



**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.2.4

December 19, 2008
08-PAS-041(R)

**MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA
HEADS OF PRINCIPAL STAFF ELEMENTS**

SUBJECT: Audit Guidance on Limited Scope Audit Reports on Internal Controls

FAO Managers are required to brief FAO staff members on this guidance by March 30, 2009.

Summary

When internal control deficiencies are identified in other than an internal control audit (e.g., forward pricing proposal audit) the FAO should not wait to perform a full system review to report the deficiencies. The FAO should (1) issue a flash report to report the potential deficiencies, and (2) establish a separate limited scope audit assignment to review the control activities related to the applicable control objective. The limited scope audit assignment should be completed as soon as possible (preferably within 30 days) after the condition is identified. The limited scope audit package must stand on its own and document sufficient work as a basis for the audit opinion and to demonstrate compliance with GAGAS. If the control activities audited are not adequate to ensure that the control objective is accomplished, the audit report will report that the system is inadequate and recommend that the contracting officer disapprove the affected portions of the system (if applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs. In addition, the ICAPS will be updated to reflect the opinion of inadequate. This guidance has been communicated to DCMA Headquarters.

Background

Current policy requires potential internal control deficiencies found in related audits to be reported in flash reports between internal control audit cycles (CAM 5-103), however, these flash reports have not always received the attention warranted. Under current policy, the issuance of the flash report does not change the overall system opinion, as it can only be changed based on reported conditions in internal control system audits or follow-up system audits. Rather than waiting for completion of the next scheduled audit of the contractor's system, the FAO may have sufficient evidence, based on flash reports and additional testing, to determine that a control objective is not being accomplished and to report the system as inadequate in a limited scope audit report. Flash reports on the same or similar deficiencies are a strong indicator of the need for a limited scope audit.

SUBJECT: Audit Guidance on Limited Scope Audit Reports on Internal Controls

Guidance

Internal Control Deficiencies Identified During Audits Other Than Internal Control Audits

A contractor's failure to accomplish a single control objective will render the overall internal control system inadequate, therefore, it is important to promptly report a significant deficiency found during a related audit. When a deficiency is identified in other than an internal control audit (e.g., forward pricing proposal audit) a flash report should be issued to report the potential significant deficiency/material weakness in accordance to CAM 10-413, Real Time Reporting (Flash Reports). The FAO should not wait until the current audit is completed to issue the flash report. If the contractor does not provide comments on the draft flash report within seven days, the FAO should issue the flash report without the contractor's comments noting that the contractor failed to respond within the time provided. In addition to issuing the flash report, a separate limited scope audit assignment should be established to review the contractor's control activities related to the applicable control objective.

Limited Scope Internal Control Audit Assignments

The limited scope internal control audit assignment should be established using the activity code for the applicable system (e.g., 24010 for estimating system) and the standard audit program steps should be tailored appropriately for the applicable control objective. The auditor should reference the originating assignment in the limited scope assignment and, to the extent practical, incorporate and/or reference working papers from that assignment. In addition, the auditor should perform and document any additional work needed to obtain sufficient evidence. The limited scope audit package must stand on its own and document sufficient work as a basis for the audit opinion and to demonstrate compliance with GAGAS (e.g., adequate planning and supervision, sufficient evidence).

The limited scope audit should be completed as soon as possible (preferably within 30 days after the condition is identified). Limited scope internal control audits will generally only be performed at major contractors and will not extend the internal control audit cycle (see CAM 5-103.1(a)). However, the audit cycle may need to be accelerated if other risk exists.

The audit report will provide an opinion on the adequacy of the internal control activities related to the control objective(s) reviewed. If the control activities are not adequate to accomplish the control objective, the audit report should summarize the significant deficiencies/material weaknesses and report that the contractor's system is inadequate. In addition, the audit report will identify the portions of the system affected by the deficiencies and recommend the contracting officer disapprove the affected portions of the system (if applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs. The enclosed audit report shell provides the appropriate limited scope audit report language to be used in the circumstances covered by this guidance (Enclosure 1) and is available in APPS under Other Audit Guidance and on the DCAA Intranet.

