS 408 Requirement	GAAP Requirement	Queries
	<p>services rendered in prior years. (Jury duty and military active leave benefits generally do not accumulate if unused and, unless they accumulate, a liability for those benefits shall not be accrued at year-end.) On the other hand, if unused rights do accumulate and increase the benefits otherwise available in subsequent years, a liability shall be accrued at year-end to the extent that it is probable that employees will be paid in subsequent years for the increased benefits attributable to the accumulated rights and the amount can be reasonably estimated.</p>	
<p>(b) Measurement of entitlement. (1) For purposes of compliance with 9904.408-40(a), compensated personal absence is earned at the same time and in the same amount as the employer becomes liable to compensate the employee for such absence if the employer terminates the employee's employment for lack of work or other reasons not involving disciplinary action, in accordance with a plan or custom of the employer. Where a new employee must complete a probationary period before the employer becomes liable, the employer may nonetheless treat such service as creating entitlement in any computations required by this Standard,</p>	<p>ASC 710-10-25-1 An employer shall accrue a liability for employees' compensation for future absences if all of the following conditions are met:</p> <ul style="list-style-type: none"> a. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered. b. The obligation relates to rights that vest or accumulate. Vested rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service. Accumulate means that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there 	<p>CAS limits recording cost in the year earned to employees' being entitled to payment if terminated. The corresponding concept in GAAP is "vested rights". CAS also allows, however, recognition of costs in the year earned even when an employee must complete a probationary period, so long as this practice is followed consistently.</p> <p>QUERY: Is this extension of entitlement in CAS similar to GAAP's requirements to recognize the costs in the year earned when payment is probable?</p> <p>QUERY: Do CAS and GAAP align cost recognition in the year in which the employee services were performed upon which the benefit was earned, as long as</p>

CAS 408 Requirement	GAAP Requirement	Queries
<p>provided that he does so consistently.</p>	<p>may be a limit to the amount that can be carried forward.</p> <p>c. Payment of the compensation is probable.</p> <p>d. The amount can be reasonably estimated.</p> <p>ASC 710-10-25-2 A liability for amounts to be paid as a result of employees' rights to compensated absences shall be accrued, considering anticipated forfeitures, in the year in which earned. For example, if new employees receive vested rights to two-weeks' paid vacation at the beginning of their second year of employment with no pro rata payment in the event of termination during the first year, the two-weeks' vacation shall be considered to be earned by work performed in the first year and an accrual for vacation pay shall be required for new employees during their first year of service, allowing for estimated forfeitures due to turnover.</p> <p>ASC 710-10-15-3 The requirement to accrue a liability for nonvesting rights to compensated absences depends on whether the unused rights expire at the end of the year in which earned or accumulate and are carried forward to succeeding years, thereby increasing the benefits that would otherwise be available in those later years. If the rights expire, a liability for future absences shall not be accrued at year-end</p>	<p>future payment has reasonable certainty?</p> <p>QUERY: Do CAS and GAAP avoid cost recognition in the current year of benefits paid in the current year that were earned in the prior year?</p> <p>GAAP provides for cost recognition in the year earned of "accumulated rights", meaning earned benefits that may be carried forward to future periods although not paid if an employee is terminated. GAAP also requires anticipated forfeitures to be considered when determining the accrual amount.</p> <p>QUERY: Are these GAAP requirements together materially equivalent to those in CAS?</p>

CAS 408 Requirement	GAAP Requirement	Queries
	<p>because the benefits to be paid in subsequent years would not be attributable to employee services rendered in prior years. (Jury duty and military leave benefits generally do not accumulate if unused and, unless they accumulate, a liability for those benefits shall not be accrued at year-end.) On the other hand, if unused rights do accumulate and increase the benefits otherwise available in subsequent years, a liability shall be accrued at year-end to the extent that it is probable that employees will be paid in subsequent years for the increased benefits attributable to the accumulated rights; and the amount can be reasonably estimated.</p>	
<p>(b)(2) Where a plan or custom provides for entitlement to be determined as of the first calendar day or the first business day of a cost accounting period based on service in the preceding cost accounting period, the entitlement shall be considered to have been earned, and the employer's liability to have arisen, as of the close of the preceding cost accounting period.</p>	<p>ASC 710-10-25-2 A liability for amounts to be paid as a result of employees' rights to compensated absences shall be accrued, considering anticipated forfeitures, in the year in which earned. For example, if new employees receive vested rights to two-weeks' paid vacation at the beginning of their second year of employment with no pro rata payment in the event of termination during the first year, the two-weeks' vacation shall be considered to be earned by work performed in the first year and an accrual for vacation pay shall be required for new employees during their first year of service, allowing for estimated forfeitures due to turnover.</p>	<p>QUERY: Are these requirements equivalent?</p>

CAS 408 Requirement	GAAP Requirement	Queries
(b)(3) In the absence of a determinable liability, in accordance with paragraph (b)(1) of this subsection, compensated personal absence will be considered to be earned only in the cost accounting period in which it is paid.	ASC 710-10-25-1, An employer shall accrue a liability for employees' compensation for future absences if all of the following conditions are met...	No explicit language is in ASC 710-10-25-1 for absence of a liability. For GAAP, however, no accrual would be recorded when the conditions for a liability are not met and the cost would be recorded in the period in which it is paid. QUERY: Does this result in equivalent treatment for both CAS and GAAP?
(c) Determination of employer's liability. In computing the cost of compensated personal absence, the computation shall give effect to the employer's liability in accordance with the following paragraphs.		
(c)(1) The estimated liability shall include all earned entitlement to compensated personal absence which exists at the time the liability is determined, in accordance with paragraph (b) of this subsection.	See ASC 710-10-25-1, ASC 710-10-25-2 and ASC 710-10-25-3 above	QUERY: Do CAS and GAAP require equivalent treatment, notwithstanding the discussion of GAAP recognition of "accumulated rights" versus CAS entitlement shown in comments of CAS 408-50(b)(1)?
(c)(2) The estimated liability shall be reduced to allow for anticipated nonutilization, if material.	ASC 710-10-25-2 A liability for amounts to be paid as a result of employees' rights to compensated absences shall be accrued, considering anticipated forfeitures, in the year in which earned.	QUERY: Do CAS and GAAP require equivalent treatment?
(c)(3) The liability shall be estimated consistently either in terms of current or of anticipated wage rates. Estimates may be made with respect to individual	No explicit language in GAAP to use current or anticipated wage rates.	QUERY: Are liabilities under GAAP recorded based on current wage rates?

CAS 408 Requirement	GAAP Requirement	Queries
<p>employees, but such individual estimates shall not be required if the total cost with respect to all employees in the plan can be estimated with reasonable accuracy by the use of sample data, experience or other appropriate means.</p>		
<p>(d) Adjustments. (1) The estimate of the employer's liability for compensated personal absence at the beginning of the first cost accounting period for which a contractor must comply with this standard shall be based on the contractor's plan or custom applicable to that period, notwithstanding that some part of that liability has not previously been recognized for contract costing purposes. Any excess of the amount of the liability as determined in accordance with paragraph (c) of this subsection over the corresponding amount of the liability as determined in accordance with the contractor's previous practice shall be held in suspense and accounted for as described in subparagraph (d)(3) of this subsection.</p>	<p>See ASC 710-10-25-1 and ASC 710-10-25-2 above.</p>	<p>QUERY: Does the GAAP requirement to record accrued personal absence cost in the year earned achieve the equivalent concept of this CAS requirement?</p> <p>QUERY: That is, if a contractor became CAS covered, would the personal absence costs from prior years already have been recognized as cost and not be chargeable to government contracts in the current period?</p>

CAS 408 Requirement	GAAP Requirement	Queries
<p>(d)(2) If a plan or custom is changed or a new plan or custom is adopted, and the new determination made in accordance with paragraph (a) of this subsection results in an increase in the estimate of the employer's liability for compensated personal absence at the beginning of the first cost accounting period for which the new plan is effective over the estimate made in accordance with the contractor's prior practice, then the amount of such increase shall be held in suspense and accounted for as described in paragraph (d)(3) of this subsection.</p>	<p>See ASC 710-10-25-1, ASC 710-10-25-2, and ASC 710-10-25-3 above.</p>	<p>QUERY: Based on experience, are plan changes prospective and recognized beginning in the first period to which the change applies, or are plan changes retroactive to earlier cost accounting periods?</p> <p>QUERY: For GAAP, when would the accrual for the new plan or changes to an existing plan be recorded?</p>
<p>(d)(3) At the close of each cost accounting period, the amount held in suspense shall be reduced by the excess of the amount held in suspense at the beginning of the cost accounting period over the employer's liability (as estimated in accordance with paragraph (c) of this subsection) at the end of that cost accounting period. The cost of compensated personal absence assigned to that cost accounting period shall be</p>	<p>No corresponding content in GAAP</p>	<p>QUERY: Based on experience, are plan changes prospective and recognized beginning in the first period to which the change applies, or are plan changes retroactive to earlier cost accounting periods?</p>

CAS 408 Requirement	GAAP Requirement	Queries
increased by the amount of the excess.		
(e) Allocations. Except where the use of a longer or shorter period is permitted by the provisions of the Cost Accounting Standard on Cost Accounting Period (9904.406), the cost of compensated personal absence shall be allocated to cost objectives on a pro-rata basis which reflects the total of such costs and the total of the allocation base for the entire cost accounting period. However, this provision shall not preclude revisions to an allocation rate during a cost accounting period based on revised estimates of period totals.	No corresponding content in GAAP	QUERY: Would CAS 406 address this gap?

B. Initial assessment of CAS 409 Cost accounting standard depreciation of tangible capital assets

Initial promulgation

Based on the preambles for CAS 409 published in the Federal Register for its initial promulgation on January 29, 1975, depreciation cost was considered an issue for contracting purposes going back to the 1960's. A number of contractors at that time primarily relied on the Internal Revenue Code (IRC) to measure depreciation costs. The IRC contained accelerated depreciation methods for tax purposes, and the Board viewed this as being inequitable and improper cost accounting because the methods did not match the depreciation expense over the useful life of the asset.

Regulatory developments after initial promulgation

GAAP now prohibits using the accelerated depreciation methods in the IRC for financial reporting purposes if the amounts do not fall within a reasonable range of the asset's useful life. Thus, the principal concern for the promulgation of CAS 409 may no longer exist. GAAP has added significant content since the initial promulgation of CAS 409, while CAS for the most part has not changed subsequent to the initial promulgation. A comparison of the requirements in CAS 409 with GAAP reveal comparable content. Additionally, FAR includes substantive content regarding the allowability of depreciation costs in certain circumstances that may further protect the interests of the Government.

CAS 409 Compared with GAAP ASC-360-10

The Board found corresponding requirements, primarily in GAAP, for nearly all of the requirements of CAS 409. There are, however, a few exceptions of potential gaps as described below on which the Board especially appreciates comments.

1. Service lives

The first potential gap is the requirement for record-keeping of actual service lives of assets and the use of such records as the basis for estimating service lives of tangible capital assets acquired thereafter (see CAS 409-50(e)(2)). GAAP does not explicitly require the same level of record keeping as CAS as it relates to historical service lives experienced on assets.

During the ordinary course of business, a contractor would typically maintain some records of assets through disposition that would include the dates the asset is put into use and disposed. The Board is interested in whether this record keeping would be expected to continue for GAAP accounting regardless of the elimination of requirements in CAS 409. In particular, the Board is interested in respondents providing comments about what detailed records contractors would keep and for what purpose (e.g., GAAP compliance) if the requirement in CAS 409 to support service lives with actual historic records was eliminated?

ASC 360-10-35-3 reads in part, “Depreciation expense for financial statements for an asset shall be determined based upon the asset’s useful life.” Thus, GAAP requires that the cost of an asset be spread over the expected useful life of the asset, but does not explicitly require that the “expected useful life” of the asset be based on the contractor’s asset history. It may be reasonable to interpret that the expected useful life required by GAAP is based on the individual contractor’s expectation of asset life based on their own circumstances, which may include their historical experience with how long similar assets have been used or a future anticipation of how long they will use the asset. It may also be equally reasonable to interpret GAAP based on general circumstances not individually specific to the contractor, relying on broadly accepted useful lives for a category of assets as may be found in accounting reference guides. The Board is interested in respondents providing comments

about the impact to estimated service lives used, if any, anticipated if the requirement to use estimated service lives based on contractor historical experience was eliminated?

2. Certain gains/losses on dispositions within 12 months of transfer

The second potential gap is the CAS requirement to assign to the transferor the gain/loss on disposition of an asset transferred in an other than an arms-length transaction and subsequently disposed of within 12 months of transfer (see CAS 409-50-(j)(4)). There is no similar requirement in GAAP. The concern is without the constraint of this CAS 409 requirement, a contractor may transfer assets between segments with no purpose other than to recover a loss or avoid sharing a gain with the Government on an asset disposition.

The Board is interested in public comments about the frequency of such transfers and data about the magnitude of the gains/losses experienced on the assets transferred. In addition, how could the selection of service life, depreciation method, and residual value mitigate the risk of a significant gain/loss at disposition?

3. Residual values

CAS 409-50(h) requires that “estimated residual values shall be determined for all tangible capital assets (or groups of assets). For tangible personal property, only estimated residual values that exceed 10 percent of the capitalizable cost of the asset (or group of assets) need to be used in establishing depreciable costs. Where either the declining balance method of depreciation or the class life asset depreciation range system is used consistent with the provisions of this Standard, the residual value need not be deducted from capitalized cost to determine depreciable costs. No

depreciation cost shall be charged which would significantly reduce book value of a tangible capital asset (or group of assets) below its residual value.” Note that the 10 percent threshold does not apply to real property assets.

GAAP (see ASC 360-10-35-4) includes a requirement to deduct the salvage value, which has the same meaning as residual value in CAS, from the value of the tangible capital asset to be depreciated. Although GAAP is much less prescriptive than CAS, it may offer some mitigation of the risk of eliminating this requirement in CAS 409.

In addition, FAR requirements may further mitigate the risk of a contractor setting no or too low a residual value. FAR 31.205-11(a) reads in part, “Depreciation cost that would significantly reduce the book value of a tangible capital asset below its residual value is unallowable.” Therefore, if a contractor depreciated a tangible capital asset significantly below its residual value, the Government’s interests are protected by recovering the excess depreciation as an unallowable cost.

The Board is interested in public comments about how contractors set residual or salvage values for categories of assets and the frequency that for a particular asset the residual value used for CAS and a salvage value used for GAAP are the same.

Are there any other gaps between CAS 409 and GAAP that the Board did not identify but should consider?

Compliance History

The Board is interested in public comments with facts and data of the history of CAS 409 non-compliance issues raised and how they were resolved. In particular, what is the frequency and magnitude of the issues identified on Government contracts? Furthermore, could the issue raised have been considered non-compliant with GAAP, other CAS or FAR?

Detailed comparison

A detailed comparison of the current requirements in CAS 409 and corresponding GAAP requirements is provided below. The Board is interested in public comments and especially recommendations of any changes to the Standard to conform it to GAAP.

CAS 409 Requirements Comparison with GAAP, Other CAS, FAR

CAS 409 Requirement	GAAP Requirement	Queries
CAS 409-40 Fundamental Requirement		
(a) The depreciable cost of a tangible capital asset (or group of assets) shall be assigned to cost accounting periods in accordance with the following criteria:	ASC 360-10-35-4 The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles (GAAP) require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner.	QUERY: Are these equivalent concepts for recognizing the cost of a capital asset, or group of assets, over a number of accounting periods?
(1) The depreciable cost of a tangible capital asset shall be its capitalized cost less its estimated residual value.	ASC 360-10-35-4 - This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner.	QUERY: Are these concepts of residual value and salvage value equivalent?
(2) The estimated service life of a tangible capital asset (or group of assets) shall be used	ASC 360-10-35-4 - Generally accepted accounting principles (GAAP) require that this cost be spread over the expected useful	QUERY: Are these concepts of estimated service life and useful life equivalent?

CAS 409 Requirement	GAAP Requirement	Queries
to determine the cost accounting periods to which the depreciable cost will be assigned.	life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility.	
(3) The method of depreciation selected for assigning the depreciable cost of a tangible capital asset (or group of assets) to the cost accounting periods representing its estimated service life shall reflect the pattern of consumption of services over the life of the asset.	ASC 360-10-35-4 –above ASC 360-10-35-7 – The declining-balance method is an example of one of the methods that meet the requirements of being systematic and rational. If the expected productivity or revenue earning power of the asset is relatively greater during the earlier years of its life, or maintenance charges tend to increase during later years, the declining-balance method may provide the most satisfactory allocation of cost. That conclusion also applies to other methods, including the sum -of- the-years'-digits method that produces substantially similar results.	QUERY: Are the selection criteria in CAS and GAAP of matching the pattern of asset consumption to the method of depreciation equivalent?
(4) The gain or loss which is recognized upon disposition of a tangible capital asset shall be assigned to the cost accounting period in which the disposition occurs.	ASC 360-10-40-5 A gain or loss not previously recognized that results from the sale of a long-lived asset (disposal group) shall be recognized at the date of sale.	QUERY: Are the CAS and GAAP requirements for recognition of a gain or loss on disposition in the period in which it occurs equivalent? In addition, FAR 31.205-16(a) requires that – Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (f) of this [FAR] subsection).

CAS 409 Requirement	GAAP Requirement	Queries
(b) The annual depreciation cost of a tangible capital asset (or group of assets) shall be allocated to cost objectives for which it provides service in accordance with the following criteria:	No corresponding content in GAAP.	
(1) Depreciation cost may be charged directly to cost objectives only if such charges are made on the basis of usage and only if depreciation costs of all like assets used for similar purposes are charged in the same manner.	No corresponding content in GAAP.	<p>QUERY; Are there requirements in other CAS that address this?</p> <p>For example, CAS 402-40 – All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives.</p> <p>In addition, CAS 418 specifically addresses the allocation of direct and indirect costs.</p>
(2) Where tangible capital assets are part of, or function as, an organizational unit whose costs are charged to other cost objectives based on measurement of the services provided by the organizational unit, the depreciation cost of such assets shall be included as part of the cost of the organizational unit.	No corresponding content in GAAP.	<p>QUERY: Do requirements in other CAS address this?</p> <p>For example, CAS 418-40(c) – Pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives as follows:</p> <p>(1) If a material amount of the costs included in a cost pool are costs of management or supervision of activities involving direct labor or direct material costs, resource consumption cannot be specifically identified with cost objectives. In that circumstance, a base shall be used which is</p>

CAS 409 Requirement	GAAP Requirement	Queries
		<p>representative of the activity being managed or supervised.</p> <p>(2) If the cost pool does not contain a material amount of the costs of management or supervision of activities involving direct labor or direct material costs, resource consumption can be specifically identified with cost objectives. The pooled cost shall be allocated based on the specific identifiability of resource consumption with cost objectives by means of one of the following allocation bases:</p> <ul style="list-style-type: none"> (i) A resource consumption measure, (ii) An output measure, or (iii) A surrogate that is representative of resources consumed. <p>There is related content in FAR as well. FAR 31.203(b) –After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to intermediate or two or more final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective.</p> <p>FAR 31.203(c) – The contractor shall accumulate indirect costs by logical cost groupings with due consideration of the reasons for incurring such costs. The contractor shall determine each grouping</p>

CAS 409 Requirement	GAAP Requirement	Queries
		<p>so as to permit use of an allocation base that is common to all cost objectives to which the grouping is to be allocated. The base selected shall allocate the grouping on the basis of the benefits accruing to intermediate and final cost objectives. When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation.</p>
<p>(3) Depreciation costs which are not allocated in accordance with paragraph (b) (1) or (2) of this subsection, shall be included in appropriate indirect cost pools.</p>	<p>No corresponding content in GAAP.</p>	<p>QUERY: Do requirements in other CAS address this? CAS 418 and FAR 31.203 (b) & (c) – see above.</p>
<p>(4) The gain or loss which is recognized upon disposition of a tangible capital asset, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs. Where such gain or loss is not material, the amount may be included in an appropriate indirect cost pool.</p>	<p>No corresponding content in GAAP.</p>	<p>Typically the gain or loss on disposition of an asset is recorded in the same cost pool as the depreciation cost would have been. This would be consistent with the requirements of CAS 418 (see above).</p> <p>In addition see FAR 31.205-16(a) – Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (f) of this [FAR] subsection).</p>

CAS 409 Requirement	GAAP Requirement	Queries
CAS 409-50 Techniques for application		
<p>(a) Determination of the appropriate depreciation charges involves estimates both of service life and of the likely pattern of consumption of services in the cost accounting periods included in such life. In selecting service life estimates and in selecting depreciation methods, many of the same physical and economic factors should be considered. The following are among the factors which may be taken into account: Quantity and quality of expected output, and the timing thereof; costs of repair and maintenance, and the timing thereof; standby or incidental use and the timing thereof; and technical or economic obsolescence of the asset (or group of assets), or of the product or service it is involved in producing.</p>	<p>ASC 360-10-35-3 Depreciation expense in the financial statements for an asset shall be determined based on an asset's useful life.</p> <p>ASC 360-10-35-4 The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles (GAAP) require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner.</p> <p>ASC 360-10-35-33 The service potential of a long-lived asset (asset group) encompasses its remaining useful life, cash-flow-generating capacity, and for tangible assets, physical output capacity. Those estimates shall include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset (asset group), including those that replace the service potential of component parts of a long-lived asset (for example, the roof of a building) and component assets other than the primary asset of an asset group.</p> <p>ASC 360-10-35-7 The declining-balance method is an example of one of the methods</p>	<p>The determination of depreciation amounts for both CAS and GAAP include the elements of service life (useful life) of the asset and a methodology that results in recognition of the cost in the periods during which the asset provides services and in a pattern reflective of the relative productivity of the asset.</p> <p>QUERY: Are these equivalent?</p> <p>In addition, FAR 2.101(b) – “Depreciation” means a charge to current operations that distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.</p>

CAS 409 Requirement	GAAP Requirement	Queries
	<p>that meet the requirements of being systematic and rational. If the expected productivity or revenue-earning power of the asset is greater during the earlier years of its life, or maintenance charges tend to increase in later years, the declining-balance method may provide the most satisfactory allocation of cost.</p> <p>ASC 360-10-35-8 – In practice, experience regarding loss or damage to depreciable assets is in some cases one of the factors considered in estimating the depreciable lives of a group of depreciable assets, along with such other factors as wear and tear, obsolescence, and maintenance and replacement policies.</p>	
<p>(b) Depreciation of a tangible capital asset shall begin when the asset and any others on which its effective use depends are ready for use in a normal or acceptable fashion. However, where partial utilization of a tangible capital asset is identified with a specific operation, depreciation shall commence on any portion of the asset which is substantially completed and used for that operation. Depreciable spare parts which are required for the operation of such tangible capital assets shall be accounted for over the service life of the assets.</p>	<p>ASC 835-20-25-5 –The capitalization period shall end when the asset is substantially complete and ready for its intended use.</p> <p>ASC 360-10-35-4 see above.</p>	<p>Both CAS and GAAP require depreciation to begin when an asset is substantially complete and ready for use.</p> <p>CAS provides additional information about partial utilization and spare parts that is not explicitly included in GAAP.</p> <p>QUERY: Based on interpreting GAAP, would it result in the same cost treatment as CAS without the explicit language?</p>
<p>(c) A consistent policy shall be followed in determining the depreciable cost to be assigned to the beginning and ending cost accounting periods of asset use. The policy may provide for any reasonable starting and</p>	<p>ASC 250-10-45-1 – A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one</p>	<p>QUERY: Are these CAS and GAAP requirements for consistency equivalent?</p> <p>QUERY: In addition, are other requirements of CAS addressing consistency relevant?</p>

CAS 409 Requirement	GAAP Requirement	Queries
ending dates in computing the first and last year depreciable cost.	accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data.” ASC 250-10-45-2(b) – A reporting entity shall change an accounting principle only if either of the following apply: a. The change is required by a newly issued Codification update. b. The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable	48 CFR 9903.201-4(a)(2), CAS clause [FAR 52.230-2] (a)(2) – Follow consistently the Contractor's cost accounting practices in accumulating and reporting contract performance cost data concerning this contract. If any change in cost accounting practices is made for the purposes of any contract or subcontract subject to CAS requirements, the change must be applied prospectively to this contract and the Disclosure Statement must be amended accordingly. If the contract price or cost allowance of this contract is affected by such changes, adjustment shall be made in accordance with subparagraph (a)(4) or (a)(5) of this clause, as appropriate.
(d) Tangible capital assets may be accounted for by treating each individual asset as an accounting unit, or by combining two or more assets as a single accounting unit, provided such treatment is consistently applied over the service life of the asset or group of assets.	ASC 360-10-35-4, ASC 250-10-45-1, ASC 250-10-45-2(b) see above	QUERY: Are CAS and GAAP equivalent for the treatment of assets individually or as a group of assets? QUERY: Could consistency in the cost treatment be addressed as described above in ASC 250-10-45-1 and ASC 250-10-45-2(b) and 48 CFR 9903.201-4(a)(2)?
(e) Estimated service lives initially established for tangible capital assets (or groups of assets) shall be reasonable approximations of their expected actual periods of usefulness, considering the factors mentioned in paragraph (a) of this subsection. The estimate of the expected actual periods of usefulness need not include the additional period tangible capital assets are retained for	ASC 360-10-35-4, ASC 360-10-35-8 and ASC 360-10-35-33 see above. ASC 360-10-35-21 A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be	Although CAS and GAAP both require the selection of a service life within a reasonable range of the asset's useful life, CAS is more prescriptive and certain record keeping is explicitly required. QUERY: Would the records maintained to support the claim of Facilities Capital Cost

CAS 409 Requirement	GAAP Requirement	Queries
standby or incidental use where adequate records are maintained which reflect the withdrawal from active use.	recoverable. The following are examples of such events or changes in circumstances:	of Money under CAS 417 be similar to those required CAS 409-50(e)(2)?
(1) The expected actual periods of usefulness shall be those periods which are supported by records of either past retirement or, where available, withdrawal from active use (and retention for standby or incidental use) for like assets (or groups of assets) used in similar circumstances appropriately modified for specifically identified factors expected to influence future lives. The factors which can be used to modify past experience include:	<ul style="list-style-type: none"> a. A significant decrease in the market price of a long-lived asset (asset group) b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition c. A significant change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group) 	<p>QUERY: Would these records be maintained as part of any other ordinary business practice?</p> <p>Both CAS and GAAP require some consideration of actual asset experience when selecting service lives and depreciation methods for assets, although CAS is more prescriptive.</p>
(i) Changes in expected physical usefulness from that which has been experienced such as changes in the quantity and quality of expected output.	e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)	In addition, FAR 2.101(b) – “Depreciation” means a charge to current operations that distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor’s operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.
(ii) Changes in expected economic usefulness, such as changes in expected technical or economic obsolescence of the asset (or group of assets), or of the product or service produced.	f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.	
(2) Supporting records shall be maintained which are adequate to show the age at retirement or, if the contractor so chooses, at withdrawal from active use (and retention for standby or incidental use) for a sample of assets for each significant category. Whether assets are accounted for individually or by groups, the basis for estimating service life	ASC 360-10-35-22 When a long-lived asset (asset group) is tested for recoverability, it	

CAS 409 Requirement	GAAP Requirement	Queries
<p>shall be predicated on supporting records of experienced lives for either individual assets or any reasonable grouping of assets as long as that basis is consistently used. The burden shall be on the contractor to justify estimated service lives which are shorter than such experienced lives.</p>	<p>also may be necessary to review depreciation estimates and method as required by Topic 250 or the amortization period as required by Topic 350. Paragraphs 250-10-45-17 through 45-20 and 250-10-50-4 address the accounting changes in estimates, including changes in the method of depreciation, amortization, and depletion. Paragraphs 350-30-35-1 through 35-5 address the determination of the useful life of an intangible asset. Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows to test the asset (asset group) for recoverability (see paragraphs 360-10-35-31 through 35-32). However, any change in the accounting method for the asset resulting from that review shall be made only after applying this Subtopic.</p> <p>ASC 360-10-35-30 Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity's own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to assumptions used in developing other information used by the entity for comparable periods, such as internal</p>	

CAS 409 Requirement	GAAP Requirement	Queries
	budgets and projections, accruals related to incentive compensation plans, or information communicated to others.	
(3) The records required in subparagraphs (e) (1) and (2) of this subsection, if not available on the date when the requirements of this Standard must first be followed by a contractor, shall be developed from current and historical fixed asset records and be available following the second fiscal year after that date. They shall be used as a basis for estimates of service lives of tangible capital assets acquired thereafter. Estimated service lives used for financial accounting purposes (or other accounting purposes where depreciation is not recorded for financial accounting purposes for some non-commercial organizations), if not unreasonable under the criteria specified in paragraph (e) of this subsection, shall be used until adequate supporting records are available.	No corresponding content for explicit record keeping in GAAP, however see ASC 360-10-35-21, ASC 360-10-35-22 and ASC 360-10-35-30 above.	GAAP does not require the same prescriptive record-keeping as CAS nor explicit reliance on historical records for selecting service lives. GAAP does, however, refer to using actual experience to review depreciation estimates and methods and making changes to them.
(4) Estimated service lives for tangible capital assets for which the contractor has no available data or no prior experience for similar assets shall be established based on a projection of the expected actual period of usefulness, but shall not be less than asset guideline periods (mid-range) established for asset guideline classes under Internal Revenue Procedures which are in effect as of	No corresponding content for explicit record keeping in GAAP, however, see ASC 360-10-35-4, ASC 360-10-35-21, ASC 360-10-35-22 and ASC 360-10-35-30 above.	GAAP does not require the same prescriptive record-keeping as CAS nor explicit reliance on historical records for selecting service lives. GAAP does, however, refer to using actual experience to review depreciation estimates and methods and making changes to them. The record

CAS 409 Requirement	GAAP Requirement	Queries
the first day of the cost accounting period in which the assets are acquired. Use of this alternative procedure shall cease as soon as the contractor is able to develop estimates which are appropriately supported by his own experience.		keeping for service lives is identified as a gap by the Board.
(5) The contracting parties may agree on the estimated service life of individual tangible capital assets where the unique purpose for which the equipment was acquired or other special circumstances warrant a shorter estimated service life than the life determined in accordance with the other provisions of this 9904.409-50(e) and where the shorter life can be reasonably predicted.	No corresponding content in GAAP.	There are regulatory provisions for a contractor and the government to make agreements. See FAR 31.109(a) – To avoid possible subsequent disallowance or dispute based on unreasonableness, unallocability or unallowability under the specific cost principles at Subparts 31.2, 31.3, 31.6, and 31.7, contracting officers and contractors should seek advance agreement on the treatment of special or unusual costs and on statistical sampling methodologies at 31.201-6(c).
(f)(1) The method of depreciation used for financial accounting purposes (or other accounting purposes where depreciation is not recorded for financial accounting purposes) shall be used for contract costing unless:	ASC 360-10-35-4 – The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles (GAAP) require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less	CAS relies on the GAAP method of depreciation today, although with certain exceptions. Both CAS and GAAP generally reject the use of accelerated depreciation using the IRS rules.
(i) Such method does not reasonably reflect the expected consumption of services for the tangible capital asset (or group of assets) to which applied, or		

CAS 409 Requirement	GAAP Requirement	Queries
<p>(ii) The method is unacceptable for Federal income tax purposes.</p> <p>[(f)(1) continued.] If the contractors' method of depreciation used for financial accounting purposes (or other accounting purposes as provided above) does not reasonably reflect the expected consumption of services or is unacceptable for Federal income tax purposes, he shall establish a method of depreciation for contract costing which meets these criteria, in accordance with subparagraph (f)(3) of this subsection.</p>	<p>salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner.</p> <p>ASC 360-10-35-7 – The declining-balance method is an example of one of the methods that meet the requirements of being systematic and rational. If the expected productivity or revenue earning power of the asset is relatively greater during the earlier years of its life, or maintenance charges tend to increase during later years, the declining-balance method may provide the most satisfactory allocation of cost. That conclusion also applies to other methods, including the sum-of-the-years'-digits method, that produce substantially similar results.</p> <p>ASC 360-10-35-9 If the number of years specified by the Accelerated Cost Recovery System of the Internal Revenue Service (IRS) for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions shall not be used as depreciation for financial reporting.</p>	
<p>(2) After the date of initial applicability of this Standard, selection of methods of depreciation for newly acquired tangible capital assets, which are different from the methods currently being used for like assets in similar circumstances, shall be supported by projections of the expected consumption of services of those assets (or groups of assets) to which the different methods of</p>	<p>No corresponding content for explicit record keeping in GAAP, however see ASC 360-10-35-4, .ASC 360-10-35-21, ASC 360-10-35-22 and ASC 360-10-35-30 above.</p>	<p>GAAP does not require the same prescriptive record-keeping as CAS nor explicit reliance on historical records for selecting depreciation methods. GAAP does, however, refer to using actual experience to review depreciation estimates and methods and making changes to them.</p>

CAS 409 Requirement	GAAP Requirement	Queries
depreciation shall apply. Support in accordance with paragraph (f)(3) of this subsection shall be based on the expected consumption of services of either individual assets or any reasonable grouping of assets as long as the basis selected for grouping assets is consistently used.		
(3) The expected consumption of asset services over the estimated service life of a tangible capital asset (or group of assets) is influenced by the factors mentioned in paragraph (a) of this subsection which affect either potential activity or potential output of the asset (or group of assets). These factors may be measured by the expected activity or the expected physical output of the assets, as for example: Hours of operation, number of operations performed, number of units produced, or number of miles traveled. An acceptable surrogate for expected activity or output might be a monetary measure of that activity or output generated by use of tangible capital assets, such as estimated labor dollars, total cost incurred or total revenues, to the extent that such monetary measures can reasonably be related to the usage of specific tangible capital assets (or groups of assets). In the absence of reliable data for the measurement or estimation of the consumption of asset services by the techniques mentioned, the expected consumption of services may be represented	See ASC 360-10-35-4, ASC 360-10-35-7 and ASC 360-10-35-22 above.	<p>CAS is more prescriptive than GAAP regarding the factors for selecting a depreciation method, however both CAS and GAAP require selection of a method which aligns with the pattern of consumption or productivity of the asset.</p> <p>QUERY: Is the resulting cost treatment for CAS and GAAP equivalent?</p>

CAS 409 Requirement	GAAP Requirement	Queries
by the passage of time. The appropriate method of depreciation should be selected as follows:		
(i) An accelerated method of depreciation is appropriate where the expected consumption of asset services is significantly greater in early years of asset life.		
(ii) The straight-line method of depreciation is appropriate where the expected consumption of asset services is reasonably level over the service life of the asset (or group of assets).		
(g) The estimated service life and method of depreciation to be used for an original complement of low-cost equipment shall be based on the expected consumption of services over the expected useful life of the complement as a whole and shall not be based on the individual items which form the complement.	ASC 360-10-35-4 see above.	CAS is more detailed than GAAP, but both rules have content for an original complement or asset group. QUERY: Do CAS and GAAP result in equivalent cost treatment of an asset group?
(h) Estimated residual values shall be determined for all tangible capital assets (or groups of assets). For tangible personal property, only estimated residual values which exceed ten percent of the capitalized cost of the asset (or group of assets) need be used in establishing depreciable costs. Where either the declining balance method of depreciation or the class life asset depreciation range system is used consistent	ASC 360-10-35-4 and ASC 360-10-35-33 see above.	CAS has more prescriptive requirements for establishing residual values. GAAP refers to salvage value being a reduction to the depreciable asset value and is more focused on the reasonableness of the carrying value of the asset going forward in comparison to the remaining productivity of the asset. This has been identified as a gap by the Board.

CAS 409 Requirement	GAAP Requirement	Queries
<p>with the provisions of this Standard, the residual value need not be deducted from capitalized cost to determine depreciable costs. No depreciation cost shall be charged which would significantly reduce book value of a tangible capital asset (or group of assets) below its residual value.</p>		<p>The CAS 409 language can also be found in FAR 31.205-11(a) – For tangible personal property, only estimated residual values that exceed 10 percent of the capitalized cost of the asset need be used in establishing depreciable costs. Where either the declining balance method of depreciation or the class life asset depreciation range system is used, the residual value need not be deducted from capitalized cost to determine depreciable costs. Depreciation cost that would significantly reduce the book value of a tangible capital asset below its residual value is unallowable.</p>
<p>(i) Estimates of service life, consumption of services, and residual value shall be reexamined for tangible capital assets (or groups of assets) whenever circumstances change significantly. Where changes are made to the estimated service life, residual value, or method of depreciation during the life of a tangible capital asset, the remaining depreciable costs for cost accounting purposes shall be limited to the undepreciated cost of the assets and shall be assigned only to the cost accounting period in which the change is made and to subsequent periods.</p>	<p>ASC 250-10-20 – Change in Accounting Estimate A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.</p>	<p>QUERY: Are CAS and GAAP equivalent?</p> <p>In addition, FAR 31.205-11(g)(2) – In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, allowable depreciation of the impaired assets is limited to the amounts that would have been allowed had the assets not been written down (see 31.205-16(g)). However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services, or residual value. Other causes such as permissible changes in estimates of service life, consumption of services, or residual value.</p>

CAS 409 Requirement	GAAP Requirement	Queries
	<p>ASC 360-10-35-22 – When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and method as required by Topic 250 or the amortization period as required by Topic 350. Paragraphs 250-10-45-17 through 45-20 and 250-10-50-4 address the accounting for changes in estimates, including changes in the method of depreciation, amortization, and depletion. Paragraphs 350-30-35-1 through 35-5 address the determination of the useful life of an intangible asset. Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability (see paragraphs 360-10-35-31 through 35-32). However, any change in the accounting method for the asset resulting from that review shall be made only after applying this Subtopic.</p> <p>ASC 250-10-45-17 – A change in accounting estimate shall be accounted for in the period of change if the change affects that period only or in the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.</p>	
(j)(1) Gains and losses on disposition of tangible capital assets shall be considered as adjustments of depreciation costs previously recognized and shall be assigned to the cost accounting period in which disposition	No corresponding content in GAAP, except for the measurement of gains and losses described above.	<p>No corresponding GAAP requirements, however, there is applicable content in FAR.</p> <p>FAR 31.205-16(a) – Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall</p>

CAS 409 Requirement	GAAP Requirement	Queries
occurs except as provided in subparagraphs (j) (2) and (3) of this subsection. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds in the event of involuntary conversion, and its undepreciated balance. However, the gain to be recognized for contract costing purposes shall be limited to the difference between the original acquisition cost of the asset and its undepreciated balance.		<p>be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (f) of this [FAR] subsection). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see 31.205-52).</p> <p>FAR 31.205-16(c) – Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(h)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance.</p>
(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where:		
(i) Assets are grouped and such gains and losses are processed through the accumulated depreciation account, or	No corresponding content in GAAP	FAR 31.205-16(f) – Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when --(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 31.205-11.
(ii) The asset is given in exchange as part of the purchase price of a similar asset and the	ASC 360-10-40-4 For purposes of this Subtopic, a long-lived asset to be disposed of in	QUERY: Are CAS and GAAP equivalent?

CAS 409 Requirement	GAAP Requirement	Queries
gain or loss is included in computing the depreciable cost of the new asset.	an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed.	In addition, FAR 31.205-16(f)(2) – The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.
[(j)(2) continued] Where the disposition results from an involuntary conversion and the asset is replaced by a similar asset, gains and losses may either be recognized in the period of disposition or used to adjust the depreciable cost base of the new asset.	ASC 360-10-40-4 see above.	FAR 31.205-16(e)(2) – <i>[Special considerations for involuntary conversions]</i> When the converted asset is replaced, the contractor shall either --(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or (ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (e)(1) of this [FAR] subsection.
(3) The contracting parties may account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties.	No corresponding content in GAAP.	FAR 31.205-16(g) – Gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations shall be considered on a case-by-case basis.
(4) Gains and losses on disposition of tangible capital assets transferred in other than an arms-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.	No corresponding content in GAAP.	This is a gap identified by the Board.

CAS 409 Requirement	GAAP Requirement	Queries
(5) The provisions of this subsection 9904.409-50(j) do not apply to business combinations. The carrying values of tangible capital assets acquired subsequent to a business combination shall be established in accordance with the provisions of subsection 9904.404-50(d).	ASC 805-20-25-1 As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquire.	<p>Note that this refers to CAS 404, which will be addressed in future rulemaking by the CAS Board.</p> <p>FAR 31.205-52 (a) – For tangible capital assets, when the purchase method of accounting for a business combination is used, whether or not the contract or subcontract is subject to CAS, the allowable depreciation and cost of money shall be based on the capitalized asset values measured and assigned in accordance with 48 CFR 9904.404-50(d), if allocable, reasonable, and not otherwise unallowable.</p>
(k) Where, in accordance with 9904.409-40(b)(1), the depreciation costs of like tangible capital assets used for similar purposes are directly charged to cost objectives on the basis of usage, average charging rates based on cost shall be established for the use of such assets. Any variances between total depreciation cost charged to cost objectives and total depreciation cost for the cost accounting period shall be accounted for in accordance with the contractor's established practice for handling such variances.	No corresponding content in GAAP	QUERY: Do other requirement in CAS address this? (See CAS 402 above)
(l) Practices for determining depreciation methods, estimated service lives and estimated residual values need not be changed for assets acquired prior to	No corresponding content in GAAP	QUERY: Is this requirement in CAS necessary?

CAS 409 Requirement	GAAP Requirement	Queries
<p>compliance with this Standard if otherwise acceptable under applicable procurement regulations. However, if changes are effected such changes must conform to the criteria established in this Standard and may be effected on a prospective basis to cover the undepreciated balance of cost by agreement between the contracting parties pursuant to negotiation under subdivision (a)(4) (ii) or (iii) of the contract clause set out at 9903.201-4(a) [CAS clause, FAR 52.230-2].</p>		

Pentagon Plans to Triple Audits Amid Surge in Defense Spending



Photographer: Saul Loeb/AFP via Getty Image

Photographer: Saul Loeb/AFP via Getty Image

A surge of defense spending is prompting the Pentagon's audit agency to triple the number of evaluations it will undertake in order to uncover or prevent unjustified profits based on incomplete, flawed or inaccurate cost data.

The Defense Contract Audit Agency intends to complete as many as 60 Truth In Negotiations Act reviews in the coming fiscal year, compared to about 20 in the year ending Sept. 30, according to spokesman Christopher Sherwood. The agency completed 21 such audits in 2018 and 26 in 2017. About half the reviews focused on the top 25 defense contractors.

President Donald Trump's efforts to bolster defense spending were aided by Congress's decision to revise spending caps for the final two years of the 2011 Budget Control Act. That effectively added tens of billions of dollars potential defense spending to the Pentagon budget: \$90.3 billion in fiscal year 2020 and \$81.3 billion in the following year.

Congress has signaled its concern that the money could be misspent. The staff of Republican Senator Chuck Grassley, chairman of the Senate Finance Committee, as well as investigators for Democratic Representative Elijah Cummings, chairman of the House Oversight Committee, are already reviewing the Pentagon's enforcement of the law intended to prevent unjustified profits based on incomplete, flawed or inaccurate cost and pricing data for military unique items.



Elijah Cummings

Photographer: Andrew Harrer/Bloomberg

[Read More: Defense Abuses Like 9,400% Markup on Parts Targeted in New Bill](#)

"The committee is investigating whether defense contractors are providing complete and accurate cost data, as required by law," Cummings said in an emailed statement.

The 1962 Truth In Negotiations Act sought to put government contracting officers on equal footing with company counterparts, requiring firms during negotiations to provide government buyers all the variables that influenced the final price of a product or service unique to the military. They must also legally certify that the information is accurate, complete and current.

The TINA audits are separate from Pentagon reviews that uncover instances of overcharging for basic spare parts such as nuts and pins. Those types of goods are considered "commercial items," normally exempt from the law's price data requirements since there is already publicly available data to compare them with.

Fraud Alert

Under the ramped up audit policy, the number of "work years," or time devoted to compiling compliance audits, will increase by approximately 500%, Sherwood said.

Previous reviews show there's reason to be concerned. As an example, Shay Assad, the Pentagon's former director of defense pricing and contracting, said evaluations during his tenure showed that essentially 100% of the contracts examined at one top-25 defense contractor had suspect pricing.



Shay Assad

Photographer: Rich Clement/Bloomberg

"If one looks deep enough there is some element of fraud typically lurking," he said.

Sherwood said the contracts most prone to significant risk of "excess profits" are large, firm-fixed price types. In 2015, the audit agency formed a specialized, 20-person unit to handle reviews of "high-risk" contracts.

Based on initial reviews commissioned before the team was formed, Assad said in a written statement that "it became obvious to us that we needed to step up defective pricing review efforts."

80% Profits

"In a number of cases we expected profit outcomes of 12% to 15%," Assad said, but they found levels of between 25% and 80% on some sole-source weapons contracts. "That does not happen by outstanding performance" but by faulty contractor cost estimating "or in the worst case, fraud," he added. Assad retired this year.

Since 2015, the unit has conducted audits on 108 high-risk contracts totaling \$74 billion. Of those, 79 -- or nearly 75% -- uncovered potential defective pricing of \$589 million that could eventually translate into contractor repayments after the contested charges go through a negotiations process.

