



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAS 730.3.B.2.4

December 19, 2008
08-PAS-043(R)

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

SUBJECT: Audit Guidance on Significant Deficiencies/Material Weaknesses and Audit Opinions
on Internal Control Systems

Summary

This guidance clarifies what constitutes a significant deficiency/material weakness and establishes new guidance on reporting audit opinions on contractors' internal control systems. Effective immediately, audit reports on contractors' internal controls that report any significant deficiencies/material weaknesses will include an opinion that the system is inadequate. **DCAA will no longer report inadequate in part opinions.** In addition, the audit report will identify the portions of the system affected by the deficiencies and recommend that the contracting officer disapprove the system (if applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs. (APPS audit report shells have been revised to reflect the appropriate recommendation depending on the system involved and should be used for any in-process assignments.) **Further, suggestions to improve the system will no longer be reported in internal control audit reports.** This guidance has been communicated to DCMA Headquarters.

Guidance

Clarification of Significant Deficiency/Material Weakness

In previous guidance we told you that a significant deficiency/material weakness is an internal control deficiency 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 a reasonable possibility that unallowable costs will be charged to the Government, and (3) the potential unallowable cost is not clearly immaterial (MRD 08-PAS-011(R), Subject: Audit Guidance on Reporting Internal Control Deficiencies, dated March 3, 2008). As further clarification, the contractor's failure to accomplish any control objective tested for in DCAA's internal control audits will or could ultimately result in unallowable costs charged to Government contracts, even when the control objective does not have a direct relationship to charging costs to Government contracts. For example, the control objective related to ethics and integrity is not directly related to charging costs to Government contracts. However, the contractor's failure to accomplish the control objective creates an environment that could ultimately result in mischarging to Government contracts. It is not necessary to demonstrate actual questioned cost to report a significant deficiency/material weakness. In addition, by limiting

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internal control audits to major contractors, DCAA only performs audits of contractor systems that are material to Government contract costs. As a result, internal control deficiencies identified in DCAA audits will generally have an impact or potential impact to Government contract costs that is material. Therefore, a contractor's failure to accomplish any applicable control objective should be reported as a significant deficiency/material weakness.

Audit Opinions on Internal Control Systems

Effective immediately, audit reports on contractors' internal controls that include any significant deficiencies/material weaknesses will result in an opinion that the system is inadequate. DCAA will no longer report inadequate in part opinions. In addition, the audit report will identify the portions of the system affected by the deficiencies (i.e., areas related to control objectives not accomplished due to the deficiencies) and recommend that the contracting officer disapprove the system (if applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs in accordance with the procedures in DFARS. The ICAPS audit report shells have been revised to reflect this new policy on the opinion and the appropriate recommendation depending on the system involved. The new report shells should be used for any in-process assignments.

Suggestions to Improve the System

Under GAGAS 6.35, determining whether and how to communicate to contractor management internal control deficiencies that have an inconsequential effect on the subject matter is a matter of auditor judgment. Our practice of reporting suggestions to improve the system has caused confusion in the past. Therefore, since GAGAS does not require it, and to avoid confusion, suggestions to improve the system will no longer be reported in internal control audit reports.

Concluding Remarks

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 e-mail: DCAA-PAS@dcaa.mil.

/s/

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Policy and Plans

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