SUBJECT: Audit Guidance on Limited Scope Audit Reports on Internal Controls

Updating the ICAPS

Upon completion of the limited scope audit assignment the auditor should update the ICAPS control risk assessment (Section II) for the applicable control objective(s) and summarize the impact on the related contract audit effort (Section IV). In addition, the ICAPS overall system opinion (Section III) should be updated to reflect an opinion of inadequate, if applicable (see CAM 3-300). However, since not all control objectives are reviewed, the ICAPS overall system opinion will not be changed from inadequate to adequate based on a limited scope audit that finds the internal control activities related to the single control objective adequate.

Additional Remarks

All limited scope internal control audit assignments must have regional review (e.g., RAM, RST) prior to the issuance of the audit report.

FAO managers are required to brief FAO staff members on this guidance by March 30, 2009. To facilitate that briefing, a PowerPoint presentation is included as Enclosure 2.

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

/s/

Kenneth J. Saccoccia
Assistant Director
Policy and Plans

Enclosures: 2

1. Limited Scope Audit Report Shell
2. Limited Scope Audit Staff Conference Slides

DISTRIBUTION: C

Version No. 1.0	Limited Scope Audit Report Shell System Controls Audit Report (XXXXX)	December 2008
Reviewer's Approval and Date:		



DEFENSE CONTRACT AUDIT AGENCY

**AUDIT REPORT NO. [Office Organizational
Code]– [Government Fiscal Year (4
digit)][Team Code][Five-Digit Activity
Code][Last 3 digits of Assignment Number]**



[date]

PREPARED FOR: [ACO, PCO, or Other]
[Customer Name 1st Line]
[Customer Name 2nd Line]
[Customer Name 3rd Line]
ATTN: [Attention To]
[Customer Address 1st Line]
[Customer Address 2nd Line]
[City of Customer], [State of Customer] [Zip Code of Customer]
[Country of Customer]

PREPARED BY: DCAA [Office Name]
[Office Address 1st Line]
[Office Address 2nd Line]
[City of Office], [State of Office] [Zip Code of Office]
Telephone No. [Main Phone Number of Office]
FAX No. [Fax Number of Office]
E-mail Address [E-Mail of Office]

SUBJECT: [Title of Audit Assignment]

REFERENCES: *If applicable, include appropriate references.*

CONTRACTOR: [Contractor Name 1st Line]
[Contractor Name 2nd Line]
[Contractor Name 3rd Line]
[Contractor Address 1st Line]
[Contractor Address 2nd Line]
[City of Contractor], [State of Contractor] [Zip Code of Contractor]
[Country of Contractor]

REPORT RELEASE RESTRICTIONS: See Page 3

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SUBJECT OF AUDIT

We have examined [*Contractor Name 1st Line*] ([*Contractor Acronym*])'s [*insert the name of the internal control system*] control activities related to the [*insert the specific control objective*] as of [*insert date audit fieldwork was completed*]. The purpose of our examination was to determine if [*Contractor Acronym*]'s internal control activities:

- comply with applicable laws and regulations,
- are effective over compliance with applicable laws and regulations, and
- are adequate and operating effectively.

[*Contractor Acronym*] is responsible for establishing and maintaining an adequate [*identify internal control system*]. Our responsibility is to express an opinion on whether the tested [*identify internal control system*] internal control activities are in place and operating effectively and as described based on our examination.

EXECUTIVE SUMMARY

[If applicable (10-210.3), this section gives a brief overview of the audit findings. Refer to 10-406. Below is an example of how the section may read when deficiencies are found.]

The internal control activities related to the [*identify the specific control objective*] associated with [*Contractor Acronym*]'s [*identify internal control system*] are not adequate and operating effectively. Our examination disclosed [*insert number of deficiencies*] significant deficiencies that are considered to be material weaknesses in [*Contractor Acronym*]'s [*identify internal control system*] internal control activities that result in [*describe the effect of the deficiencies*].

SIGNIFICANT ISSUES

- [*insert summary of significant issues/deficiencies*]
- [*if applicable*] [*Contractor Acronym*] agrees and is taking aggressive action to correct these deficiencies.