"If both parties arrive at a mutually agreeable settlement, the contractor will make a payment to the government," Sherwood said. But if not, the government's principal negotiator "issues a demand for payment, at which point the contractor may elect to make the payment or pursue legal action," he added.

In that same period, the audit agency has referred 10 compliance audits with "suspected irregular conduct" to the Pentagon's Defense Criminal Investigative Service. Eight of those 10 have resulted in active cases, Sherwood said.

UP NEXT

Biggest African Waterfall Victoria Falls at 24-year-Low



PUBLIC
CONTRACTING
INSTITUTE

Materiality in Incurred Cost Audits

Instructors:

James Freeman, DCAA

Brent Calhoon, Baker Tilly

September 18, 2019

2:00-3:30pm

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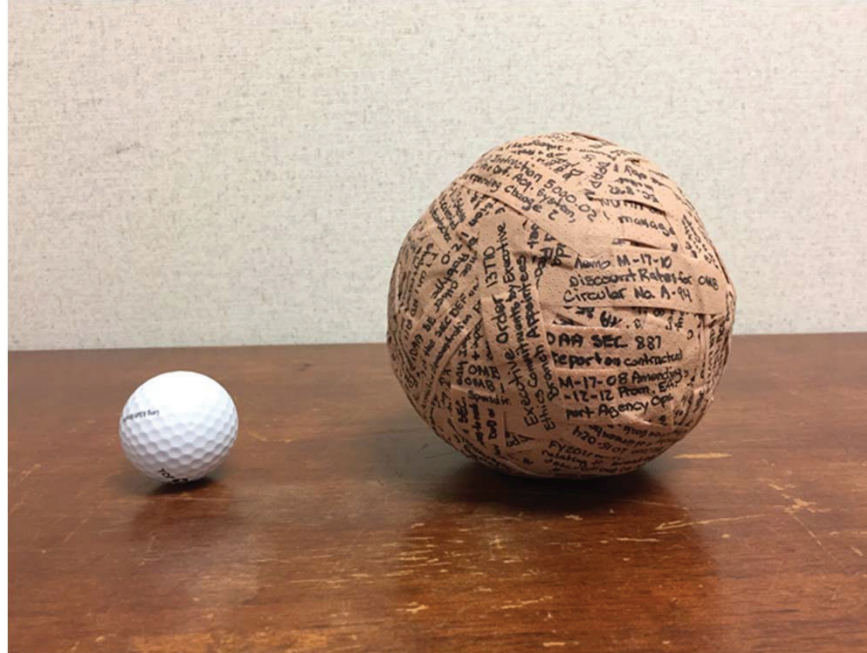
Agenda

- Introductions
- Background
 - Section 809 Panel & Final Report Vol. 1 (January 2018)
 - The Professional Practice Guide working group
 - Overview of the Professional Practice Guide (Section 809 Panel Final Report Vol. 3)
- Key Concepts
 - Misstatements & materiality
 - Importance of materiality
 - Materiality in financial statement audits vs. contract cost audits
 - Materiality vs. significance
 - Quantitative materiality vs. qualitative materiality
- Application
 - Calculating quantified materiality
 - Audit planning
 - Applying quantified materiality to cost elements
 - Applying adjusted materiality to accounts
 - Adjustments for indirect costs
 - Audit reporting

Background

Section 809 Panel

- Section 809 of the FY 2016 NDAA required the Secretary of Defense to appoint a panel to streamline and improve the defense acquisition process. It has two years to develop recommendations
- All new legislation or regulation impacting government contracting since 2008 was written on band-aids and stuck to a golf ball.
- Some of the Panel's recommendations remove certain band-aids; others suggest throwing the ball away.



Section 809 Panel Vol #1 Report

- Section 2 – Contract Compliance and Audit
 - 11 recommendations aimed toward –
 - Enhancing DCAA's focus on the contracting officer and acquisition team,
 - Using accepted commercial standards and practices with objective and standardized compliance criteria, and
 - Providing more effective and efficient contract compliance oversight.
 - Recommendation No. 11: Develop a Professional Practice Guide for DoD's oversight of contractor costs and business systems
 - Professional standards are common in the accounting and auditing profession, but none have been developed or interpreted for the unique purpose of federal government contract oversight
 - Without a Professional Practice Guide (PPG), contracting officers will be underserved and likely confused by inevitable inconsistencies among audit and advisory reports issued by DCAA, DCMA, and CPA firms.
 - Professional standards that require a collaborative interpretation include (among many others) independence, objectivity, materiality, sufficient evidence, and reliance on the work of others.
 - Working group to include at a minimum GAO, DCAA, AICPA, and industry

The PPG Working Group

- Participants invited by Section 809 Panel (to volunteer)
- Formed in March 2018
- Met at least weekly through December 2018 (conference calls and in-person)
- Included the following principal members:
 - Charlie Williams, Section 809 Panel Commissioner
 - Four Representatives from DCAA Headquarters
 - Rich Casey, DCMA
 - Tim DiNapoli, GAO
 - Matt Zaun, GAO
 - Ahava Goldman, AICPA
 - Laurie Schmidgall, Aerospace Industries Association (Boeing)
 - Brent Calhoon, 809 Panel SME (Baker Tilly)
 - Pat Fitzgerald, 809 Panel SME (Baker Tilly)

PPG Overview

- The Section 809 Panel introduced *The Professional Practice Guide for Audits and Oversight of Defense Contractor Costs and Internal Controls* as recommendation no. 71 and published it as an Appendix to Section 6 of Final Report Vol. 3 (January 2019).
- The Guide contains three chapters:
 - CHAPTER 1: RISK ASSESSMENT
 - CHAPTER 2: MATERIALITY IN AUDITS OF INCURRED COSTS
 - CHAPTER 3: AUDITS OF INTERNAL CONTROL OVER GOVERNMENT CONTRACT COMPLIANCE
- DCAA's recent audit guidance (MRD 19-PAS-003(R)) implements Chapter 2 of the Professional Practice Guide over a year earlier than required by statute.

Materiality: Key Concepts

Misstatements and Materiality

- Misstatement:
 - Generally, a noncompliance that can be measured as a dollar amount.
 - Primary sources: cost type (FAR 31.205), contract clauses, cost reasonableness, and cost allocation (FAR 31.201 to 31.204, or CAS if applicable).
- Materiality:
 - Misstatements, including omissions, are material if, *individually or in the aggregate*, they could *reasonably be expected to influence relevant decisions of intended users* that are made based on the subject matter.
 - Materiality is considered in the context of **qualitative** factors and, when applicable, **quantitative** factors.
 - The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter of an auditor's professional judgment.
 - In the context of incurred cost audits, auditors should *document the justification for deviating* from applicable numeric materiality thresholds.

Importance of Materiality

- Expressly acknowledges that some degree of imperfection is acceptable to the users of financial information (as emphasized throughout commercial and government auditing standards, regulations for the oversight of financial markets, FAR and CAS).
- The Federal Acquisition System's Guiding Principles recognize that there is an acceptable level of imprecision when determining or settling fair and reasonable contract prices (encourages risk management vs. avoidance).
- Provides an element of consistency in contract cost audits performed by DCAA and CPA firms.
- Promotes audit efficiency without sacrificing effectiveness.
- Introduces an objective feature to a topic that was historically subjective.
- Facilitates negotiations, decisions, and cost/benefit decisions.

Quantitative vs. Qualitative Materiality

- Quantitative Materiality
 - Expressed as a dollar *amount*
 - Proportionate to the total amount of something (i.e., subject matter)
 - Proportion:
 - May be **static** or **dynamic** as the total subject matter increases or decreases
 - Depends on the user and intended use of the audited information
- Qualitative Materiality
 - Relating to the *nature* of something, rather than solely the dollar amount
 - Often relevant in the context of:
 - Illegal activity
 - Gross negligence
 - Deception
 - Noncompliance with unambiguous requirements
 - Habitual mistakes
 - Unmitigated or unmanaged risk

Materiality in Financial Statement vs. Incurred Cost Audits

- Financial Statement Audits
 - Users: owners, investors, lenders, etc.
 - Purpose: investment and lending decisions; industry analysis
 - Funds at risk: private
 - Quantitative measure: often expressed as static % of net income, net assets, etc.
 - Qualitative considerations: illegal activities, deceptive reporting, aggressiveness vs. conservatism
- Contract Cost Audits
 - Users: contracting officers (primarily)
 - Purpose: determining fair and reasonable prices, cost reimbursements, settlements, compliance with contract terms
 - Funds at risk: public
 - Quantitative measure: expressed as a dynamic % that decreases as the subject matter increases
 - Qualitative considerations: customer mix, contract mix, expressly unallowable costs, inequitable cost allocations, fraudulent and deceptive activities, noncompliance with unambiguous contract terms

Materiality vs. Significance

- *Materiality* is a term used in the AICPA's attestation examination standards, but is not limited to only these types of engagements.
- Generally Accepted Government Auditing Standards (GAGAS) define *significance* in the context of performance audits but notes that "the term *significant* is comparable to the term *material* as used in the context of financial statement engagements."
- Both terms are used interchangeably in the Professional Practice Guide and are not intended to have different meanings.
- The terms *significant cost element* and *significant account* indicate contractor cost presentations that require further evaluation, and possibly testing, due to the **potential of material misstatements** based on quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer.

Materiality: Application

Calculating Quantified Materiality

- Total Subject Matter:
 - Direct and indirect cost of flexibly priced prime contracts and subcontracts awarded by DoD or an agency other than DoD that has agreed to the audit.
 - The amount billed on prime T&M contracts that are awarded by DoD or an agency other than the DoD that has agreed to the audit.

- Quantified Materiality

$$\text{Materiality Threshold} = \$5,000 \times ((\text{Total Subject Matter} / \$100,000) ^ .75)$$

Subject Matter Cost:	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
Materiality Amount:	\$5,000	\$28,117	\$158,686	\$889,140	\$2,973,018	\$5,000,000	<i>Varies</i>
Materiality Percentage:	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

- For Total Subject Matter from \$1 to \$1,000,000,000 use:
 - Materiality Threshold = $\$5,000 \times ((\text{Total Subject Matter} / \$100,000) ^ .75)$
- For Total Subject Matter greater than \$1,000,000,000 use:
 - Materiality Threshold percentage of 0.50%
- Quantified materiality neither limits auditor judgment nor places restrictions on what an auditor can test based solely on dollar value.
- The quantified materiality amount is intended to create a consistent threshold that helps an auditor calibrate the nature, timing, and extent of audit procedures relative to the unique risks and qualitative considerations of each engagement.

Calculating Materiality: Example

$$\$8,425 = \$5,000 \times ((\$200,500/\$100,000) ^{.75})$$

The quantified materiality amount is \$8,425, which is 4.2% of the total engagement subject matter (\$8,425/\$200,500).

Incurred Cost Submission:	Total
Direct Labor	\$100,000
Direct Materials	\$50,000
Other Direct Costs	\$10,000
Overhead	\$20,000
<hr/>	
G&A Expense	\$20,500
<hr/>	
Total Subject Matter (a)	\$200,500
Materiality Threshold (b)	4.2%
Materiality (c)	\$8,425

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Audit Planning

- Identify Significant Cost Elements
 - Identify all cost elements equal to or greater than quantified materiality as significant.
 - Consider risk and qualitative factors for all cost elements less than quantified materiality.
- Note: auditors may incorporate variability, or unpredictability, in the selection of cost elements to test.

Cost Element	Amount	> Materiality of \$134,200
Direct Labor	\$2,441,657	YES
Travel	\$54,092	NO
Direct Materials	\$188,716	YES
ODC	\$11,175	NO
Subcontracts	\$3,329,051	YES
Indirect Overhead	\$1,138,408	YES
G&A (Value Added)	\$872,925	YES
Total Subject Matter	\$8,036,024	
Materiality Threshold	1.67%	
Materiality	\$134,200	

Audit Planning (cont'd)

- Identify Significant Accounts
 - Accounts \geq **adjusted materiality** are significant.
 - Consider qualitative factors for all account balances less than adjusted materiality.
Note: auditors may incorporate an element of variability in the selection of accounts to test.
- Adjusted Materiality
 - Adjusted materiality is less than quantified materiality so auditors can identify immaterial misstatements that, in the aggregate, become material or are material by their nature even if immaterial in amount.
 - Adjusted materiality is stated as 20%-80% of quantified materiality based on audit risk (i.e., the nature (or sensitivity) of transactions within each account).
 - Considerations include: specific cost allowability criteria, other substantive procedures performed (i.e., whether controls are tested), and the needs of the users of audited information.

Audit Planning (cont'd)

- Using Adjusted Materiality to Identify Significant Accounts

Category	Description	Amount	> Materiality \$1,025	> Adjusted Materiality \$820
Subcontracts	Cost Element	\$750	NO	N/A
Direct Materials	Cost Element	\$5,000	YES	N/A
Direct Materials Acct X1	Account	\$850	N/A	YES
Direct Materials Acct X2	Account	\$450	N/A	NO
Direct Materials Acct X3	Account	\$980	N/A	YES
Direct Materials Acct X4	Account	\$500	N/A	NO
Direct Materials Acct X5	Account	\$350	N/A	NO
Direct Materials Acct X6	Account	\$1,870	N/A	YES

- Note: for statistical sampling purposes (after removing transactions > adjusted materiality), adjusted materiality should be used as the tolerable misstatement.

Audit Planning (cont'd)

- Materiality and Indirect Costs
 - Adjust quantified materiality to account for government participation in indirect cost pools

Incurred Cost Proposal		> Materiality \$136,490 (YES/NO)
Direct Costs:		
Direct Labor	\$ 5,000,000	YES
Direct Materials	\$ 100,000	NO
Other Direct Costs	\$ 80,000	NO
Subcontracts	\$ 1,000,000	YES
Indirect Costs:		
Overhead	\$ 1,112,400	YES
General and Administrative	\$ 927,000	YES
Total Subject Matter:	\$ 8,219,400	
Materiality Threshold:	\$ 136,490	

Audit Planning (cont'd)

- Determine Participation % for each Indirect Cost Pool

Indirect Costs:	Total Subject Matter	Total Cost in Pool	Participation Rate
Overhead	\$1,112,400	\$11,124,000	10%
General and Administrative	\$927,000	\$11,587,500	8%

- Calculate Revised Quantified Materiality

Indirect Costs:	Participation Percent	Materiality	Revised Materiality
Overhead	10%	\$136,490	\$1,364,898
General and Administrative	8%	\$136,490	\$1,706,122

- Calculate Adjusted Materiality

Indirect Costs:	Revised Materiality	Adjustment	Adjusted Materiality
Overhead	\$ 1,364,898	20%	\$ 1,091,918
General and Administrative	\$ 1,706,122	20%	\$ 1,364,898

Audit Planning (cont'd)

- Compare the adjusted materiality amount of \$1,091,918 to accounts in the overhead cost pool.
- Based on adjusted materiality, only the labor account is considered significant.

Overhead Pool Accounts		Amount	> Adjusted Materiality (YES/NO)
6001	Labor	\$ 3,000,000	YES
6002	Operating Supplies	\$ 900,000	NO
6003	Computer & Data Process Supply	\$ 100,000	NO
XXXX
		<hr/>	
		\$ 11,124,000	

Audit Reporting

- Evaluating and Reporting Identified Misstatements
 - Summarize all misstatements and compare them individually, and in the aggregate, to quantified materiality.
 - If the aggregate amount of identified misstatements < quantified materiality, then an auditor may issue an **unqualified** opinion (provided that no quantitatively immaterial misstatements are qualitatively material).
 - If the aggregate of all misstatements > quantified materiality, or if one or more misstatements are qualitatively material, the an auditor will issue a **qualified** or **adverse** opinion, as applicable.
 - An **adverse** opinion is appropriate if material misstatements are so pervasive that the subject matter, taken as a whole, is not reliable.

Audit Reporting (cont'd)

- Notable considerations:
 - The dollar value of some misstatements may be **greater than** the value of the underlying misstated transaction (e.g., direct labor).
 - The dollar value of some misstatements may be **less than** the value of the underlying misstated transaction (e.g., indirect costs).
 - A nominal reporting amount is any misstatement that would be immaterial regardless of other qualitative factors.
 - Both material and immaterial misstatements should be reported or communicated to the contracting officer in accordance with Government Auditing Standards

Questions & Comments

Thank you for joining us today!

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February 2019

CONTRACTOR BUSINESS SYSTEMS

DOD Needs Better Information to Monitor and Assess Review Process

Why GAO Did This Study

Contractor business systems produce critical data that contracting officers use to help negotiate and manage defense contracts. These systems and their related internal controls act as important safeguards against fraud, waste, and abuse of federal funding. Federal and defense acquisition regulations and DOD policies require that DOD take steps to review the adequacy of certain business systems, but GAO and other oversight entities have raised questions about the sufficiency and consistency of DOD's review process.

The National Defense Authorization Act for Fiscal Year 2018 contained a provision for GAO to evaluate how DOD implemented legislation intended to improve its business system review process. Among other things, this report examines (1) the changes DOD made to its review process and (2) the extent to which DOD is ensuring timely business system reviews.

GAO analyzed DOD acquisition regulations, policies, and procedures for conducting contractor business system reviews and analyzed data on reviews conducted between fiscal years 2013 and 2018.

What GAO Recommends

GAO recommends that DCMA, in collaboration with DCAA, develop a mechanism to monitor and ensure contractor business system reviews are conducted in a timely fashion. DOD concurred with the recommendation.

View [GAO-19-212](#). For more information, contact Timothy J. DiNapoli, (202) 512-4841, dinapoli@gao.gov

February 2019

CONTRACTOR BUSINESS SYSTEMS

DOD Needs Better Information to Monitor and Assess Review Process

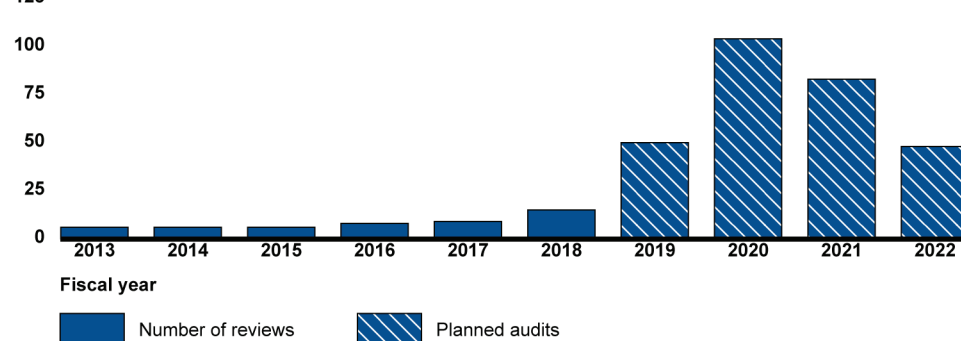
What GAO Found

Since 2011, the Department of Defense (DOD) has implemented several changes to its processes for reviewing contractor business systems—which include systems such as accounting, estimating, and purchasing. Among other changes, DOD

- clarified the roles and responsibilities of the Defense Contract Management Agency (DCMA) and the Defense Contract Audit Agency (DCAA)—the two agencies that are responsible for conducting the reviews;
- clarified timeframes for business system reviews and established criteria for business systems; and
- withheld payments from contractors that were found to have significant deficiencies in their business systems.

DOD does not have a mechanism to monitor and ensure that these reviews are being conducted in a timely manner. For its part, DCAA has conducted few business system audits since 2013, as it focused its efforts on other types of audits. DCAA plans to significantly increase the number of business system audits over the next 4 years, but its success in doing so depends on its ability to shift resources from other audits; to use public accounting firms to conduct other, non-business system audits; and DCAA staff's ability to execute new audit plans in a timely manner.

Number of Contractor Business System Audits Completed or Planned by Defense Contract Audit Agency



Source: GAO analysis of Defense Contract Audit Agency data. | GAO-19-212

DCMA relies on the three offices responsible for conducting DCMA-led reviews to manage the reviews, but DCMA does not formally monitor whether these reviews are being conducted consistent with policy nor does it monitor DCAA's efforts to complete the audits for which it is responsible. DCMA is ultimately responsible for approving a contractor's business systems. DCMA currently lacks a mechanism based on relevant and reliable information, such as the number of reviews that are outstanding and the resources available to conduct such reviews, to ensure reviews are being completed in a timely fashion. Such information could help inform more strategic oversight on whether the current review process is achieving its intended results, or whether additional changes to the timing of or criteria for conducting reviews are needed.

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Abbreviations

ACO	Administrative Contracting Officer
CBAR	Contract Business Analysis Repository
CBS	Contractor Business System
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DPC	Defense Pricing and Contracting
DOD	Department of Defense
FAR	Federal Acquisition Regulation
IG	Inspector General
NDAA	National Defense Authorization Act

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February 7, 2019

Congressional Committees

Contractor business systems, which include a contractor's accounting, estimating, and property management systems, produce critical data that Department of Defense (DOD) contracting officers use to help negotiate and manage hundreds of billions of contract dollars each year. These business systems and their related internal controls act as the first line of defense against fraud, waste, and abuse of federal funding. For example, an approved accounting system can help prevent contractors from overcharging or mischarging federal contracts. Federal and defense acquisition regulations and DOD policy require DOD to take steps to review the adequacy of these business systems and to ensure that contractors correct identified deficiencies. These reviews and audits are conducted primarily by two defense agencies: the Defense Contract Management Agency (DCMA) and the Defense Contract Audit Agency (DCAA). DCMA generally has responsibility for approving contractors' business systems; DCMA and DCAA have specific responsibilities for reviewing these systems.

In 2009, the Commission on Wartime Contracting and GAO highlighted significant concerns about how DOD was conducting CBS reviews at that time. Congress later enacted Section 893 of the National Defense Authorization Act (NDAA) for Fiscal Year 2011.¹ This provision mandated that DOD develop a program to improve contractor business systems. Subsequently, Section 893 of the NDAA for Fiscal Year 2017 amended the earlier provision to 1) define "covered" contractors generally as those with government contracts subject to cost accounting standards that account for more than 1 percent of the company's total gross revenue and 2) allow contractors to use registered public accounting firms to review their systems in place of DOD's review.²

¹Pub. L. No. 111-383, § 893 (2011).

²Pub. L. No. 114-328, § 893 (2016). The cost accounting standards are rules designed to ensure contractors consistently apply cost accounting practices to contracts with the government. Regulations establish applicability and criteria for full and modified cost accounting standards coverage. See 48 C.F.R. part 9903. Section 893's definition of a covered contractor excludes contractors that are exempt from the full cost accounting standards.

Section 890 of the NDAA for Fiscal Year 2018 contained a provision for GAO to evaluate the implementation and effectiveness of these changes to the contractor business system (CBS) review process.³ This report (1) describes the changes DOD made to its CBS review process; (2) examines the extent to which DOD is ensuring CBS reviews are being conducted in a timely fashion; and (3) describes the steps DOD has taken to implement selected provisions of Section 893 of the NDAA for fiscal year 2017.

To determine what changes DOD made to its CBS review process, we reviewed Section 893 of the NDAA for Fiscal Year 2011, applicable Federal Acquisition Regulation (FAR) and Defense Federal Acquisition Regulation Supplement (DFARS) sections and clauses, and relevant DCMA and DCAA policies, instructions, and memoranda. We compared current steps in the CBS review process to those used by DCMA and DCAA prior to the Fiscal Year 2011 NDAA to gain a better understanding of the changes made and discussed those changes with DCMA and DCAA officials. We also analyzed DCMA and DCAA data to determine the number of business systems reviewed by either agency from fiscal years 2015 through 2017—the last three fiscal years for which we could obtain data for all CBS systems. To determine the reliability of these data, we interviewed appropriate DCMA and DCAA officials and collected information on the steps taken by their agencies to ensure data reliability. Based on these steps, we determined the data were sufficiently reliable for the purposes of reporting the number of systems reviewed and how many deficiencies were found.

To further our understanding of how changes to the CBS review process were implemented and to gain insight into the effect they had on contractors and program offices, we selected a nongeneralizable sample of six defense contractors based on such factors as the amount of DOD contract obligations awarded to the contractor in fiscal year 2017; the contractor's size (i.e., large or small); and whether one or more of the contractor's business systems were disapproved as reported in DOD's Contract Business Analysis Repository (CBAR) as of November 2017. To better understand the process of identifying and resolving system

³Pub. L. No. 115-91 § 890 (2017). The mandate included several elements, including a request that we describe the known costs of the CBS review process to the government and covered contractors. With regard to this element, we found that neither the government nor contractors maintained reliable and verifiable information that would allow us to sufficiently assess the known costs of the CBS review process.

deficiencies, we selected five contractors that had at least one business system that had been found to be materially deficient and one contractor that had not had any material deficiencies identified. We interviewed representatives from each of the six contractors as well as DCMA officials responsible for approving the contractor's business systems. Finally, we interviewed contracting officers from military department buying commands to determine how these officials mitigate risk when awarding contracts or overseeing contractors with business system deficiencies. When available, we collected and analyzed contract file documentation describing how business system deficiencies affected contract awards.

To determine the extent to which DCMA and DCAA are ensuring CBS reviews are being conducted in a timely fashion, we reviewed DCMA and DCAA policies, instructions, and memoranda to identify the offices and individuals responsible for providing management oversight, conducting CBS audits and reviews, and approving contractor business systems. We interviewed DCMA and DCAA officials and collected relevant data, such as DCAA's planned audits for fiscal years 2019 through 2022, to understand their approach to prioritizing reviews and the challenges, if any, in completing the reviews in a timely fashion.

To determine the extent to which DOD has implemented changes to its CBS review process in response to the NDAA for Fiscal Year 2017, we interviewed DOD Defense Pricing and Contracting (DPC) officials responsible for drafting the proposed regulations. We also interviewed DCMA and DCAA policy officials, contractors, and program offices to obtain their perspectives on the potential benefits and challenges associated with these changes. We reviewed selected contractors' annual U.S. Securities and Exchange Commission filings to gauge what effect, if any, the amended statutory definition of what is considered a covered contractor may have on these contractors. The 20 contractors we reviewed represented 86 percent of obligations in fiscal year 2016 on contracts that were identified in the Federal Procurement Data System-Next Generation as covered by cost accounting standards.

We conducted this performance audit from September 2017 to February 2019 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Federal acquisition regulations require certain contractors who do business with the government to maintain acceptable business systems that reduce risk to the government and taxpayer. Contractors may have up to six major business systems that require review. DOD's acquisition regulation establishes criteria for each of the six types of contractor business systems, which are implemented by the inclusion of certain contract clauses. Where a contract includes these clauses, the contractor's business systems generally must meet the criteria. Factors such as the type of contract and the dollar value determine whether the clauses are included in a contract (see table 1).

Table 1: Description of the Six Major Contractor Business Systems and the Factors for Including the Business System Criteria in Contracts

System	Description	Factors for Including the Business System Criteria in Contracts
Accounting	System or systems for accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions. Systems may include subsystems for specific areas such as indirect and other direct costs, compensation, billing, labor, and general information technology.	Cost-reimbursement, incentive type, time-and-materials, or labor-hour contracts; or contracts that provide for progress payments based on costs or on a percentage or stage of completion.
Estimating	Policies, procedures, and practices for budgeting and planning controls, and generating estimates of costs and other data included in proposals submitted to the government in the expectation of receiving contract awards.	Contracts awarded on the basis of certified cost or pricing data. Additional requirements apply when the contractor is considered a large business and, in the preceding fiscal year, either received Department of Defense prime contracts or subcontracts, totaling <ul style="list-style-type: none"> \$50 million or more for which certified cost or pricing data were required; or \$10 million or more (but less than \$50 million) for which certified cost or pricing data were required; and the procuring contracting officer, with concurrence or request of the administrative contracting officer, determines it to be in the best interests of the government.
Material Management and Accounting	Manual or automated system or systems for planning, controlling, and accounting for the acquisition, use, issuing, and disposition of material, which may be integrated with other systems such as estimating, purchasing, inventory, and accounting.	Contracts for non-commercial items that exceed the simplified acquisition threshold and are either cost-type contracts or fixed-price contracts with progress payments based upon costs incurred as work in progress. This does not apply to contractors that are small businesses, educational institutions, or nonprofit organizations.

System	Description	Factors for Including the Business System Criteria in Contracts
Purchasing	System or systems for purchasing and subcontracting, including make-or-buy decisions, the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administering of orders, and expediting delivery of materials.	Contracts that include the standard FAR subcontracts clause. ^a The subcontracts clause generally is included in cost-type contracts and certain other types of contracts that exceed the simplified acquisition threshold. ^b
Property Management	System or systems for managing and controlling government property.	Contracts that include the standard FAR government property clause. ^c The government property clause generally is included in cost-reimbursement, time-and-material/ labor hour, or fixed price contracts where property is expected to be furnished by the government or a contract for commercial items where government property exceeds the simplified acquisition threshold and the contractor is directed to use government property.
Earned Value Management	A system for project management that effectively integrates the project scope of work with cost, schedule and performance elements for optimum project planning and control.	Cost or incentive contracts valued at \$20 million or more and certain other contracts for which earned value management is applied.

Source: GAO analysis of the Federal Acquisition Regulation, Defense Federal Acquisition Regulation Supplement, and Defense Contract Audit Agency and Defense Contract Management Agency instructions | GAO-19-212

^aFAR § 52.244-2.

^bPurchasing system requirements also are included in contracts that include the DFARS counterfeit electronic part detection and avoidance system clause (DFARS § 252.246-7007).

^cFAR § 52.245-1.

In certain cases, the absence of an adequate system may preclude the government from using a particular contract type or may require additional oversight or analysis. For example, the FAR states that:

- A cost-reimbursement contract may be used only when, among other things, contractors' **accounting systems** are adequate for determining costs applicable to the contracts or orders; an adequate accounting system is also required for the use of progress payments.⁴
- Without an approved **purchasing system**, contractors may require additional oversight of their subcontracting decisions.⁵
- Significant deficiencies with contractors' **estimating systems** shall be considered during negotiation. Alternatively, an adequate estimating system may reduce the scope of reviews to be performed on

⁴FAR §§ 16.301-3(a)(3), 32.503-3.

⁵See FAR § 44.201-1.

individual proposals, expedite the negotiation process, and increase the reliability of proposals.⁶

DCMA and DCAA are responsible for providing contracting and audit support to the military departments and are responsible for conducting business system reviews, along with a host of other responsibilities (see table 2).

Table 2: Roles and Responsibilities of the Defense Contract Management Agency (DCMA) and the Defense Contract Audit Agency (DCAA)

	DCMA	DCAA
Mission	DCMA performs contract administration services and contingency contract administration service for the Department of Defense (DOD), other federal agencies, foreign governments, international organizations, and others as authorized.	While serving the public interest as its primary customer, DCAA performs all necessary contract audits for DOD and provides accounting and financial advisory services regarding contracts and subcontracts to all DOD components responsible for procurement and contract administration.
Background	DCMA plays a significant role in DOD's oversight and management of contracts and provides analytical support for award decisions made by contracting officers. The Director, DCMA, reports to the Under Secretary of Defense for Acquisition and Sustainment.	DCAA was established to provide more efficient and consistent audit support by centralizing these duties in a single defense organization. It performs contract audits for DOD and provides accounting and financial advisory services regarding contracts and subcontracts to DOD components. The Director, DCAA, reports to the Under Secretary of Defense – Comptroller.
Roles and responsibilities	<ul style="list-style-type: none"> Provides advice and information to help DOD prepare solicitations, identify acquisition risks, select capable contractors, and write contracts that meet the needs of DOD, other federal agencies, and allied government agencies. Monitors contractors' performance and management systems to ensure that cost, product performance, and delivery schedules are in compliance with contracts. Administers, manages, and operates procurement management review programs, providing oversight of acquisition processes employed by DOD components. 	<ul style="list-style-type: none"> Audits primarily cost-reimbursable and other non-fixed-price contracts, which generally pose the highest risk to the government. Performs pre-award services such as pre-award accounting system surveys, price proposal audits, and forward pricing rate audits. Performs post-award services such as incurred cost audits and Cost Accounting Standards compliance and adequacy reviews May perform analysis of contractor information following audit report completion and support contracting officers during contract negotiations.

Source: GAO analysis of DODD 5105.36 Defense Contract Audit Agency (DCAA), DODD 5105.64 Defense Contract Management Agency (DCMA), and Defense Contract Audit Agency and Defense Contract Management Agency information I GAO-19-212

Under DCMA's November 2013 instruction, the final determination of adequacy for all of the contractor business systems resides with the DCMA administrative contracting officers (ACO).⁷ An ACO may have

⁶FAR § 15.407-5.

⁷DCMA Instruction 131, *Contractor Business Systems*, Nov. 6, 2013. This instruction was revised in December 2015 (DCMA Immediate Policy Change-1 (IPC-1) (Dec. 1, 2015)).

responsibility for all or a portion of a single large business or may be responsible for a number of smaller contractors within a particular region. To help inform their system determinations, an ACO can request that either DCMA or DCAA conduct business system reviews or audits when needed. Among other responsibilities, ACOs are responsible for taking actions to impose consequences when contractors do not comply with business system standards.

Prior Reports by GAO, Other Accountability Organizations, and Legislative Actions

Throughout the last 10 years, GAO and other accountability organizations have reported on challenges DOD faces when conducting CBS reviews or other critical contracting audits, such as incurred cost audits.⁸ Over this time Congress has also taken actions through various NDAA's to initiate changes to the CBS review process.

In 2009, the Commission on Wartime Contracting and GAO highlighted significant concerns about how DOD was conducting CBS reviews at that time. For example:

- The Commission reported that billions of dollars in contingency-contract costs in Iraq and Afghanistan could not be verified by government auditors and that inadequate internal controls over contractor business systems hampered the government's insight into cost errors and material misstatements.⁹ The report highlighted instances where DCMA and DCAA came to different conclusions when reviewing the same contracts and had inadequate resources to complete business system reviews. It also stated that DCMA was not aggressive in motivating contractors to improve their business systems because it accepted corrective action plans as sufficient progress to address deficiencies. The commission made recommendations to address each of these issues.

⁸DCAA conducts incurred cost audits to identify whether costs incurred on flexibly-priced contracts are allowable, allocable, and reasonable—information that contracting officers need to close the contracts.

⁹Commission on Wartime Contracting in Iraq and Afghanistan, *Special Report on Contractor Business Systems: Defense agencies must improve their oversight of contractor business systems to reduce waste, fraud, and abuse*, CWC Special Report 1, September 21, 2009. The topic was revisited in its final report as one of a variety of weaknesses that undermine the government's ability to protect its interest in economical and effective performance of contingency contracting. See Commission on Wartime Contracting in Iraq and Afghanistan. *Transforming Wartime Contracting: Controlling costs, reducing risks*, Final Report to Congress, August 2011.

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- We found issues with independence of auditors, sufficiency of evidence, and incomplete reporting of DCAA's findings.¹⁰ As result, we made 17 recommendations to DOD to help improve the quality of DCAA's audits, most of which the agency has implemented.

Since then, subsequent GAO and DOD Inspector General (IG) reports have pointed to other issues with the CBS review process and DCAA's incurred cost audit process. Namely,

- In November 2011, we found that DCAA could not complete the number of CBS reviews needed to be consistent with its guidelines because it was focused on higher priority areas—such as incurred cost audits—and, as a result, DCMA contracting officers maintained systems' determinations as adequate even though the systems had not been audited by DCAA in a number of years.¹¹ Among our recommendations, we proposed that DCMA and DCAA identify options, such as hiring external auditors, to assist in the conduct of CBS reviews until DCAA could adequately fulfill those responsibilities with its own workforce. In July 2014, DOD published a proposal to change the DFARS to allow public accounting firms to perform reviews of accounting, estimating, and material management and accounting systems. According to DPC officials, however, the department's IG raised concerns about consistency between the proposed change and statutory and regulatory requirements for IG oversight of outside audit services. Further, the private sector expressed concerns that CBS audit criteria did not align with generally accepted accounting principles used in the private sector. As result of these challenges, DOD did not implement the proposed regulation change.
- In December 2012, we found that DCAA's backlog of incomplete incurred cost audits was a contributing factor in DOD's inability to close out contracts in a timely manner.¹² To address this backlog, DCAA began implementing a new, risk-based approach that was

¹⁰GAO, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-468](#) (Washington, D.C.: Sept. 23, 2009).

¹¹GAO, *Defense Contract Management Agency: Amid Ongoing Efforts to Rebuild Capacity, Several Factors Present Challenges in Meeting Its Missions*, [GAO-12-83](#) (Washington, D.C.: Nov. 3, 2011).

¹²GAO, *Defense Contracting: DOD Initiative to Address Audit Backlog Shows Promise, but Additional Management Attention Needed to Close Aging Contracts*, [GAO-13-131](#) (Washington, D.C.: Dec. 18, 2012).

expected to shift DCAA's resources to focus on incurred cost audits involving high-dollar value and high risk proposals.

- In October 2015, the DOD IG found that DCMA contracting officers did not always comply with requirements to report business system deficiencies and found instances where CBS determinations based on DCAA-led reviews were not reported within required timeframes. The IG concluded that this likely caused delays in correcting significant business system deficiencies and lengthened the time the government was unable to rely on data generated by those business systems.
- In September 2017, we found that despite efforts by DCAA to reduce the backlog of incurred cost proposals awaiting audit, the agency was not able to meet its goals to eliminate the backlog by fiscal year 2016 and that it was unlikely to meet a revised goal of fiscal year 2018.¹³ We recommended that DCAA assess and implement options for reducing the length of time to begin incurred cost audits and establish related performance measures. DCAA concurred with these recommendations and took actions to reduce the time it takes to begin audits.

Most recently, in a January 2018 report, the Advisory Panel on Streamlining and Codifying Acquisition Regulations—commonly referred to as the Section 809 panel after the legislative provision that created it—reiterated the importance of business system internal controls.¹⁴ Noting that DOD's CBS reviews are untimely and inconsistent, the Panel made several recommendations that seek to complete reviews, especially for accounting systems, in a more timely way. Among these recommendations are the use of public accounting firms to supplement the DOD audit workforce, a change to accounting system review standards and criteria, and the development of new guidance for the conduct of business system reviews.

¹³GAO, *Federal Contracting: Additional Management Attention and Action Needed to Close Contracts and Reduce Audit Backlog*, [GAO-17-738](#) (Washington, D.C.: Sept. 28, 2017).

¹⁴Advisory Panel on Streamlining and Codifying Acquisition Regulations, *Report of the Advisory Panel on Streamlining and Codifying Acquisition Regulations Volume 1 of 3*, (Arlington, VA.: Jan. 2018). The panel was established pursuant to Section 809 of the National Defense Authorization Act for Fiscal Year 2016. The panel also released Volume 2 in June 2018 and Volume 3 in January 2019.

During the past 10 years, Congress also enacted three provisions related to improving how DOD conducts business system reviews and incurred cost audits. Specifically,

- Section 893 of the NDAA for Fiscal Year 2011 directed the Secretary of Defense to initiate a program to improve contractor business systems so that the systems provide timely and reliable information.¹⁵ The NDAA required that this program, among other things, establish requirements for each system and a process for identifying significant deficiencies within systems. It also required that DOD identify those officials responsible for approval and disapproval of a system, and that approval or disapproval of a system would be based on whether the system has a significant deficiency. Further, the law authorized DOD to withhold up to 10 percent of contract progress payments, interim payments, and performance-based payments from certain contracts when systems are disapproved based on a significant deficiency. Contractors that require review—or “covered contractors”—were defined as those subject to the cost accounting standards.
- Section 893 of the NDAA for Fiscal Year 2017 amended the fiscal year 2011 NDAA provisions by (1) revising the definition of a “covered contractor” to generally mean those with government contracts subject to the cost accounting standards accounting for more than 1 percent of the contractor’s total gross revenue and (2) allowing public accounting firms to conduct contractor business system assessments.¹⁶
- Section 803 of the NDAA for Fiscal Year 2018 required DOD to be compliant with certain standards of risk and materiality in the performance of incurred cost audits for its contracts. It also required that DOD use public accounting firms to, among other things, perform a sufficient number of incurred cost audits to eliminate the incurred

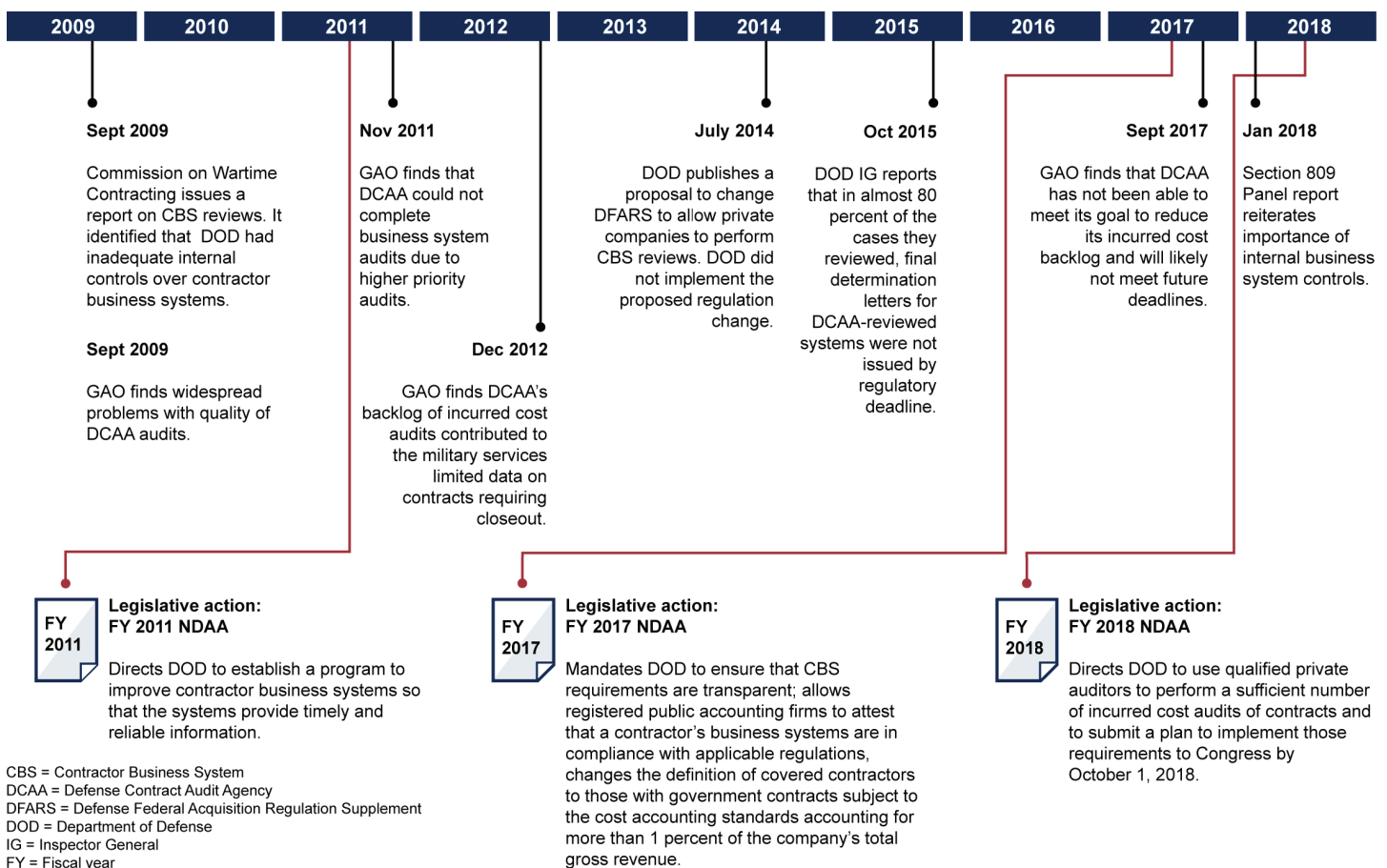
¹⁵Pub. L. No. 111-383, § 893 (2011).

¹⁶Regarding the use of public accounting firms, Section 893 of the NDAA for Fiscal Year 2017 provides that if a registered public accounting firm attests to the internal control assessments of a contractor pursuant to the Sarbanes-Oxley Act of 2002, the submission of documentation from the public accounting firm that the contractor meets CBS requirements generally eliminates the need for further review by DOD. The Sarbanes-Oxley Act of 2002 establishes requirements for assessments of a company’s internal controls for financial reporting by corporate management and registered public accounting firms. See, e.g., 15 U.S.C. § 7262.

cost audit backlog by October 1, 2020 and to allow DCAA to allocate resources to higher-risk and more complicated audits.

Figure 1 below summarizes these reports and congressional actions related to contractor business system activities over the last decade.

Figure 1: Reports and Congressional Actions Related to DOD's Contractor Business System Reviews and Other Audits



Source: GAO analysis of prior GAO, Inspector General and Commission reports, and selected National Defense Authorization Acts. | GAO-19-212

DOD Revised Its Policies and Procedures Related to the Contractor Business System Review Process

Since 2011, DOD has taken actions to (1) clarify the roles and responsibilities of DCMA and DCAA in conducting CBS reviews and consolidate the number of reviews to be performed; (2) clarify how often DOD should conduct CBS reviews; (3) establish what criteria are used to evaluate a contractor's business system; (4) establish timeframes by which ACOs are to make a determination on the adequacy of the contractors' business systems; and (5) implement the use of payment withholds for contractors that are found to have significant deficiencies in their contractor business systems. DCMA and DCAA officials noted that these changes were implemented primarily to address the 2011 statutory provisions. Our review of six selected contractors' business system reviews found that the whole process from the review or audit, to the follow up and resolution, can be lengthy. In three out of six selected cases we reviewed, it took 4 or more years for a contractor's system to be approved.

