



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PAS 730.3.B.3

March 3, 2008
08-PAS-011(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Reporting Internal Control Deficiencies

Summary

This guidance incorporates new GAGAS definitions and clarifies existing guidance related to reporting internal control deficiencies. All internal control deficiencies that result in or could result in costs being charged to Government contracts that are not in accordance with applicable laws, regulations, or contract terms should be reported as significant deficiencies and be considered material weaknesses, unless the potential unallowable cost is clearly immaterial.

Conditions that clearly would not materially impact Government contract costs, but the system would be enhanced if they were corrected, should continue to be reported as "Suggestions to Improve the System."

Background

On July 27, 2007, the Comptroller General of the United States issued the July 2007 Revision of Government Auditing Standards (the Yellow Book), which supersedes the 2003 Revision. For attestation engagements, the new standards are effective for audits of periods beginning on or after January 1, 2008. The revision clarified requirements and incorporated AICPA definitions related to reporting internal control deficiencies as material weaknesses.

Guidance

Reporting Significant Deficiencies and Material Weaknesses

For attestation engagements, the revised standards require auditors to report, based upon the work performed, significant deficiencies in internal control, identifying those considered to be material weaknesses.

With respect to Government contracting, a significant deficiency is an internal control deficiency, or combination of deficiencies, that (1) adversely affects the contractor's ability to initiate, authorize, record, process, or report Government contract costs in accordance with applicable Government contract laws and regulations, (2) results in at least a reasonable possibility that unallowable costs will be charged to the Government, and (3) the potential unallowable cost is not clearly immaterial.

SUBJECT: Audit Guidance on Reporting Internal Control Deficiencies

A material weakness is a significant deficiency (or combination of significant deficiencies) that results in or could result in material unallowable costs being charged to the Government. Since DCAA only performs internal control audits on systems that are material to Government contract costs, significant deficiencies identified in DCAA audits will generally be those considered to be material weaknesses (i.e., the impact or potential impact to Government contract costs is material). Therefore, all internal control deficiencies that result in or could result in unallowable costs being charged to the Government should be reported as significant deficiencies and be considered material weaknesses, unless the potential unallowable cost is clearly immaterial. The audit report shells for internal control audits have been revised accordingly.

If conditions are found that clearly would not materially impact Government contract costs, but the system would be enhanced if the conditions were corrected, they should continue to be reported as “Suggestions to Improve the System.” Such conditions should be referred to in the audit report as matters or conditions, not deficiencies. For example, if the majority of the contractor’s forward pricing proposals are not being submitted electronically, the auditor should recommend, as a “Suggestion to Improve the System,” that the contractor revise its estimating procedures to provide for submitting proposals electronically.

Inadequate in Part vs. Inadequate Audit Opinions

Auditors are reminded that if significant deficiencies/material weaknesses are identified, the opinion on the system should be either inadequate in part or inadequate (CAM 10-408.2a). Whether the system is inadequate or inadequate in part is a matter of auditor judgment. Generally, if deficiencies affect only certain control objectives or parts of the system, the audit opinion should state that the system is inadequate in part and identify the inadequate portions of the system. **However, if the nature of the deficiencies is such that the reliability of the entire system is affected, the audit opinion should state that the system is inadequate, even if the deficiencies only relate to certain control objectives or parts of the system.**

For example, if the contractor’s controls related to labor authorization and approvals are so deficient that they result in or could result in labor costs being charged to the wrong final cost objectives, the opinion on the labor system should be inadequate. If there is inadequate control over work authorizations, the integrity of the entire system is impacted, even though the deficiencies relate only to one control objective.

FAO personnel should direct questions to their regional POCs, and regional personnel should direct any questions to Auditing Standards Division, at (703) 767-3274 or by e-mail at DCAA-PAS@dcaa.mil.

/s/
Kenneth J. Saccoccia
Assistant Director
Policy and Plans

DISTRIBUTION: C