



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAS 730.3.B.2.4

September 29, 2011
11-PAS-016(R)

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

SUBJECT: Audit Guidance on Obtaining an Understanding of Relevant Internal Controls (Revised B-2 Working Paper)

SUMMARY

The purpose of this memorandum is to provide guidance on the revised B-2 working paper (Review of Relevant Internal Control Data) which is now being delivered in APPS for all applicable audits, except audits of major contractor business systems. We are in the process of developing revised B-2 working papers for those audits. The B-2 working paper has been revised to provide a more clearly defined process for documenting an understanding of relevant internal controls and to provide a better link between the risk assessment, including the understanding of internal controls, to the decision of what audit procedures to perform.

BACKGROUND

GAGAS 6.10 requires auditors to obtain a sufficient understanding of internal control that is material to the subject matter in order to plan the audit and design procedures to achieve the objectives of the audit. The majority of the audits that DCAA performs are compliance attestation engagements. Therefore, AT Section 601 (Compliance Attestation) of the AICPA Statements on Standards for Attestation Engagements (SSAE) also applies since the SSAE are incorporated in GAGAS. Based on AT 601.45, auditors should obtain an understanding of the relevant portions of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements. This process, performed in conjunction with the auditor's assessment of inherent risk, contributes to the auditor's evaluation of the risk that a material noncompliance exists (AT 601.34). This combined assessment of control and inherent risk is used to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance.

The prior B-2 working paper accomplished the documentation of the understanding of internal control primarily by referencing work done in prior audits of contractor systems and related internal controls (ICAPS). However, it did not clearly focus on those portions of internal control over compliance relevant to the current audit. As a result, auditors sometimes adopted the audit programs without using their understanding of the relevant internal controls and combined assessment of inherent and control risk (i.e., the risk that a material noncompliance exists) to design

PAS 730.3.B.2.4

SUBJECT: Audit Guidance on Obtaining an Understanding of Relevant Internal Controls
(Revised B-2 Working Paper)

audit procedures to achieve the objectives of the audit by adding, modifying or deleting audit program steps.

A revised B-2 working paper was implemented for forward pricing audits (activity code 21000, 23000, 27000, and 27010) earlier this year. A generic version of the revised B-2 working paper is also now being delivered for all other applicable audits, except for audits of major contractor business systems. We are in the process of developing revised B-2 working papers for those audits.

GUIDANCE

In general, the revised B-2 working paper process includes identifying the significant cost elements or sub-elements (e.g., accounts or groups of accounts) or other areas to be evaluated based on materiality and other inherent risk factors and then for each of those areas auditors should:

- Consider and document the potential material noncompliances that could occur (generally during an audit team brainstorming session where collective knowledge of the contractor and known risks are discussed);
- Document their understanding of the underlying processes and key policies and procedures/internal controls over compliance related to the particular cost element/area;
- Document previously reported deficiencies that could materially impact the element/area; and
- Tailor the audit procedures accordingly to address the overall risk.

Throughout this process, auditors should collaborate with the audit team to utilize their collective knowledge of the contractor and any known risks to identify potential material noncompliances. This collaboration begins with the initial assessment, continues during the walk-through of the contractor's submission and when establishing the final audit procedures based on the overall risk, as well as during the performance of those audit procedures.

It is not necessary to gain and document an understanding of the entire system related to the significant elements or sub-elements of cost or other areas to be evaluated. However, auditors do need to obtain and document a reasonably good understanding of the underlying processes related to those specific areas (e.g., the basis of the costs and from where the numbers/amounts are derived). This understanding is generally obtained during the walk-through of the contractor's submission. During the walk-through, the auditor should obtain an understanding of the contractor's processes in developing its submission, especially those related to the significant elements or sub-elements of cost or other areas to be evaluated, and look for points within the underlying processes where material noncompliances may occur by asking "what could go wrong" questions. (This is in addition to brainstorming potential noncompliances with the audit team prior to the walk-through.) The auditor would then obtain documentation of the key controls for preventing or detecting the potential material noncompliances. Since the number of "what could go wrong" questions or potential noncompliances could be limitless, the auditor should focus on documenting the key controls.

September 29, 2011
11-PAS-016(R)

PAS 730.3.B.2.4

SUBJECT: Audit Guidance on Obtaining an Understanding of Relevant Internal Controls
(Revised B-2 Working Paper)

The auditor uses all the information/evidence obtained during the risk assessment procedures related to the particular element, sub-element or other area (e.g., the understanding of the basis of the cost and underlying processes, potential material noncompliances, understanding of key internal controls/policies and procedures, and relevant reported deficiencies) to design further audit procedures to achieve the objectives of the audit. That means adding, deleting or modifying audit steps. There should be a clear link between the risk assessment and the audit procedures.