DOD Clarified DCMA and DCAA's Roles and Responsibilities and Consolidated the Number of Business System Reviews

Prior to 2011, DCAA conducted a series of 10 internal control audits on a cyclical basis, while DCMA performed more targeted testing on three systems. During that time, both DCMA and DCAA could review a contractor's purchasing or earned value management (EVM) system but would evaluate different aspects of each system. As a result, DCMA and DCAA reviewers could issue deficiency reports based on their separate reviews of the same contractor business systems for the consideration of ACOs. As reported in August 2009 by the Commission on Wartime Contracting, these overlapping reviews led to instances where DCMA and DCAA came to different conclusions about the adequacy of the same business system.

To address this issue and clarify roles and responsibilities, in November 2013 DCMA established policies that guide oversight and implementation of the CBS review process, to include approval responsibilities and procedures for the conduct and reporting of reviews.¹⁷ DCMA has separate instructions for each type of contractor business system with the exception of accounting. These separate instructions provide more details about appropriate stakeholders for specific reviews, noting particular functional experts such as offices within DCMA or DCAA that are to lead the conduct of the reviews. DCAA issued a separate memorandum in

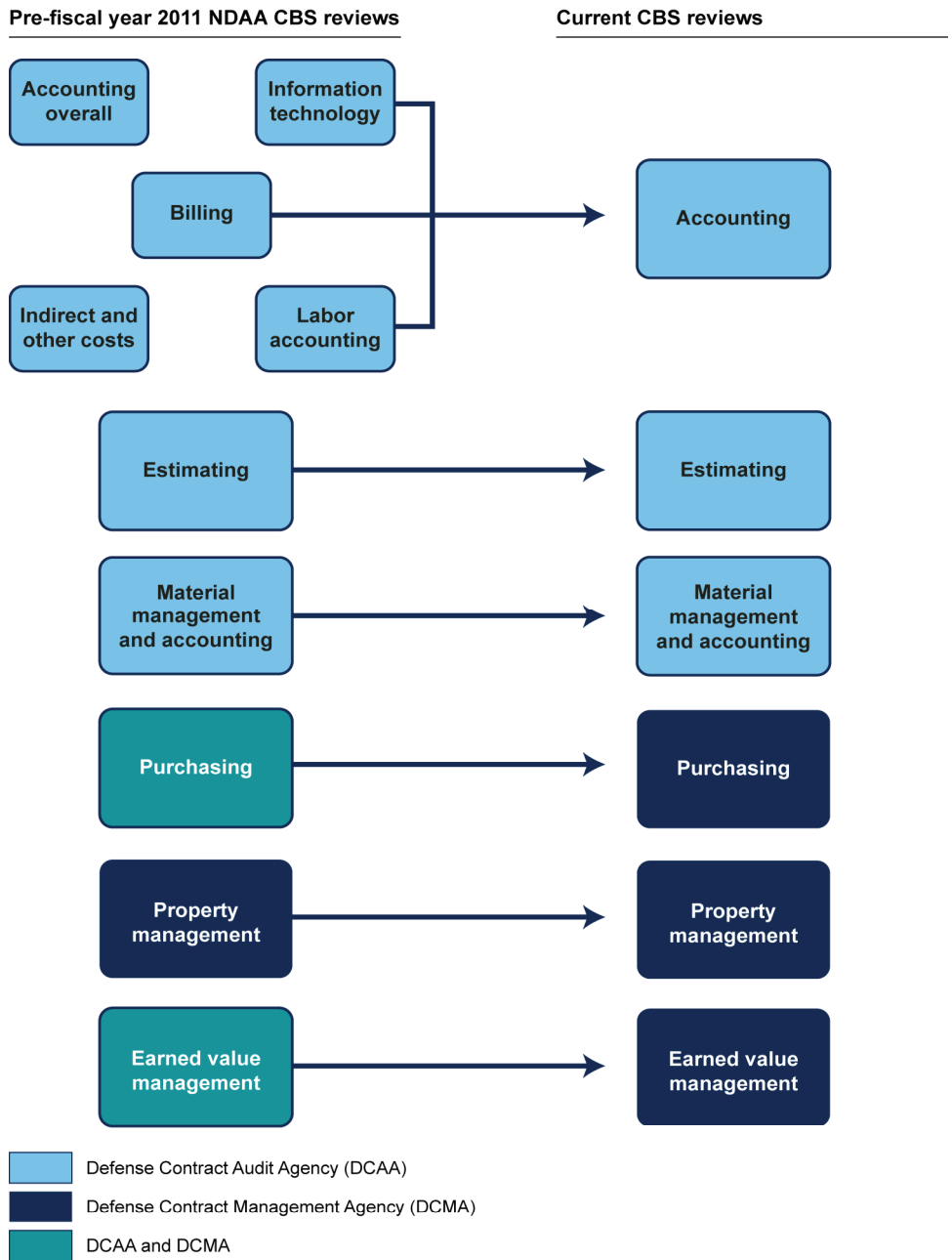
¹⁷DCMA Instruction 131.

April 2012 that details changes made to accounting system reviews as a result of changes from the NDAA for fiscal year 2011.¹⁸

Under these revised processes, DCMA now has responsibility for reviewing three contractor business systems and DCAA is responsible for the other three. In all cases, the DCMA ACO makes the final determination on whether a system is approved or disapproved. Further, the revised process consolidated the number of audits that DCAA conducts on the adequacy of the contractor's accounting system from five separate audits to one comprehensive system audit. According to DCAA, this consolidation was based on a comprehensive reassessment of the processes for assessing accounting systems and combined elements from previous internal control reviews. Figure 2 shows DCMA and DCAA responsibilities before and after the changes implemented from the NDAA for Fiscal Year 2011.

¹⁸DCAA Memorandum 12-PAS-012(R), *Audit Guidance on Auditing Contractor Business Systems and Contractor Compliance with DFARS 252.242-7006, Accounting System Administration*, April 24, 2012.

Figure 2: Contractor Business System (CBS) Review Responsibilities Before and After the National Defense Authorization Act (NDAA) for Fiscal Year 2011



Source: GAO analysis of DCMA and DCAA instructions. | GAO-19-212

Note: the administrative contracting officer at DCMA makes the final determination on whether a system is approved or disapproved.

Revised Process Clarified Specific Timeframes for How Often DOD Should Conduct Business System Reviews

The revised DCMA instructions and related DCAA memorandums for the CBS review process also clarified timeframes for how often a contractor's business system must be reviewed. Generally, each system should be reviewed every 3 years unless the ACO makes a determination that a review is not necessary based on a risk assessment or other factors (see table 3).

Table 3: Contractor Business System Review Frequency and Responsible Agencies

Agency Responsible for Review	Business System	Frequency of Business System Reviews
Defense Contract Audit Agency (DCAA)	Accounting	Every 3 years
	Estimating	Every 3 years unless a risk assessment deems otherwise
	Material Management and Accounting	Every 3 years unless substantiated evidence suggests that the contractor's systems are adequate
Defense Contract Management Agency (DCMA)	Purchasing	Every 3-5 years based on an assessment of risk completed by DCMA administrative contracting officer
	Property Management	Every 1-3 years based on a risk assessment completed by DCMA property administrator
	Earned Value Management	Every 3 years based on results of annual surveillance; full system reviews are performed based on an administrative contracting officer's determination or at the time of initial contract award

Source: GAO analysis of DOD policies and regulations | GAO-19-212

Note: For DCAA, auditors perform the audits under DCAA's purview. For DCMA, a procurement analyst performs the purchasing system reviews; a property administrator performs the property system reviews, and an Earned Value Management specialist performs system surveillance and full reviews. DCMA's administrative contracting officer makes the final determination about whether the system is approved or disapproved.

DFARS Revisions Established Specific Criteria for Business Systems

DOD also revised the DFARS in 2012 to provide definitions for acceptable contractor business systems and established individual DFARS clauses that define the criteria for each of the six business systems. As appropriate, these clauses are included in contracts and generally require the contractor to maintain adequate business systems, allow for the government to withhold payments when systems are found to have significant deficiencies, and list the criteria that the systems must meet. The number of criteria varies by system. For example, the DFARS clause for accounting systems includes 18 criteria used to evaluate system features such as proper segregation of direct and indirect costs,

timekeeping, and exclusion of unallowable costs.¹⁹ For EVM systems, a contractor's system must comply with private, institutional standards and includes procedures that generate timely, reliable, and verifiable reports.

To test how DCAA-led audits were being implemented under these new criteria, DCAA began a pilot program in 2014 comprised of a team of dedicated auditors to conduct CBS reviews who, in turn, were to recommend changes in audit plans and other practices. DCAA initially focused on material management and accounting systems audits, then moved to estimating systems, and finally accounting systems. As result of this pilot, DCAA issued new audit guidance for all three systems in 2018, with the latest guidance for accounting system audits issued in October 2018. DCAA officials told us that they are implementing lessons learned from the pilot program and developing training on how to conduct the revised audit plans.

DCMA Established Timeframes for ACOs to Make Adequacy Determinations

The revised DCMA instructions provide timeframes for ACOs to communicate their initial and final determinations to contractors (see textbox) and define the responsibilities of DCMA management and ACOs for confirming significant deficiencies and resolving disagreements between functional specialists and the ACO.

Revised Contractor Business System Review Process Timeframes

According to the revised contractor business system review process, when significant deficiencies are found:

- Administrative Contracting Officers (ACO) have 10 days to communicate an initial determination of business system compliance to the contractor under review.
- The contractor is requested to respond to the letter within 30 days after that to respond to the letter communicating whether or not it concurs with the determination.
- The ACO issues a final determination 30 days after receipt of the contractor's response.

According to Defense Contract Management Agency (DCMA) officials, data for fiscal year 2017 indicated that 80 percent of final determination letters were issued within this required timeframes.

Source: GAO analysis of DCMA instruction I GAO-19-212

¹⁹One of the recommendations of the Advisory Panel on Streamlining and Codifying Acquisition Regulations was to replace the 18 system criteria in the DFARS clause with an internal control audit to assess the adequacy of contractors' accounting systems based on 7 system criteria. See recommendation number 72 in the *Report of the Advisory Panel on Streamlining and Codifying Acquisition Regulations Volume 3 of 3*, (Arlington, VA.: Jan. 2019)

In instances where deficiencies are found, these findings are reviewed by a panel within DCMA to help ensure standards are consistently applied. When there is disagreement between the ACO and functional specialist concerning the nature or severity of deficiencies found, a DCMA board of review may be requested by the ACO to resolve differences and produce a final determination. According to DCMA officials responsible for maintaining business system review policies, differences between functional specialists and contracting officers are generally resolved without the need for a board discussion. These officials said that only a few board discussions have been convened since implementation of the new review structure.

Mandatory Payment Withholds Drive Timely Contractor Response to Significant Deficiencies

Section 893 of the NDAA for Fiscal Year 2011 generally established that DOD be allowed to withhold payments under certain contracts when DOD disapproves one or more of a covered contractor's business systems.²⁰ DCMA officials previously had the latitude to withhold a portion of the payments owed to contractors as result of deficiencies identified in their reviews, but were not required to do so. From 2011 through 2013, DOD revised the DFARS and related agency instructions to generally require that ACOs apply a 2 to 5 percent contract payment withholding for a single deficient system and a maximum of a 10 percent withhold when multiple systems are found to have significant deficiencies.²¹ ACOs are authorized to reduce the amount being withheld after the ACO determines that the contractor has submitted an adequate corrective action plan and began its implementation.

Our review of DCMA and DCAA information indicates that for all the CBS reviews conducted between fiscal years 2015 and 2017, DCMA and DCAA often identified significant deficiencies in three business systems. These were the cost estimating, material management and accounting, and purchasing systems. For example, DCAA identified a significant deficiency in nine of the 12 material management and accounting systems reviewed, while DCMA identified significant deficiencies in 260 of the 330 purchasing systems reviewed (see table 4).

²⁰Section 893 established that DOD's program to improve contractor business systems is to provide for the disapproval of a business system when it has a significant deficiency. Section 893 defined a significant deficiency as a shortcoming in a system that materially affects the ability of DOD and contractor officials to rely upon information produced by the system that is needed for management purposes.

²¹DFARS §§ 242.7000, 252.242-7005; and DCMA Instruction 131.

Table 4: Deficiencies Identified Between Fiscal Years 2015 and 2017 for Completed DOD Contractor Business System Reviews

Agency	Business system	Reviews completed	Reviews where significant deficiencies were found	Percentage of reviews where significant deficiencies were found
Defense Contract Audit Agency	Accounting	3	0	0%
	Estimating	9	7	78%
	Material Management and Accounting	12	9	75%
Defense Contract Management Agency	Purchasing	330	260	79%
	Property Management	2,934	26	1%
	Earned Value Management	891	9	1%

Source: GAO analysis of data from Defense Contract Management Agency functional offices and Defense Contract Audit Agency | GAO-19-212

Note: These figures reflect only business system reviews evaluating compliance with Defense Federal Acquisition Regulation Supplement criteria; they exclude follow-up and limited scope reviews. Earned Value Management system reviews include annual surveillance reviews that evaluate contractor business systems over a 3 year period.

Because DCMA and DCAA officials do not maintain historical data on payment withholdings, it is not possible to determine the number of payment withholdings that were implemented over these years as a result of these significant deficiencies.²² The system used to track the status of systems and payment withholdings, CBAR, is updated by ACOs as corrective actions are completed and payment withholdings are removed, and thus shows only a snapshot in time. Our review of CBAR data from July 2018 found that DOD was withholding payments from 11 contractors with a total collective value of approximately \$238 million at that time.²³ One third of these payment withholdings were associated with significant deficiencies found in contractors' estimating systems. DCMA and DCAA officials we spoke with noted that the withhold provision has led to contractors' increased response to deficiencies, but they did not have data to determine the extent to which contractors' responsiveness has

²²Payments withheld as result of contractor business system disapproval are provided to the contractor after the contracting officer determines that all significant deficiencies have been corrected.

²³In some instances, multiple payment withholds were implemented based on deficiencies found at more than one location for the same contractor. In the course of our review, we identified certain erroneous data entries for payment withholds which were investigated by DCMA and resulted in changes to CBAR reporting requirements to help ensure the accuracy of dollar amounts associated with payment withholds. These changes included more detailed instruction to ACOs.

increased. Some contractors we spoke with stated that because deficiencies will affect the company's cash flow, senior management and board members have become more engaged in matters of business system compliance.

CBS Review and Corrective Action Process Can Be Lengthy

Our review of six selected contractors' business system reviews illustrates the challenges in identifying and resolving deficiencies in a timely manner. Overall, our review of these six cases found that it took from 15 months to 5 years or more to resolve deficiencies initially identified by DCAA or DCMA. Factors contributing to the time it took to resolve these issues included contractors submitting inadequate corrective action plans, DCMA or DCAA identifying additional deficiencies in subsequent reviews or audits, and the use of different auditors to conduct the reviews.

While the selected cases are not generalizable to all CBS reviews, they do highlight issues that can arise during the process. For example:

- In one case it took almost 4 years to resolve deficiencies identified in a contractor's accounting system. In this case, DCAA issued an audit report in July 2014 that found seven significant deficiencies including inadequate monitoring and adjusting of rates the contractor was billing the government. DCMA subsequently issued an initial determination 7 days later disapproving the system, citing three of the seven deficiencies identified by DCAA. In August 2014, the contractor responded by providing a corrective action plan for the three deficiencies DCMA cited. DCMA sent a second determination letter the next month citing two additional deficiencies identified by DCAA. In October, the assigned ACO for the contractor left and new staff was assigned to the review. Ten days later, the contractor submitted a second corrective action plan to address the two deficiencies identified. Disagreement between the ACO and DCAA on the inclusion of the two remaining deficiencies identified by DCAA for the accounting system resulted in a need to convene a board of review by DCMA. The board decided that the two deficiencies would be included in the final determination. This, in turn, delayed issuance of a final determination until mid-December 2014. According to contractor representatives, over the next 3 years, they submitted various corrective action plans that DCMA determined were inadequate to address the deficiencies. Each time, the ACO requested additional information and follow-up DCAA audits to help assess the adequacy

of the contractor's corrective action plans. Eventually the contractor's accounting system was approved in June 2018.

- In another case, a contractor's estimating system has been disapproved for over 5 years. In June 2013, DCAA identified four significant deficiencies in the contractor's system, including inadequate support for commerciality determinations.²⁴ As a result, following a final determination of inadequacy, DCMA implemented a payment withhold of 5 percent. In response, the contractor submitted a corrective action plan in September 2013 addressing the deficiencies that was accepted by DCMA and the withhold was reduced to 2 percent. In a follow-up review in July 2014, DCAA identified two new deficiencies, which the contractor corrected. In March 2015 DCAA reviewed the contractor's forward pricing rate proposal and identified 11 new deficiencies in the estimating system. By August 2015, the contractor had corrected the new deficiencies but the system remained disapproved because the previous four deficiencies remained uncorrected. Finally, in September 2016, DCAA canceled its audit of the estimating system because these four deficiencies remained. According to officials, the contractor was not ready for re-evaluation. At the time of this review the system remains disapproved.
- In another case, a contractor's property management system was disapproved for more than 4 years. In November 2013, DCMA reviewed the contractor's property management system and, according to officials, identified nine significant deficiencies, including those related to missing records and supporting documentation for all contracts. DCMA issued an initial determination of disapproval. DCMA officials stated that they did not receive an adequate response from the contractor for nearly 7 months, and in June 2014, DCMA issued a final determination of system disapproval. The contractor subsequently submitted a corrective action plan in August to address the deficiencies. A DCMA official stated that they re-analyzed the system in November 2014 and found one outstanding issue. According to the official, the DCMA property administrator in charge of the review elevated the issue to the assigned ACO, but received no response. According to contractor representatives, they requested a

²⁴Under certain circumstances, contractors must determine whether a particular subcontract item meets the definition of a commercial item. The FAR defines commercial items to include items customarily used by and sold (or offered for sale) to the general public, including products with minor modifications. For a complete definition of commercial item, see FAR § 2.101.

follow-up review from the DCMA ACO several times from August 2014 to June 2015 but did not receive a response until after June 2015. According to a DCMA official, this was due to resource issues as the review went dormant because the new ACO assigned to the contractor went overseas. The system was reviewed again in November 2017 and the contractor's system was approved in January 2018.

- In another case, an audit of a contractor's estimating system took DCAA 2 years to complete. The DCAA audit began in November 2014. According to contractor representatives, they were initially told that the review would take 9 to 12 months, but a number of different DCAA auditors were assigned to the review over time and each identified different findings which led to a prolonged process. DCMA approved the contractor's estimating system in December 2016.
- In another case, a contractor's estimating system was disapproved for 15 months. In June 2016 DCMA disapproved a contractor's estimating system due to three significant deficiencies, including one related to performing adequate price and cost analysis on subcontractor proposals. According to contractor representatives, they submitted a corrective action plan, but after submitting the plan DCAA performed an audit of the contractor's forward pricing rates and identified additional deficiencies. In December 2016 DCMA officials determined that the corrective action plan the contractor provided was not sufficient. DCMA subsequently approved the contractor's estimating system in September 2017.

DCMA and DCAA officials believe the cases we analyzed were not representative of the length of time needed to complete the CBS review process, but could not provide data to support their views because DCMA and DCAA do not track data on the length of time it takes to complete the entire CBS review process (i.e., from the start of an audit or review to the resolution of system deficiencies and final determination). Our review of selected cases was not intended to be projectable to all reviews and audits conducted by DCMA and DCAA, but rather to be illustrative of the challenges that may be encountered during the review process.

From the perspective of program and contracting officers, the status of a contractor's business system may have an impact on both contract award decisions and contract monitoring, but officials stated that they can mitigate the risks associated with a disapproved system. For example, Army and Air Force program officials noted that a contractor leading certain weapon system development and logistics efforts had a deficient cost estimating system. According to the contracting officials, as the

government could not rely on the contractor's proposed costs to use a fixed-price contract, they awarded a fixed-price incentive contract for the program to better monitor the contractor's cost reporting compared to under a fixed-price contract.

DOD Does Not Have a Mechanism to Monitor and Ensure That Contractor Business System Reviews and Audits Are Conducted in a Timely Manner

DCMA and DCAA do not have a mechanism to monitor and ensure that CBS reviews and audits are conducted in a timely manner. DCAA's data show that it conducted few business system audits in the past 6 years, due, in part, to the need for it to reduce its backlog on completing incurred cost audits. Looking to the future, DCAA has developed plans for the number of CBS audits it intends to perform over the next 3 years and expects that it will be caught up in conducting the audits for which it is responsible by fiscal year 2022. Successfully executing its plan is dependent on several factors, including the ability to shift resources from conducting incurred cost audits to business systems audits, the use of public accounting firms to perform a portion of the incurred cost audits, and the ability of DCAA auditors to use new audit plans and complete the required audits in a timely manner. For its part, DCMA relies on the offices that perform the reviews of the three systems to maintain the information on the reviews completed and to plan for future reviews, but DCMA headquarters does not centrally track its reviews or whether audits conducted by DCAA are being completed within the timeframes described in policy.

DCAA Plans to Address Previous Shortfalls in Conducting CBS Audits Are Dependent on Several Factors

DCAA officials acknowledged they have not been able to conduct audits of contractor business systems within the timeframes outlined in DCMA instructions. DCAA officials attributed their inability to do so to the need to conduct higher priority audits—such as incurred cost audits—and staffing constraints. For example, in fiscal year 2017, DCAA initially proposed to perform a total of 76 CBS audits for the three business systems in its purview. However, DCAA completed only nine audits after assessing available resources. Further, DCAA estimates that in fiscal year 2017 it spent approximately 44 percent of its resources addressing incurred cost audits, and 17 percent on other audits such as forward pricing rate agreements. In contrast, only 6 percent of its resources were devoted to business system audits and related activities.

Recognizing that it cannot perform all of the required CBS audits in a timely fashion to meet current DCMA policy requirements, DCAA officials told us they focus their audits on business systems they identify as high-risk. To do so, DCAA officials consider factors such as the contractor's

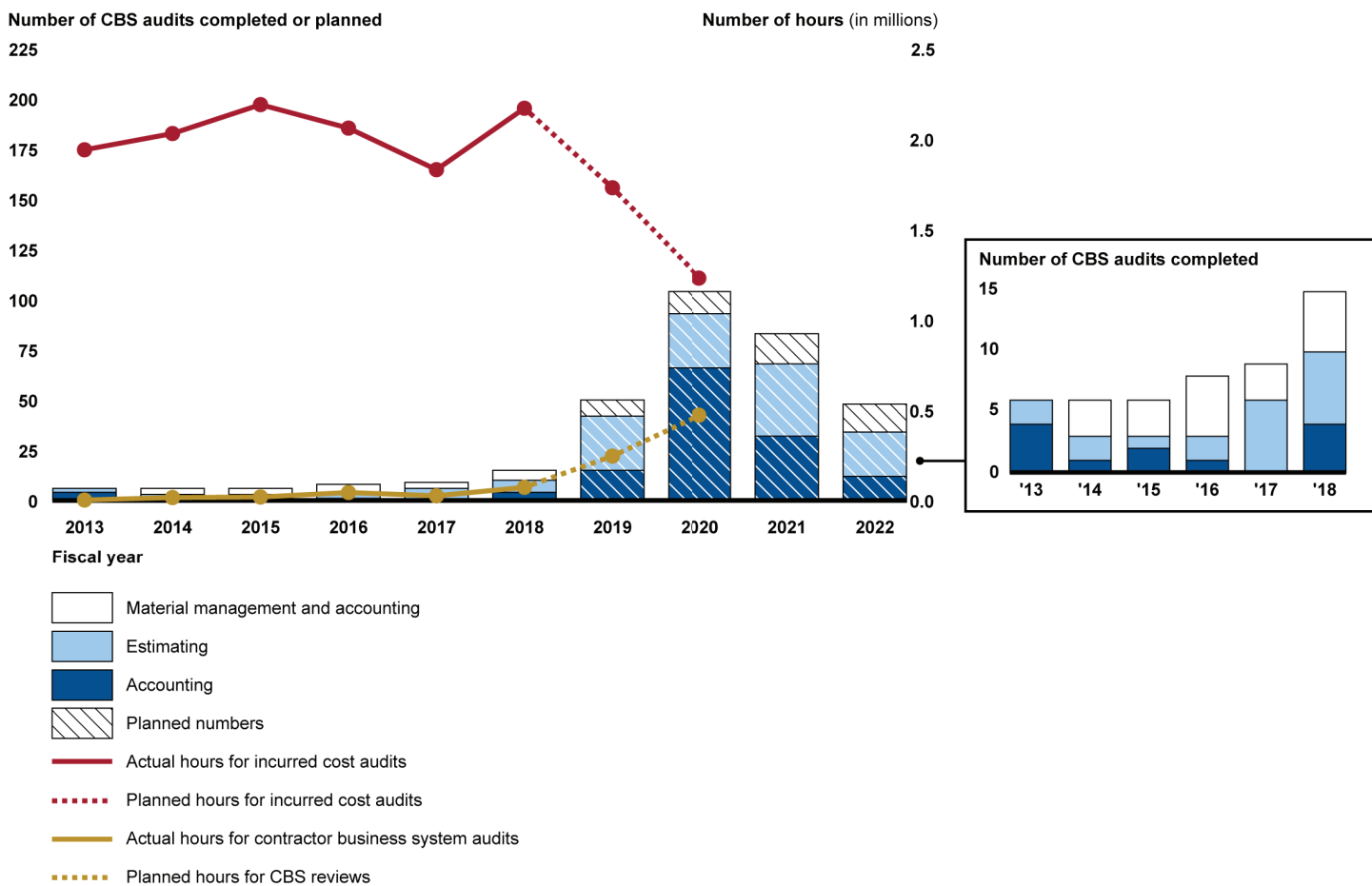
current system status, the contractor size in terms of dollars on contract, the amount of cost-type contracts, organizational changes, audit requests by a DOD contracting officer or an ACO, and the types of deficiencies identified and its impact on cost and schedule. DCAA headquarters officials assess the candidates at an annual DCAA planning meeting to determine which audits can be performed given the level of resources available. DCAA officials told us, however, that the current policy requirement—which generally requires review of the systems every three years—would require DCAA to dedicate substantial resources to CBS audits to maintain currency. As of November 2018, DCAA identified 285 systems that require an audit.²⁵ DCAA officials stated that a risk based approach to reviewing these systems would provide more value than a routine 3 year cycle. DCAA officials stated they are willing to work with others within DOD to develop risk factors that can be used to determine when a business system needs a review.

To better assess and plan future workload, DCAA issued a memorandum in January 2017 to introduce a strategic workload resource initiative that will project workload and resource availability in the out-years. Under this process, DCAA field management teams provide information on workload projections in March, and DCAA executive level officials make workload planning recommendations in June that result in an agency-wide plan. DCAA officials noted, however, that the projection for the second year is less accurate, and as a result, the further out year projections are reviewed every six months with adjustments made as needed. DCAA officials also told us that the planning process is currently being expanded to allow the agency to plan three years out. DCAA officials stated that the fiscal year 2021 plans will be tentatively approved by the end of January 2019 and fiscal year 2022 plans will be approved by June 2019.

Based on these planning efforts, DCAA plans to conduct a total of 285 CBS audits from fiscal years 2019 through 2022, including 50 audits in fiscal year 2019 and 104 in fiscal year 2020. It also plans to shift some of the hours previously devoted to incurred cost audits to CBS audits (see figure 3).

²⁵In its projections for fiscal years 2019 through 2022, as of November 2018, DCAA identified 125 accounting systems that require an audit, 48 material management and accounting systems, and 112 estimating systems.

Figure 3: Number of Hours and Audits Related to Contractor Business Systems Completed and Planned by Defense Contract Audit Agency (DCAA) Fiscal Years 2013-2020, and Hours Related to Incurred Cost Audits



Source: GAO analysis of Defense Contract Audit Agency data. | GAO-19-212

Note: DCAA was not able to provide us with estimated hours to perform CBS and incurred cost audits for fiscal years 2021 and 2022.

Our analysis indicates that successfully executing this plan is dependent on several factors, including the ability to shift resources from conducting incurred cost audits to business systems audits, the use of public accounting firms to perform a portion of the incurred cost audits, and the ability of DCAA auditors to use new audit plans and complete the required audits in a timely manner.

- First, the plan is contingent upon DCAA being able to successfully shift resources from incurred cost audits to CBS audits. According to DCAA data, DCAA plans to shift more than 378,000 hours from

incurred cost audits to CBS audits between fiscal years 2018 and 2020. DCAA officials noted, however, that although they have made significant progress in addressing incurred cost audits, the fiscal year 2018 NDAA requires DCAA to have all incurred cost audits performed within 12 months. DCAA officials noted that this means it will have to continue to spend significant resources on incurred cost audits in fiscal year 2019 to meet this legislative requirement.

- Second, DCAA officials stated that these estimates include the resources that are expected to become available to perform CBS audits as DCAA starts using public accounting firms to perform incurred cost audits.²⁶ In its October 2018 report to Congress on the progress made to implement Section 803 of the Fiscal Year 2018 NDAA, DCAA estimated that public accounting firms would be able to perform 100 incurred cost audits per year for 2019 and 2020, which would then increase to 200 each year for 2021 through 2025. DCAA further projected, for example, that about 147,500 hours would become available in 2020 based on the proposed plan to use public accounting firms. DCAA officials told us they are in the process of developing a solicitation to contract for these services, which they anticipate releasing in the spring of 2019.
- Lastly, these plans assume that each audit conducted by DCAA can be completed within an average number of hours based on the experiences of the team that developed the revised audit plans released in 2018. DCAA officials noted that these hours assume that DCAA audit teams will experience some challenges conducting the initial set of audits, but will be able to conduct them in fewer hours as they gain more experience in implementing the new audit plans. DCAA officials told us that, if successful, this plan will enable it to be caught up on CBS reviews by 2022.

²⁶Section 803 of the Fiscal Year 2018 NDAA requires DCAA to contract with qualified private auditors to perform incurred cost audits on its behalf. This provision differs from Section 893 of the Fiscal Year 2017 NDAA, which generally allows DOD to enable contractors to use registered public accounting firms to perform business system audits and eliminate the need for further review by DCMA or DCAA. We discuss the status of DOD's efforts to implement Section 893 later in the report.

DCMA Headquarters
Makes Limited Use of
Data Collected by
Functional Offices to
Assess the CBS Review
Process and does not
Monitor DCAA's Progress
In Completing Its Audits

For the DCMA-led reviews, DCMA relies on its functional offices that perform reviews of their respective systems to monitor the status of CBS reviews, but does not use the information to ensure that all three reviews are conducted within the timeframes established under DCMA's instructions. The three DCMA functional offices use spreadsheets to manually track reviews their office has completed, and track data on when the next review should be scheduled. Each functional office plans and tracks this data individually. For example,

- The property management functional office identifies the number of contractor property systems requiring review on a monthly basis, and tracks its progress in completing these reviews. In fiscal year 2018, this functional office completed over 95 percent of the 850 property system reviews required.
- The EVM system functional office identifies the number of reviews that should be conducted annually. In fiscal year 2018, the office reported completion of 92 percent of the 125 required EVM system reviews.
- The purchasing functional office uses a rolling process to determine which systems require a review. To do this, the ACO performs a required risk assessment every 3 years to identify whether a full business system review is required and then the purchasing functional office develops a prioritization plan for the systems flagged for review. The exact number of reviews conducted in a single year is dependent upon the risk assessments; however, an official from the purchasing system functional office estimated that their office is staffed to complete approximately 125 reviews per year. The official also noted that they do track to ensure all systems are reviewed in the required timeframes.

Officials from the functional offices described to us what information they provide to senior leadership, but DCMA headquarters does not collect or use this information to oversee the CBS review process. For example, a supervisor from the property management functional office told us that the office reports monthly to their supervisors on the status of their reviews and whether they are on schedule, which also serves as a method for requesting additional resources if necessary. EVM system functional officials told us they report the number of planned and completed reviews to a DCMA internal website for senior leadership to review, but did not know what senior leadership does with this information. Purchasing officials said their office provides monthly reports on the status of reviews for specific large contractors, and weekly reports of the number of reviews completed to the agency director and component heads. DCMA

headquarters officials stated that they informally share information with ACOs in a variety of ways, including quarterly meetings, but headquarters officials could not provide documentation on how this information is used to monitor and assess whether CBS reviews were being conducted in accordance with the policy timeframes.

Further, DCMA officials indicated that they do not formally monitor DCAA's efforts to complete the audits for which DCAA is responsible. Despite being the agency responsible for issuing the instructions and whose ACOs are responsible for making final determinations of business system compliance, DCMA officials indicated that it is not their responsibility to monitor or assess DCAA's efforts to complete the reviews in DCAA's area of responsibility. DCMA and DCAA officials stated, however, that they recently began to hold quarterly meetings, during which time they can discuss CBS issues, including potential revisions to the criteria and timeframes for conducting CBS reviews. But it is uncertain what outcomes will come from this or the extent to which this will contribute to improved management of CBS reviews.

According to federal standards for internal controls, an agency should use quality information to help ensure that it achieves its objectives.²⁷ These internal controls also state that monitoring activities should be conducted to ensure that agency objectives are being met. Developing a mechanism to track and monitor the number of CBS reviews that are outstanding, the risk level assigned to those systems and the resources available to conduct such reviews, would help DCMA and DCAA better manage the CBS review process to ensure that contractor systems that are reviewed and approved in a timely fashion.

²⁷GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: Sept. 10, 2014).

DOD Has Not Yet Implemented Recent Legislative Provisions to Change the Definition of a Covered Contractor or to Enable the Use of Public Accounting Firms

Section 893 of the Fiscal Year 2017 NDAA amended the CBS provisions of the Fiscal Year 2011 NDAA by revising the statutory definition of a covered contractor and by allowing contractors to use registered public accounting firms to review their business systems in place of DOD's review. As of November 2018, DOD had not yet proposed regulations to implement these legislative changes, and therefore we were unable to fully evaluate the potential effects of these provisions. The Fiscal Year 2017 NDAA did not provide a specific timeframe for DOD to revise its regulations, but the Director of the Defense Acquisition Regulation Council—who is responsible for promulgating proposed and final rule changes to the DFARS—tasked her staff to draft a proposed rule by March 2017.²⁸ This deadline was subsequently extended to January 23, 2019. In November 2018, Defense Pricing and Contracting (DPC) officials told us that they now expect to issue the proposed rule for public comment in the third or fourth quarter of fiscal year 2019. DPC officials attributed this delay, in part, to a recent executive order that calls for the reduction and control of regulatory costs, as well as the complexity of having public accounting firms perform CBS reviews.²⁹

Section 893 of the Fiscal Year 2017 NDAA changed the definition of covered contractors—those contractors that may require CBS reviews—from contractors subject to cost accounting standards to generally only those with contracts subject to cost accounting standards that account for more than 1 percent of their gross revenue. DPC officials stated that DOD may require contractors to self-report on their revenue levels to determine whether the contractor's systems require review. DPC officials told us, however, that they had not yet considered certain aspects of how contractors may calculate revenues. For example, DPC officials had not yet decided whether revenue should be determined based on specific

²⁸The process by which DOD and federal agencies develop and issue procurement regulations generally includes publication of a notice of the proposed regulation in the Federal Register, allowing interested parties an opportunity to provide comments on the proposed regulation, followed by agency consideration of the comments received. See 41 U.S.C. § 1707. This process gives the public an opportunity to provide information to agencies on the potential effects of the regulation or to suggest alternatives for agencies to consider. For additional information on the federal rule making process, see GAO, *Federal Rulemaking: OMB Should Work with Agencies to Improve Congressional Review Act Compliance during and at the End of Presidents' Terms*, [GAO-18-183](#) (Washington, D.C.: Mar 13, 2018).

²⁹Exec. Order No. 13,771, *Reducing Regulation and Controlling Regulatory Costs*, 82 Fed. Reg. 9,339 (Feb. 3, 2017).

business segments, or whether it should include international sales revenue. These officials also had not yet decided how many years of revenue should be included in the analysis. Further, DPC officials could not yet estimate the potential effect of implementing this provision on contractors. Based on our analysis of publicly available contractor financial data for the 20 contractors that we reviewed, the lowest percentage of total revenue derived from government contracts was 10 percent.³⁰

Section 893 of the 2017 NDAA also authorized the use of registered public accounting firms to assess compliance with DOD's CBS requirements. Under this provision, if a registered public accounting firm certifies that a contractor's business system meets DOD's requirements, it would eliminate the need for further review by DOD.³¹ Some government acquisition officials we spoke with expressed concerns that would need to be addressed to effectively implement the legislation, including:

- Ensuring that public accounting firms have sufficient understanding of the processes or regulations to conduct the audits and provide conclusions that DOD could rely upon.
- Encouraging DCMA and DCAA functional experts and auditors to accept public accounting firms' findings rather than conduct additional reviews and audits on their own, which would undermine the ability to save both government and contractor resources.
- Determining the potential for the cost of public accounting firm reviews being passed on to the government through the contracts of the businesses under review.

The DPC official responsible for implementing this provision stated that they are aware of these concerns. He also stated that, as a first step in implementation, his office has requested that DCMA and DCAA review the criteria and audit plans used by their staff and identify areas where these criteria and plans could be adjusted to make them more consistent with criteria that public accounting firms use in the private sector.

³⁰We reviewed publicly available contractor financial data for the 20 contractors that represented 86 percent of obligations in fiscal year 2016 on contracts that were identified in the Federal Procurement Data System-Next Generation as covered by cost accounting standards.

³¹The provision also notes that a milestone decision authority may require review of a contractor business system in certain situations.

Conclusions

By clarifying DCMA and DCAA's roles and responsibilities as well as the timeframes for conducting the audits, DOD has improved the CBS review process. But there are still issues that need to be addressed. DCAA acknowledges it is well behind in its efforts to complete the three CBS audits for which it is responsible but believes that it can be caught up by the end of fiscal year 2022 if significantly more resources are available. In addition, DCMA does not monitor progress of either its functional offices or of DCAA against the policies that the six systems each be reviewed generally every 3 years. This is because DOD currently lacks a mechanism based on relevant and reliable information, such as the number of CBS reviews that are outstanding, the risk level assigned to those systems, and the resources available to conduct such reviews, to ensure CBS reviews are being completed in a timely fashion. Such information could help inform more strategic oversight to determine whether the current CBS review process is achieving intended results, or whether additional changes to the timing of or criteria for conducting CBS reviews are needed. As the agency that is responsible for issuing the overarching policies that govern CBS reviews and is ultimately responsible for approving contractor business systems, DCMA is in the best position to lead the effort to develop this mechanism. As each agency is responsible for executing its mission and managing its resources, however, this effort should be conducted in collaboration with DCAA.

Recommendation for Executive Action

We recommend that the Director, DCMA, in collaboration with the Director, DCAA, develop a mechanism to monitor and assess whether contractor business systems reviews are being completed in a timely manner. (Recommendation 1)

Agency Comments

DOD agreed with the recommendation. In an email, a DPC official stated that DCMA and DCAA are collaborating to determine the best way to implement the recommendation. DOD's comments are reprinted in Appendix I.

We are sending copies of this report to the appropriate congressional committees; the Acting Secretary of Defense; the Under Secretary of Defense for Acquisition and Sustainment; the Under Secretary of Defense – Comptroller; the Director, DCMA; the Director, DCAA; and other

interested parties. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions concerning this report, please contact me at (202) 512-4841 or by e-mail at dinapolit@gao.gov. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report were Tatiana Winger (Assistant Director), Emily Bond, Matthew T. Crosby, Suellen Foth, Sameena Ismailjee, Jean McSween, Ramzi Nemo, Miranda Riemer, Christy Smith, Roxanna Sun, Tom Twambly, and Jacqueline Wade.

A handwritten signature in black ink, appearing to read "Timothy J. DiNapoli". The signature is fluid and cursive, with the first name "Timothy" and last name "DiNapoli" clearly distinguishable.

Timothy J. DiNapoli
Director, Contracting and National Security Acquisitions

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Appendix I: Comments from the Department of Defense



ACQUISITION
AND SUSTAINMENT

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

JAN 23 2019

Mr. Timothy J. DiNapoli
Director, Contracting and National Security Acquisitions
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. DiNapoli:

This is the Department of Defense (DoD) response to the Government Accountability Office (GAO) Draft Report, GAO-19-212, "CONTRACTOR BUSINESS SYSTEMS: DOD Needs Better Information to Monitor and Assess Review Process" dated December 12, 2018, (GAO Code 102329). Detailed comments on the report recommendations are enclosed.

Sincerely,

A handwritten signature in blue ink, appearing to read "Kim Herrington", is positioned above the printed name.

Kim Herrington
Acting Principal Director,
Defense Pricing and Contracting

Enclosure:
As stated

GAO Draft Report Dated December 12, 2018
GAO-19-212 (GAO CODE 102329)

**“CONTRACTOR BUSINESS SYSTEMS: DOD NEEDS BETTER INFORMATION TO
MONITOR AND ASSESS REVIEW PROCESS”**

**DEPARTMENT OF DEFENSE COMMENTS
TO THE GAO RECOMMENDATION**

RECOMMENDATION 1: The Government Accountability Office (GAO) recommends that the Director, DCMA, in collaboration with the Director, DCAA, develop a mechanism to monitor and assess whether contractor business systems reviews are being completed in a timely manner.

DoD RESPONSE: Concur. The Director, Defense Contract Management Agency concurs with the GAO recommendation to collaborate with the Defense Contract Audit Agency, in developing a mechanism to increase oversight and improve management of contractor business system audits and determinations.

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Report to Congress on FY 2018 Activities Defense Contract Audit Agency

U.S. Department of Defense

March 31, 2019





DEFENSE CONTRACT AUDIT AGENCY

8725 JOHN J. KINGMAN ROAD, SUITE 2135
FT BELVOIR, VA 22060-6219

Congressional Defense Committees:

I am pleased to submit the Defense Contract Audit Agency's Fiscal Year 2018 annual Report to Congress, as required by 10 U.S.C. §2313a. This report highlights DCAA's audit performance, recommendations to improve the audit process, industry outreach activities, and key accomplishments.

As a result of DCAA audits, contract officials saved \$3.2 billion in defense spending last year—significant savings that can be reinvested in our warfighters or go back to the treasury. We examined nearly \$409 billion in defense contractor costs, identified over \$9.6 billion of audit exceptions across 3,717 audit reports, and supported Contracting Officers with other valuable products and services to help them ensure fair and reasonable contract prices. Additionally, we continued to improve communication and coordination with our acquisition partners, resulting in responsive approaches that met their needs and timelines.

In FY 2018, DCAA successfully eliminated the incurred cost backlog. This was a significant undertaking by the entire workforce resulting in 8,482 incurred cost years closed with a total dollar value of \$392.2 billion. We also worked with DCMA and industry to lay the groundwork for the use of Independent Private Accountants to conduct select incurred cost audits. We feel we have laid a solid foundation in this area to ensure they will be prepared and successful. We look forward to continuing this coordination.

Our vision, *Every audit or service we deliver is on time, on point, and highly valued*, is demonstrated by our workforce every day. I look forward to working with Congress and other stakeholders to achieve the vision for acquisition reform. I am proud of our workforce and our ability to deliver outstanding audit products and services to the Department in FY 2018.

Respectfully,

A handwritten signature in black ink, appearing to read "Anita F. Bales", is positioned above the printed name.

Anita F. Bales
Director

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1. DEFENSE CONTRACT AUDIT AGENCY MISSION

DCAA provides audit and financial advisory services to DoD and other federal entities responsible for acquisition and contract administration. DCAA audits only contractors; it has no internal audit responsibilities in DoD. DCAA's role in the financial oversight of government contracts is critical to ensure DoD gets the best value for every dollar spent on defense contracting. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. Its work benefits our men and women in uniform and the American taxpayer.

The Agency's primary function is to conduct contract audits and related financial advisory services. Contract audits are independent, professional reviews of financial representations made by defense contractors, and DCAA helps determine whether contract costs are allowable, allocable, and reasonable. DCAA conducts audits in accordance with Generally Accepted Government Auditing Standards (GAGAS), a set of standards that ensures audit conclusions are unbiased and well supported by evidence. The type and extent of DCAA's audit work varies based on the type of contract awarded, but its audit services are generally limited to acquisitions under Federal Acquisition Regulation Part 15 (Contracting by Negotiation). The extent of auditing performed is based on risk and materiality considerations.

DCAA provides recommendations to government officials on contractor cost assertions regarding specific products and services. DCAA auditors examine contractor accounts, records, and business systems to evaluate whether contractor business practices and procedures are in compliance with the Federal Acquisition Regulation (FAR), the Defense Federal Acquisition Regulation Supplement (DFARS), Cost Accounting Standards (CAS), and other applicable government laws and regulations. Its work supports contracting officials as they make procurement decisions. DCAA has no direct role in determining which companies are awarded defense contracts.