SCOPE OF AUDIT

Except for the qualifications discussed below [*omit if the report is not rendering a qualified opinion and there is no "Qualifications" section within the "Scope" paragraph*], we conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we obtain a sufficient understanding of internal controls to plan our examination and determine the nature, timing, and extent of tests to be performed. An examination of internal control activities includes:

- identifying relevant system control objectives and associated control activities,

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- obtaining an understanding of all applicable components of internal control for the identified control objectives and activities,
- determining if the internal controls are adequate and in operation, and
- assessing control risk to use as a basis for planning the nature, timing, and extent of substantive testing in other attestation audits.

We evaluated the [*identify internal control system*] internal control activities related to the [*identify the control objective*] using the applicable requirements contained in the [*list only applicable references*]:

- *Federal Acquisition Regulation (FAR);*
- [*Defense FAR Supplement (DFARS) or non-DoD agency supplements, as applicable*],
- *Cost Accounting Standards, and*
- *Industry or Technical Guides. [Identify any applicable guides actually used]*

Our examination specifically tested the [*identify the internal control system*] control activities associated with the following control objective(s):

- [*List only the control objective(s) being evaluated*]

Test procedures were applied from [*Period of Performance - Start Date*] to [*Period of Performance - Completion Date*].

We believe that our examination provides a reasonable basis for our opinion.

QUALIFICATIONS

[*Any external factors that restrict or limit the scope of the audit should be clearly described within the scope of audit section under a separate heading entitled “Qualifications” (see 10-407e and 10-210.4). Internal decisions to limit the audit scope are not “qualifications.” When necessary to avoid user misunderstanding, scope limitations should be briefly described within the scope of audit section.*]

[*Conclude the Scope of Audit section with the inherent limitations paragraph as follows:*]

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control activities within the [*identify internal control system*] to future periods are subject to the risk that the internal control activities may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

RESULTS OF AUDIT

[*The opening paragraph for this section of the report expresses an opinion on the control activities tested. Refer to 10-408 for additional information.*]

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In our opinion [except for the (*describe the qualification and the potential impact on the results*)], the internal control activities related to the [*identify the specific control objective*] associated with [*Contractor Acronym*]'s [*identify internal control system*] [*are/are not*] adequate and operating effectively.

[If the paragraph above states that the control activities are not adequate and operating effectively, include the next two paragraphs:]

Our examination noted certain significant deficiencies that are considered to be material weaknesses in the design or operation of the internal control structure. In our judgment, these deficiencies could adversely affect the organization's ability to initiate, authorize, record, process, and/or report costs in a manner that is consistent with applicable Government contract laws and regulations. As a result, we consider [*Contractor Acronym*] [*identify the internal control system*] inadequate. These conditions are detailed in the "Statement of Condition(s) and Recommendation(s)" on page [xx] and summarized below:

[Briefly summarize the conditions.]

[If the paragraph above states that the control activities are not adequate and operating effectively, include a paragraph recommending that the contracting officer disapprove the affected portions of the system (if applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs. Refer to the internal control audit report shell on the DCAA Intranet under the activity code for the applicable system for the appropriate recommendation].

Based on the results of our audit of the contractor's [*identify the internal control system*] internal control activities related to [*identify control objective*] and our control risk assessments, we will perform [*minimum/increased*] substantive testing (i.e., analytical procedures and/or transactions tests) in the following areas:

[List the audit areas affected.]

We only examined control activities related to [*identify the internal control system*]. Accordingly, we express no opinion on [*Contractor Acronym*]'s system of internal controls taken as a whole.

[Conclude the Results of Audit section of the report narrative with the following additional remarks, as appropriate.]

We discussed the results of our examination with [*Name and Title of contractor representative*] in an exit conference held on [*Date*]. [*If there are system deficiencies, summarize the contractor's reaction here.*] [*If the evaluation requires a Statement of Condition(s) and Recommendation(s) be furnished to the contractor, include the following statement*]. We provided a draft copy of [*the Report*] or [*the Results of Audit*] or [*the Statement of Condition and Recommendation*] and/or [*Other (describe)*] to the contractor's representative at the exit conference.

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[When the contractor provides a formal, written response, it should be referenced within the Results of Audit section and included as an appendix to the report. Put any rebuttals in the "Auditor's Response" portion of the explanatory notes and include the following statement.] The complete text of the contractor's response appears as Appendix [x].

[Use the guidelines provided in 10-210.5e(2) to prepare any other additional remarks.]