Auditors may determine that performing a combination of tests of controls (i.e., testing some of the key controls identified during the risk assessment) in addition to substantive procedures is an efficient and effective audit approach for certain cost elements or other audit areas. Whether to perform only substantive procedures or a combination of tests of controls and substantive procedures for a specific area is generally a matter of auditor judgment based on the risk assessment. However, if the auditor plans to rely on the internal controls relevant to a specific area to reduce substantive procedures in that audit area, those controls must have been tested and found effective either in another audit or in the current audit. If the controls were tested in another audit, and are current and relevant to the audit being performed, auditors should reference that assignment and incorporate or reference working papers from that assignment to clearly document the specific procedures that provide sufficient evidence of the operating effectiveness of the controls.

FAO personnel should direct questions regarding this memorandum 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.

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

Enclosure:

Working Paper B-2 Review of Relevant Internal Control Data

DISTRIBUTION: C

REVIEW OF RELEVANT INTERNAL CONTROL DATA

This working paper is used for various types of audits and is therefore written in general terms. Auditors should use judgment in applying the general nature of these instructions to the audit being performed.

1. **Understanding of Internal Control (B-01, Step 7)-**

GAGAS 6.10 requires auditors to obtain a sufficient understanding of internal control that is material to the subject matter in order to plan the audit and design procedures to achieve the objectives of the audit (i.e., to identify potential questioned costs, inadequacies or noncompliances with the established criteria (FAR, CAS, contract terms, or other criteria depending on the type of audit) and to design appropriate audit procedures to meet the objectives of the audit).

Complete the table below for each significant element/area to document your understanding of the internal controls relating to these elements/areas and the audit procedures designed to achieve the objectives of the audit based on your understanding. See “Guidelines for Completing Table” embedded below.

Significant Element/ Area	
Basis of Contractor’s Cost (if applicable)	
(A) Potential Noncompliances. <i>Based on your understanding of this element or area being evaluated, consider and document types of potential inadequacies or noncompliances with FAR, CAS, contract terms or other applicable criteria that could occur. The tailoring of audit procedures in section D below should include steps to identify these potential noncompliances to achieve the objectives of the assignment.</i>	
(B) Applicable Policies & Procedures or Other Internal Control. <i>Document your understanding of the key processes related to this element or area being evaluated. For those key processes, document your understanding of the applicable policies and procedures or other related internal controls related to specific areas of the contractor’s systems that impact this element/area, including those that would prevent or detect the potential inadequacies or noncompliances identified in (A) above. The identified key processes and related policies and procedures should be considered in section D below when tailoring audit procedures to achieve the objectives of the assignment.</i>	
(C) Relevant Reported Deficiencies. <i>Document in this section any reported deficiencies that could materially impact the significant elements/areas being evaluated or that relate to a policy/procedure or internal control identified above. The identified deficiencies should be considered in section D below when tailoring the audit procedures to achieve the objectives of the assignment.</i>	
(D) Tailoring Audit Procedures. <i>Consider how your understanding of the information gathered</i>	

B-02 (4/6)

Auditor:	
Date:	

REVIEW OF RELEVANT INTERNAL CONTROL DATA

above affects the audit procedures needed to achieve the objectives of the assignment and tailor (add/delete/modify) the audit steps accordingly. You should consider cross-referencing this section to the -01 working papers where audit steps have been tailored.

Note: Gaining an understanding of internal control does not result in reduced control risk. The objective is to gain a sufficient understanding of relevant policies and procedures/processes to design audit procedures to achieve the objectives of the audit. See Section 2 below for assessment of control risk.

Use the table format above for all Significant Elements

Guidelines for Completing Table:



Guidelines For
Completing Table.doc

2. Assessment of Control Risk

Based on your understanding of the relevant internal control obtained in step 1 above, and the current system audit assessments (i.e., adequate or inadequate), document below your assessment of the control risks.

	Maximum Control Risk <i>Control risk is assessed at maximum because (i) it is more efficient to perform substantive testing than perform tests of internal controls or (ii) the internal controls are ineffective or nonexistent.</i>
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	Below Maximum Control Risk <i>Reminder: Control risk can only be assessed below maximum if significant internal controls applicable to the CFY being audited have been reviewed and sufficiently tested for operational effectiveness. If control risk is assessed below maximum, document/reference where in the working papers of the assignments discussed above the tests of controls were performed that supports the assessment.</i>
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3. Computerized Information (B-01, Step 8).

(GAGAS requires auditors to document their consideration that the planned procedures be designed to achieve the objectives of audit when the evidence obtained during the audit is dependent on computerized information, material to the audit, and the auditors are not relying on the effectiveness of internal controls).

B-02 (5/6)

Auditor:	
Date:	

REVIEW OF RELEVANT INTERNAL CONTROL DATA

During the walk-through, obtain an understanding of computerized information used to prepare the submission or that will be used as evidence for the area being evaluated.