Government officials draw on DCAA audit findings throughout the acquisition process. With these recommendations, contracting officers are better able to negotiate prices and settle contracts for major weapons systems, services, and supplies. At the front end, DCAA's findings can directly impact the price that the government pays for contracted work. Even after a contract is underway, DCAA findings may address instances where the government overpaid contractors for work, uncover potential fraud or misuse of funds, and impact future contract prices by addressing inadequacies early on. Before the contracting officer can officially close out a flexibly priced contract, DCAA assesses whether the contractor's claims for final annual incurred costs during contract performance are allowable and reasonable according to applicable acquisition regulations and contract provisions. This final task in the contract audit process ensures that no excess costs were charged to the government.

2. ORGANIZATIONAL STRUCTURE AND STAFFING

A. Organizational Structure. DCAA's organizational structure consists of four Corporate Audit Directorates organized by major contractors, three geographical regions primarily focused on other large, mid-sized, and small contractors, and a Field Detachment focused on classified work. DCAA has about 300 offices located throughout the United States, Europe, and the Middle East.

Headquarters is at Fort Belvoir, Virginia. Principal elements are the Director, Deputy Director, General Counsel, Office of Inspector General, and the Assistant Directors for Operations, Policy and Plans, Integrity and Quality Assurance, and Human Capital and Resource Management.

Regional Offices/Field Detachment are located in Smyrna, Georgia; Irving, Texas; La Palma, California; and Reston, Virginia. Each region directs and administers the DCAA audit mission at locations near the contractor base. Each region is staffed with 800 to 1000 employees and serves 2000 to 3000 contractors. The Field Detachment has 400 employees to serve 750 contractors.

Corporate Audit Directorates (CAD) are located in Lowell, Massachusetts (Raytheon, General Dynamics, BAE); McLean, Virginia (Northrop Grumman); Hazelwood, Missouri (Boeing, Honeywell); and Fort Worth, Texas (Lockheed Martin). Each CAD directs and administers the DCAA mission at its major defense contractors.

Branch Offices are strategically situated within the regions and are responsible for the majority of contract audit services within their assigned geographical areas. Branch offices often have smaller suboffices to ensure adequate audit coverage.

Resident offices are established at specific contractor locations of both regions and CADs where the audit workload justifies the assignment of a permanent staff of auditors and support staff. These offices allow auditors to work on location with the largest major industrial manufacturers that the government buys from, such as Lockheed Martin, DynCorp, and General Dynamics.

DCAA liaison activities are conducted at DoD acquisition or contract administration offices to directly communicate and coordinate audit processes.

B. Staffing. DCAA has a professional workforce of about 4,600 employees. Roughly 93 percent of these employees have a bachelor's degree, 43 percent have a higher level degree, 23 percent are Certified Public Accountants (CPA), and 10 percent have a professional certification such as a Certified Fraud Examiner (CFE), Certified Internal Auditor (CIA), Certified Information System Auditor (CISA) or Certified Defense Financial Manager (CDFM). About 89 percent of DCAA employees are auditors, and 11 percent are professional support staff in various fields including administrative support, budget, human resources, information technology, and legal (Table 1).

Table 1 – DCAA Workforce and Education

Auditors	4148	89%
Professional Support Staff	502	11%
Total Employees	4,650	100%
Bachelor's Degrees	4327	93%
Advanced Degrees	1994	43%
Certified Public Accountants	1078	23%
Other Professional Certificates	464	10%

3. TYPES OF AUDITS

- A. Forward Pricing.** Forward pricing audits are generally completed before contract award where DCAA evaluates a contractor's estimate of how much it will cost the contractor to provide goods or services to the government. Accurate contract prices are the starting point for fair and reasonable prices throughout the acquisition process because subsequent costs are often based on the initial estimated contract costs. Forward pricing includes demand work—proposal audits, forward pricing rates, and high risk estimating system audits.
- B. Incurred Cost.** Incurred cost audits determine the accuracy of a contractor's annual allowable cost representations. When a contract price is not fixed, DCAA conducts an incurred cost audit after contract award to determine the accuracy of contractor cost representations. DCAA expresses an opinion as to whether such costs are allowable, reasonable, and allocable to the contract, based on government accounting and acquisition provisions. Audits allow the contracting officer to recover the questioned costs before the contract is officially closed out, which prevents excess payments by the government.
- C. Special Audits.** Special audits can be conducted before or after contract award. Most of the reports in this category are issued in response to requests from contracting officers who need an independent financial opinion on specific elements of a contract or on a contractor's accounting business system in order for the contract work to proceed. Special audits are conducted after contract award primarily to address circumstances where contracts are adjusted for changes or are partially or fully terminated before completion. These circumstances represent complex and high-risk audits where DCAA must carefully evaluate the cost of original contract work from the changed scope of work. Special audits include pre-award surveys, claims, and terminations.
- D. Other Audits.** Other audits primarily consist of audits performed after contract award and can be requested by a contracting officer or initiated by DCAA. DCAA typically initiates this type of audit when there is potential for a high risk for misallocation or mischarging of costs. The audit effort in this category focuses on adequacy of the contractor's Cost Accounting Standards Disclosure Statement, compliance with cost accounting standards, assessment of contractor Cost Impact Statements for noncompliances, review of contractor business systems, and contractor compliance with the Truth in Negotiation (TIN).

4. FY 2018 AUDIT PERFORMANCE

A. Overview. DCAA uses a risk-based approach to target its limited resources on the work that provides the most value. Using this approach, DCAA examined \$409 billion in contract costs, identified over \$9.6 billion in audit exceptions, reported \$3.2 billion in net savings, and produced a return on investment of about \$5 to \$1. In addition to eliminating the incurred cost backlog, the Agency also continued to conduct other audits to help contracting officers establish fair and reasonable prices and reduce the risk of contractor overpayments.

(1) Net Savings. In FY 2018, DCAA reported net savings of \$3.2 billion, marking the eighth consecutive year that the Agency returned over \$3 billion in savings to the government (Figure 1).

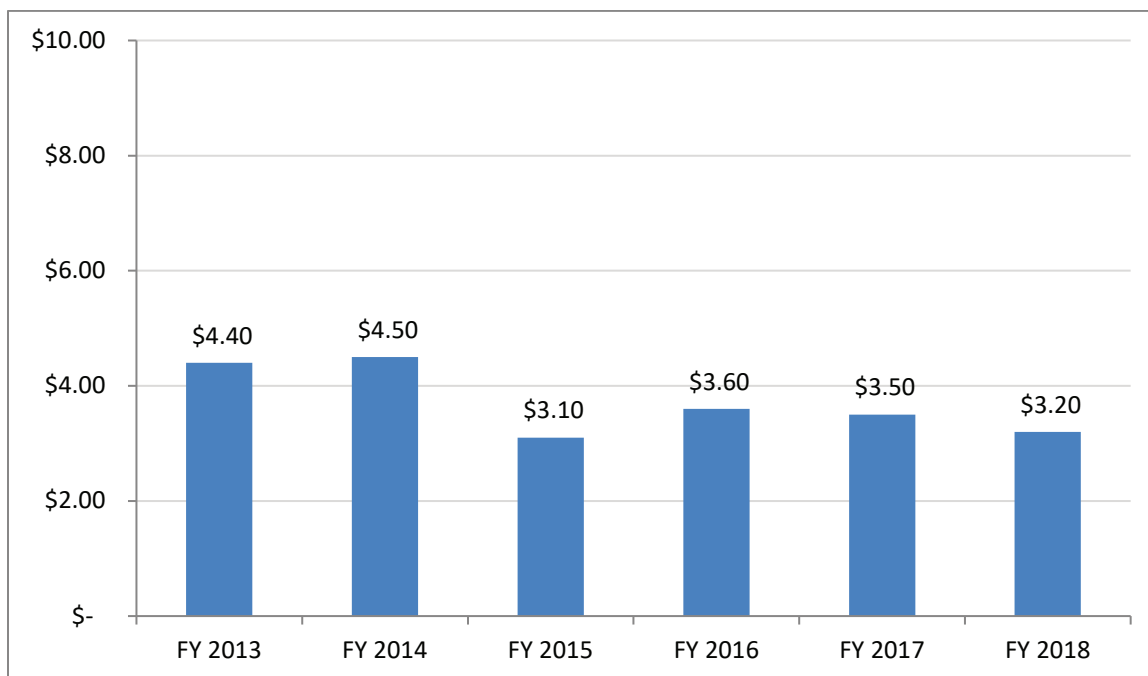


Figure 1 – DCAA Net Savings (in billions)

(2) Return on Investment. DCAA is conservative when reporting savings and return on investment (ROI), foregoing projections of potential or future savings and only reporting actual savings based on contract actions taken by government contracting officers. In FY 2018, the return on taxpayers' investment in DCAA was about \$5 for each dollar invested, savings that DoD can reinvest in the warfighter or return to the Treasury (Figure 2).

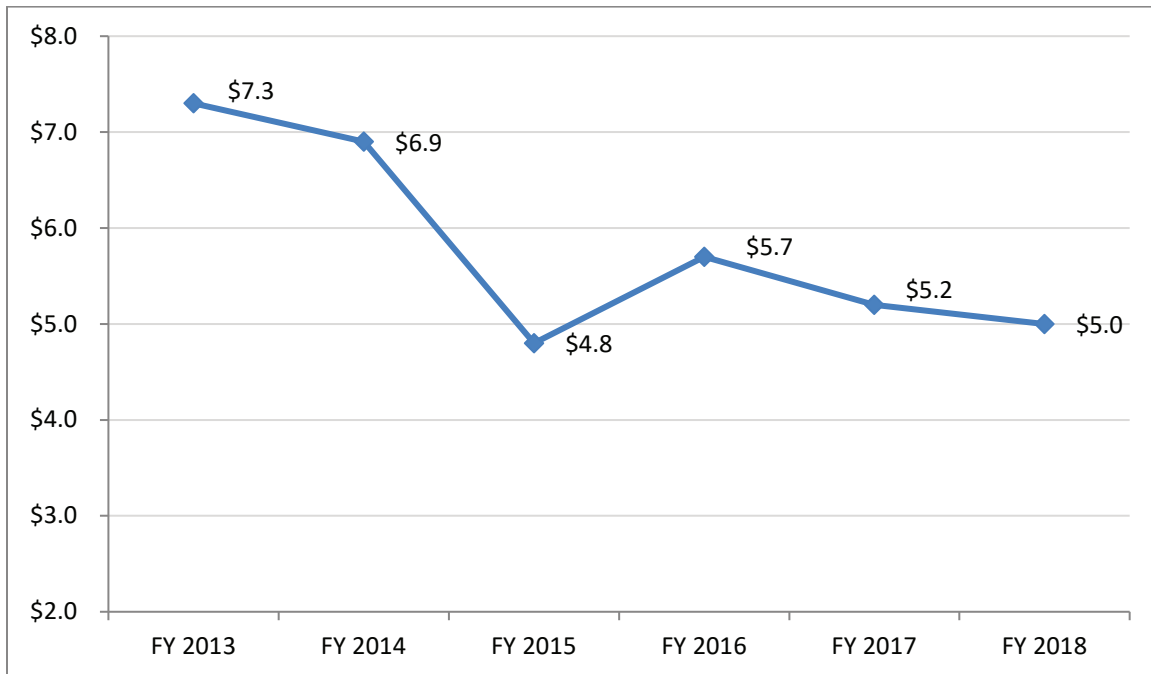


Figure 2 – DCAA Return on Investment

(3) Aggregate cost of performing audits by audit type. DCAA's cost of performing audits was calculated using annual funding and annual hours by audit type (Table 2).

Table 2 – Aggregate Cost of Performing Audits by Audit Type (in thousands)

Audit Type	Aggregate Annual Cost
Forward pricing	\$106,391
Incurred Cost	\$332,070
Special Audits	\$30,950
Other Audits	\$175,384
Total	\$644,795

B. Questioned Cost Sustained. DCAA sustained \$4.0 billion of \$7.9 billion in questioned costs for contract actions contracting officers negotiated and provided data on during FY 2018. Table 3 shows audit exceptions and sustention data. These data are calculated based on contracting officer negotiation decisions, not estimates or savings projections. Table 4 shows the return on investment by audit type based on sustention and cost of audit.

Table 3 – Sustention by Amount and Percentage of Audit Exceptions (in thousands)

Audit Type	Audit Exceptions	Exceptions Sustained	Percent Sustained
Forward Pricing	5,233,964	3,223,403	61.6%
Incurred Cost	2,101,587	507,103	24.1%
Special Audits	338,338	231,020	68.3%
Other Audits	297,302	134,353	45.2%
Total	7,971,191	4,095,879	51.4%

Table 4 – Ratio of Sustained Questioned Costs (Net Savings) to the Cost of Audits by Type (in thousands)

Audit Type	Aggregate Annual Cost	Net Savings	Return on Investment*
Forward Pricing	\$106,391	2,355,116	\$22.10
Incurred Cost	332,070	499,822	\$1.50
Special Audits	30,950	225,627	\$7.20
Other Audits	175,384	162,559	\$0.90

* In our FY 2017 Report to Congress we used a simple average to calculate return on investment (ROI). This year, we used a weighted average because it more accurately reflects ROI by type of audit.

C. Audit reports completed in FY 2018. DCAA conducts thousands of audits each year that provide the basis for recommendations to the acquisition community. Each audit that DCAA completes, whether before or after contract award, supports government officials who negotiate prices and settle contracts for major weapons systems, services, and supplies. When conducting an audit, DCAA evaluates whether contractor business practices and procedures are in accordance with the FAR, DFARS, Cost Accounting Standards (CAS), and other applicable government laws and regulations. In FY 2018, DCAA issued 3,717 audit reports with over \$9.6 billion in audit exceptions from \$409 billion total dollars examined. (Table 5).

DCAA also supports contracting officers with advisory services that do not result in an audit; for example, negotiation support, independent financial opinion on specific elements of a contract, and assessment of compliance with specific acquisition regulations or contract terms.

Table 5 – FY 2018 Audit Reports Completed and Dollars (in billions) Examined

Audit Type	Reports	Dollars Examined
Forward Pricing	766	\$58.7
Incurred Cost	651	\$349.0
Special Audits	2,027	\$1.4
Other Audits	273	\$0.1
Total	3,717	\$409.0

D. Incurred Cost. A contractor is required to submit a certified incurred cost submission of its costs for each year of contract performance under flexibly-priced contracts. After receiving an annual incurred cost submission, DCAA auditors review it to determine if the submission and supporting data are adequate and in accordance with the FAR. If the submission is not adequate, it is returned to the contractor for correction and resubmission. When a submission is adequate, it becomes part of DCAA’s inventory of incurred cost audits. For inventory purposes, the date is determined by date of adequate submission, not date costs were incurred.

In FY 2018, DCAA closed 8,482 incurred cost years with a total dollar value of \$392.2 billion (Figure 3). Major contractors made up the majority of incurred cost work last year, an audit mix that resulted in significantly more dollars examined over fewer incurred cost years.

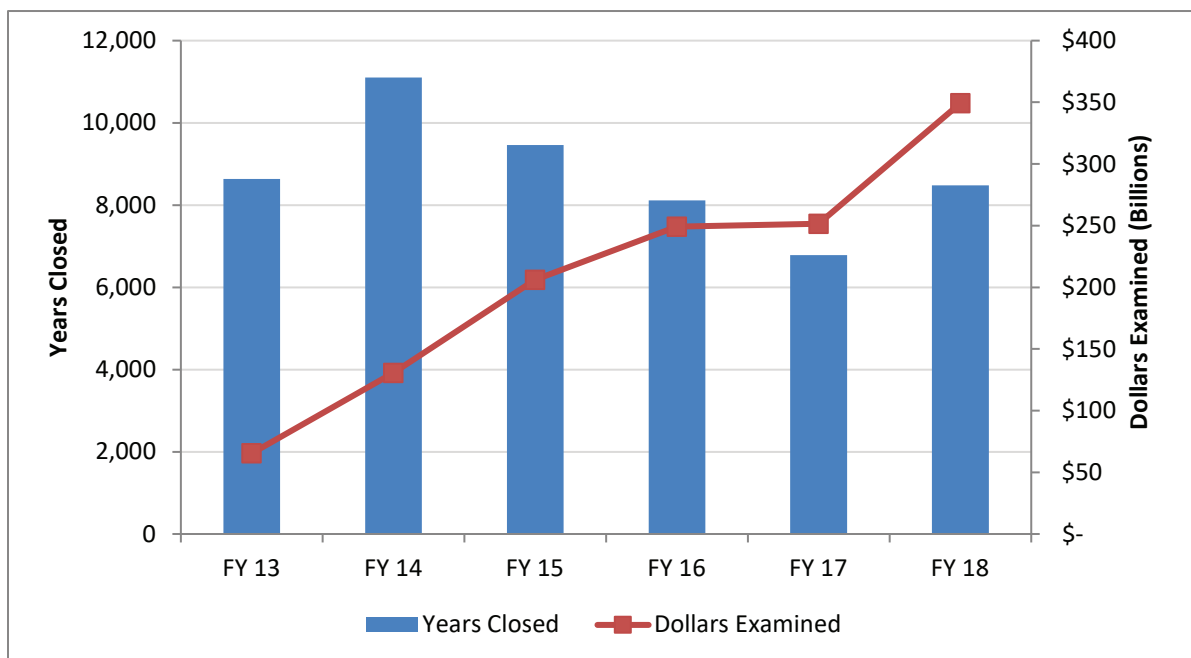


Figure 3 – Incurred Cost Years Closed and Dollars Examined

In our risk-based approach, we close incurred cost years in several ways. We conduct audits on high risk submissions and a sample of low risk submissions. For other low risk submissions, we provide valuable assistance to contracting officers by issuing low risk memos. Because DCAA has the authority to establish final indirect rates, contracting officers can avoid negotiations and go straight to closing out contracts using the rates established in these memos. Incurred cost assignments can be closed for a variety of other reasons as well. In some cases, a formal audit report or memo is unnecessary when, for example, a contractor has gone out of business or doesn’t have any flexibly priced contracts.

In FY 2018, DCAA issued 2,027 reports, 4,512 low risk memos, and closed 1,943 assignments for other reasons (Table 6).

Table 6 – Incurred Cost Closed by Method and Dollars (billions) Examined

Incurred Cost Years Closed	Number	Dollar Value
Reports	2,027	\$349.2
Memos	4,512	\$43.0
Closed for Other Reasons	1,943	\$0
Total	8,482	\$392.2

Prior to the 2018 National Defense Authorization Act (NDAA), DCAA had considered the last two fiscal years of incurred cost as “regular inventory,” while audits older than two fiscal years were considered “backlogged.” At the end of FY 2018, DCAA had reduced its backlog by 99.3%, from 21,000 years (FY 2011) to 152 years (FY 2018) (Figure 4).

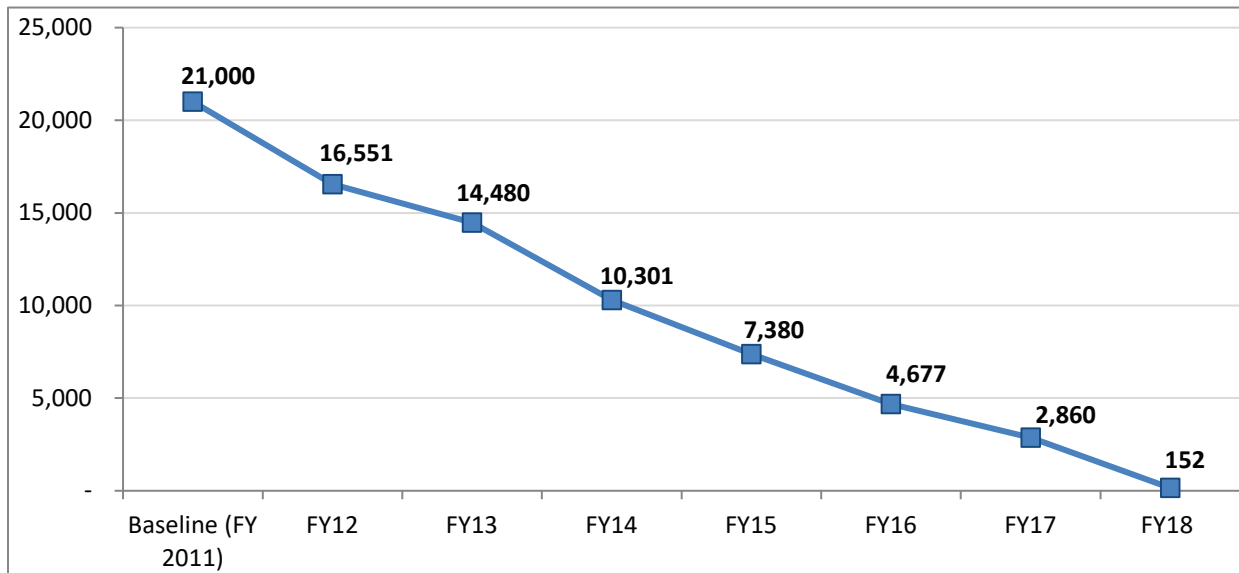


Figure 4 – Incurred Cost Backlog FY 2011 - FY 2018

The majority of the 152 that remain are for reasons beyond DCAA’s control; for example, litigation holds, contractor action on inadequate proposals, and funding delays on reimbursable assignments. The rest have been delayed for other reasons; for example, DCAA may hold assignments to time phase them with the completion of corporate audits or prior contractor fiscal years.

DCAA is now required to complete all incurred cost audits received after December 12, 2017, within 12 months of receiving the contractor's adequate proposal. We are continuing to dedicate the audit resources necessary to meet the NDAA requirements in FY 2019.

Sometimes the start of an audit can be delayed based on overall audit priorities, resources, workload, and other circumstances. The chart below depicts incurred cost assignments pending longer than one year from the date of adequate submission (Table 7). As with those left in our backlog, many of the older years (2012-2015) remain pending for external reasons. We are successfully working through all of our pending audits and seeing significant results. For example, at the close of FY 2017, we had 4,358 assignments pending for over one year. By the end of FY 2018, we had reduced that number by 60% to 1,844. We expect to be in compliance with the one-year requirement in FY 2019.

Table 7 – Incurred Cost Pending Longer than One Year from Date of Adequate Submission

Year Proposal Received	Number of Assignments	Estimated Dollar Value
2012	1	\$ 1,600,000
2013	4	\$ 2,349,000
2014	4	\$ 2,427,011
2015	12	\$ 2,381,257
2016	52	\$ 6,661,964
2017	1771	\$ 85,303,820
Total	1,844	\$100,723,052

E. Improvement in Meeting Agreed-to Dates. Since FY 2013, DCAA has steadily improved its record for meeting agreed-to dates, finishing FY 2018 with an 86 percent success rate (Figure 5). Our goal in FY 2018 was to meet our agreed-to dates in 80 percent of our audits. Striving for 100 percent is an unrealistic goal because scope changes occur once the mutually determined agreed-to date has been locked in. For example, the contacting officer may adjust the scope of an audit, or we may discover significant noncompliances that require us to make scope adjustments.

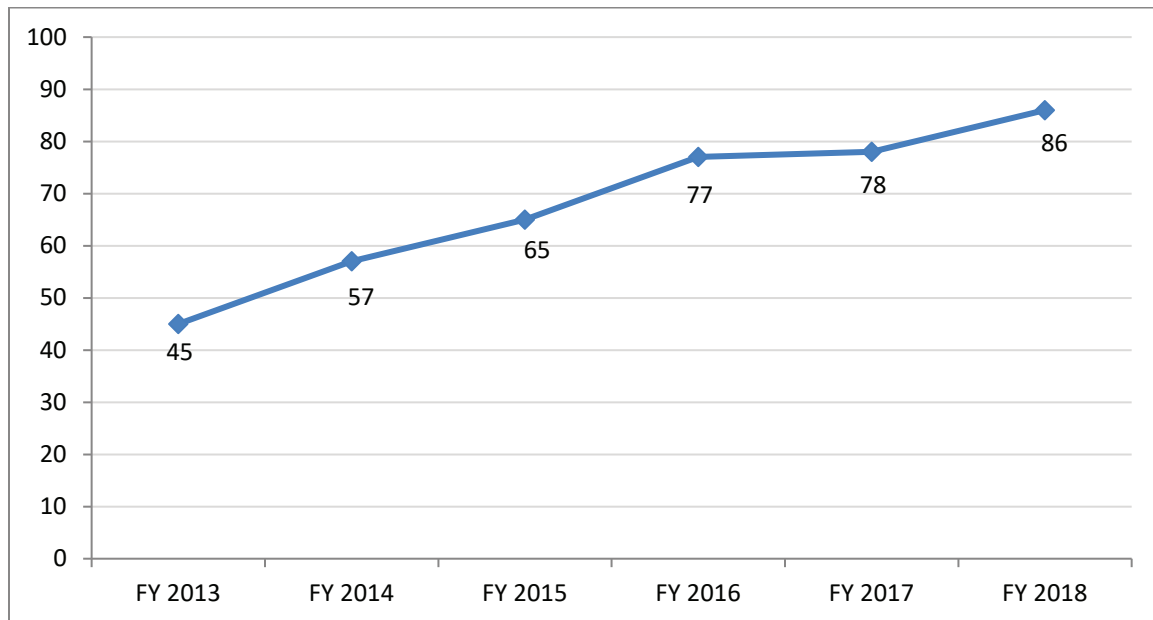


Figure 5 – Forward Pricing Agreed-to Dates Met (percentage)

We know the acquisition community relies on us to meet our agreed-to dates and help them keep the contract award process on track. When we don't expect to meet the date, we communicate with the command and make sure we provide data throughout the audit to minimize any impact on the acquisition cycle. DCAA's ongoing communication with DCMA, buying commands, and military service executives has also played a significant role in eliminating duplication of effort, clarifying roles and responsibilities, and establishing realistic timelines. We meet regularly with these acquisition partners to explore root causes of issues and develop system-wide solutions to work effectively as a one-government team.

F. Prioritization of Audits. DCAA’s risk-based planning process helps ensure that audit resources are focused on the highest-payback areas to DoD, the warfighter, and the taxpayer. DCAA prioritizes the audits that pose greatest risk to the government, assessing the risk for different types of audit, as well as the risk factors within individual audits, regardless of type. Contracts considered “high-risk” typically involve significant costs, significant audit findings in the past, or circumstances that reduce the incentive to control costs, such as those inherent in cost-type contracts.

- Incurred Cost audits continue to be a priority to facilitate contract closeout. Getting current on incurred cost means that we can conduct these audits closer to the year the costs were actually incurred, which will improve our ability to retrieve relevant records, ease contractor burden, encourage better compliance, and identify issues that may impact future audits.
- Forward pricing audits net the highest rate of return and are time sensitive—to be of value, they must be completed before contract negotiations. We have found that proactive and ongoing engagement with contracting officers, particularly before receiving the contractor’s proposal, enables us to understand audit requirements early, plan for appropriate staffing, and meet contracting needs in a timely manner. Throughout FY 2018, DCAA continued to build on successful initiatives to engage with contracting officials at all levels, confirm that we are focusing on the highest risk contract actions, and ensure that we are providing the right audit services to meet their needs.
- Special audits represent time-sensitive requests for contract terminations or claims as well as pre-award accounting surveys for new contractors. DCAA prioritizes these audits in coordination with contracting officer needs.
- Other audits are a high priority when DCAA or the contracting officer identifies a high risk area such as inadequate business systems. DCAA assigns priority to additional audits based on individual contract and audit risks to the government. This category includes post-award audits of compliance with the Truth in Negotiations (TIN) and CAS Disclosure statement audits. This also includes high-risk, time-sensitive labor and material reviews; contractor billings; provisional billing rates; pre- and post-payment reviews; and high risk Accounting Systems and Material Management and Accounting Systems (MMAS) audits.

G. Length of time to complete audits. The timeline for an audit is based on audit type, dollars involved, level of risk, and needs of the requester. As a result, DCAA does not have specific or mandatory time requirements for audit completion; instead, we assess what is necessary to conduct an audit that will meet professional audit standards and provide timely, valuable advice to contracting officials. DCAA works closely with contracting officers to set reasonable due dates based on the requirements of the audit and the needs of the buying commands. Additionally, DCAA and contracting officers work as a team to set priorities, create milestone plans, and decide on agreed-to dates.

Forward Pricing. The time to complete a forward pricing audit is measured from the date DCAA receives the audit request or adequate proposal. The clock stops on the date we issue the audit report (Figure 6).

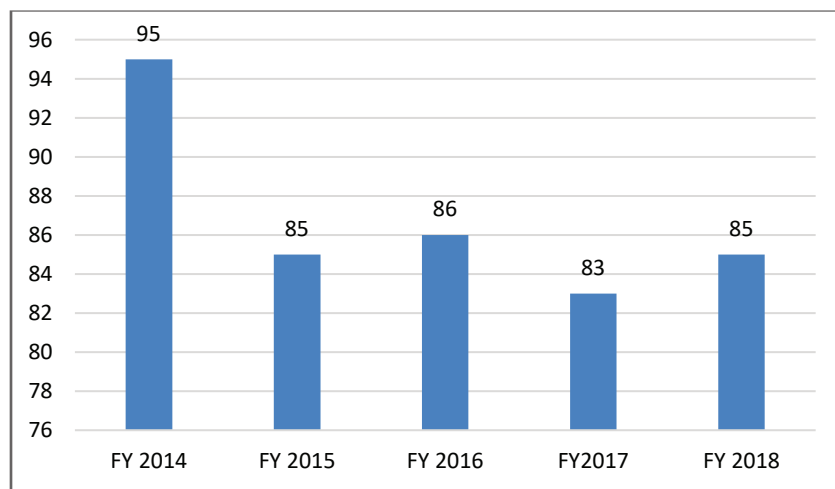


Figure 6 – Forward Pricing average elapsed days

Incurred Cost. The time to complete an incurred cost audit is measured from the date of the entrance conference to report issuance. Last year, DCAA's prioritization of incurred cost audits reduced elapsed days to 125 (Figure 7).

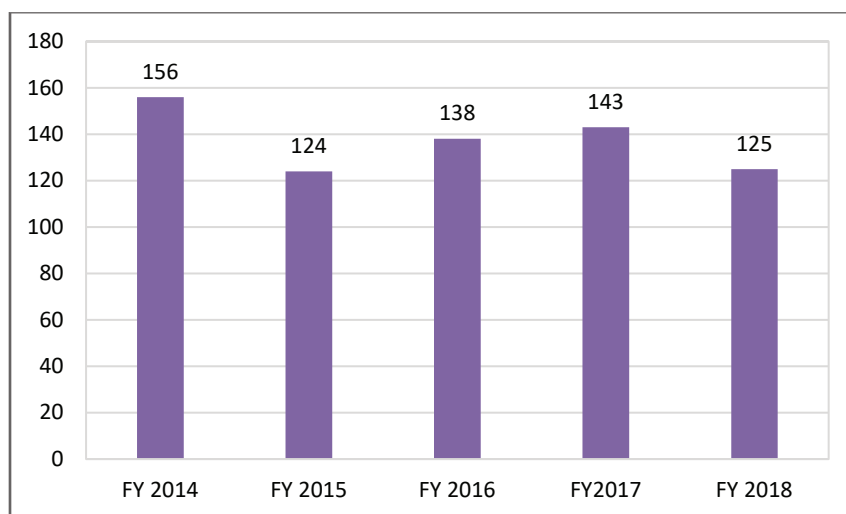


Figure 7 – Incurred Cost average elapsed days

Special Audits. The time to complete a special audit is measured from the date DCAA receives the audit request to the date we issue the audit report (Figure 8).

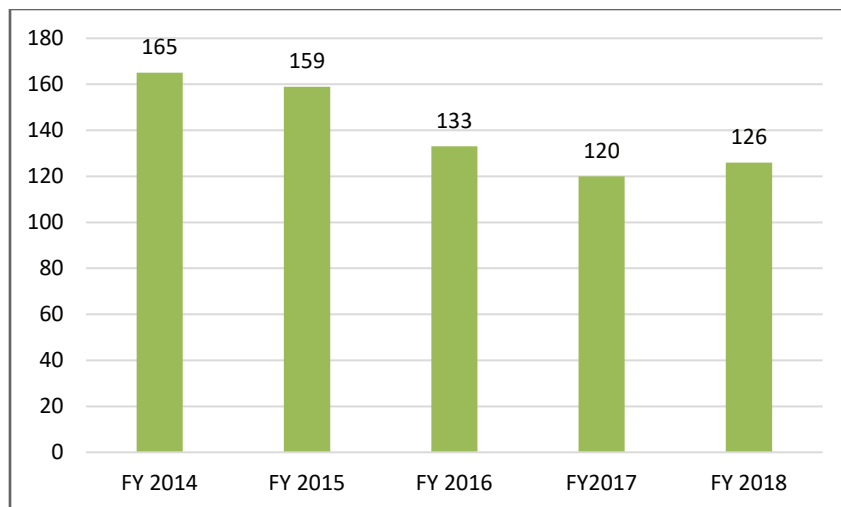


Figure 8 – Special Audits average elapsed days

Other Audits. The time to complete other audits is generally measured from the time audit work began to the date of the audit report issuance (Figure 9).

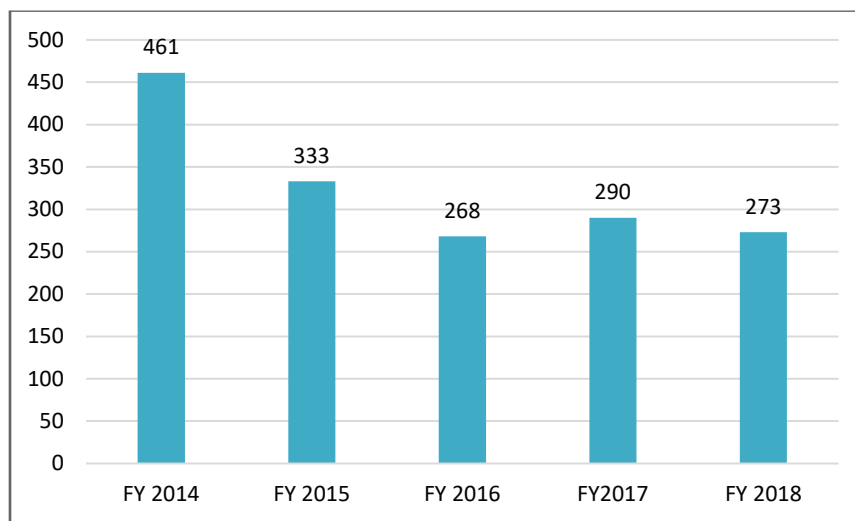


Figure 9 – Other Audits average elapsed days

5. SUMMARY OF RECOMMENDED ACTIONS OR RESOURCES TO IMPROVE THE AUDIT PROCESS

Contract auditing is a critical step in the acquisition process, and DCAA's independent audit opinions directly affect the value that the government, taxpayer, and warfighter receive for contracted work. To ensure DCAA is providing the highest value to its acquisition stakeholders, we have identified ways to improve the audit process.

- A. DCAA Engagement on Congressional Proposals.** DCAA appreciates our strong working relationship with Congress and looks forward to continued dialog. Our participation during the 2018 legislative cycle demonstrated the benefits of early engagement as we were able to assist Congress in meeting its goals related to acquisition reform. This early engagement is critical to ensure Congress has the information it needs and to share the status of DCAA's operational plans that may address desired outcomes. We look forward to continuing this level of engagement as we execute new initiatives in FY 2019, including the use of IPAs and recommendations from the Section 809 panel. As we implement these initiatives, we would welcome further engagement with Congress as we offer refinements or recommend additional actions to help achieve Congressional objectives and capitalize on progress made.
- B. Defense Acquisition Workforce Development Fund (DAWDF).** The defense acquisition workforce is critical to DoD's success in delivering and sustaining capabilities the warfighters need, and DCAA continues to use these funds to recruit and develop a high quality, high-performing, agile workforce.

Last year, DCAA attended 130 recruiting and outreach events, including those exclusively for veterans and wounded warriors. We also held three Expedited Hiring events and successfully made on-the-spot job offers to 150 qualified individuals. These efforts, along with others, resulted in hiring 481 auditors last fiscal year.

DCAA also uses DAWDF funding for workforce development and leadership training. Our Defense Contract Audit Institute (DCAI) provides centralized training to our new hires, taking a raw talent pool and shaping it into a competent and capable workforce. DCAI's audit and leadership academies develop new and revise current courses to strengthen our workforce's technical and leadership skills. DAWDF funding contributed to 237 advanced degree or professional certification courses or tests, 1,439 career field training seats, and 453 other degree and certification requirements. Finally, DAWDF funding was used in the development and conduct of the Director's Development Program in Leadership, an 18-month executive-level program that helps senior-level career employees prepare for critical positions in the federal government.

We ask that Congress maintain DAWDF funds, which are critical to recruiting and developing our workforce.

6. OUTREACH ACTIONS TOWARD INDUSTRY

DCAA proactively engages with industry to clarify audit requirements, understand and address contractor concerns, and improve acquisition and audit processes. Following is a summary of those outreach actions.

- A. Engagement with Industry Organizations.** DCAA gains insight from industry groups through both recurring and as-requested venues. DCAA is focused on increasing dialogue with industry at all Agency levels, encouraging Agency consideration of industry issues, and improving the Agency's ability to address industry concerns.

While DCAA has existing relationships and communications with various industry groups, a review by one of our Strategic Action Teams revealed new avenues to improve these relationships and promote even greater understanding between DCAA and the contracting community. Additionally, the team recommended ways to improve these relationships from the ground up, not just at the executive level. Through our efforts in 2018, DCAA established a process for regular engagement with two industry groups—the Aerospace Industry Association (AIA) and the Professional Services Council (PSC)—and recommended engagement with several others.

As a result of this new approach, DCAA's policy directorate is working with AIA on incurred cost audit issues. Additionally, DCAA is now a regular participant in AIA's meetings, an important venue for proactively identifying and discussing industry concerns. Even though DCAA and industry may not agree on all issues, we're finding that regular dialogue is a great opportunity to clarify rationales, increase understanding, and identify how we can work together to make improvements or changes when possible. We are confident that our renewed focus on these recurring meetings, now and in the future, will lead to better communication and cooperation throughout the acquisition process.

- B. Engagement with 809 Panel.** DCAA participated in a collaborative process with the congressionally mandated Section 809 Panel working group to inform and assist their efforts to streamline the defense acquisition process. Our efforts were focused on the Panel's recommendations set forth in the Panel reports.

The working group spent significant effort establishing a Professional Practice Guide (PPG), which includes discussion of risk and materiality. This guide will provide consistency in the way DCAA and Independent Professional Accounting Firms consider risk and materiality. The guide will be important to IPAs when they perform select incurred cost audits for contractors previously audited by DCAA. Internal to DCAA, we plan to use the PPG to meet Congressional requirements to establish, codify, and implement these new materiality thresholds.

7. SIGNIFICANT FY 2018 ACTIVITIES AND THEIR IMPACT

DCAA had many organizational accomplishments in FY 2018. Some of these are summarized below.

- A. Director's Development Program in Leadership.** In keeping with DCAA's ongoing commitment to preparing future leaders, the Agency executed a new leadership development program for senior managers in FY 2018.

The Director's Development Program in Leadership (DDPL) is an 18-month, executive-level program that helps senior-level, career employees prepare for critical leadership positions in the federal government. The inaugural session of DDPL began in December, 2017 with 22, GS13-15 students from DCAA, the Defense Threat Reduction Agency (DTRA), and Army Audit Agency (AAA). This first DDPL cohort graduated in February 2019.

DCAA's Defense Contract Audit Institute (DCAI) designed DDPL based on ten specific competencies in the DoD Civilian Leadership Development Continuum. In this unique program, students travel to premier universities and military commands for seminars on each of the leadership competencies, a course of study that strengthens students' leadership skills and ability to lead organizations, programs, and people. Students also engage in two capstone events putting leadership concepts to work in the complex environment of a major command.

The leadership lessons these students learned and the networks they built over their course of study will serve them well as they advance into positions of greater responsibility.

- B. Customer Outreach.** Customer engagement is a priority at DCAA. We develop and foster relationships with our customers through constant communication at all levels of leadership throughout the audit cycle. This engagement is not just about ongoing audits—we also provide education, offer advice, and listen to concerns. An audit is only one part of the acquisition process, but its results can positively or negatively impact the entire process. For this reason, we strongly believe customer engagement is essential to an efficient and effective acquisition cycle.

DCAA engages with its customers on several levels; Military Services at the Senior Executive (SES) level, Buying command Program Executive Offices (PEO), and individual contracting officers. This tiered system provides multiple touchpoints at different levels of management to advise and assist on all aspects of DCAA support and services.

At the Service level, our Regional Directors focus their efforts on engaging with senior service acquisition officials who have oversight of several procurement offices. This high level engagement provides a system-wide view of the entire procurement cycle with multiple, ongoing contract actions. Engagement at this level allows our Regional

Directors to hear ongoing challenges and provide assistance with solutions at a DCAA-wide level.

At the mid-level, our Financial Liaison Advisors' engagement at the buying command/PEO is focused on ongoing audit support and upcoming contracts and proposal. The FLA is there to advise the buying command, answer questions on audits and services, and inform audit offices on upcoming procurement actions. Additionally, because the FLAs support several DCAA offices, they are available to coordinate across Regional and Corporate Audit Directorate boundaries to provide a "One Agency" approach.

Finally, at the field audit office level, engagement with customers is continuous. Early engagement is focused on identification of potential risk areas and advice on writing contract documents to avoid issues. Once an audit is requested, audit teams communicate regularly with the contracting officer to discuss findings and challenges that arise during the audit, which enables the contracting officer to address issues promptly with the contractor and still meet deadlines. This engagement doesn't end until negotiations are complete.

Our tiered levels of engagement are reinforced by constant communication across DCAA. Feedback from customers is useful for standardizing audit programs and developing best practices, which leads to more efficient and effective acquisition process for all involved.

C. DCAA improves process efficiency to help close contracts with cancelling funds.

Open contracts with canceling funds are a priority for contract closeout because, once the funds are cancelled, any remaining costs incurred must be paid with current year budgets. DCAA provided significant support to Defense Contract Management Agency (DCMA) on a dedicated effort to close contracts with cancelling funds before the end of the fiscal year. A key contributor to their success was an automated system developed by DCAA's information systems specialists in coordination with Defense Pricing and Contracting, Defense Logistics Agency, DCMA, and Defense Finance and Accounting Service. This system greatly increased the efficiency of matching open audits in DCAA's information management system with DCMA's list of incurred cost contracts with canceling funds. Automating what was previously a time-consuming, manual process saved hundreds of hours, freeing up our audit teams to more quickly finish the audits.

8. OUTLOOK

DCAA is an integral member of the acquisition team and continues to deliver high quality audits and services that assist contracting officials negotiate fair and reasonable prices for goods and services. We completed over 99 percent of the incurred cost backlog in FY 2018 and, in FY 2019, we expect to be in full compliance with the NDAA 2018 requirements to complete incurred cost audits within 12 months of receiving a contractor's adequate proposal. With the backlog behind us, we will be returning to a more balanced mix of audits across our whole portfolio, including business systems, Truth in Negotiations, Cost Accounting standards, pre-award surveys, claims, and terminations.

Throughout FY 2019, DCAA will continue to implement the Strategic Workload Resource Initiative (SWRI), a three-year planning model that allows us to do long-term strategic planning and forecasting of workload and resources. Despite the fluidity of the acquisition cycle, we must strive to create accurate workload forecasts to the greatest extent possible. The SWRI process is showing significant potential to conduct longer term planning, increase coordination and resource planning at all levels across the agency, and make geographically-based workload assessments that put resources where they are needed most.

We remain committed to building strong relationships with customers and industry to identify needs and concerns, ensure mutual understanding, facilitate cooperation, and deliver outstanding service. Additionally, our collaborative work with the 809 panel has provided an effective opportunity to evaluate our processes, make improvements, and identify new ways to maximize our value within the acquisition community.

I am proud of the DCAA workforce and the tremendous work they did to achieve significant milestones this past year. The outlook for the agency is strong, and I look forward to a very productive FY 2019 and a renewed engagement with our full spectrum of audits and services.

ACRONYMS

CAM	Contract Audit Manual
CAS	Cost Accounting Standards
DCAA	Defense Contract Audit Agency
DCAI	Defense Contract Audit Institute
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DoD	Department of Defense
DoDIG	Department of Defense Inspector General
FAR	Federal Acquisition Regulation
FEVS	Federal Employee Viewpoint Survey
GAO	Government Accountability Office
GAGAS	Generally Accepted Government Auditing Standards
NDAA	National Defense Authorization Act
NDIA	National Defense Industrial Association
OCO	Overseas Contingency Operations
OSBP	Office of Small Business Programs
OSD	Office of Secretary of Defense
PTAC	Procurement Technical Assistance Centers
SBA	Small Business Association



Defense Contract Audit Agency
8725 John J. Kingman Road
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(703) 767-3200
www.dcaa.mil



DEFENSE CONTRACT AUDIT AGENCY

8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PAS 710.7

July 19, 2019
19-PAS-003(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA; CORPORATE AUDIT DIRECTORS, DCAA; ASSISTANT DIRECTORS, HQ, DCAA

SUBJECT: Audit Guidance on Using Materiality in Incurred Cost Audits

This memorandum establishes audit policy for applying materiality in incurred cost audits. The newly implemented materiality guidance applies to incurred cost audits that are initiated after the date of this memorandum, and can be found at CAM 6-107. The incurred cost audit programs have also been updated to reflect the materiality guidance. The new guidance will ensure materiality concepts are consistently applied across the Agency.