STATEMENT OF CONDITION(S) AND RECOMMENDATION(S)

[The statements of condition(s) and recommendation(s) are an integral part of the results of audit and should follow the narrative described in the Results of Audit. Alternatively, they may be included in attached appendixes. The presentation should follow the six-element outline as noted below to present a logical statement of condition(s) and recommendation(s). The two main subheadings should be "Condition" and "Recommendation." Although the six elements of an audit finding should not be addressed under separate subheadings, they must be included as part of the statement of condition to present a logical, convincing case. Refer to 10-409.

(1) Condition – This attribute identifies the nature of the deficiency, finding, or unsatisfactory condition by disclosing how things are.

(2) Criterion – This attribute establishes the legitimacy of the finding disclosing how things should be.

(3) Cause – This attribute gets to the root of the problem by answering the question, "Why did it happen?"

(4) Fact – Examples should be included to demonstrate to the contracting officials and contractor that the reported conditions do exist.

(5) Effect – This attribute convinces the reader that the condition is significant by answering the question, "What happened or could happen as a result of this condition? What is the harm or potential harm to the Government?"

(6) Recommendation – This attribute suggests remedial action answering the question, "What must be done to eliminate the cause of the condition?" If the relationship between the cause and the condition is clear and logical, the recommended action(s) will most likely be feasible and appropriately directed.]

CONTRACTOR ORGANIZATION AND SYSTEMS

[This section should furnish pertinent information necessary for the reader to understand the area audited. This information should be classified under separate subheadings for the organization and individual system(s). Refer to 10-410 for additional information and examples.]

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DCAA PERSONNEL

Telephone No.

Primary contact(s) regarding this audit:

[Auditor's Name], Auditor

[Auditor's Phone Number]

[Supervisor's Name], Supervisory Auditor

[Supervisor's Phone Number]

Other contact(s) regarding this audit report:

[FAO Manager's Name], Branch Manager

[FAO Manager's Phone Number]

[FLA Name], Financial Liaison Advisor

[Phone Number of FLA]

FAX No.

[Office Name]

[Fax Number of Office]

[FLA Name], Financial Liaison Advisor

[Fax Number of FLA]

E-mail Address

[Office Name]

[E-Mail of Office]

General information on audit matters is available at <http://www.dcaa.mil/>.

RELEVANT DATES

[Use this section in customer requested assignments. These should include, at a minimum, the dates of ACO and PCO requests and the dates of any extensions. The format should facilitate computation of elapsed days (see ao-211 and Fig. 10-2-3).]

AUDIT REPORT AUTHORIZED BY:

[FAO Manager's Name]

[Title]

DCAA [Office Name]

AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

DISTRIBUTION

[All recipients of the audit report will be identified in this section of the report. See 10-412 and 10-212 for additional information.]

<i>[ACO, PCO, or Other]</i>	<u>E-mail Address</u>
<i>[Customer Name 1st Line]</i>	<i>[Customer Prepared For Email Address]</i>
<i>[Customer Name 2nd Line]</i>	
<i>[Customer Name 3rd Line]</i>	
<i>ATTN: [Attention To]</i>	
<i>[Customer Address 1st Line]</i>	
<i>[Customer Address 2nd Line]</i>	
<i>[City of Customer], [State of Customer] [Zip Code of Customer] [Country of Customer]</i>	
<i>[Contractor Name 1st Line]</i>	<i>[Contractor Email Address]</i>
<i>[Contractor Name 2nd Line]</i>	
<i>[Contractor Name 3rd Line]</i>	
<i>[Contractor Address 1st Line]</i>	
<i>[Contractor Address 2nd Line]</i>	
<i>[City of Contractor], [State of Contractor] [Zip Code of Contractor] [Country of Contractor]</i>	
<i>(Copy furnished thru ACO)</i>	
<i>[Buying Command line 1]</i>	<i>[E-Mail of FLA]</i>
<i>[Buying Command line 2]</i>	
<i>ATTN: [FLA Attention line]</i>	
<i>[FLA Address 1st Line]</i>	
<i>[FLA Address 2nd Line]</i>	<u>Telephone No.</u>
<i>[City of FLA], [State of FLA] [Zip Code of FLA] [Country of FLA]</i>	<i>[Phone Number of FLA]</i>

RESTRICTIONS

1. Information contained in this audit report may be proprietary. It is not practical to identify during the conduct of the audit those elements of the data which are proprietary. Make proprietary determinations in the event of an external request for access. Consider the restrictions of 18 U.S.C. 1905 before releasing this information to the public.