Background

The policy complies with Section 803 of the fiscal year (FY) 2018 National Defense Authorization Act (NDAA), which requires the Agency to adopt commercially accepted standards of materiality for incurred cost audits.

Calculating the Quantitative Materiality Threshold

The use of a quantified materiality threshold is intended to facilitate a consistent approach that helps an auditor determine the nature, timing, and extent of audit procedures on those cost elements and accounts that are significant, or material, to the audit opinion.

To calculate the quantitative materiality threshold, the auditor should first determine the total subject matter of audit. The total subject matter of audit represents the information on which the auditor provides an opinion (i.e., assurance). The total subject matter of audit is generally Auditable Dollar Volume (ADV), plus amounts associated with assist audits (see CAM 6-107.2 for additional consideration when determining the total subject matter of audit).

The auditor should then calculate quantified materiality using one of the following formulas:

For Incurred Cost Proposal Audit Subject Matter from \$1 to \$1,000,000,000 use the following formula:

$$\text{Materiality Threshold} = \$5,000 \times ((\text{Total Subject Matter} / \$100,000)^{.75})$$

For Incurred Cost Proposal Audit Subject Matter greater than \$1,000,000,000 use the following formula:

Materiality Threshold percentage of 0.50 percent

SUBJECT: Audit Guidance on Using Materiality in Incurred Cost Audits

Note: when entering the formula in Microsoft Excel, the quantified materiality formula for an audit with a \$1,000,000 total subject matter of audit appears as follows:

$$=5,000*((1,000,000/100,000)^{.75})$$

The quantified materiality threshold in this example is \$28,117. See the enclosure for a worksheet that demonstrates the quantified materiality calculation above.

The following table depicts quantified materiality thresholds (both dollar amounts and percentages) at various subject matter amounts:

Quantified Materiality Thresholds for Incurred Cost Audits

Subject Matter Cost	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
Materiality Amount	\$5,000	\$28,117	\$158,114	\$889,140	\$2,973,018	\$5,000,000	Varies
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

Calculating Adjusted Materiality

Materiality requires the use of two separate thresholds: quantified materiality to identify significant cost elements, and adjusted materiality to identify significant accounts recorded in the significant cost elements. Adjusted materiality is less than quantified materiality and is applied to accounts within a cost element. For purposes of selecting accounts for audit testing, adjusted materiality can be stated as a reduction of the quantified materiality threshold by 20 percent to 80 percent based on auditor judgment.

Other Considerations

It is important to remember to use professional judgment when applying materiality concepts. Materiality considers both qualitative factors (e.g., customer concerns, prior findings, etc.) and quantitative factors. The relative importance of qualitative and quantitative factors when considering materiality in a particular engagement is a matter of the auditor's professional judgment. The auditor should document the justification for deviating from the numeric materiality thresholds.

Available Training

DCAI and Policy developed a new E-Learning Course, *AUD112E – Materiality in Audits of Incurred Costs*, which became available July 19, 2019. All auditors should take the course prior to beginning an incurred cost audit. Policy is working with DCAI to ensure that other course materials are updated accordingly.

PAS 710.7

SUBJECT: Audit Guidance on Using Materiality in Incurred Cost Audits

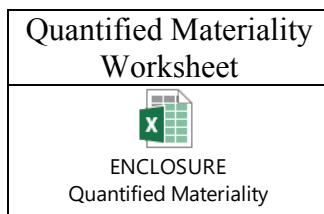
July 19, 2019
19-PAS-003(R)

Additional Questions

FAO personnel with questions regarding this memorandum should contact their regional or CAD offices. Regional/CAD personnel with questions regarding this memorandum should contact to Auditing Standards Division, at (703) 767-3274, or by e-mail to DCAA-PAS@dcaa.mil.

/s/ Barbara Richon
/for/ Martha E. McKune
Assistant Director, Policy and Plans

Enclosure:
Quantified Materiality Worksheet



DISTRIBUTION: E



ARTICLE

DCAA Materiality MRD

Jul 29, 2019

Related sections

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- GOVERNMENT CONTRACTING & COMPLIANCE

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In what we hope is a sign of positive things to come, this month DCAA issued a Memorandum for Regional Directors (MRD) to implement new audit policy for evaluating materiality in incurred cost audits (<https://www.dcaa.mil/content/Documents/mmr/19-PAS-003.pdf>).

Although Congress required the Department of Defense to develop and adopt commercially-accepted materiality standards by October 2020 (see Section 803 of the 2018 National Defense Authorization Act), DCAA acted quickly to embrace and roll out the core materiality concepts recommended in the [Section 809 Panel's Professional Practice Guide](#).

This new guidance, which DCAA also incorporated into Chapter 6, Section 107 of its Contract Audit Manual (CAM), provides a new benchmarking equation for determining materiality based on total incurred costs subject to annual audit, as shown below. We encourage everyone to review Chapter 2 of the Professional Practice Guide for definitions of terms and other important context.

For Incurred Cost Proposal Audit Subject Matter from \$1 to \$1,000,000,000 use the following formula:

$$\text{Materiality Threshold} = \$5,000 \times ((\text{Total Subject Matter} / \$100,000)^{0.75})$$

For Incurred Cost Proposal Audit Subject Matter greater than \$1,000,000,000 use the following formula:

$$\text{Materiality Threshold} = \text{Total Subject Matter} \times 0.50 \text{ percent}$$

Quantified Materiality Thresholds for Incurred Cost Audits

Subject Matter	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
----------------	--------	------	-------	--------	--------	------	--------

Cost							
Materiality Amount	\$5,000	\$28,117	\$158,114	\$889,140	\$2,973,018	\$5,000,000	Varies
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

This new guidance represents a big step toward clarifying one of the most important aspects of government contract oversight. We believe it will support more timely, efficient, and effective incurred cost audits.

DCAA's collaboration with 809 Panel Commissioners, DCMA, GAO, AICPA, and industry (including several Panel volunteers from [Baker Tilly's Government Contracts practice](#)) created the Panel's Professional Practice Guide, which applies commercial auditing concepts to the unique aspects of government contract cost audits.

This direction is beneficial for everyone in the government contracting community, and we encourage DCAA to keep going.



→ [Download the Section 809 Panel Professional Practice Guide](#)

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Advisory Practice



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Department of Defense

Professional Practice Guide

Audits and Oversight of
Defense Contractor Costs and
Internal Controls

FIRST EDITION
January 2019

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INTRODUCTION

The Section 809 Panel developed this Professional Practice Guide (PPG) as a supplement to existing guidance for professionals involved in Department of Defense (DoD) procurement contract auditing. A Section 809 Panel working group collaboratively developed this guide to provide additional information regarding how to interpret and apply specific auditing concepts for government contract audits to assist auditors, contracting officers, and other stakeholders involved in the audit process. It is intended to assist professionals with delivering high quality, consistent financial audit and advisory services to contracting officers.

Independent public accountants (IPAs) and other qualified professional services firms play an increasingly important role in the government's oversight of federal government contractors. Although professional standards are common across the auditing profession—applicable to both public and private organizations—these standards were not developed or interpreted for the unique purpose of federal government contract oversight. To address this need, the Section 809 Panel assembled a working group of subject matter experts in the fields of contract auditing and compliance, professional standards, and audit resolution. The Section 809 Panel wishes to thank the working group members for their dedication and generous contribution of time and energy toward the development of the guide. The working group consisted of representatives from the following organizations.

- Defense Contract Audit Agency
- Defense Contract Management Agency
- US Government Accountability Office
- American Institute of Certified Public Accountants
- Aerospace Industries Association
- Baker Tilly Virchow Krause, LLP

The working group evaluated a variety of professional standards to identify concepts that may benefit from collaborative interpretation as they apply in a contract oversight environment, including risk, materiality, audits of internal controls, independence, objectivity, sufficient evidence, and reliance on the work of others. Given the Section 809 Panel's limited statutory term, the working group prioritized its work to focus on risk, materiality, and audits of internal controls. Accordingly, these three concepts are addressed in this first edition of the PPG.

Although these concepts are well established in auditing literature, this guide focuses on how the concepts should be used for the purpose of federal government contract oversight. It describes how these concepts are to be applied in the context of government contract audits and provides practical examples and best practices to help auditors perform audits.

Maintenance

The Section 809 Panel recommends the Secretary of Defense charter and reconstitute a Professional Practice Guide Working Group, chaired by both DCAA and DCMA on a biennial rotation, to ensure the same collaborative process is used for changes and additions to the PPG as was established by the Section 809 Panel. The process should ensure that the PPG remains current and that additional topical areas are considered collaboratively by a diverse group of experts in the field of contract auditing and compliance. Specifically, the Section 809 Panel recommends that the Working Group should have five permanent representatives, including a representative from each of the following:

- Defense Contract Audit Agency (DCAA), appointed by the director of DCAA.
- Defense Contract Management Agency (DCMA), appointed by the director of DCMA.
- Government Accountability Office (GAO), appointed by the Comptroller General of the United States.
- Industry, nominated by *Council of Defense and Space Industry Associations* (CODSIA) and agreed on by a majority of the representatives from DCAA, DCMA, and GAO.
- American Institute of Certified Public Accountants, agreed on by a majority of the representatives from DCAA, DCMA, and GAO.

The chair of the Working Group (i.e., either DCAA or DCMA, biennially) is responsible for scheduling and recording proceedings and decisions made by Working Group. The Working Group members do not have terms, but membership may be assessed annually by the collective members and changes made based on this assessment. The appointees from DCAA, DCMA, GAO, and AICPA will be automatically removed from the Working Group should they leave their respective organizations. The Working Group will meet not less than semi-annually and otherwise as determined necessary by the members. The Working Group shall have an indefinite termination date.

The PPG will be made available to the public in the *Guidance* section of DCAA's website. New Editions of the PPG will be announced internally within DCAA by a Memorandum for Regional Directors, a copy of which will also be published promptly on DCAA's website.

Overview

The PPG provides information on how to interpret and apply specific auditing concepts to audits of government contract costs and compliance-related internal controls. This guide will assist government auditors, private-sector auditors, contracting officers, contractors, and other stakeholders better understand the audit process.

Financial and business system oversight of defense contractors is a crucial function of DoD's system of acquisition internal controls. This oversight function performs both preventive and detective control activities, designed to reasonably ensure DoD's contractors comply with a variety of contract requirements. These contract requirements allow DoD's procuring and administrative contracting officers to exercise good stewardship of taxpayer dollars, as well as deliver timely, high-quality goods and services to warfighters and accomplish other operations critical to DoD's mission.

The PPG recognizes, in Chapter 1, that a more robust *risk assessment* process will allow DoD to deploy its limited resources more effectively. The PPG further recognizes, in Chapter 2, that DoD can deploy its resources more efficiently, without harming effectiveness, through a common understanding of *materiality*. Finally, in Chapter 3, the PPG recognizes that a common framework will streamline and bring consistency to DoD's *audits of contractor systems of internal control* over government contract compliance.

This guide recognizes that systems of internal control are not expected to provide absolute assurance that specified objectives are met. The costs of attaining absolute assurance are generally greater than the benefits attained from such assurance, and there are inherent limitations in any system of internal control due to factors such as human error and the uncertainty inherent in judgment. This first edition of the PPG focuses on this axiom with respect to both DoD's system of acquisition internal control and contractors' systems of internal control over government contract compliance.

Chapter 1, Incurred Cost Risk Assessment, establishes guidance that DCAA will use to focus its limited resources when auditing costs incurred by contractors on flexibly priced defense contracts. This chapter implicitly acknowledges that (a) DCAA is an important element of DoD's system of acquisition internal controls, (b) DCAA does not have sufficient resources to audit every DoD contractor, and (c) adding more oversight resources would likely produce diminishing returns relative to the increased cost. The risk assessment process also incentivizes larger contractors to achieve or maintain compliant cost accounting and effective accounting system internal controls, such that they can reduce their assessed risk profile and, thus, audit frequency.

Chapter 2, Engagement Materiality Framework, addresses Congress's direction to the Section 809 Panel in the FY 2018 NDAA, Section 803, with respect to numeric materiality for audits of incurred cost. This chapter sets forth clear materiality guidelines that help oversight professionals plan their work and provide the information contracting officers need to make reasonable business decisions. What may be material to a particular business decision will be influenced by a variety of qualitative and quantitative considerations, recognizing that the contracting officer's role is to manage DoD's risk, rather than avoid risk. The cost of DoD oversight, including adverse effects on timeliness of decision making, must be balanced with expected benefits of that oversight. Guidance in this chapter should be used in conjunction with the Cost Accounting Standards Board's (CASB's) administrative regulations (48 CFR 9903.305) that establish a variety of materiality considerations appropriate for any DoD business decision concerning contract costs/prices.

Chapter 3, Audits of Internal Controls over Government Contract Compliance, introduces a body of professional standards based on an internal control audit framework and developed to address the requirements of Sarbanes-Oxley Act (SOX) Section 404(b). This framework serves as the means by which DoD will obtain reasonable assurance that contractors have effective internal controls over their business systems as they relate to government contract compliance. Internal control audits will be the basis for assessing adequacy of defense contractor accounting systems. These audits are well established and understood by the auditing profession. They will also provide more useful, relevant information to the acquisition team, contracting officers, and contractors.

References to the *Government Auditing Standards* 2018 Revision in this guide refer to attestation engagements and performance audits performed once the 2018 revision becomes effective. For attestation engagements, it is for periods ending on or after June 30, 2020. For performance audits, it is for audits beginning on or after July 1, 2019. For all engagements performed prior to the respective effective dates of the 2018 revision, the auditor should refer to the 2011 revision of the *Government Auditing Standards*.

CHAPTER 1: RISK ASSESSMENT

The Need for Risk Assessment

DoD's system of acquisition internal controls is subject to the same economic constraints as those faced in other government agencies, organizations, and corporations. Increasing resources become necessary to achieve desired risk levels approaching zero (i.e., absolute risk avoidance).

DCAA serves many roles within DoD's system of acquisition internal controls. Chief among them is DCAA's role as auditor of costs incurred by, and reimbursed to, commercial companies that perform flexibly-priced defense procurement contracts. DoD cannot reimburse commercial companies for their contract performance costs unless they comply with contract terms and conditions.

Each year, thousands of commercial companies incur costs while performing flexibly-priced defense contracts. Accordingly, this Chapter establishes a risk assessment framework intended to focus DCAA's finite resources such that DoD's risk is appropriately managed.

Risk Assessment Framework

The foundation for this risk assessment framework rests on the materiality concepts introduced in Chapter 2 of the PPG, insofar as it aligns increasing risk levels with the annual costs incurred by contractor business units (as represented on annual final indirect cost rate proposals, also referred to as incurred cost proposals (ICPs)). As annual costs increase, so does the likelihood of being audited.

The risk assessment framework also takes into consideration several qualitative factors that may either increase or decrease the likelihood of being selected for audit. The risk assessment framework provides incentives for contractors to achieve or maintain compliant cost accounting and internal controls over government contract compliance. It also provides disincentives for those contractors who have not.

The risk assessment framework provides for three levels, or *strata* of risk: low, medium, and high. These levels are based on a contractor business unit's Auditable Dollar Volume¹ (ADV). Within each risk strata, contractor ICPs fall within specified ranges of ADV and may be selected for audit based on the stratum's criteria. Each stratum is also affected by specific risk questions that affect the frequency of the contractor being audited. This aligns audit frequency with the performance of the contractor with regards to the history of questioned costs and status of business systems. The questions differ for each stratum but relate to the following risk factors:

- The significance of historic questioned costs.
- The existence of specific Department concerns.
- The status of the business systems.
- The existence of uncorrected system deficiencies (if any).
- The existence of significant accounting or organizational changes (e.g., merger).

For contractors with final indirect cost rate proposals for which total incurred cost on DoD flexibly priced contracts is equal to or greater than \$1 Billion of ADV, DoD will conduct an audit regardless of the above factors. For all other final indirect cost rate proposals, the frequency of audit should decrease

¹ADV is the sum of all of the costs on flexibly-priced contracts for a contractor during a given fiscal year

provided the risk factors are met. The risk assessment framework is provided below and available on the DCAA website.

Table 1. Risk Assessment Framework

	Low Risk Strata	Medium Risk Strata	High Risk Strata
	< 100M	\$100M-\$500M	> \$500M
Sampling Notes	N/A	\$100M–\$250M: Audit every 5 th year if not selected during sampling process > \$250M–\$500M: Audit every 4 th year if not selected during sampling process.	\$1B or more: Audit > \$500M–<\$1B, if the answer to each of the question below is No, the contractor's ICP will move to the medium risk category with the possibility of being sampled for audit in that year. Must be audited every other year.
Risk Assessment Protocol	For contractors with < \$5M ADV, answer questions 1 and 2 below. For contractors with \$5M to <\$100M ADV, answer all three questions below. 1) Assess the risk of incurred cost proposal using the questions (below). 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.	For contractors with \$100M–\$250M in ADV, was a determination letter used to close the prior four contractor fiscal years? (A YES response indicates proposal must be audited regardless of initial risk.) For contractors with > \$250M–\$500M in ADV, was a determination letter used to close the prior three contractor fiscal years? (A YES response indicates proposal must be audited regardless of initial risk.) 1) Assess the risk of incurred cost proposal using the six questions (below). 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.	For contractors with > \$500M and <\$1B in ADV, was a determination letter used to close the prior contractor fiscal year? (A YES response indicates proposal must be audited regardless of initial risk.) For contractors with \$1B or more in ADV, an audit must be conducted every contractor fiscal year. 1) Assess the risk of incurred cost proposal using the six questions below. 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.
Risk Assessment Results	ICPs with ADV <\$5M placed in low risk strata sampling universe for sampling if the answers to questions 1 and 2 below are NO. Note: The regional Audit Manager must approve the performance of an audit. ICPs with ADV \$5M – <100\$M in low risk strata sampling universe if the answers to all the questions below are No.	ICPs with ADV of \$100M–\$500M placed in medium risk sampling universe for sampling if the answers to all six questions below are NO.	ICPs with ADV of > \$500M–\$1B placed in medium risk sampling universe for sampling if the answers to all six questions below are NO.
Question 1	Are there significant Questioned costs in the last completed incurred cost audit?	Are there significant Questioned costs in the last completed incurred cost audit?	Are there significant Questioned costs in the last completed incurred cost audit?
Question 2	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?
Question 3	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?
Question 4	N/A	Does the contractor have any business system deficiencies relevant to incurred costs for the year subject to audit?	Does the contractor have any business system deficiencies relevant to incurred costs for the year subject to audit?
Question 5	N/A	Does the contractor have any significant account practice changes in the year subject to audit?	Does the contractor have any significant account practice changes in the year subject to audit?
Question 6	N/A	Has the contractor experienced significant organizational changes in the year subject to audit?	Has the contractor experienced significant organizational changes in the year subject to audit?

CHAPTER 2: MATERIALITY IN AUDITS OF INCURRED COSTS

This chapter presents guidelines and a framework for determining materiality for use in audits of incurred costs. However, this framework and the recommended materiality thresholds are not a substitute for professional judgment.

Materiality and Significance in Incurred Cost Audits

The term *incurred cost audit* means an audit of charges to the government by a contractor under a flexibility priced contract.² These charges are reported annually by contractor business units, in a final indirect cost rate proposal (also referred to as an incurred cost proposal), as required by FAR 52.216-7. This proposal represents the subject matter of the incurred cost audit. The risk to the government and others who rely on this information is that amounts are materially misstated due to contractors' noncompliance with contract terms or federal regulations. If the incurred cost proposal is not materially compliant and complete, it could adversely affect decision making by those who use the information.

The objectives of an incurred cost audit are to (a) provide assurance that contractors' incurred cost proposals can be relied on to settle final indirect cost rates and (b) communicate any misstatements that may affect contract cost reimbursements. Contract costs that do not comply with contract terms, federal regulations, or agreements are referred to in audits of contract costs as *misstatements*. An incurred cost audit is designed to identify material (or significant, as explained below) misstatements, based on both quantitative considerations (amount) and qualitative considerations (nature).

A material misstatement, as used throughout this guide, means misstatements, including omissions, individually or in the aggregate, that could reasonably be expected to influence relevant decisions of intended users that are made based on the subject matter. Materiality, by definition, is more than just a number and is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment.³

Audits of incurred costs can be performed using standards for performance audits (GAO, *Government Auditing Standards* 2018 revision), and standards for attestation examination engagements (AICPA, *Professional Standards*, Statements on Standards for Attestation Engagements). The definition of materiality is drawn from the attestation examination standards but is not limited to only these types of engagements. For the remainder of this document use of *materiality* is based on this definition. The Government Auditing Standards define *significance* for performance audits (FY 2018 Yellow Book, paragraph 8.15) as

The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors. Such factors include the magnitude of the matter in relation to the subject matter of the audit, the nature and effect of the matter, the relevance of the matter, the needs and interests of an objective third party with knowledge of the relevant information, and the matter's effect on the audited program or activity. Professional judgment assists auditors when evaluating the significance

² The term 'flexibly priced contract' has the meaning given the term 'flexibly-priced contracts and subcontracts' in part 30 of the Federal Acquisition Regulation (section 30.001 of title 48, Code of Federal Regulations).

³ Paragraph A15 of AT-C section 205, *Examination Engagements* (AICPA, Professional Standards, AT-C sec. 205)

of matters within the context of the audit objectives. In the performance audit requirements, the term significant is comparable to the term material as used in the context of financial statement engagements.

The definition of *significant* for performance audits is similar to the definition of *materiality* for attestation examination engagements. For purposes of this document, these terms may be used interchangeably.

Both the terms *materiality* and *significance* refer to characteristics of the subject matter that are important, or relevant, to the users of the information. The terms *significant cost element* or *significant account* in this chapter refer to items that require further evaluation, and possibly testing, due to the potential of material misstatements based on quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer. During the planning and fieldwork phase of the audit, *significance* is used in the context of a potential risk of misstatement (quantitative or qualitative) in a cost element or account that is more than clearly trivial. During the reporting phase of the audit, *material* or *significant* misstatements will affect the auditor's opinion or conclusion.

Compatibility of Commercially Accepted Standards for Risk and Materiality

The commercial concepts of risk and materiality are compatible with the objectives of contract cost auditing. They represent auditors' professional responsibility to determine *what matters* (i.e., the risk that costs do not comply with contract terms and federal regulations) and *how much matters* (i.e., materiality) in the context of a particular audit. What and how much matters depends on the use of the audited information.

With respect to financial statement audits of for-profit companies, the owners, potential investors, and banks use audited financial information to make investment and lending decisions. With respect to contract cost audits, contracting officers use audited financial information to negotiate contract prices, reimburse contract costs, and evaluate a contractors' compliance with contract terms. To ensure the integrity of information on which economic decisions will be made, organizations (in the context of financial statements of for-profit companies) and contracting officers (in the context of procurement contracts) use auditors to provide assurance on that information.

Commercial standards of risk and materiality conceptually apply to contract cost audits, yet the process in which they are applied is viewed through the lens of contracting officers and their responsibility to expend public funds fairly and reasonably. Auditors' evaluation of what matters (i.e., risk or significance) is made in the context of the engagement type and contracting officers' (or other government customers') needs. The auditors' assessment of what matters is also a necessary precondition to determining how much matters (i.e., materiality).

Materiality in the Context of Contract Cost Audits

The concepts of materiality and significance expressly acknowledge that some degree of imperfection is acceptable to the users of financial information. This point is emphasized throughout the commercial and government auditing standards, regulations for the oversight of financial markets, FAR and the Cost Accounting Standards (CAS). This chapter discusses materiality, consistent with commercial standards, as a guide to help auditors when performing audits of incurred contract costs.

Materiality, in the context of contract costs, represents the government’s acknowledgement, consistent with the Federal Acquisition System’s Guiding Principles, that there is an acceptable level of imprecision when determining or settling fair and reasonable contract prices. *Material* misstatements, individually or in aggregate, would reasonably be expected to influence the economic decisions of the government.⁴ *Immaterial* misstatements would not adversely affect the economic decisions of the government as a buyer of goods and services in the commercial marketplace.

Commercial standards of risk and materiality provide for both *qualitative* and *quantitative* considerations. In the context of government contract costs, an auditor is concerned with both the nature (i.e., quality) and the amount (i.e., quantity) of a cost.

Audits of incurred contract costs generally focus on cost allowability and the completeness of contractors’ cost representations. Contract cost auditors evaluate contractors’ cost accounting and presentation for compliance with contract terms, FAR Part 31 cost principles (and CAS, as applicable), and other agreements between contractors and the government (e.g., advance agreements). Auditors are encouraged to discuss quantitative and qualitative materiality considerations with contracting officers or other government customers to obtain their perspectives on what is important to them. For example, auditors may be informed by contracting officers of the importance of a certain aspect of the information, such as a cost element or account, which auditors may take into consideration in their determination of materiality.

Definitions

For the purposes of this PPG, the terms below are defined as follows:

Table 2. Audit Terminology

Term	Definition
Total Subject Matter Amount	The incurred cost claimed on flexibly priced contracts during the fiscal year. It includes different categories of contract cost such as labor, materials, other direct costs, indirect costs, and is adjusted for certain types of contracts and activity such as commercial contracts. The FY 2018 NDAA, Section 803, defines <i>incurred cost audit</i> as an audit of charges to the government by a contractor under a flexibly priced contract. See Appendix B for additional information.
Accounts	Records used to group same or similar types of financial transactions during a fiscal period. An expense account’s balance at the end of a fiscal period reflects the total dollar amount of transactions recorded to that account. For example, a labor expense account will include individual transactions associated with amounts paid to employees.
Cost Element	Represents the summation of accounts of a similar character and type that is included in the total subject matter. For example, the direct materials cost element is comprised of all material costs on government contracts, and may include, for example, accounts for direct purchases, allocations from company owned inventory, and allocations for material factors. The cost element is similar to a line item in financial statements.

⁴ The FY2018 NDAA, Section 803, defines *numeric materiality standard* as “a dollar amount of misstatements, including omissions, contained in an incurred cost audit that would be material if the misstatements, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the Government made on the basis of the incurred cost audit.”

Term	Definition
Significant Cost Element or Account	Represents a cost element or account that requires further evaluation and testing due to quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer, and is applicable to any type of engagement performed. Significance is relevant in the planning and reporting phases of the audit.
Materiality	In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence relevant decisions of intended users that are made based on the subject matter. Materiality is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment. ⁵
Quantified Materiality	The numeric representation of materiality that is calculated based on the total audit subject matter. It is used in planning to identify significant cost elements. Quantified materiality is similar to planning materiality used in financial statement audits.
Adjusted Materiality	The amount or amounts set by the auditor at less than quantified materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the incurred cost proposal, taken as a whole. It also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Adjusted materiality is similar to performance materiality used in financial statement audits.
Quantitative Materiality Factors	Quantitative factors relate to the magnitude of misstatements or questioned costs relative to the reported amounts for those aspects of the subject matter, if any, which are expressed numerically or otherwise related to the numeric values. ⁶
Qualitative Materiality Factors	Risk and qualitative materiality factors are understood in the context of the subject matter as relating to, or measured by, the quality of subject matter rather than its quantity. Qualitative materiality factors can include whether the misstatement affects compliance with laws or regulations, the result of an intentional act (i.e., fraud), and importance to the users of the information regardless of dollar amount. ⁷ For planning purposes, the auditor may design audit procedures to address risk of potential material noncompliance related to these qualitative factors. For reporting purposes, and after completion of fieldwork, the actual misstatements should be evaluated for significance based on these qualitative factors in addition to quantitative factors.
Nominal Reporting Amount	The nominal reporting amount is an amount at which any adjustment (misstatements or noncompliance) taken individually would be immaterial regardless of other factors. It is used during the reporting of results to determine the impact of certain qualitative amounts that are significant based on nature but so small in value they are still considered immaterial. Regardless, although not included in the audit report, these items are separately communicated to the contracting officer in a summary of misstatements. The nominal reporting amount is similar to the nominal amount used in financial statement audits.
Misstatement	When the contract costs that are billed, or reported, to the government do not comply with contract terms and federal regulations such as FAR and CAS. The primary source of misstatements for incurred cost audits is cost type (FAR 31.205), contract clauses, cost reasonableness, and cost allocation (FAR 31.201 to 31.204 or CAS if applicable). When a misstatement is identified, it is typically referred to as a noncompliance that can be measured as a dollar amount of questioned contract costs.

⁵ Paragraph A15 of AT-C section 205

⁶ Paragraph A19 of AT-C section 205

⁷ Paragraph A18 of AT-C section 205

Engagement Materiality Framework

The Engagement Materiality Framework describes the process for calculating and using materiality throughout the audit process and is organized by phases of the audit, as follows:

Table 3. Engagement Materiality Framework

Audit Phase	Engagement Materiality Framework Step
Planning	1) Calculate quantified materiality
Planning	2) Identify significant cost elements
Planning	3) Identify significant accounts within significant cost elements
	4) Consider the use of adjusted material in sampling and tolerable error
	5) Determine the nature, timing, and extent of audit procedures on significant cost elements and accounts considering risk and materiality.
Fieldwork	6) Perform testing procedures and document results.
Conclusion and Reporting	7) Evaluate misstatements based on quantitative and qualitative materiality characteristics.
	8) Report or communicate misstatements, in compliance with Government Auditing Standards.

Step 1: Calculate Quantified Materiality

Quantified materiality relates to the magnitude of misstatements relative to reported amounts for those aspects of the subject matter, if any, that are expressed numerically or otherwise related to numeric values. Use of quantified materiality is appropriate for audits of incurred cost because the total subject matter can be measured as a numeric value. Quantified materiality is used in the planning phase of the audit to identify significant cost elements and affects use of adjusted materiality during fieldwork (Engagement Materiality Framework Step 3). The process to calculate qualified materiality includes the following:

- **Define Total Audit Subject Matter:** The audit subject matter is expressed numerically, and for purposes of the materiality calculation, includes the total subject matter upon which an auditor will be expressing an opinion and providing assurance.
- **Calculate Quantified Materiality:** Quantified materiality is based on auditor judgment and is influenced by industry benchmarks, reasonableness, and the needs of the users of the information. It represents the amount, or percentage, of the Total Audit Subject Matter that can be misstated and influence the decisions of those who use the information.

Commercially accepted practices for determining quantitative materiality involve the application of percentages to elements of financial information. For example, a financial statement auditor may use 5 percent of net income, or 0.5 percent of net assets, as a benchmark for quantitative materiality. If net income is \$1,000,000, then, in an auditor's judgement, misstatements of more than \$50,000 (5 percent) individually, or in the aggregate, would likely influence the economic decisions of financial statement users. If net income is \$100,000,000, then misstatements of more than \$500,000 (5 percent) individually, or in the aggregate, would likely influence the economic decisions of financial statement users.

As the examples above show, commercially accepted materiality benchmarks tend to maintain their proportionality as financial values increase. This proportionality occurs because financial statement users need assurance that the financial statements fairly represent a company's financial position in accordance with GAAP. It is not necessarily the dollar value of misstatements that matters to financial statement users; rather, it is whether the financial statements fairly represent the company's performance within an acceptable margin of imperfection.

Recommended materiality thresholds are provided below that are consistent with industry norms and acceptable for use in incurred cost audits. The practical application of quantified materiality is not limited to these thresholds as auditor judgment with consideration of qualitative factors, risk, and variability have an impact.

The materiality thresholds recommended below adjust (by algebraic equation) downward as the amount of cost subject to audit increases. Because contract audits involve contractors' costs that may be reimbursed with public funds, applying a static benchmark could produce unacceptably large materiality thresholds. For example, 5 percent of \$100,000 (or \$5,000) is perceived much differently than that same percentage applied to \$1,000,000,000 (or \$50,000,000). In this instance, it would be more appropriate to use a threshold of 0.5 percent for \$1,000,000,000 because the resulting materiality threshold of \$5,000,000 is more aligned with the government's economic decision-making responsibility.

Recommended Materiality Thresholds for Incurred Cost Audits

Table 4. Incurred Cost Audit Proposals Subject Matter

Subject Matter Cost	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
Materiality Amount	\$5,000	\$28,117	\$158,686	\$889,140	\$2,973,018	\$5,000,000	<i>Varies</i>
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

For Incurred Cost Proposal Audit Subject Matter from \$1 to \$1,000,000,000 use:

- Materiality Threshold = \$5,000 x ((Total Subject Matter / \$100,000) ^ .75)

For Incurred Cost Proposal Audit Subject Matter greater than \$1,000,000,000 use:

- Materiality Threshold percentage of 0.50 percent

Quantified materiality does not change due to the type of engagement performed (e.g., examination or performance audit). Professional judgments about quantitative materiality are made in light of contract dollars subject to audit (i.e., engagement subject matter) and are not affected by the level of assurance. Materiality is based on the needs of those who use the information irrespective of the type of engagement performed.

The application of quantified materiality neither limits auditor judgment nor places restrictions on what an auditor can test based solely on dollar value. Rather, the quantified materiality amount is

intended to create a consistent threshold that helps an auditor calibrate the nature, timing, and extent of audit procedures relative to the unique risks and qualitative considerations of each engagement. It is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter of the practitioner's professional judgment.⁸

The example below illustrates a basic quantified materiality calculation. The total subject matter represents all costs for flexibly priced contracts (i.e., engagement subject matter), whether direct or indirect, of \$200,500. The total subject matter is then multiplied by the quantified materiality formula to compute the materiality amount used during the audit.

Figure 1. Illustrative Basic Quantified Materiality Calculation

$$\text{\$8,425} = \text{\$5,000} \times ((\text{\$200,500}/\text{\$100,000})^{.75})$$

The quantified materiality amount is \$8,425, which is 4.2% of the total engagement subject matter (\$8,425/\$200,500).

Incurred Cost Submission:	Total
Direct Labor	\$100,000
Direct Materials	\$50,000
Other Direct Costs	\$10,000
Overhead	\$20,000
G&A Expense	\$20,500
Total Subject Matter (a)	\$200,500
Materiality Threshold (b)	4.2%
Materiality (c)	\$8,425

Step 2: Identify Significant Cost Elements

A significant cost element is identified by quantified materiality, qualitative materiality characteristics, and other risk factors. The process for determining a significant cost element is as follows:

- **Quantified Materiality:** The auditor should identify all cost elements equal to or greater than quantified materiality as significant.
- **Risk and Qualitative Factors:** The auditor should consider risk and qualitative factors for all cost elements less than quantified materiality. Cost elements may still be considered significant and subject to testing procedures based on risk factors and qualitative characteristics such as a

⁸ Statements on Standards for Attestation Engagements (SSAE) Number 18; AT-C 205.A15.

history of identified misstatements, nature of particular costs, and needs of the users of the audited information.

- **Variability:** The auditor may use judgment and incorporate variability, or unpredictability, in the selection of cost elements to test. For example, an auditor has elected to not test a cost element for the last 2 years due to an immaterial balance. In the current year, and to ensure variability and unpredictability in the testing approach, the auditor may select the cost element for testing. This prevents a pattern from forming and discourages the contractor from recording misstatements in cost elements that have a history of not being tested.

The following example compares the quantified materiality amount of \$134,200 to the cost elements within the subject matter. The materiality amount was calculated by including the total subject matter of \$8,036,024 in the materiality threshold equation. The associated materiality threshold percentage is 1.67 percent ($\$134,200/\$8,036,024$). In the example, an auditor would identify the cost elements of direct labor, direct materials, subcontracts, overhead, and general and administrative costs as significant based on quantified materiality.

Table 5. Comparison of Quantified Materiality to Cost Elements

Cost Element	Amount	> Materiality of \$134,200
Direct Labor	\$2,441,657	YES
Travel	\$54,092	NO
Direct Materials	\$188,716	YES
ODC	\$11,175	NO
Subcontracts	\$3,329,051	YES
Indirect Overhead	\$1,138,408	YES
G&A (Value Added)	\$872,925	YES
Total Subject Matter	\$8,036,024	
Materiality Threshold	1.67%	
Materiality	\$134,200	

A YES in the table above means that the cost element is significant and should be further evaluated at the account level, but it does not automatically mean the entire amount will be tested. An auditor is responsible for auditing significant costs elements based on materiality or other factors, but the nature, timing, and extent of audit procedures may vary based on auditor judgment.

The cost elements that are less than the quantified materiality amount may be tested due to qualitative materiality characteristics, other risk factors, or if, in an auditor's judgment, they may contain immaterial misstatements that could be material in the aggregate. The following examples illustrate an auditor's potential qualitative considerations relative to the travel cost element, which is less than the quantified materiality amount. In this example, the auditor did not identify qualitative or risk concerns for the ODC cost element, which is also less than the quantified materiality amount:

- The contractor's travel cost element has a history of misstatements, which have been investigated in the past, and is a stated concern of the contracting officer. If the user of the information (i.e. the contracting officer) considers a particular cost element to be significant based on qualitative facts and circumstances, then an auditor may evaluate it at the account level in the same manner as any other significant cost element.
- The contractor's travel cost element has no history of misstatements, and the contracting officer did not express any concerns in this area. However, the travel cost element was not tested in the prior 2 years. The auditor could test the travel cost element to ensure variability and unpredictability in the audit approach, regardless of whether the risk and qualitative characteristics indicate no testing may be appropriate.

The body of work necessary to support the opinion, or audit conclusions, is generally met with the testing of cost elements and accounts with values greater than materiality or adjusted materiality. The use of qualitative or other risk factors to identify significant cost elements should be based on actual, objective, and measurable facts and circumstances such as history of questioned costs, and needs of the users of the audited information. Absent these objective factors, the auditor is expected to adhere to materiality thresholds. The auditor should document the justification for deviating from the materiality thresholds. See Appendix A for unique considerations regarding indirect costs.

Step 3: Identify Significant Accounts

A significant account is identified by adjusted materiality (as explained below), qualitative materiality characteristics, and other risk factors. The process for identifying significant accounts is as follows:

- (1) ***Adjusted materiality:*** The auditor should identify all accounts equal to or greater than adjusted materiality as significant.
- (2) ***Risk and Qualitative Factors:*** The auditor should consider qualitative factors for all account balances less than adjusted materiality. Accounts may still be considered significant and subject to testing procedures based on risk and qualitative factors such as a history of misstatements, sensitivity, and needs of the users of the audited information.
- (3) ***Variability:*** The auditor should incorporate an element of variability in the selection of accounts to test. For example, an auditor elected not to test an account for the last 2 years due to an immaterial balance. In the current year, and to ensure variability and unpredictability of the testing approach, an auditor may select the account for testing. This prevents a pattern from forming and discourages the contractor from recording misstatements in accounts that have a history of not being tested.

An auditor will use *adjusted materiality* to identify significant accounts subject to audit evaluation. Quantified materiality represents the total amount the subject matter can be misstated without misleading the users of the information. Adjusted materiality is less than quantified materiality. Unless quantified materiality is adjusted at the account level, an auditor would have limited ability to identify immaterial misstatements that, in the aggregate, become material or are material by their nature even if immaterial in amount.

Adjusted materiality is used at a more discrete level in the books and records and is applied to accounts that make up the cost elements. For purposes of selecting accounts for audit testing, adjusted materiality can be stated as 20 percent to 80 percent of quantified materiality based on audit risk, the nature (or sensitivity) of transactions relative to specific cost allowability criteria, other substantive procedures performed (i.e., whether controls are tested), and the needs of the users of audited information.

The following are key concepts with the application of adjusted materiality:

- Adjusted materiality is applied to the accounts within significant cost elements.
- Once an account is selected, an auditor will test the transactions that sum to the account balance.
- Adjusted materiality is determined separately for each significant cost element.

See Appendix A for guidance on how to calculate adjusted materiality for indirect costs where the government's participation is less than 100 percent.

Adjusted materiality can be used as tolerable error (or tolerable misstatement) for the purpose of statistical sample selection (see the Step 4, Engagement Materiality Framework). The following table provides examples of justifications for degrees of adjustment to the quantified materiality for the purpose of calculating adjusted materiality:

Table 6. Justifications for Degrees of Adjustment to the Quantified Materiality

Percent Adjustment	Examples
(80%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element has a history of material misstatements in multiple accounts. ▪ The contractor is unwilling to correct prior-year material misstatements in subsequent proposals. ▪ The contractor is currently in litigation for historical costs in the same cost element and accounts. ▪ The contracting officer has significant concerns regarding the cost element that increase the sensitivity and importance.
(50%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element and multiple accounts have a history of material misstatements. ▪ Management is responsive with correcting misstatements in subsequent proposals. ▪ The contracting officer has concerns regarding the cost element that increase the sensitivity and importance.
(20%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element and accounts have limited to no instances of historical material misstatements on an aggregated basis. ▪ The reduction is to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds total quantified materiality.

The following example illustrates how to calculate adjusted materiality: Based on professional judgment, an auditor elects to reduce the quantified materiality by 20 percent (see Figure 2). If the adjusted materiality is reduced by 20 percent, the remainder represents 80% of the quantified materiality amount (100 percent - 80 percent = 20 percent reduction). The adjustment materiality is calculated by multiplying the quantified materiality of \$1,025 by 80 percent (100 percent - 20 percent), for an adjusted materiality amount of \$820.

Figure 2. Calculated Adjusted Materiality Illustration

Quantified Materiality	\$1,025
Adjustment (less):	(20 percent)
Adjusted Materiality:	\$820

Use of materiality to identify significant amounts becomes more relevant at the account level in the books and records, which make up cost elements. The higher the level aggregation of costs, the more likely that the cost will be selected.

The table below illustrates the practical application of materiality at lower levels of cost in the books or records, or at the account level. The quantified materiality is compared to the cost elements rather than the account level (as indicated by *N/A*), whereas adjusted materiality is compared at the account level (as indicated by *N/A* at the cost element level). Please note that, even if the direct material cost element is greater than quantified materiality, it may not be necessary to test each account in the cost element.

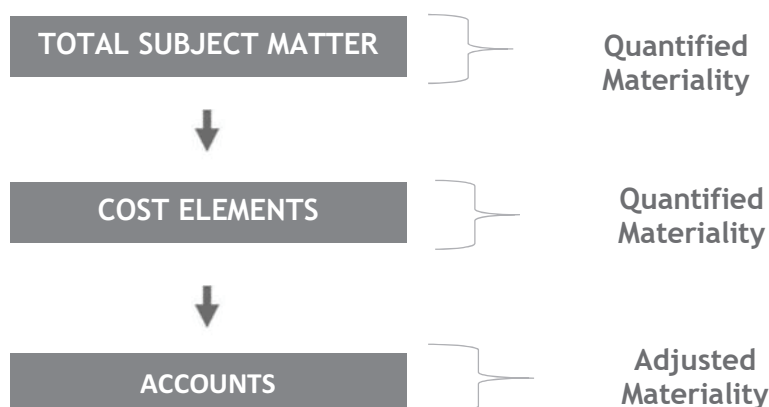
Application of adjusted materiality at the account level identifies three of the six accounts as being material and, thus, needing to be tested. The body of work necessary to support an audit is generally met when an auditor tests cost elements and accounts with values greater than quantified or adjusted materiality. Cost elements and accounts with balances below adjusted materiality (i.e., those with a *NO* response below) may still be subject to testing based on an auditor's judgment, risk factors, qualitative factors, or variability.

Table 7. Application of Materiality at Lower Levels of Cost

Category	Description	Amount	> Materiality \$1,025	> Adjusted Materiality \$820
Subcontracts	Cost Element	\$750	NO	N/A
Direct Materials	Cost Element	\$5,000	YES	N/A
Direct Materials Acct X1	Account	\$850	N/A	YES
Direct Materials Acct X2	Account	\$450	N/A	NO
Direct Materials Acct X3	Account	\$980	N/A	YES
Direct Materials Acct X4	Account	\$500	N/A	NO
Direct Materials Acct X5	Account	\$350	N/A	NO
Direct Materials Acct X6	Account	\$1,870	N/A	YES

Think of it as follows:

Figure 3. Application of Materiality at Lower Levels of Cost



An auditor may combine accounts of the same or substantially similar nature when applying adjusted materiality. For example, a contractor records engineering labor in separate general ledger accounts by project, but the combination of these accounts results in a homogenous amount that is subject to the same audit criteria. Although the contractor separated these like costs into separate accounts for operational or cost accounting purposes, an auditor may combine them for assessing adjusted materiality and testing purposes if that approach makes sense for the audit.

Step 4: Statistical Sampling and Consideration of Tolerable Error Based on Adjusted Materiality

An auditor may use adjusted materiality when determining the tolerable misstatement (or tolerable error) for statistical sample size determination.

An incurred cost audit cannot be completed *effectively and efficiently* by testing 100 percent of all transactions in the subject matter. For this reason, the auditing profession uses statistical sampling to test a representative portion of a transaction population that is sufficient to determine whether the total population is fairly stated.

Although statistical sampling techniques are outside the scope of the document, an important element of statistical sampling is *tolerable misstatement*. Tolerable misstatement represents the total amount of error an auditor is willing to accept in the statistical sample. When auditors use statistical sampling, they are incorporating materiality into the audit. See the AICPA Statistical Sampling guide for additional information.