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2. Under the provisions of Title 32, Code of Federal Regulations, Part 290.7(b), DCAA will refer any Freedom of Information Act requests for audit reports received to the cognizant contracting agency for determination as to releasability and a direct response to the requestor.
3. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.

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APPENDIXES

[Use as appropriate. Refer to 10-213 and 10-409 for additional information.]



Defense Contract Audit Agency

Limited Scope Audit Reports on Internal Controls



Limited Scope Audit Reports

Why was the guidance issued?



Purpose of New Audit Guidance

- Instances of internal control deficiencies reported in flash reports between audit cycles and not affecting the system opinion timely.
- Flash reports do not always receive the attention warranted.
- Under the previous policy the overall system opinion could only be changed based on reported conditions in system audits or follow-up system audits.



Purpose of New Audit Guidance

- Failure to accomplish a single control objective will render the overall system inadequate.
- May be sufficient evidence based on flash reports and limited additional testing to determine control objective is not being accomplished and to report system is inadequate.
- Flash reports on same or similar deficiencies are a strong indicator of need for limited scope audit.



Limited Scope Audit Reports

What has changed?



Limited Scope Audit Reports

- New Guidance:
 - ➔ Auditors will not wait to perform a full or follow-up system audit to change the opinion on the contractor's system when deficiencies are identified in other audits.
 - ➔ Auditors will use a limited scope audit to review control activities related to the applicable control objective.
 - ➔ The limited scope audit report will render an opinion of inadequate if the contractor fails to accomplish a single control objective.



Limited Scope Audit Reports

What do you do when you find an internal control deficiency in an audit other than an internal control audit?



Limited Scope Internal Control Audits

- When an internal control deficiency is identified in audits other than internal control audits:
 - ➔ Issue flash report in accordance with CAM 10-413, Real Time Reporting (Flash Reports)
 - ➔ Establish a separate limited scope audit assignment to review the control activities related to the applicable control objective.



Limited Scope Internal Control Audits

- Do not wait until the current audit is completed to issue the flash report.
- Issue flash report without contractor comments if the contractor does not provide comments within seven days.
 - ➔ Note in report that the contractor failed to respond within the time provided.



Limited Scope Internal Control Audits

For Limited Scope Assignment:

- Use activity code for the applicable system.
- Tailor standard audit program steps appropriately for the applicable control objective.
- To extent practical, incorporate and/or reference working papers from originating assignment.
- Perform and document any additional work to obtain sufficient evidence and to otherwise comply with GAGAS.



Limited Scope Internal Control Audits

For Limited Scope Assignment (cont.):

- **Sufficient work must be documented in the limited scope assignment as a basis for the opinion and to demonstrate compliance with GAGAS**
 - ➔ e.g., adequate planning and supervision, sufficient evidence
- **Limited scope audit package must stand on its own.**
- Guidance requires regional review (e.g., RAM, RST).



Limited Scope Internal Control Audits

Audit Opinion:

- Internal control activities related to control objective reviewed [**are/are not**] adequate, operating effectively and as described.
- **If not:**
 - ➔ Our examination noted certain significant deficiencies/material weaknesses
 - ➔ As a result, we consider the contractor's system inadequate.
 - ➔ Recommend contracting officer disapprove affected portions of system and/or pursue suspension of percentage of progress payments or reimbursement of costs



Limited Scope Internal Control Audits

Updating ICAPS

- Upon completion of limited scope audit assignment :
 - ➔ Update ICAPS control risk assessment (Section II) for applicable control objective(s)
 - ➔ Summarize impact on related contract audit effort (ICAPS Section IV).
 - ➔ Update ICAPS overall system opinion (Section III) to reflect opinion of inadequate, if applicable.



Limited Scope Internal Control Audits

- Limited scope audits should be completed ASAP (preferably within 30 days after condition is identified).
- Generally only performed at major contractors.
- Do not delay the ICAPS cycle.
- May need to accelerate cycle if other risks exist.



Defense Contract Audit Agency

Questions?