There is an interrelationship between adjusted materiality, tolerable misstatement, and audit sampling. By using adjusted materiality (converted to a percentage of the transaction population value) as tolerable misstatement, statistical sample sizes will be commensurate with the size of the population in relation to the overall subject matter, audit risk, and materiality. The higher the tolerable misstatement, the lower the sample size.

In practice, an auditor will remove transactions greater than adjusted materiality from the population and test 100 percent of these amounts separately. The remainder of the transactions within the

population would then be subject to the statistical sampling process. If the value of the remaining population (after removing transactions with values greater than adjusted materiality) is less than adjusted materiality, then an auditor may judge it immaterial and forego further statistical sampling. Generally, when the remaining population has an aggregate value greater than adjusted materiality, the transactions will be subjected to audit procedures. This process accounts for the aggregated nature of misstatements to the overall assessment of adjusted materiality.

Steps 5 and 6: Determine the Nature, Timing, and Extent of Audit Procedures; Perform Audit Procedures; Document Results

These steps represent the planning process and fieldwork related to the nature, timing, and extent of audit procedures based on the risk of material misstatement and the Audit Risk Model (inherent risk, control risk, and detection risk), if applicable. The concepts of quantified materiality and adjusted materiality should be considered, as set forth in this chapter, in this part of the audit process.

The auditor should document the basis for materiality and the method of determining materiality.

Step 7: Reporting Audit Results

An auditor can use quantified materiality as a guide for determining the existence of one or more material misstatements when forming an audit opinion, or audit conclusion, on the subject matter. An auditor will summarize all misstatements and compare them individually, and in the aggregate, to quantified materiality.

For example, in the instances of an attestation engagement if the aggregate amount of identified misstatements is less than quantified materiality, then an auditor may issue an unqualified opinion provided, however, that no *quantitatively immaterial* misstatements are *qualitatively material*. If the aggregate of all misstatements is greater than quantified materiality, or if one or more misstatements are qualitatively material, an auditor will issue a qualified or adverse opinion, as applicable. This same process can be used to evaluate scope limitations and disclaimer of opinion.

A few key points for attestation engagements include the following:

- If misstatements individually or in the aggregate exceed quantified materiality, they will result in a qualified opinion, but not necessarily an adverse opinion. An adverse opinion is appropriate if material misstatements are so pervasive that the subject matter, taken as a whole, is not reliable.
- The dollar value of some misstatements may be greater than the value of the underlying misstated transaction. For example, a misstated direct labor cost may draw allocable indirect costs. In this instance, an auditor should evaluate the fully-absorbed value of the misstatement relative to quantified materiality.
- The dollar value of some misstatements may be less than the value of the underlying misstated transaction. Indirect cost misstatements should be adjusted for participation percentages to normalize the amount to account for the proportion of the cost that is allocated to a contractor's work outside of the engagement subject matter. For example, an auditor identifies a \$500,000 misstatement in an indirect cost pool with a government participation percentage of 20 percent.

The actual effect of the misstatement on the engagement subject matter (i.e., indirect costs allocated to the government contracts) is \$100,000 (\$500,000 * 20 percent). In this instance, an auditor should evaluate the value of the indirect cost misstatement, after adjustment for government participation, relative to quantified materiality.

- Although qualitative factors are discussed below, it is important to emphasize that some misstatements may be considered material and affect the audit opinion regardless of dollar value.

Quantified materiality is based on the presumption that misstatements, individually or in the aggregate, that exceed that amount would influence the judgment of a reasonable person using the audited financial information with knowledge of the uncorrected misstatements.

An auditor’s assessment of materiality requires consideration of both quantitative and qualitative factors in the context of the *total mix* of information available to the users of the audited financial information. As a result, qualitative factors, such as the existence of expressly unallowable costs or evidence of irregularities, could be material facts within the *total mix* of information regardless of dollar value.

The following table sets forth examples of qualitative considerations unique to incurred costs audits that may result in quantitatively immaterial misstatements being considered material and, in turn, affect the audit opinion or audit conclusion. The information below is intended to be illustrative of relevant qualitative factors, rather than exhaustive.

Table 8. Examples of Qualitative Considerations Unique to Incurred Costs Audits

Qualitative Factor	Explanation
Expressly Unallowable Indirect Costs	According to FAR 52.242-3, the inclusion of expressly unallowable indirect costs, when identified, explicitly contradicts the contract terms and subjects the contractor to penalties. The pervasive existence of this form of misstatement creates a higher level of sensitivity and risk when reporting audit results. The determination of a material misstatement is at the auditor’s judgment, but generally these misstatements should be evaluated for materiality with less emphasis on the quantified materiality.
Specific Contract Terms	The audit criteria applicable to audits of incurred costs represent contract terms that incorporate specific elements of the FAR, CAS, and so forth. In addition to these regulations, certain contracts may have unique clauses, such as cost limitations on certain activities and the disallowance of certain types of costs such as overtime. Because these unique clauses establish the specific desires of a particular government customer, quantitatively immaterial but pervasive misstatements in this regard may be viewed as material to that customer.

Other relevant qualitative factors may relate to the audit subject matter and the needs of the acquisition community. For example, a contractor may have significant restructuring costs, purchase accounting for an acquisition, overseas operations, or other issues that have qualitative considerations that differ from the ones identified above but are just as relevant. The nominal reporting amount can be considered for reporting misstatements due to qualitative factors.

Step 8: Report or Communicate Misstatements

The auditor should report or communicate, as appropriate, both material and immaterial misstatements to the contracting officer in accordance with Government Auditing Standards (FY 2018 Yellow Book, paragraphs 7.46 and 9.38):

When auditors detect instances of noncompliance with provisions of laws, regulations, contracts, and grant agreements that do not warrant the attention of those charged with governance, the auditors' determination of whether and how to communicate such instances to audited entity officials is a matter of professional judgment.

For incurred cost audits, the need for communicating immaterial information is important because it can result in the transfer of funds between the contractor and government. For example, \$5,000 of questioned direct cost not only may impact the audit opinion or conclusion, but also represents an amount that may be recovered by the government. These amounts should be communicated to the contracting officer to facilitate appropriate disposition.

CHAPTER 3: AUDITS OF INTERNAL CONTROL OVER GOVERNMENT CONTRACT COMPLIANCE

Government Perspective on the Importance of Internal Controls

For government officials to manage programs and contracts effectively, they must be able to rely on information produced by the contractor. The ability of contractors to produce materially accurate information depends on the design and operating effectiveness of their business system internal controls. Without internal controls, it could be difficult for contractors to produce reliable and timely information. Although no internal control system can provide absolute assurance that the information will never include material errors or misstatements, an effective system of internal controls over contractor business systems can substantially reduce the risk of error and misstatements.

Obtaining timely assurance that contractors have effective internal controls is an essential component of all cost-effective compliance frameworks. Consideration of how recently a business system audit was performed and the results is a critical part of the DoD's own system of acquisition internal controls. Effective contractor internal controls permit most additional audits and reviews to be performed more efficiently and timely. Obtaining assurance about internal controls effectiveness is one of the most efficient ways to protect the Government's interest, reduce risk, and improve timeliness.

Defining Internal Controls

Internal controls are the responsibility of the contractor. The auditor will test the internal controls and provide an opinion, or conclusion, on whether they are suitably designed and operating effectively.

Internal controls are defined as a process, affected by the entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.⁹ This definition emphasizes the achievement of objectives. For companies or organizations with Government contracts, the objective is to bill, or report, contract costs in compliance with contract terms and federal regulations. The relationship between objective, risks, and internal controls is as follows:

- An objective defines what the contractor wants to achieve,
- A risk represents a situation, circumstance, or event that the contractor wants to avoid (i.e., an occurrence that results from not achieving the objective), and
- Internal control activities are procedural steps designed and performed to prevent, or detect and correct, the occurrence of a risk such that the objective is achieved.

An internal control framework should generally address five components: control environment, risk assessment, control activities, information and communication, and monitoring activities. However, the extent of implementation by the contractor is dependent on size and complexity and is explained in greater detail in the subsection on Internal Controls Frameworks. These components are introduced in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control—

⁹ The Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control—Integrated Framework (May 2013)

Integrated Framework (May 2013) framework and have been recognized and accepted by the AICPA, and the Government Accountability Office.

The only way to determine if internal controls are suitably designed and operating effectively is to test them. It is not appropriate to presume that a contractor has effective internal controls based on the results of audits that do not test internal controls. The existence of a material misstatement in an audit of contract costs does indicate an internal control deficiency. However, the converse is not true. The absence of a material misstatement does not provide the requisite assurance regarding the effectiveness of a contractor's systems and internal controls. The severity of an internal control deficiency is determined by assessing the likelihood that it will result in a material misstatement and is not contingent on whether a material misstatement has occurred. While the contractor may bill or report costs that comply with contract terms in any one period, if the contractor's internal controls are ineffective, the internal controls cannot provide reasonable assurance that a material mistake, fraud, or management override will be prevented or detected and corrected timely. An accounting system that lacks effective internal controls has a greater likelihood of billing or reporting costs that are not compliant with contract terms and federal regulations.

Internal Control Frameworks

The type of internal control framework and the extent of adoption is at the discretion of the contractor. The Committee of Sponsoring Organizations (COSO) of the Treadway Commission has developed an Internal Control—Integrated Framework (May 2013) which has gained broad acceptance in the private sector and is widely used around the world. The federal government has developed a similar framework that adapts the COSO Internal Control – Integrated Framework principles and addresses the unique government environment in the *Standards for Internal Control in the Federal Government* (GAO-14-704G), which is commonly referred to as the *Green Book*.

An internal controls framework assists management, board of directors, external stakeholders, and others interacting with the entity in their respective duties regarding internal control without being overly prescriptive. It does so by providing both understanding of what constitutes a system of internal control and insight into when internal control is being applied effectively¹⁰. For accounting system audits related to government contract costs, the auditor does not test the internal controls framework, but rather, tests the internal controls. Regardless, it is important to acknowledge the fact that the internal controls and framework are, by definition, inter-related and a poorly implemented framework may result in ineffective internal controls.

Whether or not a contractor adopts an internal control framework often relates to a contractor's size and complexity. Contractors design and implement control activities relative to their own risks, size, complexity and other relevant factors. For example, a large public company may have adopted an internal control framework (e.g. COSO) to define and meet its control objectives. In contrast, a smaller company with less complex operations may not be aware of formal internal control frameworks, but nevertheless have internal controls commensurate with its size, complexity, and other relevant factors. Auditors are encouraged to understand the contractor's business, the environment in which it operates, the software systems it uses for accounting purposes, how accounting-related business processes are

¹⁰ COSO Internal Control – Integrated Framework, Executive Summary, May 2013

performed, and the contractor's employees either responsible for or participating in those processes. This chapter creates no requirement that the contractor adopt the COSO or any other internal controls framework.

For every contractor, regardless of size, each component of an internal control framework (e.g. control environment, risk assessment, control activities, etc.) will likely be reflected in the manner by which management runs its business (regardless of whether or not management has consciously or formally adopted an internal control framework). Because every business is unique, the auditor should approach an internal control audit using an internal control framework as a means to understand each contractor's unique accounting system controls. Auditors should not expect contractor internal controls to function identically or even at the same level for every company.¹¹

Concept of Reasonable Assurance

The contractor is responsible for designing and operating effective business processes and internal controls to, provide reasonable assurance that the cost information is reliable and complies with contract terms and federal regulations, as applicable. The concept of "reasonable assurance" recognizes that the cost of achieving greater assurance will, at some point, exceed the benefit of the higher assurance. This concept is acknowledged in the Federal Acquisition Regulation Guiding Principles¹². The concept of reasonable assurance as it relates to systems of internal control also recognizes that it is not possible to declare with absolute certainty that an error or misstatement will not occur. For example, the system is operated by people and people inevitably make mistakes, systems breakdown, and organizations change. In addition, intentional misconduct, like fraud and collusion, can prevent controls from working as intended regardless of how well the controls were designed.

For the auditor, evaluating whether or not a contractor's accounting system internal controls provide reasonable assurance is inherently dependent on each contractor's unique facts and circumstances. In this regard, Public Company Accounting Oversight Board's (PCAOB) definition of reasonable assurance is instructive. In the context of an internal control audit over financial reporting, reasonable assurance means that there is a remote likelihood that material misstatements will not be prevented or detected and corrected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. This concept can be applied to audits of contractor accounting system internal controls relative to the criteria contained in DFARS 252.242-7006, Accounting System Administration.

Contractor Internal Controls

The internal controls and business processes are the responsibility of the contractor. This section is designed to provide information on certain aspects of the contractor's internal controls and the scaling of risk.

The objective of the accounting system is to record, accumulate, and summarize financial transactions related to financial reporting, performance reporting, and government contracts (i.e. costs comply with

¹¹ COSO Internal Control over Financial Reporting – Guidance for Smaller Public Companies, dated June 2006

¹² FAR 1.102-2(c)(2), "To achieve efficient operations, the [Federal Acquisition] System must shift its focus from "risk avoidance" to one of "risk management." The cost to the taxpayer of attempting to eliminate all risk is prohibitive."

contract terms and federal regulations). This objective statement is broad and refers to the entire accounting system. The accounting system includes many different types of costs (e.g. labor, materials) that represent different operational activities and distinct business processes. For example, the business processes and internal controls for labor cost are different when compared to other cost elements such as travel.

Contractor Objectives and Business Processes

The contractor will design and implement business processes that achieve operational and financial objectives. The accounting system, as defined at DFARS 252.242-7006, is the collection of accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions.

The accounting system should be designed to meet the contractor's objectives and incorporate the necessary internal control activities to reasonably assure that those objectives are met. Whether the contractor's accounting system is already established, or is in the process of being newly implemented, the following diagram illustrates how to evaluate a business process and identify its internal controls.

Figure 4. Evaluating a Business Process and Identifying Internal Controls



- ***Objectives:*** Through business process walkthroughs and inquiries, the auditor identifies the contractor's objectives related to operations, reporting (e.g., financial statements, incurred cost proposals) and compliance. The overall objective for government contracts is for costs to be billed, or reported, to the government in compliance with contract terms and federal regulations.
- ***Risk Assessment:*** The process for identifying and analyzing risks forms the basis for determining how risks should be managed to achieve the entity's objectives.¹³ The risk assessment process consists of
 - considering the business processes, *or how things are done*,
 - identifying the risks that the objective will not be achieved,
 - estimating the significance of the risks,
 - assessing the likelihood of the risks occurring, and

¹³ Risk Assessment definition from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control – Integrated Framework (2013).

- deciding what actions to implement to address those risks.
- ***Internal Control Activities:*** The contractor will implement internal control activities based on the risk assessment and business process to mitigate the risk of not meeting the objectives.

Contractor Objectives for Government Contracts and Scaling of Risk

In simplified terms, risk is the inverse of an objective. The following are the different categories of risk from the perspective of the accounting system:

- ***Accounting System Criteria and Risk:*** The Accounting System Criteria represents the overall objectives of an accounting system. The associated risk, or the potential for not meeting these objectives, is global across the entire contractor for government contracts and applicable to every cost element billed or reported to the Government.
- ***Process Objectives and Risks:*** Process risks are defined at the process level. They are based on the Accounting System Criteria but defined in the context of the costs and business process.

The Accounting System Criteria are the benchmarks used to measure whether the objective has been achieved. If the system has implemented internal controls that mitigate the risks of the Accounting System Criteria not being met, the contractor and the government can state the system was suitably designed to mitigate the risks of noncompliance with the overall objective.

The following table shows the interrelationship among the objective, Accounting System Criteria, and the risks of not achieving the objective:

Table 9. Interrelationships among Objective, Accounting System Criteria, and Risk of Not Achieving Objective

Accounting System Criteria	Risk
(1) Classification of direct costs and indirect costs in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Contract costs are not properly classified as direct and indirect in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(2) Identification and accumulation of direct costs by contract in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Direct contract costs are not identified and accumulated to the correct contract in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(3) Methods to accumulate and allocate indirect costs to contracts in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Indirect costs are not accumulated and allocated to contracts in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(4) General ledger control accounts that accurately reflect all transactions recorded in subsidiary ledgers or other information systems that either integrate or interface with the general ledger including, but not limited to, timekeeping, labor cost distribution, fixed assets, accounts payable, project costs, and inventory.	The general ledger does not reflect transactions recorded in subsidiary ledgers or other information systems that integrate or interact with the general ledger.
(5) Adjustments to the general ledger, subsidiary ledgers, or other information systems bearing upon the determination of contract costs (e.g. adjusting journal entries, reclassification journal entries, cost transfers, etc.) for reasons that do not violate contract terms, FAR, CAS, and other regulations, as applicable.	Adjustments made to the general ledger from whatever source violate contract terms, FAR, CAS, or other regulations, as applicable.
(6) Identification and treatment of unallowable costs in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Unallowable costs are not identified in the accounting system and not properly resolved in accordance with contract terms, FAR, CAS, or other regulations, as applicable.
(7) Billings prepared in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Billings are not prepared in accordance with contract terms, FAR, CAS, or other regulations, as applicable.
Objective: The contractor bills and reports costs that comply with contract terms and government regulations such as FAR and the CAS, if applicable.	

To implement internal control activities, the risks must be defined and understood in the context of the business processes and costs. Business processes and internal controls are designed to mitigate the risks of noncompliance with the Accounting System Criteria. The level and nature of the documentation will vary based on the size of the contractor and the complexity of the control.

Contractor Risk Assessment and Internal Control Activities

This section refers to contractors' assessment of risk and the implementation of internal controls for their own processes. The auditors' risk assessment process, performed as part of the internal controls audit, is different and discussed in a section below.

Contractors are responsible for assessing risk and implementing internal controls to address those risks. The risk assessment links global risks of not meeting the Accounting System Criteria to business processes, process risk, and internal control activities. If contractors have documented risk assessment

to meet the criteria of the accounting system, this may be useful to the auditor and should be requested. The risk assessment process, formality, and its associated documentation is at the discretion of the contractor. It is possible for a contractor to have effective internal controls without formally documenting a risk assessment.

A common method used in the risk assessment process is to ask the question, *What can go wrong?* in the context of the government risks and the accounting system. The basis for this question is the inherent in the Accounting System Criteria for government contract risk. When contractors design the business process, this question may be asked, and the internal control activities designed to mitigate the risk. Likewise, auditors will follow a similar process when evaluating design of contractors' internal controls, but it is important to make the distinction that business processes and internal controls are the sole responsibility of contractors. Auditors' role is to evaluate the effectiveness of contractors' internal controls in mitigating the risks. The internal controls audit is a useful tool for the contractor in determining whether the internal controls are sufficient.

An internal control activity is defined as an action established through policies and procedures that helps ensure management's goal of achieving its objectives and mitigating the risks is attained.

There are different types of internal control activities:

- Manual internal control activities are performed by the contractor personnel using the software application or on hard copy documents; for example, the review and sign-off of a journal entry.
- Automated internal control activities are imbedded in software applications used to process business transactions. For example, the feature in the timekeeping system that limits the charge codes to certain personnel based on work location and position title.
- Manual and automated internal control activities can be either preventative or detective in design and operation.
- Information Technology General Computer Controls, which apply to many applications affect compliance with the Accounting System Criteria and internal controls.
- If contractors outsource a significant business process, such as processing payroll or another service, the internal controls over this service should be evaluated as part of the overall internal controls assessment.
- Entity-level controls function at higher levels in the organization; are generally not process or cost element specific; and include controls over the control environment, monitoring, and controls over management control. For example, a business unit general manager reviews actual indirect cost rates compared to provisional indirect rates.
- Process-level internal control activities are designed and placed in operation at the business process and cost element level. For example, the review and approval of a timesheet is a process level internal control for the labor cost element.

Auditors and Testing of Internal Controls

The objective of an internal controls audit of the accounting system is to determine if internal controls are effective in mitigating the risk of the noncompliance with contract terms and federal regulations. The audit subject matter is the contractor internal controls related to government contract risk and the audit criteria is defined by the Accounting System criteria.

The definition of the accounting system is broad and includes all costs that are recorded, accumulated, and reported (i.e. billed to government contracts) by the contractor, but this does not mean the auditor must test every aspect of the contractor accounting system:

- The auditor should focus on the government contract compliance risks (i.e., Accounting System Criteria).
- The auditor should focus on testing the internal controls related to material, or significant, cost elements.
- The auditor should test the internal controls that are the most effective at mitigating the risks of noncompliance. These are generally referred to as *key internal controls*.

Additionally, considering internal control in the context of a comprehensive internal control framework, such as Standards for Internal Control in the Federal Government or COSO Internal Control—Integrated Framework can help auditors to determine whether underlying internal control deficiencies exist as the root cause of findings.¹⁴

During the planning phase of the audit, the auditor should obtain an understanding of the significant cost elements billed, or reported, through the accounting system and associated contractor business processes and internal controls. The auditor should request the contractor risk assessment (if available) and discuss with the contractor. Significant cost elements are determined based on dollar value (quantitative), qualitative characteristics, or importance to the contracting officer.

The contractors accounting system and business processes may be complex. The top-down approach can be used in the planning phase of the audit to align auditors' efforts with significant costs to the government. The approach begins with the identification of significant cost elements in the contractor billing or final indirect cost rate proposal (e.g., incurred cost proposal). For each significant cost element, auditors focus on the entity-level controls and works down to the accounts, business processes, and process-level controls. The auditor verifies his or her understanding of the risks and business processes to address the risk of material noncompliance. This process is a holistic approach to internal controls in which auditors focus on the total process and other mitigating controls. It also allows for auditors to consider the materiality of the cost element and potential error when determining the severity of the internal control deficiency.

For a cost element, auditors obtain an understanding of the process and internal control activities by performing a walkthrough which traces the transactions through the accounting system. This

¹⁴ GAO, Auditing Standards revision 2018, paragraph 8.130.

walkthrough includes noting the reason for an action to record the cost, performance of the action that creates the costs, a description of how the action and the associated cost is tracked, and the internal control activities. The walkthrough is typically performed in the planning phase of the audit and is documented in a sequential order from the initial transactions to the accumulation of the cost on the books and records and can include multiple policies and procedures.

Not all internal controls are equal in importance. Auditors should identify key internal controls for each cost element and associated business process. Key internal controls are the primary means for providing reasonable assurance that contract costs comply with contract terms and federal regulations. If the key internal controls are designed and functioning, then the risks should be mitigated. In contrast, if the key internal controls are not functioning, then the compensating internal controls should be tested to ensure the risk is mitigated (mitigating internal controls). Every business process will have key and non-key internal controls. From an audit perspective, it is generally acceptable to only test key internal controls if the key controls are suitably designed and functioning.

Auditors should develop audit procedures to test the design and functioning (referred to as operating effectiveness in the attestation standards) of internal controls aligned with each of the accounting system criteria:

- **Internal Control Design:** The auditor should test the design effectiveness of controls by determining whether the contractor's controls, if they were operated as designed by persons possessing the necessary authority and competence to perform the control effectively, would satisfy the company's control objectives and effectively prevent or detect errors or fraud that could result in material noncompliance.
 - Procedures auditors perform to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.
- **Internal Control Operation:** Auditors should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.
 - A smaller, less complex contractor might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex contractor might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, auditors should evaluate whether those alternative controls are effective.
 - In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to government contract costs.

- Procedures auditors perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and reperformance of the control.

Contractor may have internal controls tested by different auditors during the year, such as financial statement auditors, internal auditors, and government auditors. The auditor performing the business system audit (the *primary* auditor) may use the work of other auditors; doing so can increase audit efficiency, and may reduce the contractor compliance burden, but has limitations. The primary auditor has the sole responsibility for the opinion, or conclusion expressed, and that responsibility is not reduced by using the work of other auditors. The primary auditor should determine that the work performed by others is sufficient and appropriate for use in the audit. The other auditors must be independent of the subject matter, competent, and objective. The mere fact that other auditors performed internal control testing does not automatically imply that the work can be used by the primary auditor. See the AICPA Professional Standards, *Standards on Attestation Engagements*, and GAO, Government Auditing Standards 2018 revision, for additional information on using the work of others.

Hierarchy of Internal Control Deficiencies

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct (a) impairments of effectiveness or efficiency of operations, (b) misstatements in financial or performance information, or (c) noncompliance with provisions of laws, regulations, contracts, or grant agreements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.¹⁵

A misstatement represents information provided to the government that does not comply with contract terms and applicable federal regulations, such as the FAR and CAS. A material misstatement could reasonably be expected to influence, and may adversely affect, the economic or management decisions of information users. A material misstatement will normally result in a material noncompliance because all misstatements are due to a noncompliance with contract terms or federal regulations. A *material noncompliance* is defined as:

A misstatement in the information provided to the Government (e.g. billings, incurred cost submissions, pricing proposals, etc.) that will materially influence, and may adversely impact the economic or management decisions of the users of the information.

For a compliance audit designed to test specific system related criteria, a deficiency can occur due to either internal control deficiencies or system shortcomings. A shortcoming pertains to a noncompliance

¹⁵ Paragraph .07 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, AU-C sec. 265).

with system criteria, and not necessarily internal controls, although it is unlikely one would exist without the other. For accounting systems, internal control deficiencies are categorized by severity as material weakness, significant deficiency, and other deficiency. The categorization is irrespective of the type of engagement (e.g., attestation, inspection) that is performed to test internal controls or compliance with a specific system criterion. The system deficiencies are as follows:

- **Material Weakness:** A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliance or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.
- **Significant Deficiency:** A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.
- **Other Deficiency:** A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that have a clearly trivial, or inconsequential, effect on the ability of the business system to detect and correct errors on a timely basis.

The *other deficiency* definition acknowledges the possibility that a system deficiency, or combination of systems deficiencies, may have a clearly trivial effect on the quality of information produced by the contractor's business system. Clearly trivial represents the inverse of *material* whether judged by any criteria of size, nature, or circumstances. Other deficiencies will not affect the audit opinion or conclusions and will not be included in the audit report. These deficiencies may be communicated to contracting officers using email or other communication methods.

Not all deficiencies rise to the level of a material weakness. Auditors should evaluate the deficiency in the context of the overall system, materiality, whether it is systematic or pervasive, and the existence of mitigating controls. These factors are described below:

- **Materiality:** To be a material weakness, the internal control deficiency can result in a material noncompliance which could reasonably be expected to influence, and may adversely impact, the economic or management decisions of the users of the information. For example, the auditor identifies several internal control deficiencies in the travel cost process. The travel costs are immaterial in relation to other costs at the contractor and generally represent a small percentage of costs billed or reported. In this instance, the travel costs will never result in a material weakness, because it is impossible for an immaterial cost element to have a misstatement that rises to the level of a material noncompliance. The internal control deficiencies should be evaluated for categorization as a significant deficiency or other deficiency.
- **Systematic and Pervasive:** One of the factors in determining whether a system deficiency is material depends on whether it is systematic or pervasive. Some internal control deficiencies

have a limited impact to one or only a few cost elements and will not result in a material noncompliance. When the control deficiency affects only one type of cost (e.g., labor or material cost), the severity is evaluated based on the materiality of that specific cost element. Another factor is the frequency of occurrence based on whether the root cause of the deficiency represents a unique situation or one that occurs frequently.

- **Mitigating Controls:** If the auditor discovers an internal control deficiency, the next step is to determine if there are other controls that are designed and in operation to mitigate the risks related to the deficient internal control. If this is the case, the severity of the internal control deficiency should be evaluated against the existence of other internal controls and may be determined as having no impact on the overall system.

Reporting Requirements for Internal Control Deficiencies

Contracting officers will use internal controls audit results to determine if the accounting system is approved or disapproved. The key factor in this determination is whether the business system is acceptable and materially complies with the Accounting System Criteria. An acceptable business system is defined as a contractor business system that materially complies with the criteria of the applicable business system clauses and does not contain a material weakness that would affect the ability of DoD officials to rely on information produced by the system.

When auditors identify findings, they should plan and perform procedures to develop the criteria, condition, cause, and effect of the findings to the extent that these elements are relevant and necessary to achieve the audit objectives.¹⁶ The report should provide enough information to allow the contracting officer to make an informed decision. Stating something is wrong and providing no supporting information is not sufficient. Contracting officers need to be informed of the finding, but the cause and effect provide the information necessary to determine the next course of action. The effect takes into account materiality, whether the finding is systematic or pervasive, and mitigating controls. The following provides a summary of the report note elements:

- **Criteria:** The Accounting System Criteria (see above) applicable to the overall accounting system and significant cost elements. Criteria identify the required or desired state or expectation with respect to the program or operation and provide a context for evaluating evidence and understanding the findings, conclusions, and recommendations in the report. For internal controls, the criteria should be framed in the context of the cost element, business process, and accounting system criteria.
- **Condition:** The condition is a situation that exists and is discovered during the audit. For a system deficiency, the condition is due to either internal controls or other shortcomings in the system. For example, the auditor sampled 50 invoices for evidence of an approval control and identified 10 out of 50 as lacking approval.
- **Cause:** The cause is the factor or factors responsible for the deficiency. For internal controls, the cause can be due to the design or operation, and for shortcomings the cause could be due to a

¹⁶ GAO, FY 2018 Yellow Book, paragraph 7.19

noncompliance with a prescribed contract term or a deviation in the contractors documented policy and procedures. The cause is the factor or factors responsible for the difference between the condition and the criteria, and may also serve as a basis for recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria and inconsistent, incomplete, or incorrect implementation.

- ***Effect or Potential Effect:*** The effect or potential effect is the outcome or consequence resulting from the difference between the condition and the criteria. The severity of the system deficiency as a material weakness, significant deficiency, or other deficiency is correlated to the effect or potential effect. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

APPENDIX A: CONSIDERATION OF MATERIALITY AND INDIRECT COSTS

Indirect costs are allocated to contracts by using indirect cost rates, which represent a pool of indirect costs divided by a cost base of a contractor's direct and/or indirect activities. Indirect costs are, by definition, costs that cannot be directly allocated to contracts. A contractor's final indirect cost rate proposal (i.e., incurred cost proposal) contains several schedules that identify these pools and bases.

Participation Percent: Because indirect costs are not directly charged to contracts, they are allocated over a base of costs representing business activities that may include a mix of commercial and competitively award fixed price work, as well as flexibly-priced government contracts. Therefore, the indirect costs allocated to flexibly priced government contracts may be less than the total amount of the respective indirect cost pool(s). The participation percentage for each final indirect cost pool reflects the proportion of flexibly-priced government contract activity within the allocation base to the total of all activity in the allocation base. For example, if a general and administrative (G&A) cost base is \$1,000,000 and the cost of activity on flexibly priced government contracts is \$100,000 of the base, then the participation percent is 10 percent ($\$100,000/\$1,000,000$). This affects the audit approach for indirect costs because adjusted materiality should take into account the participation percent.

See the FAR and CAS for additional information on indirect costs and rates.

The following steps should be followed by an auditor when calculating adjusted materiality for indirect costs:

- The auditor will calculate quantified materiality and determine whether the indirect cost elements are significant.
- From the perspective of quantified materiality, the significance of indirect costs is based on the contribution of those costs to the total subject matter.
- If the specific indirect cost element is immaterial, then the auditor may perform limited procedures.

The example below includes direct and indirect cost elements with a total subject matter amount of \$8,219,400. The subject matter amount is the summation of all costs direct and indirect. Quantified materiality is calculated using the total subject matter and the materiality formula in this chapter, which results in a benchmark of \$136,490, or 1.66 percent of the subject matter ($\$136,490/\$8,219,400$). An auditor will compare the quantified materiality to the cost elements and determine whether they are significant. Using this approach, the cost elements of direct labor, subcontracts, overhead indirect costs, and G&A costs are considered quantitatively material. Note, an auditor may still consider certain quantitatively immaterial cost elements to be material based on their professional judgment concerning risk and qualitative factors.

Figure 5. Example with Indirect Costs

Incurred Cost Proposal		> Materiality \$136,490 (YES/NO)
Direct Costs:		
Direct Labor	\$ 5,000,000	YES
Direct Materials	\$ 100,000	NO
Other Direct Costs	\$ 80,000	NO
Subcontracts	\$ 1,000,000	YES
Indirect Costs:		
Overhead	\$ 1,112,400	YES
General and Administrative	\$ 927,000	YES
Total Subject Matter:	\$ 8,219,400	
Materiality Threshold:	\$ 136,490	

For the calculation of adjusted materiality, an auditor should revise quantified materiality for the indirect costs 'participation percent' to identify significant accounts. The table below compares the costs allocated to flexibly priced government contracts (i.e., subject matter) to the total costs in the pool, which, when divided together, yields the participation percent.

Table 10. Comparison of Costs Allocated to Flexibly Priced Government Contracts

Indirect Costs:	Total Subject Matter	Total Cost in Pool	Participation Rate
Overhead	\$1,112,400	\$11,124,000	10%
General and Administrative	\$927,000	\$11,587,500	8%

Based on the above calculation the government participation percent for overhead costs is 10 percent and G&A costs is 8 percent. An auditor may now revise the quantified materiality for the participation percent. This aligns the materiality for the engagement to the total cost in the pools. Because the government participates in these pools, 10 percent and 8 percent, respectively, misstatements (individually or in the aggregate) in the overhead and G&A pools would have to exceed \$1,364,898 and \$1,706,122, respectively, to yield a \$136,490 misstatement on flexibly priced government contracts.

Table 11. Revised Materiality Calculations

Indirect Costs:	Participation Percent	Materiality	Revised Materiality
Overhead	10%	\$136,490	\$1,364,898
General and Administrative	8%	\$136,490	\$1,706,122

The revised materiality amount for the overhead cost is calculated by dividing the quantified materiality of \$136,490 by 10 percent. The revised materiality amount for general and administrative cost is calculated by dividing the quantified materiality of \$136,490 by 8 percent.

- Calculate adjusted materiality using the revised quantified materiality (see above) and in the same manner as Step 3 of the Engagement Materiality Framework. The adjusted materiality will be used for the identification of significant accounts that comprise the indirect cost rate pool.

The following example uses a reduction of 20 percent to calculate adjusted materiality.

Table 12. Materiality Adjusted by 20 Percent

Indirect Costs:	Revised Materiality	Adjustment	Adjusted Materiality
Overhead	\$ 1,364,898	20%	\$ 1,091,918
General and Administrative	\$ 1,706,122	20%	\$ 1,364,898

- Based on adjusted materiality, determine which accounts are quantitatively material. Evaluate the accounts for factors such as risk, qualitative factors, and variability. Determine the nature, timing, and extent of testing.

The following example compares the adjusted materiality amount of \$1,091,918 to accounts in the overhead cost pool. This illustration lists only three accounts of many. Based on adjusted materiality, only the labor account is considered significant. The process for the general and administrative accounts is the same as the overhead accounts.

Table 13. Comparison of Adjusted Materiality to Accounts in Overhead Cost Pool

Overhead Pool Accounts		Amount	> Adjusted Materiality (YES/NO)
6001	Labor	\$ 3,000,000	YES
6002	Operating Supplies	\$ 900,000	NO
6003	Computer & Data Process Supply	\$ 100,000	NO
XXXX
		\$ 11,124,000	

Auditors are responsible for determining the nature, timing, and extent of audit procedures for the labor account. Note, auditors may consider accounts less than adjusted materiality to be significant based on their professional judgment of risk and qualitative factors.

APPENDIX B: TOTAL SUBJECT MATTER

From an audit perspective, the total subject matter is defined as the information on which the auditor provides an opinion (i.e., assurance) or conclusion. For incurred cost audits, the subject matter is defined as cost claimed on flexibly priced contracts during the year and includes different categories of cost such as labor, materials, other direct costs, and indirect costs. For time and material (T&M) contracts, the definition of flexibly priced contracts includes the material portion, but it is not uncommon to test both materials and labor (e.g., labor categories and labor hours) as part of the incurred cost audit due to audit efficiency.

Section 803 of the FY 2018 NDAA, defines *flexibly priced contract* the same as the term *flexibly-priced contracts and subcontracts* in FAR Part 30 (Section 30.001 of Title 48, CFR).

Total subject matter generally includes the following:

- The direct and indirect cost of flexibly priced prime contracts and subcontracts awarded by DoD.
- The direct and indirect costs of flexibly priced prime contracts and subcontracts awarded by an agency other than DoD and the agency has agreed to the audit.
- The amount billed on prime T&M contracts that are awarded by DoD.
- The amount billed on prime T&M contracts that are awarded by an agency other than the DoD and the agency has agreed to the audit.

Total subject matter generally excludes the following:

- The direct and indirect cost of flexibly priced contracts and subcontracts awarded by agencies other than DoD that have not agreed to the audit.
- The amount billed for prime T&M contracts awarded by agencies other than DoD that have not agreed to the audit.
- Amounts for contracts that are not flexibly priced such as firm-fixed-price contracts.
- Amounts for nongovernment activity such as commercial activities.

June 12, 2019

COFC Decision on Offsetting Impact of Cost Accounting Practice Changes Paves the Way for Pre-Award Protests

Advisory

By Paul E. Pompeo, Sonia Tabriz

The Boeing Company v. United States, Civil No. 17-1969C (May 29, 2019) reveals the Court of Federal Claims' (COFC) interpretation of the Cost Accounting Standards (CAS) statute as primarily benefiting the government, and directs contractors challenging the Federal Acquisition Regulation (FAR) 30.606(a)(3)(ii) prohibition on offsetting the impact of simultaneous cost accounting practice changes to raise those challenges in a pre-award protest or risk waiver. Importantly, the court's decision could have broad implications, requiring contractors to protest the applicability and interpretation of any extra-contractual FAR provisions—not just those involving the CAS statute—that expound upon a FAR Part 52 contract clause.

Adopting a novel theory rooted in the US Constitution, The Boeing Company (Boeing) filed an action under the Contract Disputes Act (CDA) alleging that the FAR 30.606 offset prohibition is an "illegal exaction" in violation of the CAS statute, which specifically prohibits windfalls to the government resulting from changes to a contractor's cost accounting practices. Boeing also claimed that FAR 30.606 was "extra-contractual" and therefore, should not preclude Boeing from offsetting changes that increase costs to the government from those that decrease costs. The COFC dismissed Boeing's constitutional claim for lack of subject matter jurisdiction and concluded that Boeing had effectively waived its contract claims upon failing to raise them in a pre-award protest or during negotiations with the government.

The History of FAR 30.606

The long-accepted practice for determining the cost impact of multiple changes in cost accounting practices was to offset negative impacts against any positive benefit to the government. Thus, offsetting cost impacts could result in a reduced or no contract adjustment. Effective April 8, 2005, the FAR Council promulgated FAR 30.606 to address cost impacts under the CAS. FAR 30.606(a)(3)(ii) provides that, when a contractor implements multiple changes at once, the government "[s]hall not combine the cost impacts" of those changes "unless all of the cost impacts are increased costs to the Government." In other words, if a

contractor implements more than one cost accounting practice change and any one of those changes yields decreased costs to the government, the contractor is not permitted to offset the decreased costs against any increased costs when calculating the cost impact and resultant payment due the government.

The Armed Services Board of Contract Appeals (ASBCA) waded into the subject of offsetting both before and after the FAR 30.606 offset prohibition took effect. In *The Boeing Company*, ASBCA No. 57549, 13 BCA ¶ 35427, the ASBCA confirmed that contractors could offset decreased costs to the government against increased costs for other, simultaneous cost accounting practice changes for contracts entered into before the 2005 amendment. The ASBCA concluded that the regulations were previously silent on the subject, and that the practice was to offset. As to those contracts entered into after FAR 30.606(a)(3)(ii) took effect, the ASBCA upheld the validity of the offsetting prohibition. In *Raytheon Company, Space & Airborne Systems*, ASBCA No. 5781, 15-1 BCA ¶ 36024, the contractor argued, among other things, that FAR 30.606(a)(3)(ii) is invalid because it infringes on the CAS Board's exclusive authority to prescribe and interpret cost accounting standards. The ASBCA rejected this argument, characterizing the offsetting prohibition as "more in the nature of contract administration or a policy determination than an accounting issue." Ultimately, the ASBCA resolved all of the issues affecting contracts entered into after April 8, 2005 on other grounds; thus, under the law of the Federal Circuit, that portion of the *Raytheon* decision on the validity of FAR 30.606(a)(3)(i) would be non-precedential dicta. *See, e.g., Nat'l Am. Ins. Co. v. US*, 498 F.3d 1301, 1305 (Fed. Cir. 2007)

Boeing's Most Recent Challenge

Taking note of the ASBCA's position on FAR 30.606(a)(3)(ii), Boeing launched an innovative, constitutional challenge before the COFC, alongside numerous contract claims, contesting its inability to offset simultaneous cost accounting practice changes as memorialized in a contracting officer's final decision on a government claim and the government's rejection of Boeing's claim.

The CAS Statute Benefits the Government, Not Contractors

Boeing first alleged that the government's application of FAR 30.606 constituted an illegal exaction in violation of the US Constitution—specifically, the Due Process Clause of the Fifth Amendment, which prohibits the deprivation of property without due process of law. An illegal exaction arises when money is "improperly paid, exacted or taken from the claimant in contravention of the Constitution, a statute, or a regulation." *Norman v. United States*, 429 F.3d 1081, 1095 (Fed. Cir. 2005). According to Boeing, FAR 30.606(a)(ii)(3) violates the CAS statute, codified in relevant part at 41 U.S.C. § 1503(b), which provides that when a contractor changes its cost accounting practices, "[t]he Federal Government may not recover costs greater than the aggregate increased cost to the Federal Government."

The government successfully moved to dismiss Boeing's constitutional claim on jurisdictional grounds. According to the COFC, there is no rule barring illegal exaction claims accompanying contract claims under the CDA. Nevertheless, the COFC concluded that it had no subject matter jurisdiction over the illegal exaction claim because Boeing failed to establish that its claim was based upon a "money-mandating statute," as Federal Circuit precedent required. The court rejected Boeing's characterization of the CAS statute as mandating the return of windfalls reaped by the government and concluded that there is "no right to bring a claim for monetary damages expressly contained in the statute."

To the contrary, the COFC held that the CAS statute "primarily protects the government," and not contractors. Thus, while a contractor is permitted to challenge the government's compliance with the CAS statute, it cannot assert an illegal exaction in connection with the CAS statute under the US Constitution.

Are Protests the New Frontier for FAR 30.606 Challenges and Beyond?

Boeing's numerous contract claims were also unsuccessful. According to Boeing, FAR 30.606 was "extra-contractual" because it was not incorporated into its contract either in full text or by reference. Thus, Boeing argued that it should not be bound by the offset prohibition. In response, the government raised the affirmative defense of waiver and argued that Boeing cannot challenge the legality of FAR 30.606(a)(3)(ii) years after entering into and performing under the subject contract. The COFC denied Boeing's claims on this basis.

The COFC stated that Boeing is no stranger to FAR 30.606, having launched numerous challenges to the offset prohibition in the past. The court cited these challenges, as well as Boeing's innumerable contracts subject to FAR 30.606(a)(3)(ii), as evidencing Boeing's actual and constructive knowledge of the provision's applicability. Boeing responded that the contract was at best ambiguous, because it included a reference to the CAS statute, which Boeing reads as contrary to FAR 30.606. The COFC was unpersuaded, characterizing any such ambiguity as patent—i.e., a facial inconsistency requiring Boeing to pursue a "pre-award protest or negotiation with the government, before its contracts were awarded." Having not done so, the court held that Boeing's later contract claims were foreclosed as a matter of law.

This holding is significant, and suggests that protests may be the appropriate mechanism for adjudicating conflicts between the CAS statute and the FAR 30.606(a)(3)(ii) prohibition on offsetting the impact of simultaneous cost accounting practice changes. The COFC was disinclined to permit a sophisticated contractor like Boeing to "change the pricing framework for its contract, years after the competition for that contract ended." As a consequence, all contractors now run the risk of waiving the right to challenge applicability of FAR 30.606 if such challenges are not first raised before contract award.

Additionally, the COFC decision presents the potential for a disturbing, broader application. As discussed above, the court cited Boeing's awareness of FAR 30.606, along with fifty-year-old case law presuming that contractors have constructive knowledge of procurement regulations, as a basis for its holding that Boeing was bound to challenge the FAR 30.606(a)(3)(ii) offset prohibition in a protest or during negotiations before award. That holding could apply with equal force to any provision in the FAR that purports to interpret or implement a FAR Part 52 contract clause. Thus, what might ordinarily have been the subject of a dispute under the CDA, may now be waived absent the filing of a pre-award protest.

It remains to be seen whether Boeing will appeal this decision to the Federal Circuit for further consideration of these potentially far-reaching implications.

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July 18, 2019

Federal Circuit Affirms *Tecom* Test Governing the Allowability of Government Contractor Litigation Costs

Advisory

By Paul E. Pompeo, Amanda J. Sherwood, Nathaniel Castellano

The Federal Circuit's landmark *Tecom* decision flipped decades of caselaw on its head and established the general rule governing the ability of contractors to recover costs of settling certain third-party litigation under government contracts.¹ In *Bechtel v. United States*, the contractor sought to carve an exception from *Tecom* and potentially reverse the *Tecom* rule. Instead, earlier this week the Federal Circuit doubled down on its prior decision. In the *Bechtel* decision, the Federal Circuit affirmed the Court of Federal Claim's strict application of *Tecom* and rejected the argument that a Department of Energy (DOE) contract clause providing for contractor recovery of litigation costs in some circumstances served as an exception to *Tecom*, notwithstanding regulatory history and prior course of dealing indicating that the parties intended such costs to be recoverable. This case narrows the circumstances under which contractors may be able to carve out the *Tecom* standard through contract terms. And, unfortunately, the Federal Circuit declined to answer many of contractors' pressing questions about the reaffirmed *Tecom* test—leaving open the prospect of broader application.

Context: Allowability of Litigation Costs

The history of the allowability of litigation costs under government contracts is a convoluted one. For decades, third-party litigation costs, including those associated with cases involving alleged employment discrimination, were allowed as ordinary costs of doing business.² This position began to crumble in the early 2000's, and the Federal Circuit's 2009 *Geren v. Tecom, Inc.* decision formalized the start of a new era.³

In *Tecom*, the Federal Circuit explained that "where neither the contract nor the FAR dictates the treatment of specific costs, we must determine how those costs are to be treated by looking to the principles and standards in [FAR 31.204(c)] and the treatment of similar or related selected items."⁴ The Circuit then announced a two-part test to govern when costs incurred by a contractor in defending and settling third-party claims—at least in the context of Title VII discrimination cases—are allowable under a government contract:

(1) we ask whether, if an adverse judgment [had been] reached, the damages, costs, and attorney's fees would be allowable; (2) if not, we ask whether the costs of settlement would be allowable.⁵

Tecom involved the costs of settling and defending a lawsuit alleging employment discrimination, and the contract at issue incorporated the clause at 52.222-26, "Equal Opportunity." The Circuit reasoned that, because an adverse judgment that the contractor had violated Title VII of the Civil Rights Act of 1964 would breach the underlying contract, the costs of defending and settling such a lawsuit were unallowable—unless the contracting officer determined that Title VII plaintiff had "very little likelihood of success on the merits."⁶ The Circuit provided no insight into the meaning of "very little likelihood of success on the merits."

After *Tecom*, contractors were left in a quandary about the treatment of litigation expenses. Should the costs be segregated under FAR 31.205-47(g) pending resolution, as a successful defense would render the costs allowable, and resolution through settlement would be unknowable at commencement of a case? Would the standard apply only to Title VII litigation or to all third-party litigation? What would be sufficient to demonstrate that the plaintiff would have "very little likelihood of success on the merits"? And, so on.

***Bechtel*: Prior Proceedings**

The *Bechtel* case involved allowability of costs associated with two discrimination lawsuits brought by former employees on a contract that included FAR 52.222-26, "Equal Opportunity." The contracting officer reviewed the claims and issued a final decision disallowing the contractor's costs associated with defending the cases, citing *Tecom*. The contractor appealed, arguing that because the underlying contract included a specific DOE Acquisition Regulation (DEAR) speaking to the allowability of litigation costs,⁷ that the Federal Circuit's two-part test from *Tecom* should not apply. Specifically, Bechtel invoked the qualifying language from *Tecom* suggesting that its two-part test only applies "where neither the contract nor the FAR dictates the treatment of specific costs." There was no challenge to the contracting officer's determination with respect to the likelihood on the merits of the third-party claims. The Court of Federal Claims rejected this argument, finding the settlement costs unallowable under *Tecom*.⁸

Appeal to the Federal Circuit

Bechtel appealed, arguing primarily that the Court of Federal Claims improperly applied the *Tecom* standard on the basis that the DOE clause provided for the allowability of the costs at issue. Bechtel argued that the regulatory history of the DOE clause and the parties' prior course of conduct showed that DOE intended to assume the risk of reimbursing costs associated with defending against third-party claims. Bechtel further argued that, in the event the *Tecom* standard did apply, the Federal Circuit should revisit *Tecom en banc* to clarify the scope of its holding.

The Circuit affirmed by a unanimous opinion by Judge Newman in which Judges Shall and Dyk (author of the *Tecom* majority opinion) joined. The Circuit acknowledged that: "*Tecom* recognized that the analysis for determining whether the costs are allowable could change if there was a contract provision 'dictat[ing] the treatment of specific costs.'"⁹ The Circuit concluded, however, that the DEAR provision at issue does not qualify, because although the DEAR clause "generally provides for reimbursement," it only does so "subject to certain exceptions," including where other provisions of the contract disallow the costs in question.¹⁰ Because the same FAR clauses at issue in *Tecom* appeared in the DOE contract at issue here, FAR 31.204 and 52.222-26, they serve this role.¹¹ The Circuit concluded that because the contractor abandoned its arguments regarding the "little likelihood of success on the merits" prong of the *Tecom* test, the defense costs are unallowable.¹²

The panel also reemphasized and restated that one of the underlying rationales for the *Tecom* standard is the view that "'pass[ing] such costs on to the government in a contract context' would be contrary to public policy under the Supreme Court's decision in *NAACP v. Fed. Power Comm'n*, 425 U.S. 662 (1976)."¹³ This holding suggests that the prospect of "wrongdoing" was a driving factor in *Tecom* and the assessment of cost allowability.

The panel concluded that, as a prior precedential decision, it is "bound by *Tecom*" and noted that the contractor "has not demonstrated that *Tecom* is in any way unsound such that the panel should recommend en banc review pursuant to Federal Circuit Rule 35."¹⁴

Conclusion & Lessons Learned

Bechtel serves as a wholehearted reaffirmation of the *Tecom* standard, and a narrowing of the potential for contractors to sidestep the *Tecom* standard by pointing to express contract provisions and prior course of dealing indicating an agency's willingness to reimburse litigation expenses associated with defending against third-party claims.

Open issues remain, in particular with respect to how explicit a contract provision must be to avoid the *Tecom* standard. More broadly, the Circuit also declined to address whether *Tecom* may be applied to litigation defense and settlement costs outside of the employment discrimination context—for example, those associated with general breach of contract allegations—despite considerable debate between the parties on this point.¹⁵ And, the decision leaves unanswered (because the contractor did not pursue the issue on appeal) the critically important question of what is sufficient to demonstrate the "very little likelihood of success on the merits" standard. Contractors are therefore still without any guidance regarding this primary avenue through which the cost of defending or settling a third-party lawsuit may be allowable costs under government contracts.

The *Bechtel* decision is not encouraging to any who hoped the Federal Circuit might be willing to reign in *Tecom*. Unlike *Tecom*, which was a 2-1 decision with a substantial and reasoned dissent, *Bechtel* is unanimous. Although the Federal Circuit decision to rehear a case *en banc* is not dependent on any recommendation from the merits panel, the panel judges have clearly indicated they are unlikely to vote in favor of or encourage *en banc* review of *Tecom*. If *Bechtel* files a petition for *en banc* review, any *amici curae* that decide to weigh in may guide the Court's consideration.

In sum, *Bechtel* reaffirms that *Tecom* is the law of the land and narrows at least one possible avenue around application of the *Tecom* standard. Short of *en banc* action, if contractors want this standard to change, regulatory or statutory action will likely be the only way around the Federal Circuit's established test.

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¹ *Geren v. Tecom*, 566 F.3d 1037 (Fed. Cir. 2009). It is noteworthy that that Judge Lourie penned a vigorous dissent in *Tecom*.

² See Arnold & Porter's prior Advisory on the lower court *Bechtel* decision, which provides more detail.

³ 566 F.3d 1037 (Fed. Cir. 2009).

⁴ 566 F.3d at 1041 (internal quotation omitted).

⁵ *Id.* at 1041.

⁶ *Id.* at 1043-46.

⁷ DEAR 970.5204-31(e), which provides "{e}xcept as provided in subparagraphs (g) and (h)...the contractor shall be reimbursed...for liabilities...including litigation costs..." Subsections (g) and (h) list specific circumstances in which such costs are not allowable, including where they "are otherwise unallowable by law" or are the result of managerial personnel's willful misconduct or bad faith.

⁸ *Bechtel Nat'l, Inc. v. United States*, 137 Fed. Cl. 423 (2018).

⁹ *Bechtel National, Inc. v. United States*, Case No. 2018-2055 at *7 (Fed. Cir. July 16, 2019) (quoting *Tecom*, 566 F.3d at 1041).

¹⁰ *Id.* at *7-8.

¹¹ *Id.* at *8 ("DEAR 970.5204-31 does not override the FAR provisions that we interpreted in *Tecom* as disallowing those costs.").

¹² *Id.* at *10.

¹³ *Id.* at *9 (quoting *Tecom*, 566 F.3d at 1044).

¹⁴ *Id.* at *11.

¹⁵ *Id.* at *11.

October 22, 2019

Federal Circuit Issues Controversial Decision Involving Expressly Unallowable Costs

Advisory

By Paul E. Pompeo, Nathaniel Castellano

In its second significant cost allowability decision of the year, the Federal Circuit held that salaries associated with lobbying activities are expressly unallowable under Federal Acquisition Regulation (FAR) 31.205-22.¹ Although the decision is limited to salary costs associated with lobbying activities, its rationale creates uncertainty for other types of costs subject to a FAR Part 31 Cost Principle that uses similar "associated with" language. Contractors should anticipate closer scrutiny from auditors, who may feel emboldened by the Federal Circuit's decision to characterize costs as expressly unallowable. The decision may also have implications for compliance with Cost Accounting Standard 405.

Although many types of cost may be generally unallowable, a smaller subset of costs are expressly unallowable. An expressly unallowable cost is "a *particular item or type of cost* which, under the express provisions of an applicable law, regulation, or contract, is *specifically named and stated to be unallowable*."² Contractors are subject to penalty if they submit to the government any expressly unallowable cost.³ Congress made clear that the penalty was intended for limited circumstances where the regulations explicitly prohibit inclusion of a type of cost; providing alcohol as an example.

FAR 31.205-22(a) provides that costs "associated with" a list of lobbying and political activities are unallowable.⁴ FAR 31.205-22 does not specifically name and state salary, or any other type of cost; it merely states "associated with." The narrow question presented to the Federal Circuit was whether salary costs of employees engaging in such lobbying activity qualify as expressly unallowable costs.

Even though FAR 31.205-22 does not expressly name and state salary or compensation as unallowable, the Federal Circuit nevertheless held that such salary costs are expressly unallowable:

The definition in FAR § 31.001 of an "expressly unallowable cost" refers to "a particular item or type of cost." These two categories of costs confirm that an "expressly unallowable" cost includes more than an explicitly stated "item." Costs unambiguously falling within a generic definition of a "type" of unallowable cost are also "expressly unallowable." Here, salaries of in-house lobbyists are a prototypical lobbying expense. Subsection 22 disallows "costs associated with" activities such as "attempt[ing] to influence . . . legislation . . . through communication with any member or employee of the . . . legislature" or "attend[ing] . . . legislative sessions or committee hearings." Salaries of corporate personnel involved in lobbying are unambiguously "costs associated with" lobbying.⁵

The Federal Circuit's reasoning raises at least four implications moving forward.

First, whereas the FAR defines expressly unallowable costs as those "specifically named and stated to be unallowable," the Federal Circuit seems to have adopted a broader test that encompasses "[c]osts unambiguously falling within a generic definition of a 'type'" deemed unallowable. Now, instead of asking only which types of costs are specifically named and stated as unallowable, contractors must apparently also consider what types of cost unambiguously fall within generic definitions of types of unallowable costs. The Federal Circuit's attempt to distinguish an item from a type of cost appears specious. And, the Federal Circuit seems to have muddled the differing concepts of unallowable costs, directly associated costs, and expressly unallowable costs.

Moreover, the Federal Circuit's approach strikes as a contradiction of the plain language of the definition of an expressly unallowable cost, and is inconsistent with Congressional intent. The reason that Congress included the "specifically named and stated language" was to avoid penalizing contractors where the regulations lack specificity. The onus is on the government to draft cost principles that are precise.

Relevant here, the Federal Circuit's decision clarified in *dicta* that its holding effectively overturns, in part, the ASBCA's 2015 decision that bonus and incentive compensation (BAIC) are not "expressly unallowable" under FAR 31.205-22. The ASBCA had concluded such costs did not meet the definition of expressly unallowable because "neither 'BAIC' cost nor 'compensation' cost is specifically named and stated as unallowable under this cost principle, nor are such costs identified as unallowable in any direct or unmistakable terms."⁶ Without considering the underlying rationale, the Federal Circuit was not persuaded: "That decision is not binding on this court, and in any event, is contrary to the plain language of Subsection 22 to the extent that it concludes that salaries in the form of bonus and incentive compensation for lobbying and political activities are not 'expressly unallowable.'"⁷

Second, the Federal Circuit's reasoning could impact other cost principles that speak in terms of costs "associated with" a particular activity. FAR 31.205-1, for example, speaks to the allowability of public relations activities "associated with areas such as advertising, customer relations, etc." FAR 31.205-27 governs "expenditures in connection with" business organization costs. Although the Federal Circuit's decision is tied to the language of FAR 31.205-22, the Defense Contract Audit Agency (DCAA) is guaranteed to rely on this case with abandon to assert that a host of costs are expressly unallowable.

Third, despite the concern of DCAA overreach, the Federal Circuit's conclusion seems inherently tied to its understanding of the relationship between lobbying and lobbyists: "salaries of in-house lobbyists are a prototypical lobbying expense." Inherent in the decision is the Federal Circuit's inability to identify any other types of costs associated with lobbying. Thus, in the eyes of the Federal Circuit, salary would qualify as expressly unallowable under the "prototypical lobbying expense" standard. Furthermore, the Federal Circuit examined the history of the cost principle, which, under DAR 15.205.51 specifically disallowed the "applicable portion of the salaries of the contractor's employees . . . engaged in lobbying."⁸ Thus, to the extent there is a silver lining to this case, it is that it may be limited to salaries, and is dependent on the unique history of the prohibition. It still leaves open the question of what other types of cost are so "unambiguously falling" within an "associated with" type of cost.

Finally, this case implicates CAS 405. That standard directs the segregation of expressly unallowable costs from billings, claims, and proposals. The uncertainty that the Federal Circuit has created regarding the definition of an expressly unallowable cost—which is identical in CAS 405—could lead to an implosion of alleged noncompliances with CAS 405, itself subject to compound daily interest.⁹

Contractors should consider reviewing their accounting systems and implementing a more risk averse posture with respect to allocation of any types of costs that could be characterized as "unambiguously falling" within a type of cost identified as unallowable, or as a "prototypical expense" of an expressly unallowable costs.

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¹ *Raytheon Co. v. Secretary of Defense*, No. 2018-2371, 2019 WL 5280873 (Oct. 18, 2019).

² FAR 31.0001 (emphasis added); *see also* CAS 405-30(a)(2).

³ FAR 42.709-1(a)(1).

⁴ FAR 31.205-22(a).

⁵ *Raytheon*, No. 2018-2371 at *6-7 (alteration in original, internal citation omitted).

⁶ *Raytheon Co.*, ASBCA No. 57576, 15-1 BCA ¶ 36043.

⁷ *Raytheon*, No. 2018-2371 at *4.

⁸ *Raytheon*, No. 2018-2371 at *7.

⁹ *Gates v. Raytheon co.*, 548 F.3d 1062, 1070 (Fed. Cir. 2009).

Report of the Advisory Panel on Streamlining and Codifying Acquisition Regulations

Volume 3 of 3
January 2019



Department of Defense

Professional Practice Guide

Audits and Oversight of
Defense Contractor Costs and
Internal Controls

FIRST EDITION
January 2019

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INTRODUCTION

The Section 809 Panel developed this Professional Practice Guide (PPG) as a supplement to existing guidance for professionals involved in Department of Defense (DoD) procurement contract auditing. A Section 809 Panel working group collaboratively developed this guide to provide additional information regarding how to interpret and apply specific auditing concepts for government contract audits to assist auditors, contracting officers, and other stakeholders involved in the audit process. It is intended to assist professionals with delivering high quality, consistent financial audit and advisory services to contracting officers.

Independent public accountants (IPAs) and other qualified professional services firms play an increasingly important role in the government's oversight of federal government contractors. Although professional standards are common across the auditing profession—applicable to both public and private organizations—these standards were not developed or interpreted for the unique purpose of federal government contract oversight. To address this need, the Section 809 Panel assembled a working group of subject matter experts in the fields of contract auditing and compliance, professional standards, and audit resolution. The Section 809 Panel wishes to thank the working group members for their dedication and generous contribution of time and energy toward the development of the guide. The working group consisted of representatives from the following organizations.

- Defense Contract Audit Agency
- Defense Contract Management Agency
- US Government Accountability Office
- American Institute of Certified Public Accountants
- Aerospace Industries Association
- Baker Tilly Virchow Krause, LLP

The working group evaluated a variety of professional standards to identify concepts that may benefit from collaborative interpretation as they apply in a contract oversight environment, including risk, materiality, audits of internal controls, independence, objectivity, sufficient evidence, and reliance on the work of others. Given the Section 809 Panel's limited statutory term, the working group prioritized its work to focus on risk, materiality, and audits of internal controls. Accordingly, these three concepts are addressed in this first edition of the PPG.

Although these concepts are well established in auditing literature, this guide focuses on how the concepts should be used for the purpose of federal government contract oversight. It describes how these concepts are to be applied in the context of government contract audits and provides practical examples and best practices to help auditors perform audits.

Maintenance

The Section 809 Panel recommends the Secretary of Defense charter and reconstitute a Professional Practice Guide Working Group, chaired by both DCAA and DCMA on a biennial rotation, to ensure the same collaborative process is used for changes and additions to the PPG as was established by the Section 809 Panel. The process should ensure that the PPG remains current and that additional topical areas are considered collaboratively by a diverse group of experts in the field of contract auditing and compliance. Specifically, the Section 809 Panel recommends that the Working Group should have five permanent representatives, including a representative from each of the following:

- Defense Contract Audit Agency (DCAA), appointed by the director of DCAA.
- Defense Contract Management Agency (DCMA), appointed by the director of DCMA.
- Government Accountability Office (GAO), appointed by the Comptroller General of the United States.
- Industry, nominated by *Council of Defense and Space Industry Associations* (CODSIA) and agreed on by a majority of the representatives from DCAA, DCMA, and GAO.
- American Institute of Certified Public Accountants, agreed on by a majority of the representatives from DCAA, DCMA, and GAO.

The chair of the Working Group (i.e., either DCAA or DCMA, biennially) is responsible for scheduling and recording proceedings and decisions made by Working Group. The Working Group members do not have terms, but membership may be assessed annually by the collective members and changes made based on this assessment. The appointees from DCAA, DCMA, GAO, and AICPA will be automatically removed from the Working Group should they leave their respective organizations. The Working Group will meet not less than semi-annually and otherwise as determined necessary by the members. The Working Group shall have an indefinite termination date.

The PPG will be made available to the public in the *Guidance* section of DCAA's website. New Editions of the PPG will be announced internally within DCAA by a Memorandum for Regional Directors, a copy of which will also be published promptly on DCAA's website.

Overview

The PPG provides information on how to interpret and apply specific auditing concepts to audits of government contract costs and compliance-related internal controls. This guide will assist government auditors, private-sector auditors, contracting officers, contractors, and other stakeholders better understand the audit process.

Financial and business system oversight of defense contractors is a crucial function of DoD's system of acquisition internal controls. This oversight function performs both preventive and detective control activities, designed to reasonably ensure DoD's contractors comply with a variety of contract requirements. These contract requirements allow DoD's procuring and administrative contracting officers to exercise good stewardship of taxpayer dollars, as well as deliver timely, high-quality goods and services to warfighters and accomplish other operations critical to DoD's mission.

The PPG recognizes, in Chapter 1, that a more robust *risk assessment* process will allow DoD to deploy its limited resources more effectively. The PPG further recognizes, in Chapter 2, that DoD can deploy its resources more efficiently, without harming effectiveness, through a common understanding of *materiality*. Finally, in Chapter 3, the PPG recognizes that a common framework will streamline and bring consistency to DoD's *audits of contractor systems of internal control* over government contract compliance.

This guide recognizes that systems of internal control are not expected to provide absolute assurance that specified objectives are met. The costs of attaining absolute assurance are generally greater than the benefits attained from such assurance, and there are inherent limitations in any system of internal control due to factors such as human error and the uncertainty inherent in judgment. This first edition of the PPG focuses on this axiom with respect to both DoD's system of acquisition internal control and contractors' systems of internal control over government contract compliance.

Chapter 1, Incurred Cost Risk Assessment, establishes guidance that DCAA will use to focus its limited resources when auditing costs incurred by contractors on flexibly priced defense contracts. This chapter implicitly acknowledges that (a) DCAA is an important element of DoD's system of acquisition internal controls, (b) DCAA does not have sufficient resources to audit every DoD contractor, and (c) adding more oversight resources would likely produce diminishing returns relative to the increased cost. The risk assessment process also incentivizes larger contractors to achieve or maintain compliant cost accounting and effective accounting system internal controls, such that they can reduce their assessed risk profile and, thus, audit frequency.

Chapter 2, Engagement Materiality Framework, addresses Congress's direction to the Section 809 Panel in the FY 2018 NDAA, Section 803, with respect to numeric materiality for audits of incurred cost. This chapter sets forth clear materiality guidelines that help oversight professionals plan their work and provide the information contracting officers need to make reasonable business decisions. What may be material to a particular business decision will be influenced by a variety of qualitative and quantitative considerations, recognizing that the contracting officer's role is to manage DoD's risk, rather than avoid risk. The cost of DoD oversight, including adverse effects on timeliness of decision making, must be balanced with expected benefits of that oversight. Guidance in this chapter should be used in conjunction with the Cost Accounting Standards Board's (CASB's) administrative regulations (48 CFR 9903.305) that establish a variety of materiality considerations appropriate for any DoD business decision concerning contract costs/prices.

Chapter 3, Audits of Internal Controls over Government Contract Compliance, introduces a body of professional standards based on an internal control audit framework and developed to address the requirements of Sarbanes-Oxley Act (SOX) Section 404(b). This framework serves as the means by which DoD will obtain reasonable assurance that contractors have effective internal controls over their business systems as they relate to government contract compliance. Internal control audits will be the basis for assessing adequacy of defense contractor accounting systems. These audits are well established and understood by the auditing profession. They will also provide more useful, relevant information to the acquisition team, contracting officers, and contractors.

References to the *Government Auditing Standards* 2018 Revision in this guide refer to attestation engagements and performance audits performed once the 2018 revision becomes effective. For attestation engagements, it is for periods ending on or after June 30, 2020. For performance audits, it is for audits beginning on or after July 1, 2019. For all engagements performed prior to the respective effective dates of the 2018 revision, the auditor should refer to the 2011 revision of the *Government Auditing Standards*.

CHAPTER 1: RISK ASSESSMENT

The Need for Risk Assessment

DoD's system of acquisition internal controls is subject to the same economic constraints as those faced in other government agencies, organizations, and corporations. Increasing resources become necessary to achieve desired risk levels approaching zero (i.e., absolute risk avoidance).

DCAA serves many roles within DoD's system of acquisition internal controls. Chief among them is DCAA's role as auditor of costs incurred by, and reimbursed to, commercial companies that perform flexibly-priced defense procurement contracts. DoD cannot reimburse commercial companies for their contract performance costs unless they comply with contract terms and conditions.

Each year, thousands of commercial companies incur costs while performing flexibly-priced defense contracts. Accordingly, this Chapter establishes a risk assessment framework intended to focus DCAA's finite resources such that DoD's risk is appropriately managed.

Risk Assessment Framework

The foundation for this risk assessment framework rests on the materiality concepts introduced in Chapter 2 of the PPG, insofar as it aligns increasing risk levels with the annual costs incurred by contractor business units (as represented on annual final indirect cost rate proposals, also referred to as incurred cost proposals (ICPs)). As annual costs increase, so does the likelihood of being audited.

The risk assessment framework also takes into consideration several qualitative factors that may either increase or decrease the likelihood of being selected for audit. The risk assessment framework provides incentives for contractors to achieve or maintain compliant cost accounting and internal controls over government contract compliance. It also provides disincentives for those contractors who have not.

The risk assessment framework provides for three levels, or *strata* of risk: low, medium, and high. These levels are based on a contractor business unit's Auditable Dollar Volume¹ (ADV). Within each risk strata, contractor ICPs fall within specified ranges of ADV and may be selected for audit based on the stratum's criteria. Each stratum is also affected by specific risk questions that affect the frequency of the contractor being audited. This aligns audit frequency with the performance of the contractor with regards to the history of questioned costs and status of business systems. The questions differ for each stratum but relate to the following risk factors:

- The significance of historic questioned costs.
- The existence of specific Department concerns.
- The status of the business systems.
- The existence of uncorrected system deficiencies (if any).
- The existence of significant accounting or organizational changes (e.g., merger).

For contractors with final indirect cost rate proposals for which total incurred cost on DoD flexibly priced contracts is equal to or greater than \$1 Billion of ADV, DoD will conduct an audit regardless of the above factors. For all other final indirect cost rate proposals, the frequency of audit should decrease

¹ADV is the sum of all of the costs on flexibly-priced contracts for a contractor during a given fiscal year

provided the risk factors are met. The risk assessment framework is provided below and available on the DCAA website.

Table 1. Risk Assessment Framework

	Low Risk Strata	Medium Risk Strata	High Risk Strata
	< 100M	\$100M-\$500M	> \$500M
Sampling Notes	N/A	\$100M–\$250M: Audit every 5 th year if not selected during sampling process > \$250M–\$500M: Audit every 4 th year if not selected during sampling process.	\$1B or more: Audit > \$500M–<\$1B, if the answer to each of the question below is No, the contractor's ICP will move to the medium risk category with the possibility of being sampled for audit in that year. Must be audited every other year.
Risk Assessment Protocol	For contractors with < \$5M ADV, answer questions 1 and 2 below. For contractors with \$5M to <\$100M ADV, answer all three questions below. 1) Assess the risk of incurred cost proposal using the questions (below). 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.	For contractors with \$100M–\$250M in ADV, was a determination letter used to close the prior four contractor fiscal years? (A YES response indicates proposal must be audited regardless of initial risk.) For contractors with > \$250M–\$500M in ADV, was a determination letter used to close the prior three contractor fiscal years? (A YES response indicates proposal must be audited regardless of initial risk.) 1) Assess the risk of incurred cost proposal using the six questions (below). 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.	For contractors with > \$500M and <\$1B in ADV, was a determination letter used to close the prior contractor fiscal year? (A YES response indicates proposal must be audited regardless of initial risk.) For contractors with \$1B or more in ADV, an audit must be conducted every contractor fiscal year. 1) Assess the risk of incurred cost proposal using the six questions below. 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.
Risk Assessment Results	ICPs with ADV <\$5M placed in low risk strata sampling universe for sampling if the answers to questions 1 and 2 below are NO. Note: The regional Audit Manager must approve the performance of an audit. ICPs with ADV \$5M – <100\$M in low risk strata sampling universe if the answers to all the questions below are No.	ICPs with ADV of \$100M–\$500M placed in medium risk sampling universe for sampling if the answers to all six questions below are NO.	ICPs with ADV of > \$500M–\$1B placed in medium risk sampling universe for sampling if the answers to all six questions below are NO.
Question 1	Are there significant Questioned costs in the last completed incurred cost audit?	Are there significant Questioned costs in the last completed incurred cost audit?	Are there significant Questioned costs in the last completed incurred cost audit?
Question 2	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?
Question 3	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?
Question 4	N/A	Does the contractor have any business system deficiencies relevant to incurred costs for the year subject to audit?	Does the contractor have any business system deficiencies relevant to incurred costs for the year subject to audit?
Question 5	N/A	Does the contractor have any significant account practice changes in the year subject to audit?	Does the contractor have any significant account practice changes in the year subject to audit?
Question 6	N/A	Has the contractor experienced significant organizational changes in the year subject to audit?	Has the contractor experienced significant organizational changes in the year subject to audit?

CHAPTER 2: MATERIALITY IN AUDITS OF INCURRED COSTS

This chapter presents guidelines and a framework for determining materiality for use in audits of incurred costs. However, this framework and the recommended materiality thresholds are not a substitute for professional judgment.

Materiality and Significance in Incurred Cost Audits

The term *incurred cost audit* means an audit of charges to the government by a contractor under a flexibility priced contract.² These charges are reported annually by contractor business units, in a final indirect cost rate proposal (also referred to as an incurred cost proposal), as required by FAR 52.216-7. This proposal represents the subject matter of the incurred cost audit. The risk to the government and others who rely on this information is that amounts are materially misstated due to contractors' noncompliance with contract terms or federal regulations. If the incurred cost proposal is not materially compliant and complete, it could adversely affect decision making by those who use the information.

The objectives of an incurred cost audit are to (a) provide assurance that contractors' incurred cost proposals can be relied on to settle final indirect cost rates and (b) communicate any misstatements that may affect contract cost reimbursements. Contract costs that do not comply with contract terms, federal regulations, or agreements are referred to in audits of contract costs as *misstatements*. An incurred cost audit is designed to identify material (or significant, as explained below) misstatements, based on both quantitative considerations (amount) and qualitative considerations (nature).

A material misstatement, as used throughout this guide, means misstatements, including omissions, individually or in the aggregate, that could reasonably be expected to influence relevant decisions of intended users that are made based on the subject matter. Materiality, by definition, is more than just a number and is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment.³

Audits of incurred costs can be performed using standards for performance audits (GAO, *Government Auditing Standards* 2018 revision), and standards for attestation examination engagements (AICPA, *Professional Standards*, Statements on Standards for Attestation Engagements). The definition of materiality is drawn from the attestation examination standards but is not limited to only these types of engagements. For the remainder of this document use of *materiality* is based on this definition. The Government Auditing Standards define *significance* for performance audits (FY 2018 Yellow Book, paragraph 8.15) as

The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors. Such factors include the magnitude of the matter in relation to the subject matter of the audit, the nature and effect of the matter, the relevance of the matter, the needs and interests of an objective third party with knowledge of the relevant information, and the matter's effect on the audited program or activity. Professional judgment assists auditors when evaluating the significance

² The term 'flexibly priced contract' has the meaning given the term 'flexibly-priced contracts and subcontracts' in part 30 of the Federal Acquisition Regulation (section 30.001 of title 48, Code of Federal Regulations).

³ Paragraph A15 of AT-C section 205, *Examination Engagements* (AICPA, Professional Standards, AT-C sec. 205)

of matters within the context of the audit objectives. In the performance audit requirements, the term significant is comparable to the term material as used in the context of financial statement engagements.

The definition of *significant* for performance audits is similar to the definition of *materiality* for attestation examination engagements. For purposes of this document, these terms may be used interchangeably.

Both the terms *materiality* and *significance* refer to characteristics of the subject matter that are important, or relevant, to the users of the information. The terms *significant cost element* or *significant account* in this chapter refer to items that require further evaluation, and possibly testing, due to the potential of material misstatements based on quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer. During the planning and fieldwork phase of the audit, *significance* is used in the context of a potential risk of misstatement (quantitative or qualitative) in a cost element or account that is more than clearly trivial. During the reporting phase of the audit, *material* or *significant* misstatements will affect the auditor's opinion or conclusion.

Compatibility of Commercially Accepted Standards for Risk and Materiality

The commercial concepts of risk and materiality are compatible with the objectives of contract cost auditing. They represent auditors' professional responsibility to determine *what matters* (i.e., the risk that costs do not comply with contract terms and federal regulations) and *how much matters* (i.e., materiality) in the context of a particular audit. What and how much matters depends on the use of the audited information.

With respect to financial statement audits of for-profit companies, the owners, potential investors, and banks use audited financial information to make investment and lending decisions. With respect to contract cost audits, contracting officers use audited financial information to negotiate contract prices, reimburse contract costs, and evaluate a contractors' compliance with contract terms. To ensure the integrity of information on which economic decisions will be made, organizations (in the context of financial statements of for-profit companies) and contracting officers (in the context of procurement contracts) use auditors to provide assurance on that information.

Commercial standards of risk and materiality conceptually apply to contract cost audits, yet the process in which they are applied is viewed through the lens of contracting officers and their responsibility to expend public funds fairly and reasonably. Auditors' evaluation of what matters (i.e., risk or significance) is made in the context of the engagement type and contracting officers' (or other government customers') needs. The auditors' assessment of what matters is also a necessary precondition to determining how much matters (i.e., materiality).

Materiality in the Context of Contract Cost Audits

The concepts of materiality and significance expressly acknowledge that some degree of imperfection is acceptable to the users of financial information. This point is emphasized throughout the commercial and government auditing standards, regulations for the oversight of financial markets, FAR and the Cost Accounting Standards (CAS). This chapter discusses materiality, consistent with commercial standards, as a guide to help auditors when performing audits of incurred contract costs.

Materiality, in the context of contract costs, represents the government's acknowledgement, consistent with the Federal Acquisition System's Guiding Principles, that there is an acceptable level of imprecision when determining or settling fair and reasonable contract prices. *Material* misstatements, individually or in aggregate, would reasonably be expected to influence the economic decisions of the government.⁴ *Immaterial* misstatements would not adversely affect the economic decisions of the government as a buyer of goods and services in the commercial marketplace.

Commercial standards of risk and materiality provide for both *qualitative* and *quantitative* considerations. In the context of government contract costs, an auditor is concerned with both the nature (i.e., quality) and the amount (i.e., quantity) of a cost.

Audits of incurred contract costs generally focus on cost allowability and the completeness of contractors' cost representations. Contract cost auditors evaluate contractors' cost accounting and presentation for compliance with contract terms, FAR Part 31 cost principles (and CAS, as applicable), and other agreements between contractors and the government (e.g., advance agreements). Auditors are encouraged to discuss quantitative and qualitative materiality considerations with contracting officers or other government customers to obtain their perspectives on what is important to them. For example, auditors may be informed by contracting officers of the importance of a certain aspect of the information, such as a cost element or account, which auditors may take into consideration in their determination of materiality.

Definitions

For the purposes of this PPG, the terms below are defined as follows:

Table 2. Audit Terminology

Term	Definition
Total Subject Matter Amount	The incurred cost claimed on flexibly priced contracts during the fiscal year. It includes different categories of contract cost such as labor, materials, other direct costs, indirect costs, and is adjusted for certain types of contracts and activity such as commercial contracts. The FY 2018 NDAA, Section 803, defines <i>incurred cost audit</i> as an audit of charges to the government by a contractor under a flexibly priced contract. See Appendix B for additional information.
Accounts	Records used to group same or similar types of financial transactions during a fiscal period. An expense account's balance at the end of a fiscal period reflects the total dollar amount of transactions recorded to that account. For example, a labor expense account will include individual transactions associated with amounts paid to employees.
Cost Element	Represents the summation of accounts of a similar character and type that is included in the total subject matter. For example, the direct materials cost element is comprised of all material costs on government contracts, and may include, for example, accounts for direct purchases, allocations from company owned inventory, and allocations for material factors. The cost element is similar to a line item in financial statements.

⁴ The FY2018 NDAA, Section 803, defines *numeric materiality standard* as "a dollar amount of misstatements, including omissions, contained in an incurred cost audit that would be material if the misstatements, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the Government made on the basis of the incurred cost audit."

Term	Definition
Significant Cost Element or Account	Represents a cost element or account that requires further evaluation and testing due to quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer, and is applicable to any type of engagement performed. Significance is relevant in the planning and reporting phases of the audit.
Materiality	In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence relevant decisions of intended users that are made based on the subject matter. Materiality is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment. ⁵
Quantified Materiality	The numeric representation of materiality that is calculated based on the total audit subject matter. It is used in planning to identify significant cost elements. Quantified materiality is similar to planning materiality used in financial statement audits.
Adjusted Materiality	The amount or amounts set by the auditor at less than quantified materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the incurred cost proposal, taken as a whole. It also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Adjusted materiality is similar to performance materiality used in financial statement audits.
Quantitative Materiality Factors	Quantitative factors relate to the magnitude of misstatements or questioned costs relative to the reported amounts for those aspects of the subject matter, if any, which are expressed numerically or otherwise related to the numeric values. ⁶
Qualitative Materiality Factors	Risk and qualitative materiality factors are understood in the context of the subject matter as relating to, or measured by, the quality of subject matter rather than its quantity. Qualitative materiality factors can include whether the misstatement affects compliance with laws or regulations, the result of an intentional act (i.e., fraud), and importance to the users of the information regardless of dollar amount. ⁷ For planning purposes, the auditor may design audit procedures to address risk of potential material noncompliance related to these qualitative factors. For reporting purposes, and after completion of fieldwork, the actual misstatements should be evaluated for significance based on these qualitative factors in addition to quantitative factors.
Nominal Reporting Amount	The nominal reporting amount is an amount at which any adjustment (misstatements or noncompliance) taken individually would be immaterial regardless of other factors. It is used during the reporting of results to determine the impact of certain qualitative amounts that are significant based on nature but so small in value they are still considered immaterial. Regardless, although not included in the audit report, these items are separately communicated to the contracting officer in a summary of misstatements. The nominal reporting amount is similar to the nominal amount used in financial statement audits.
Misstatement	When the contract costs that are billed, or reported, to the government do not comply with contract terms and federal regulations such as FAR and CAS. The primary source of misstatements for incurred cost audits is cost type (FAR 31.205), contract clauses, cost reasonableness, and cost allocation (FAR 31.201 to 31.204 or CAS if applicable). When a misstatement is identified, it is typically referred to as a noncompliance that can be measured as a dollar amount of questioned contract costs.

⁵ Paragraph A15 of AT-C section 205

⁶ Paragraph A19 of AT-C section 205

⁷ Paragraph A18 of AT-C section 205

Engagement Materiality Framework

The Engagement Materiality Framework describes the process for calculating and using materiality throughout the audit process and is organized by phases of the audit, as follows:

Table 3. Engagement Materiality Framework

Audit Phase		Engagement Materiality Framework Step
Planning	1)	Calculate quantified materiality
Planning	2)	Identify significant cost elements
Planning	3)	Identify significant accounts within significant cost elements
	4)	Consider the use of adjusted material in sampling and tolerable error
	5)	Determine the nature, timing, and extent of audit procedures on significant cost elements and accounts considering risk and materiality.
Fieldwork	6)	Perform testing procedures and document results.
Conclusion and Reporting	7)	Evaluate misstatements based on quantitative and qualitative materiality characteristics.
	8)	Report or communicate misstatements, in compliance with Government Auditing Standards.

Step 1: Calculate Quantified Materiality

Quantified materiality relates to the magnitude of misstatements relative to reported amounts for those aspects of the subject matter, if any, that are expressed numerically or otherwise related to numeric values. Use of quantified materiality is appropriate for audits of incurred cost because the total subject matter can be measured as a numeric value. Quantified materiality is used in the planning phase of the audit to identify significant cost elements and affects use of adjusted materiality during fieldwork (Engagement Materiality Framework Step 3). The process to calculate qualified materiality includes the following:

- **Define Total Audit Subject Matter:** The audit subject matter is expressed numerically, and for purposes of the materiality calculation, includes the total subject matter upon which an auditor will be expressing an opinion and providing assurance.
- **Calculate Quantified Materiality:** Quantified materiality is based on auditor judgment and is influenced by industry benchmarks, reasonableness, and the needs of the users of the information. It represents the amount, or percentage, of the Total Audit Subject Matter that can be misstated and influence the decisions of those who use the information.

Commercially accepted practices for determining quantitative materiality involve the application of percentages to elements of financial information. For example, a financial statement auditor may use 5 percent of net income, or 0.5 percent of net assets, as a benchmark for quantitative materiality. If net income is \$1,000,000, then, in an auditor's judgement, misstatements of more than \$50,000 (5 percent) individually, or in the aggregate, would likely influence the economic decisions of financial statement users. If net income is \$100,000,000, then misstatements of more than \$500,000 (5 percent) individually, or in the aggregate, would likely influence the economic decisions of financial statement users.

As the examples above show, commercially accepted materiality benchmarks tend to maintain their proportionality as financial values increase. This proportionality occurs because financial statement users need assurance that the financial statements fairly represent a company's financial position in accordance with GAAP. It is not necessarily the dollar value of misstatements that matters to financial statement users; rather, it is whether the financial statements fairly represent the company's performance within an acceptable margin of imperfection.

Recommended materiality thresholds are provided below that are consistent with industry norms and acceptable for use in incurred cost audits. The practical application of quantified materiality is not limited to these thresholds as auditor judgment with consideration of qualitative factors, risk, and variability have an impact.

The materiality thresholds recommended below adjust (by algebraic equation) downward as the amount of cost subject to audit increases. Because contract audits involve contractors' costs that may be reimbursed with public funds, applying a static benchmark could produce unacceptably large materiality thresholds. For example, 5 percent of \$100,000 (or \$5,000) is perceived much differently than that same percentage applied to \$1,000,000,000 (or \$50,000,000). In this instance, it would be more appropriate to use a threshold of 0.5 percent for \$1,000,000,000 because the resulting materiality threshold of \$5,000,000 is more aligned with the government's economic decision-making responsibility.

Recommended Materiality Thresholds for Incurred Cost Audits

Table 4. Incurred Cost Audit Proposals Subject Matter

Subject Matter Cost	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
Materiality Amount	\$5,000	\$28,117	\$158,686	\$889,140	\$2,973,018	\$5,000,000	<i>Varies</i>
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

For Incurred Cost Proposal Audit Subject Matter from \$1 to \$1,000,000,000 use:

- Materiality Threshold = \$5,000 x ((Total Subject Matter / \$100,000) ^ .75)

For Incurred Cost Proposal Audit Subject Matter greater than \$1,000,000,000 use:

- Materiality Threshold percentage of 0.50 percent

Quantified materiality does not change due to the type of engagement performed (e.g., examination or performance audit). Professional judgments about quantitative materiality are made in light of contract dollars subject to audit (i.e., engagement subject matter) and are not affected by the level of assurance. Materiality is based on the needs of those who use the information irrespective of the type of engagement performed.

The application of quantified materiality neither limits auditor judgment nor places restrictions on what an auditor can test based solely on dollar value. Rather, the quantified materiality amount is

intended to create a consistent threshold that helps an auditor calibrate the nature, timing, and extent of audit procedures relative to the unique risks and qualitative considerations of each engagement. It is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter of the practitioner's professional judgment.⁸

The example below illustrates a basic quantified materiality calculation. The total subject matter represents all costs for flexibly priced contracts (i.e., engagement subject matter), whether direct or indirect, of \$200,500. The total subject matter is then multiplied by the quantified materiality formula to compute the materiality amount used during the audit.

Figure 1. Illustrative Basic Quantified Materiality Calculation

$$\text{\$8,425} = \text{\$5,000} \times ((\text{\$200,500}/\text{\$100,000})^{.75})$$

The quantified materiality amount is \$8,425, which is 4.2% of the total engagement subject matter (\$8,425/\$200,500).

Incurred Cost Submission:	Total
Direct Labor	\$100,000
Direct Materials	\$50,000
Other Direct Costs	\$10,000
Overhead	\$20,000
G&A Expense	\$20,500
Total Subject Matter (a)	\$200,500
Materiality Threshold (b)	4.2%
Materiality (c)	\$8,425

Step 2: Identify Significant Cost Elements

A significant cost element is identified by quantified materiality, qualitative materiality characteristics, and other risk factors. The process for determining a significant cost element is as follows:

- **Quantified Materiality:** The auditor should identify all cost elements equal to or greater than quantified materiality as significant.
- **Risk and Qualitative Factors:** The auditor should consider risk and qualitative factors for all cost elements less than quantified materiality. Cost elements may still be considered significant and subject to testing procedures based on risk factors and qualitative characteristics such as a

⁸ Statements on Standards for Attestation Engagements (SSAE) Number 18; AT-C 205.A15.

history of identified misstatements, nature of particular costs, and needs of the users of the audited information.

- **Variability:** The auditor may use judgment and incorporate variability, or unpredictability, in the selection of cost elements to test. For example, an auditor has elected to not test a cost element for the last 2 years due to an immaterial balance. In the current year, and to ensure variability and unpredictability in the testing approach, the auditor may select the cost element for testing. This prevents a pattern from forming and discourages the contractor from recording misstatements in cost elements that have a history of not being tested.

The following example compares the quantified materiality amount of \$134,200 to the cost elements within the subject matter. The materiality amount was calculated by including the total subject matter of \$8,036,024 in the materiality threshold equation. The associated materiality threshold percentage is 1.67 percent ($\$134,200/\$8,036,024$). In the example, an auditor would identify the cost elements of direct labor, direct materials, subcontracts, overhead, and general and administrative costs as significant based on quantified materiality.

Table 5. Comparison of Quantified Materiality to Cost Elements

Cost Element	Amount	> Materiality of \$134,200
Direct Labor	\$2,441,657	YES
Travel	\$54,092	NO
Direct Materials	\$188,716	YES
ODC	\$11,175	NO
Subcontracts	\$3,329,051	YES
Indirect Overhead	\$1,138,408	YES
G&A (Value Added)	\$872,925	YES
Total Subject Matter	\$8,036,024	
Materiality Threshold	1.67%	
Materiality	\$134,200	

A *YES* in the table above means that the cost element is significant and should be further evaluated at the account level, but it does not automatically mean the entire amount will be tested. An auditor is responsible for auditing significant costs elements based on materiality or other factors, but the nature, timing, and extent of audit procedures may vary based on auditor judgment.

The cost elements that are less than the quantified materiality amount may be tested due to qualitative materiality characteristics, other risk factors, or if, in an auditor's judgment, they may contain immaterial misstatements that could be material in the aggregate. The following examples illustrate an auditor's potential qualitative considerations relative to the travel cost element, which is less than the quantified materiality amount. In this example, the auditor did not identify qualitative or risk concerns for the ODC cost element, which is also less than the quantified materiality amount:

- The contractor's travel cost element has a history of misstatements, which have been investigated in the past, and is a stated concern of the contracting officer. If the user of the information (i.e. the contracting officer) considers a particular cost element to be significant based on qualitative facts and circumstances, then an auditor may evaluate it at the account level in the same manner as any other significant cost element.
- The contractor's travel cost element has no history of misstatements, and the contracting officer did not express any concerns in this area. However, the travel cost element was not tested in the prior 2 years. The auditor could test the travel cost element to ensure variability and unpredictability in the audit approach, regardless of whether the risk and qualitative characteristics indicate no testing may be appropriate.

The body of work necessary to support the opinion, or audit conclusions, is generally met with the testing of cost elements and accounts with values greater than materiality or adjusted materiality. The use of qualitative or other risk factors to identify significant cost elements should be based on actual, objective, and measurable facts and circumstances such as history of questioned costs, and needs of the users of the audited information. Absent these objective factors, the auditor is expected to adhere to materiality thresholds. The auditor should document the justification for deviating from the materiality thresholds. See Appendix A for unique considerations regarding indirect costs.

Step 3: Identify Significant Accounts

A significant account is identified by adjusted materiality (as explained below), qualitative materiality characteristics, and other risk factors. The process for identifying significant accounts is as follows:

- (1) ***Adjusted materiality:*** The auditor should identify all accounts equal to or greater than adjusted materiality as significant.
- (2) ***Risk and Qualitative Factors:*** The auditor should consider qualitative factors for all account balances less than adjusted materiality. Accounts may still be considered significant and subject to testing procedures based on risk and qualitative factors such as a history of misstatements, sensitivity, and needs of the users of the audited information.
- (3) ***Variability:*** The auditor should incorporate an element of variability in the selection of accounts to test. For example, an auditor elected not to test an account for the last 2 years due to an immaterial balance. In the current year, and to ensure variability and unpredictability of the testing approach, an auditor may select the account for testing. This prevents a pattern from forming and discourages the contractor from recording misstatements in accounts that have a history of not being tested.

An auditor will use *adjusted materiality* to identify significant accounts subject to audit evaluation. Quantified materiality represents the total amount the subject matter can be misstated without misleading the users of the information. Adjusted materiality is less than quantified materiality. Unless quantified materiality is adjusted at the account level, an auditor would have limited ability to identify immaterial misstatements that, in the aggregate, become material or are material by their nature even if immaterial in amount.

Adjusted materiality is used at a more discrete level in the books and records and is applied to accounts that make up the cost elements. For purposes of selecting accounts for audit testing, adjusted materiality can be stated as 20 percent to 80 percent of quantified materiality based on audit risk, the nature (or sensitivity) of transactions relative to specific cost allowability criteria, other substantive procedures performed (i.e., whether controls are tested), and the needs of the users of audited information.

The following are key concepts with the application of adjusted materiality:

- Adjusted materiality is applied to the accounts within significant cost elements.
- Once an account is selected, an auditor will test the transactions that sum to the account balance.
- Adjusted materiality is determined separately for each significant cost element.

See Appendix A for guidance on how to calculate adjusted materiality for indirect costs where the government's participation is less than 100 percent.

Adjusted materiality can be used as tolerable error (or tolerable misstatement) for the purpose of statistical sample selection (see the Step 4, Engagement Materiality Framework). The following table provides examples of justifications for degrees of adjustment to the quantified materiality for the purpose of calculating adjusted materiality:

Table 6. Justifications for Degrees of Adjustment to the Quantified Materiality

Percent Adjustment	Examples
(80%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element has a history of material misstatements in multiple accounts. ▪ The contractor is unwilling to correct prior-year material misstatements in subsequent proposals. ▪ The contractor is currently in litigation for historical costs in the same cost element and accounts. ▪ The contracting officer has significant concerns regarding the cost element that increase the sensitivity and importance.
(50%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element and multiple accounts have a history of material misstatements. ▪ Management is responsive with correcting misstatements in subsequent proposals. ▪ The contracting officer has concerns regarding the cost element that increase the sensitivity and importance.
(20%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element and accounts have limited to no instances of historical material misstatements on an aggregated basis. ▪ The reduction is to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds total quantified materiality.

The following example illustrates how to calculate adjusted materiality: Based on professional judgment, an auditor elects to reduce the quantified materiality by 20 percent (see Figure 2). If the adjusted materiality is reduced by 20 percent, the remainder represents 80% of the quantified materiality amount (100 percent - 80 percent = 20 percent reduction). The adjustment materiality is calculated by multiplying the quantified materiality of \$1,025 by 80 percent (100 percent - 20 percent), for an adjusted materiality amount of \$820.

Figure 2. Calculated Adjusted Materiality Illustration

Quantified Materiality	\$1,025
Adjustment (less):	(20 percent)
Adjusted Materiality:	\$820

Use of materiality to identify significant amounts becomes more relevant at the account level in the books and records, which make up cost elements. The higher the level aggregation of costs, the more likely that the cost will be selected.

The table below illustrates the practical application of materiality at lower levels of cost in the books or records, or at the account level. The quantified materiality is compared to the cost elements rather than the account level (as indicated by *N/A*), whereas adjusted materiality is compared at the account level (as indicated by *N/A* at the cost element level). Please note that, even if the direct material cost element is greater than quantified materiality, it may not be necessary to test each account in the cost element.

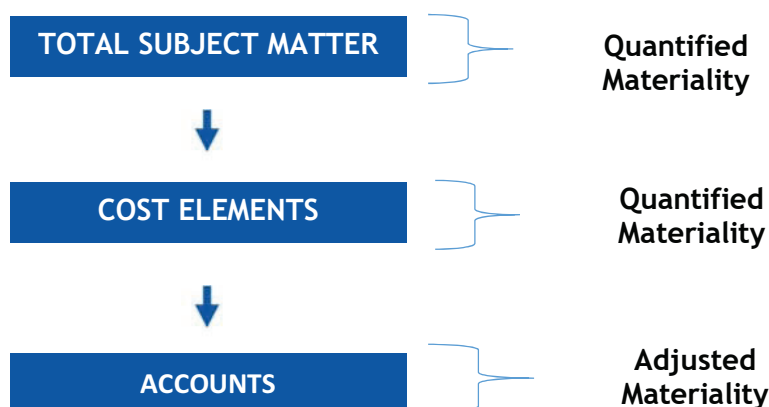
Application of adjusted materiality at the account level identifies three of the six accounts as being material and, thus, needing to be tested. The body of work necessary to support an audit is generally met when an auditor tests cost elements and accounts with values greater than quantified or adjusted materiality. Cost elements and accounts with balances below adjusted materiality (i.e., those with a *NO* response below) may still be subject to testing based on an auditor's judgment, risk factors, qualitative factors, or variability.

Table 7. Application of Materiality at Lower Levels of Cost

Category	Description	Amount	> Materiality \$1,025	> Adjusted Materiality \$820
Subcontracts	Cost Element	\$750	NO	N/A
Direct Materials	Cost Element	\$5,000	YES	N/A
Direct Materials Acct X1	Account	\$850	N/A	YES
Direct Materials Acct X2	Account	\$450	N/A	NO
Direct Materials Acct X3	Account	\$980	N/A	YES
Direct Materials Acct X4	Account	\$500	N/A	NO
Direct Materials Acct X5	Account	\$350	N/A	NO
Direct Materials Acct X6	Account	\$1,870	N/A	YES

Think of it as follows:

Figure 3. Application of Materiality at Lower Levels of Cost



An auditor may combine accounts of the same or substantially similar nature when applying adjusted materiality. For example, a contractor records engineering labor in separate general ledger accounts by project, but the combination of these accounts results in a homogenous amount that is subject to the same audit criteria. Although the contractor separated these like costs into separate accounts for operational or cost accounting purposes, an auditor may combine them for assessing adjusted materiality and testing purposes if that approach makes sense for the audit.

Step 4: Statistical Sampling and Consideration of Tolerable Error Based on Adjusted Materiality

An auditor may use adjusted materiality when determining the tolerable misstatement (or tolerable error) for statistical sample size determination.

An incurred cost audit cannot be completed *effectively and efficiently* by testing 100 percent of all transactions in the subject matter. For this reason, the auditing profession uses statistical sampling to test a representative portion of a transaction population that is sufficient to determine whether the total population is fairly stated.

Although statistical sampling techniques are outside the scope of the document, an important element of statistical sampling is *tolerable misstatement*. Tolerable misstatement represents the total amount of error an auditor is willing to accept in the statistical sample. When auditors use statistical sampling, they are incorporating materiality into the audit. See the AICPA Statistical Sampling guide for additional information.

There is an interrelationship between adjusted materiality, tolerable misstatement, and audit sampling. By using adjusted materiality (converted to a percentage of the transaction population value) as tolerable misstatement, statistical sample sizes will be commensurate with the size of the population in relation to the overall subject matter, audit risk, and materiality. The higher the tolerable misstatement, the lower the sample size.

In practice, an auditor will remove transactions greater than adjusted materiality from the population and test 100 percent of these amounts separately. The remainder of the transactions within the

population would then be subject to the statistical sampling process. If the value of the remaining population (after removing transactions with values greater than adjusted materiality) is less than adjusted materiality, then an auditor may judge it immaterial and forego further statistical sampling. Generally, when the remaining population has an aggregate value greater than adjusted materiality, the transactions will be subjected to audit procedures. This process accounts for the aggregated nature of misstatements to the overall assessment of adjusted materiality.

Steps 5 and 6: Determine the Nature, Timing, and Extent of Audit Procedures; Perform Audit Procedures; Document Results

These steps represent the planning process and fieldwork related to the nature, timing, and extent of audit procedures based on the risk of material misstatement and the Audit Risk Model (inherent risk, control risk, and detection risk), if applicable. The concepts of quantified materiality and adjusted materiality should be considered, as set forth in this chapter, in this part of the audit process.

The auditor should document the basis for materiality and the method of determining materiality.

Step 7: Reporting Audit Results

An auditor can use quantified materiality as a guide for determining the existence of one or more material misstatements when forming an audit opinion, or audit conclusion, on the subject matter. An auditor will summarize all misstatements and compare them individually, and in the aggregate, to quantified materiality.

For example, in the instances of an attestation engagement if the aggregate amount of identified misstatements is less than quantified materiality, then an auditor may issue an unqualified opinion provided, however, that no *quantitatively immaterial* misstatements are *qualitatively material*. If the aggregate of all misstatements is greater than quantified materiality, or if one or more misstatements are qualitatively material, an auditor will issue a qualified or adverse opinion, as applicable. This same process can be used to evaluate scope limitations and disclaimer of opinion.

A few key points for attestation engagements include the following:

- If misstatements individually or in the aggregate exceed quantified materiality, they will result in a qualified opinion, but not necessarily an adverse opinion. An adverse opinion is appropriate if material misstatements are so pervasive that the subject matter, taken as a whole, is not reliable.
- The dollar value of some misstatements may be greater than the value of the underlying misstated transaction. For example, a misstated direct labor cost may draw allocable indirect costs. In this instance, an auditor should evaluate the fully-absorbed value of the misstatement relative to quantified materiality.
- The dollar value of some misstatements may be less than the value of the underlying misstated transaction. Indirect cost misstatements should be adjusted for participation percentages to normalize the amount to account for the proportion of the cost that is allocated to a contractor's work outside of the engagement subject matter. For example, an auditor identifies a \$500,000 misstatement in an indirect cost pool with a government participation percentage of 20 percent.

The actual effect of the misstatement on the engagement subject matter (i.e., indirect costs allocated to the government contracts) is \$100,000 (\$500,000 * 20 percent). In this instance, an auditor should evaluate the value of the indirect cost misstatement, after adjustment for government participation, relative to quantified materiality.

- Although qualitative factors are discussed below, it is important to emphasize that some misstatements may be considered material and affect the audit opinion regardless of dollar value.

Quantified materiality is based on the presumption that misstatements, individually or in the aggregate, that exceed that amount would influence the judgment of a reasonable person using the audited financial information with knowledge of the uncorrected misstatements.

An auditor’s assessment of materiality requires consideration of both quantitative and qualitative factors in the context of the *total mix* of information available to the users of the audited financial information. As a result, qualitative factors, such as the existence of expressly unallowable costs or evidence of irregularities, could be material facts within the *total mix* of information regardless of dollar value.

The following table sets forth examples of qualitative considerations unique to incurred costs audits that may result in quantitatively immaterial misstatements being considered material and, in turn, affect the audit opinion or audit conclusion. The information below is intended to be illustrative of relevant qualitative factors, rather than exhaustive.

Table 8. Examples of Qualitative Considerations Unique to Incurred Costs Audits

Qualitative Factor	Explanation
Expressly Unallowable Indirect Costs	According to FAR 52.242-3, the inclusion of expressly unallowable indirect costs, when identified, explicitly contradicts the contract terms and subjects the contractor to penalties. The pervasive existence of this form of misstatement creates a higher level of sensitivity and risk when reporting audit results. The determination of a material misstatement is at the auditor’s judgment, but generally these misstatements should be evaluated for materiality with less emphasis on the quantified materiality.
Specific Contract Terms	The audit criteria applicable to audits of incurred costs represent contract terms that incorporate specific elements of the FAR, CAS, and so forth. In addition to these regulations, certain contracts may have unique clauses, such as cost limitations on certain activities and the disallowance of certain types of costs such as overtime. Because these unique clauses establish the specific desires of a particular government customer, quantitatively immaterial but pervasive misstatements in this regard may be viewed as material to that customer.

Other relevant qualitative factors may relate to the audit subject matter and the needs of the acquisition community. For example, a contractor may have significant restructuring costs, purchase accounting for an acquisition, overseas operations, or other issues that have qualitative considerations that differ from the ones identified above but are just as relevant. The nominal reporting amount can be considered for reporting misstatements due to qualitative factors.

Step 8: Report or Communicate Misstatements

The auditor should report or communicate, as appropriate, both material and immaterial misstatements to the contracting officer in accordance with Government Auditing Standards (FY 2018 Yellow Book, paragraphs 7.46 and 9.38):

When auditors detect instances of noncompliance with provisions of laws, regulations, contracts, and grant agreements that do not warrant the attention of those charged with governance, the auditors' determination of whether and how to communicate such instances to audited entity officials is a matter of professional judgment.

For incurred cost audits, the need for communicating immaterial information is important because it can result in the transfer of funds between the contractor and government. For example, \$5,000 of questioned direct cost not only may impact the audit opinion or conclusion, but also represents an amount that may be recovered by the government. These amounts should be communicated to the contracting officer to facilitate appropriate disposition.

CHAPTER 3: AUDITS OF INTERNAL CONTROL OVER GOVERNMENT CONTRACT COMPLIANCE

Government Perspective on the Importance of Internal Controls

For government officials to manage programs and contracts effectively, they must be able to rely on information produced by the contractor. The ability of contractors to produce materially accurate information depends on the design and operating effectiveness of their business system internal controls. Without internal controls, it could be difficult for contractors to produce reliable and timely information. Although no internal control system can provide absolute assurance that the information will never include material errors or misstatements, an effective system of internal controls over contractor business systems can substantially reduce the risk of error and misstatements.

Obtaining timely assurance that contractors have effective internal controls is an essential component of all cost-effective compliance frameworks. Consideration of how recently a business system audit was performed and the results is a critical part of the DoD's own system of acquisition internal controls. Effective contractor internal controls permit most additional audits and reviews to be performed more efficiently and timely. Obtaining assurance about internal controls effectiveness is one of the most efficient ways to protect the Government's interest, reduce risk, and improve timeliness.

Defining Internal Controls

Internal controls are the responsibility of the contractor. The auditor will test the internal controls and provide an opinion, or conclusion, on whether they are suitably designed and operating effectively.

Internal controls are defined as a process, affected by the entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.⁹ This definition emphasizes the achievement of objectives. For companies or organizations with Government contracts, the objective is to bill, or report, contract costs in compliance with contract terms and federal regulations. The relationship between objective, risks, and internal controls is as follows:

- An objective defines what the contractor wants to achieve,
- A risk represents a situation, circumstance, or event that the contractor wants to avoid (i.e., an occurrence that results from not achieving the objective), and
- Internal control activities are procedural steps designed and performed to prevent, or detect and correct, the occurrence of a risk such that the objective is achieved.

An internal control framework should generally address five components: control environment, risk assessment, control activities, information and communication, and monitoring activities. However, the extent of implementation by the contractor is dependent on size and complexity and is explained in greater detail in the subsection on Internal Controls Frameworks. These components are introduced in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control—

⁹ The Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control—Integrated Framework (May 2013)

Integrated Framework (May 2013) framework and have been recognized and accepted by the AICPA, and the Government Accountability Office.

The only way to determine if internal controls are suitably designed and operating effectively is to test them. It is not appropriate to presume that a contractor has effective internal controls based on the results of audits that do not test internal controls. The existence of a material misstatement in an audit of contract costs does indicate an internal control deficiency. However, the converse is not true. The absence of a material misstatement does not provide the requisite assurance regarding the effectiveness of a contractor's systems and internal controls. The severity of an internal control deficiency is determined by assessing the likelihood that it will result in a material misstatement and is not contingent on whether a material misstatement has occurred. While the contractor may bill or report costs that comply with contract terms in any one period, if the contractor's internal controls are ineffective, the internal controls cannot provide reasonable assurance that a material mistake, fraud, or management override will be prevented or detected and corrected timely. An accounting system that lacks effective internal controls has a greater likelihood of billing or reporting costs that are not compliant with contract terms and federal regulations.

Internal Control Frameworks

The type of internal control framework and the extent of adoption is at the discretion of the contractor. The Committee of Sponsoring Organizations (COSO) of the Treadway Commission has developed an Internal Control—Integrated Framework (May 2013) which has gained broad acceptance in the private sector and is widely used around the world. The federal government has developed a similar framework that adapts the COSO Internal Control – Integrated Framework principles and addresses the unique government environment in the *Standards for Internal Control in the Federal Government* (GAO-14-704G), which is commonly referred to as the *Green Book*.

An internal controls framework assists management, board of directors, external stakeholders, and others interacting with the entity in their respective duties regarding internal control without being overly prescriptive. It does so by providing both understanding of what constitutes a system of internal control and insight into when internal control is being applied effectively¹⁰. For accounting system audits related to government contract costs, the auditor does not test the internal controls framework, but rather, tests the internal controls. Regardless, it is important to acknowledge the fact that the internal controls and framework are, by definition, inter-related and a poorly implemented framework may result in ineffective internal controls.

Whether or not a contractor adopts an internal control framework often relates to a contractor's size and complexity. Contractors design and implement control activities relative to their own risks, size, complexity and other relevant factors. For example, a large public company may have adopted an internal control framework (e.g. COSO) to define and meet its control objectives. In contrast, a smaller company with less complex operations may not be aware of formal internal control frameworks, but nevertheless have internal controls commensurate with its size, complexity, and other relevant factors. Auditors are encouraged to understand the contractor's business, the environment in which it operates, the software systems it uses for accounting purposes, how accounting-related business processes are

¹⁰ COSO Internal Control – Integrated Framework, Executive Summary, May 2013

performed, and the contractor's employees either responsible for or participating in those processes. This chapter creates no requirement that the contractor adopt the COSO or any other internal controls framework.

For every contractor, regardless of size, each component of an internal control framework (e.g. control environment, risk assessment, control activities, etc.) will likely be reflected in the manner by which management runs its business (regardless of whether or not management has consciously or formally adopted an internal control framework). Because every business is unique, the auditor should approach an internal control audit using an internal control framework as a means to understand each contractor's unique accounting system controls. Auditors should not expect contractor internal controls to function identically or even at the same level for every company.¹¹

Concept of Reasonable Assurance

The contractor is responsible for designing and operating effective business processes and internal controls to, provide reasonable assurance that the cost information is reliable and complies with contract terms and federal regulations, as applicable. The concept of "reasonable assurance" recognizes that the cost of achieving greater assurance will, at some point, exceed the benefit of the higher assurance. This concept is acknowledged in the Federal Acquisition Regulation Guiding Principles¹². The concept of reasonable assurance as it relates to systems of internal control also recognizes that it is not possible to declare with absolute certainty that an error or misstatement will not occur. For example, the system is operated by people and people inevitably make mistakes, systems breakdown, and organizations change. In addition, intentional misconduct, like fraud and collusion, can prevent controls from working as intended regardless of how well the controls were designed.

For the auditor, evaluating whether or not a contractor's accounting system internal controls provide reasonable assurance is inherently dependent on each contractor's unique facts and circumstances. In this regard, Public Company Accounting Oversight Board's (PCAOB) definition of reasonable assurance is instructive. In the context of an internal control audit over financial reporting, reasonable assurance means that there is a remote likelihood that material misstatements will not be prevented or detected and corrected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. This concept can be applied to audits of contractor accounting system internal controls relative to the criteria contained in DFARS 252.242-7006, Accounting System Administration.

Contractor Internal Controls

The internal controls and business processes are the responsibility of the contractor. This section is designed to provide information on certain aspects of the contractor's internal controls and the scaling of risk.

The objective of the accounting system is to record, accumulate, and summarize financial transactions related to financial reporting, performance reporting, and government contracts (i.e. costs comply with

¹¹ COSO Internal Control over Financial Reporting – Guidance for Smaller Public Companies, dated June 2006

¹² FAR 1.102-2(c)(2), "To achieve efficient operations, the [Federal Acquisition] System must shift its focus from "risk avoidance" to one of "risk management." The cost to the taxpayer of attempting to eliminate all risk is prohibitive."

contract terms and federal regulations). This objective statement is broad and refers to the entire accounting system. The accounting system includes many different types of costs (e.g. labor, materials) that represent different operational activities and distinct business processes. For example, the business processes and internal controls for labor cost are different when compared to other cost elements such as travel.

Contractor Objectives and Business Processes

The contractor will design and implement business processes that achieve operational and financial objectives. The accounting system, as defined at DFARS 252.242-7006, is the collection of accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions.

The accounting system should be designed to meet the contractor's objectives and incorporate the necessary internal control activities to reasonably assure that those objectives are met. Whether the contractor's accounting system is already established, or is in the process of being newly implemented, the following diagram illustrates how to evaluate a business process and identify its internal controls.

Figure 4. Evaluating a Business Process and Identifying Internal Controls



- **Objectives:** Through business process walkthroughs and inquiries, the auditor identifies the contractor's objectives related to operations, reporting (e.g., financial statements, incurred cost proposals) and compliance. The overall objective for government contracts is for costs to be billed, or reported, to the government in compliance with contract terms and federal regulations.
- **Risk Assessment:** The process for identifying and analyzing risks forms the basis for determining how risks should be managed to achieve the entity's objectives.¹³ The risk assessment process consists of
 - considering the business processes, or *how things are done*,
 - identifying the risks that the objective will not be achieved,
 - estimating the significance of the risks,
 - assessing the likelihood of the risks occurring, and

¹³ Risk Assessment definition from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control – Integrated Framework (2013).

- deciding what actions to implement to address those risks.
- **Internal Control Activities:** The contractor will implement internal control activities based on the risk assessment and business process to mitigate the risk of not meeting the objectives.

Contractor Objectives for Government Contracts and Scaling of Risk

In simplified terms, risk is the inverse of an objective. The following are the different categories of risk from the perspective of the accounting system:

- **Accounting System Criteria and Risk:** The Accounting System Criteria represents the overall objectives of an accounting system. The associated risk, or the potential for not meeting these objectives, is global across the entire contractor for government contracts and applicable to every cost element billed or reported to the Government.
- **Process Objectives and Risks:** Process risks are defined at the process level. They are based on the Accounting System Criteria but defined in the context of the costs and business process.

The Accounting System Criteria are the benchmarks used to measure whether the objective has been achieved. If the system has implemented internal controls that mitigate the risks of the Accounting System Criteria not being met, the contractor and the government can state the system was suitably designed to mitigate the risks of noncompliance with the overall objective.

The following table shows the interrelationship among the objective, Accounting System Criteria, and the risks of not achieving the objective:

Table 9. Interrelationships among Objective, Accounting System Criteria, and Risk of Not Achieving Objective

Accounting System Criteria	Risk
(1) Classification of direct costs and indirect costs in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Contract costs are not properly classified as direct and indirect in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(2) Identification and accumulation of direct costs by contract in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Direct contract costs are not identified and accumulated to the correct contract in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(3) Methods to accumulate and allocate indirect costs to contracts in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Indirect costs are not accumulated and allocated to contracts in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(4) General ledger control accounts that accurately reflect all transactions recorded in subsidiary ledgers or other information systems that either integrate or interface with the general ledger including, but not limited to, timekeeping, labor cost distribution, fixed assets, accounts payable, project costs, and inventory.	The general ledger does not reflect transactions recorded in subsidiary ledgers or other information systems that integrate or interact with the general ledger.
(5) Adjustments to the general ledger, subsidiary ledgers, or other information systems bearing upon the determination of contract costs (e.g. adjusting journal entries, reclassification journal entries, cost transfers, etc.) for reasons that do not violate contract terms, FAR, CAS, and other regulations, as applicable.	Adjustments made to the general ledger from whatever source violate contract terms, FAR, CAS, or other regulations, as applicable.
(6) Identification and treatment of unallowable costs in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Unallowable costs are not identified in the accounting system and not properly resolved in accordance with contract terms, FAR, CAS, or other regulations, as applicable.
(7) Billings prepared in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Billings are not prepared in accordance with contract terms, FAR, CAS, or other regulations, as applicable.
Objective: The contractor bills and reports costs that comply with contract terms and government regulations such as FAR and the CAS, if applicable.	

To implement internal control activities, the risks must be defined and understood in the context of the business processes and costs. Business processes and internal controls are designed to mitigate the risks of noncompliance with the Accounting System Criteria. The level and nature of the documentation will vary based on the size of the contractor and the complexity of the control.

Contractor Risk Assessment and Internal Control Activities

This section refers to contractors' assessment of risk and the implementation of internal controls for their own processes. The auditors' risk assessment process, performed as part of the internal controls audit, is different and discussed in a section below.

Contractors are responsible for assessing risk and implementing internal controls to address those risks. The risk assessment links global risks of not meeting the Accounting System Criteria to business processes, process risk, and internal control activities. If contractors have documented risk assessment

to meet the criteria of the accounting system, this may be useful to the auditor and should be requested. The risk assessment process, formality, and its associated documentation is at the discretion of the contractor. It is possible for a contractor to have effective internal controls without formally documenting a risk assessment.

A common method used in the risk assessment process is to ask the question, *What can go wrong?* in the context of the government risks and the accounting system. The basis for this question is the inherent in the Accounting System Criteria for government contract risk. When contractors design the business process, this question may be asked, and the internal control activities designed to mitigate the risk. Likewise, auditors will follow a similar process when evaluating design of contractors' internal controls, but it is important to make the distinction that business processes and internal controls are the sole responsibility of contractors. Auditors' role is to evaluate the effectiveness of contractors' internal controls in mitigating the risks. The internal controls audit is a useful tool for the contractor in determining whether the internal controls are sufficient.

An internal control activity is defined as an action established through policies and procedures that helps ensure management's goal of achieving its objectives and mitigating the risks is attained.

There are different types of internal control activities:

- Manual internal control activities are performed by the contractor personnel using the software application or on hard copy documents; for example, the review and sign-off of a journal entry.
- Automated internal control activities are imbedded in software applications used to process business transactions. For example, the feature in the timekeeping system that limits the charge codes to certain personnel based on work location and position title.
- Manual and automated internal control activities can be either preventative or detective in design and operation.
- Information Technology General Computer Controls, which apply to many applications affect compliance with the Accounting System Criteria and internal controls.
- If contractors outsource a significant business process, such as processing payroll or another service, the internal controls over this service should be evaluated as part of the overall internal controls assessment.
- Entity-level controls function at higher levels in the organization; are generally not process or cost element specific; and include controls over the control environment, monitoring, and controls over management control. For example, a business unit general manager reviews actual indirect cost rates compared to provisional indirect rates.
- Process-level internal control activities are designed and placed in operation at the business process and cost element level. For example, the review and approval of a timesheet is a process level internal control for the labor cost element.

Auditors and Testing of Internal Controls

The objective of an internal controls audit of the accounting system is to determine if internal controls are effective in mitigating the risk of the noncompliance with contract terms and federal regulations. The audit subject matter is the contractor internal controls related to government contract risk and the audit criteria is defined by the Accounting System criteria.

The definition of the accounting system is broad and includes all costs that are recorded, accumulated, and reported (i.e. billed to government contracts) by the contractor, but this does not mean the auditor must test every aspect of the contractor accounting system:

- The auditor should focus on the government contract compliance risks (i.e., Accounting System Criteria).
- The auditor should focus on testing the internal controls related to material, or significant, cost elements.
- The auditor should test the internal controls that are the most effective at mitigating the risks of noncompliance. These are generally referred to as *key internal controls*.

Additionally, considering internal control in the context of a comprehensive internal control framework, such as Standards for Internal Control in the Federal Government or COSO Internal Control—Integrated Framework can help auditors to determine whether underlying internal control deficiencies exist as the root cause of findings.¹⁴

During the planning phase of the audit, the auditor should obtain an understanding of the significant cost elements billed, or reported, through the accounting system and associated contractor business processes and internal controls. The auditor should request the contractor risk assessment (if available) and discuss with the contractor. Significant cost elements are determined based on dollar value (quantitative), qualitative characteristics, or importance to the contracting officer.

The contractors accounting system and business processes may be complex. The top-down approach can be used in the planning phase of the audit to align auditors' efforts with significant costs to the government. The approach begins with the identification of significant cost elements in the contractor billing or final indirect cost rate proposal (e.g., incurred cost proposal). For each significant cost element, auditors focus on the entity-level controls and works down to the accounts, business processes, and process-level controls. The auditor verifies his or her understanding of the risks and business processes to address the risk of material noncompliance. This process is a holistic approach to internal controls in which auditors focus on the total process and other mitigating controls. It also allows for auditors to consider the materiality of the cost element and potential error when determining the severity of the internal control deficiency.

For a cost element, auditors obtain an understanding of the process and internal control activities by performing a walkthrough which traces the transactions through the accounting system. This

¹⁴ GAO, Auditing Standards revision 2018, paragraph 8.130.

walkthrough includes noting the reason for an action to record the cost, performance of the action that creates the costs, a description of how the action and the associated cost is tracked, and the internal control activities. The walkthrough is typically performed in the planning phase of the audit and is documented in a sequential order from the initial transactions to the accumulation of the cost on the books and records and can include multiple policies and procedures.

Not all internal controls are equal in importance. Auditors should identify key internal controls for each cost element and associated business process. Key internal controls are the primary means for providing reasonable assurance that contract costs comply with contract terms and federal regulations. If the key internal controls are designed and functioning, then the risks should be mitigated. In contrast, if the key internal controls are not functioning, then the compensating internal controls should be tested to ensure the risk is mitigated (mitigating internal controls). Every business process will have key and non-key internal controls. From an audit perspective, it is generally acceptable to only test key internal controls if the key controls are suitably designed and functioning.

Auditors should develop audit procedures to test the design and functioning (referred to as operating effectiveness in the attestation standards) of internal controls aligned with each of the accounting system criteria:

- **Internal Control Design:** The auditor should test the design effectiveness of controls by determining whether the contractor's controls, if they were operated as designed by persons possessing the necessary authority and competence to perform the control effectively, would satisfy the company's control objectives and effectively prevent or detect errors or fraud that could result in material noncompliance.
 - Procedures auditors perform to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.
- **Internal Control Operation:** Auditors should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.
 - A smaller, less complex contractor might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex contractor might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, auditors should evaluate whether those alternative controls are effective.
 - In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to government contract costs.

- Procedures auditors perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and reperformance of the control.

Contractor may have internal controls tested by different auditors during the year, such as financial statement auditors, internal auditors, and government auditors. The auditor performing the business system audit (the *primary* auditor) may use the work of other auditors; doing so can increase audit efficiency, and may reduce the contractor compliance burden, but has limitations. The primary auditor has the sole responsibility for the opinion, or conclusion expressed, and that responsibility is not reduced by using the work of other auditors. The primary auditor should determine that the work performed by others is sufficient and appropriate for use in the audit. The other auditors must be independent of the subject matter, competent, and objective. The mere fact that other auditors performed internal control testing does not automatically imply that the work can be used by the primary auditor. See the AICPA Professional Standards, *Standards on Attestation Engagements*, and GAO, Government Auditing Standards 2018 revision, for additional information on using the work of others.

Hierarchy of Internal Control Deficiencies

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct (a) impairments of effectiveness or efficiency of operations, (b) misstatements in financial or performance information, or (c) noncompliance with provisions of laws, regulations, contracts, or grant agreements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.¹⁵

A misstatement represents information provided to the government that does not comply with contract terms and applicable federal regulations, such as the FAR and CAS. A material misstatement could reasonably be expected to influence, and may adversely affect, the economic or management decisions of information users. A material misstatement will normally result in a material noncompliance because all misstatements are due to a noncompliance with contract terms or federal regulations. A *material noncompliance* is defined as:

A misstatement in the information provided to the Government (e.g. billings, incurred cost submissions, pricing proposals, etc.) that will materially influence, and may adversely impact the economic or management decisions of the users of the information.

For a compliance audit designed to test specific system related criteria, a deficiency can occur due to either internal control deficiencies or system shortcomings. A shortcoming pertains to a noncompliance

¹⁵ Paragraph .07 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, AU-C sec. 265).

with system criteria, and not necessarily internal controls, although it is unlikely one would exist without the other. For accounting systems, internal control deficiencies are categorized by severity as material weakness, significant deficiency, and other deficiency. The categorization is irrespective of the type of engagement (e.g., attestation, inspection) that is performed to test internal controls or compliance with a specific system criterion. The system deficiencies are as follows:

- **Material Weakness:** A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliance or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.
- **Significant Deficiency:** A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.
- **Other Deficiency:** A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that have a clearly trivial, or inconsequential, effect on the ability of the business system to detect and correct errors on a timely basis.

The *other deficiency* definition acknowledges the possibility that a system deficiency, or combination of systems deficiencies, may have a clearly trivial effect on the quality of information produced by the contractor's business system. Clearly trivial represents the inverse of *material* whether judged by any criteria of size, nature, or circumstances. Other deficiencies will not affect the audit opinion or conclusions and will not be included in the audit report. These deficiencies may be communicated to contracting officers using email or other communication methods.

Not all deficiencies rise to the level of a material weakness. Auditors should evaluate the deficiency in the context of the overall system, materiality, whether it is systematic or pervasive, and the existence of mitigating controls. These factors are described below:

- **Materiality:** To be a material weakness, the internal control deficiency can result in a material noncompliance which could reasonably be expected to influence, and may adversely impact, the economic or management decisions of the users of the information. For example, the auditor identifies several internal control deficiencies in the travel cost process. The travel costs are immaterial in relation to other costs at the contractor and generally represent a small percentage of costs billed or reported. In this instance, the travel costs will never result in a material weakness, because it is impossible for an immaterial cost element to have a misstatement that rises to the level of a material noncompliance. The internal control deficiencies should be evaluated for categorization as a significant deficiency or other deficiency.
- **Systematic and Pervasive:** One of the factors in determining whether a system deficiency is material depends on whether it is systematic or pervasive. Some internal control deficiencies

have a limited impact to one or only a few cost elements and will not result in a material noncompliance. When the control deficiency affects only one type of cost (e.g., labor or material cost), the severity is evaluated based on the materiality of that specific cost element. Another factor is the frequency of occurrence based on whether the root cause of the deficiency represents a unique situation or one that occurs frequently.

- **Mitigating Controls:** If the auditor discovers an internal control deficiency, the next step is to determine if there are other controls that are designed and in operation to mitigate the risks related to the deficient internal control. If this is the case, the severity of the internal control deficiency should be evaluated against the existence of other internal controls and may be determined as having no impact on the overall system.

Reporting Requirements for Internal Control Deficiencies

Contracting officers will use internal controls audit results to determine if the accounting system is approved or disapproved. The key factor in this determination is whether the business system is acceptable and materially complies with the Accounting System Criteria. An acceptable business system is defined as a contractor business system that materially complies with the criteria of the applicable business system clauses and does not contain a material weakness that would affect the ability of DoD officials to rely on information produced by the system.

When auditors identify findings, they should plan and perform procedures to develop the criteria, condition, cause, and effect of the findings to the extent that these elements are relevant and necessary to achieve the audit objectives.¹⁶ The report should provide enough information to allow the contracting officer to make an informed decision. Stating something is wrong and providing no supporting information is not sufficient. Contracting officers need to be informed of the finding, but the cause and effect provide the information necessary to determine the next course of action. The effect takes into account materiality, whether the finding is systematic or pervasive, and mitigating controls. The following provides a summary of the report note elements:

- **Criteria:** The Accounting System Criteria (see above) applicable to the overall accounting system and significant cost elements. Criteria identify the required or desired state or expectation with respect to the program or operation and provide a context for evaluating evidence and understanding the findings, conclusions, and recommendations in the report. For internal controls, the criteria should be framed in the context of the cost element, business process, and accounting system criteria.
- **Condition:** The condition is a situation that exists and is discovered during the audit. For a system deficiency, the condition is due to either internal controls or other shortcomings in the system. For example, the auditor sampled 50 invoices for evidence of an approval control and identified 10 out of 50 as lacking approval.
- **Cause:** The cause is the factor or factors responsible for the deficiency. For internal controls, the cause can be due to the design or operation, and for shortcomings the cause could be due to a

¹⁶ GAO, FY 2018 Yellow Book, paragraph 7.19

noncompliance with a prescribed contract term or a deviation in the contractors documented policy and procedures. The cause is the factor or factors responsible for the difference between the condition and the criteria, and may also serve as a basis for recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria and inconsistent, incomplete, or incorrect implementation.

- ***Effect or Potential Effect:*** The effect or potential effect is the outcome or consequence resulting from the difference between the condition and the criteria. The severity of the system deficiency as a material weakness, significant deficiency, or other deficiency is correlated to the effect or potential effect. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

APPENDIX A: CONSIDERATION OF MATERIALITY AND INDIRECT COSTS

Indirect costs are allocated to contracts by using indirect cost rates, which represent a pool of indirect costs divided by a cost base of a contractor's direct and/or indirect activities. Indirect costs are, by definition, costs that cannot be directly allocated to contracts. A contractor's final indirect cost rate proposal (i.e., incurred cost proposal) contains several schedules that identify these pools and bases.

Participation Percent: Because indirect costs are not directly charged to contracts, they are allocated over a base of costs representing business activities that may include a mix of commercial and competitively award fixed price work, as well as flexibly-priced government contracts. Therefore, the indirect costs allocated to flexibly priced government contracts may be less than the total amount of the respective indirect cost pool(s). The participation percentage for each final indirect cost pool reflects the proportion of flexibly-priced government contract activity within the allocation base to the total of all activity in the allocation base. For example, if a general and administrative (G&A) cost base is \$1,000,000 and the cost of activity on flexibly priced government contracts is \$100,000 of the base, then the participation percent is 10 percent ($\$100,000/\$1,000,000$). This affects the audit approach for indirect costs because adjusted materiality should take into account the participation percent.

See the FAR and CAS for additional information on indirect costs and rates.

The following steps should be followed by an auditor when calculating adjusted materiality for indirect costs:

- The auditor will calculate quantified materiality and determine whether the indirect cost elements are significant.
- From the perspective of quantified materiality, the significance of indirect costs is based on the contribution of those costs to the total subject matter.
- If the specific indirect cost element is immaterial, then the auditor may perform limited procedures.

The example below includes direct and indirect cost elements with a total subject matter amount of \$8,219,400. The subject matter amount is the summation of all costs direct and indirect. Quantified materiality is calculated using the total subject matter and the materiality formula in this chapter, which results in a benchmark of \$136,490, or 1.66 percent of the subject matter ($\$136,490/\$8,219,400$). An auditor will compare the quantified materiality to the cost elements and determine whether they are significant. Using this approach, the cost elements of direct labor, subcontracts, overhead indirect costs, and G&A costs are considered quantitatively material. Note, an auditor may still consider certain quantitatively immaterial cost elements to be material based on their professional judgment concerning risk and qualitative factors.

Figure 5. Example with Indirect Costs

Incurred Cost Proposal		> Materiality \$136,490 (YES/NO)
Direct Costs:		
Direct Labor	\$ 5,000,000	YES
Direct Materials	\$ 100,000	NO
Other Direct Costs	\$ 80,000	NO
Subcontracts	\$ 1,000,000	YES
Indirect Costs:		
Overhead	\$ 1,112,400	YES
General and Administrative	\$ 927,000	YES
Total Subject Matter:	\$ 8,219,400	
Materiality Threshold:	\$ 136,490	

For the calculation of adjusted materiality, an auditor should revise quantified materiality for the indirect costs 'participation percent' to identify significant accounts. The table below compares the costs allocated to flexibly priced government contracts (i.e., subject matter) to the total costs in the pool, which, when divided together, yields the participation percent.

Table 10. Comparison of Costs Allocated to Flexibly Priced Government Contracts

Indirect Costs:	Total Subject Matter	Total Cost in Pool	Participation Rate
Overhead	\$1,112,400	\$11,124,000	10%
General and Administrative	\$927,000	\$11,587,500	8%

Based on the above calculation the government participation percent for overhead costs is 10 percent and G&A costs is 8 percent. An auditor may now revise the quantified materiality for the participation percent. This aligns the materiality for the engagement to the total cost in the pools. Because the government participates in these pools, 10 percent and 8 percent, respectively, misstatements (individually or in the aggregate) in the overhead and G&A pools would have to exceed \$1,364,898 and \$1,706,122, respectively, to yield a \$136,490 misstatement on flexibly priced government contracts.

Table 11. Revised Materiality Calculations

Indirect Costs:	Participation Percent	Materiality	Revised Materiality
Overhead	10%	\$136,490	\$1,364,898
General and Administrative	8%	\$136,490	\$1,706,122

The revised materiality amount for the overhead cost is calculated by dividing the quantified materiality of \$136,490 by 10 percent. The revised materiality amount for general and administrative cost is calculated by dividing the quantified materiality of \$136,490 by 8 percent.

- Calculate adjusted materiality using the revised quantified materiality (see above) and in the same manner as Step 3 of the Engagement Materiality Framework. The adjusted materiality will be used for the identification of significant accounts that comprise the indirect cost rate pool.

The following example uses a reduction of 20 percent to calculate adjusted materiality.

Table 12. Materiality Adjusted by 20 Percent

Indirect Costs:	Revised Materiality	Adjustment	Adjusted Materiality
Overhead	\$ 1,364,898	20%	\$ 1,091,918
General and Administrative	\$ 1,706,122	20%	\$ 1,364,898

- Based on adjusted materiality, determine which accounts are quantitatively material. Evaluate the accounts for factors such as risk, qualitative factors, and variability. Determine the nature, timing, and extent of testing.

The following example compares the adjusted materiality amount of \$1,091,918 to accounts in the overhead cost pool. This illustration lists only three accounts of many. Based on adjusted materiality, only the labor account is considered significant. The process for the general and administrative accounts is the same as the overhead accounts.

Table 13. Comparison of Adjusted Materiality to Accounts in Overhead Cost Pool

Overhead Pool Accounts	Amount	> Adjusted Materiality (YES/NO)
6001 Labor	\$ 3,000,000	YES
6002 Operating Supplies	\$ 900,000	NO
6003 Computer & Data Process Supply	\$ 100,000	NO
XXXX
	<u>\$ 11,124,000</u>	

Auditors are responsible for determining the nature, timing, and extent of audit procedures for the labor account. Note, auditors may consider accounts less than adjusted materiality to be significant based on their professional judgment of risk and qualitative factors.

APPENDIX B: TOTAL SUBJECT MATTER

From an audit perspective, the total subject matter is defined as the information on which the auditor provides an opinion (i.e., assurance) or conclusion. For incurred cost audits, the subject matter is defined as cost claimed on flexibly priced contracts during the year and includes different categories of cost such as labor, materials, other direct costs, and indirect costs. For time and material (T&M) contracts, the definition of flexibly priced contracts includes the material portion, but it is not uncommon to test both materials and labor (e.g., labor categories and labor hours) as part of the incurred cost audit due to audit efficiency.

Section 803 of the FY 2018 NDAA, defines *flexibly priced contract* the same as the term *flexibly-priced contracts and subcontracts* in FAR Part 30 (Section 30.001 of Title 48, CFR).

Total subject matter generally includes the following:

- The direct and indirect cost of flexibly priced prime contracts and subcontracts awarded by DoD.
- The direct and indirect costs of flexibly priced prime contracts and subcontracts awarded by an agency other than DoD and the agency has agreed to the audit.
- The amount billed on prime T&M contracts that are awarded by DoD.
- The amount billed on prime T&M contracts that are awarded by an agency other than the DoD and the agency has agreed to the audit.

Total subject matter generally excludes the following:

- The direct and indirect cost of flexibly priced contracts and subcontracts awarded by agencies other than DoD that have not agreed to the audit.
- The amount billed for prime T&M contracts awarded by agencies other than DoD that have not agreed to the audit.
- Amounts for contracts that are not flexibly priced such as firm-fixed-price contracts.
- Amounts for nongovernment activity such as commercial activities.