Document below the audit work performed (direct testing) that supports reliance on the computer-based evidence that will be used to achieve the objectives of the audit. Specifically, document or reference one or more of the following:

(1) the other DCAA audit assignment(s) where the reliability of the data was sufficiently established (this should include a description of the steps performed, the assignment number, and the specific working paper reference);

(2) the procedures/tests that will be performed in this audit to evaluate the subject matter of this audit that will also support reliance on the evidence; and/or

(3) the tests that will be performed in this audit that will be specifically designed to test the reliability of the computer based data (e.g., directly testing the data to source documents; reviewing computer reports for completeness, obvious errors and reasonableness of amounts).

When sufficient work cannot be performed to determine reliability (i.e., reduce audit risk to an acceptable level), qualify the audit report in accordance with CAM 10-210.4a and 10-504.4 (or other applicable section of CAM for audits other than incurred cost audits).

B-02 (6/6)

Auditor:	
Date:	

Guidelines for Completing Table on Understanding of Internal Controls

The table will be completed for each significant element/area identified for evaluation based on materiality and other inherent risk factors (see “Significant Element” below). If there are sub-elements that have a different basis within a more general element/area, the auditor should consider completing a separate table for each of those sub-elements so that factors addressed in Sections A through C specific to those sub-elements can be considered in the design of audit procedures in Section D for those sub-elements. The tables will generally be started prior to the walk-through of the contractor’s submission or area being evaluated. However, auditors should use the walk-through to the extent possible to obtain an understanding of the internal controls related to the significant elements/areas. It may be necessary to hold a series of walk-throughs and/or follow-up meetings with the contractor in order to obtain a sufficient understanding of the contractor’s assertion or other area being evaluated as well as the applicable internal controls, especially for complex submissions/areas. The contractor employees responsible for the specific elements/areas should be present at the meetings. For audits of costs, during the walk-through **the contractor** should:

- Explain the basis of the significant cost elements;
- Demonstrate where the numbers/amounts for the significant cost elements are derived; and
- Explain the processes related to the cost elements and the internal controls/policies and procedures applicable to those areas. (Keep in mind that for incurred cost audits, this will be the processes, etc. that were in effect for the period under audit.)

For other types of audits, the specific information that the contractor should provide during the walk-through will depend on the subject and objectives of the audit. Generally, at a minimum, **the contractor** should explain the processes related to the specific areas identified for evaluation and the internal controls/policies and procedures applicable to those areas.

The auditors should be prepared to ask specific questions and document the information regarding the relevant policies/procedures and processes related to the significant elements/areas during the walk-through. With the proper planning, auditors should be able to gain and document a good part of the understanding of the relevant internal controls during the walk-through. For example, prior to the walk-through you should discuss with the contractor the expectations for the walk-through; e.g., what they should be prepared to discuss, who should attend the meetings and that it may entail multiple meetings/demonstrations.

Significant Element/Area - Based on the risk assessment, make an initial determination of the significant elements/areas to be evaluated based on materiality and other risk factors identified during other preliminary procedures (e.g., related to previous audits, etc.). For incurred cost audits performing the MAARs reconciliations and comparisons (analytical procedures) may assist the auditor in understanding the contractor’s accounts, transactions and events that have occurred since the previous audit and in identifying areas that may represent specific risks.

Basis of Contractor’s Cost (if applicable) – For audits of costs document the contractor’s basis for the significant element.

(A) Potential Noncompliances. Based on the understanding of the contractor’s submission or area being evaluated, the audit team should brainstorm types of potential inadequacies or

noncompliances (e.g., with FAR and CAS) that could occur. You may make an initial assessment for this section based solely on the inspection of the contractor's documents or your preliminary understanding of the area being evaluated. However, it should be finalized after obtaining a detailed understanding during the walk-through. The identified potential noncompliances should be considered in section D below when tailoring audit procedures to achieve the objectives of the assignment.

(B) Applicable Policy & Procedures or Other Internal Control. AT §601.46 provides that the auditor generally obtains an understanding of the design of specific controls by performing the following:

- Inquiries of appropriate management, supervisory, and staff personnel
- Inspection of the contractor's documents
- Observation of the entity's activities and operations

The nature and extent of procedures performed vary from contractor to contractor and are influenced by factors such as the following:

- The newness and complexity of the specified requirements
- The auditor's knowledge of internal control over compliance obtained in previous assignments (e.g., reported deficiencies)
- The nature of the specified compliance requirements
- An understanding of the industry in which the contractor operates
- Judgments about materiality

The policies and procedures or other internal controls that may have a material impact on the significant elements/areas being audited and the procedures for obtaining an understanding of those will depend on the nature of the elements/areas under audit and the basis for their development. For each element/area selected for evaluation, have the contractor explain the processes and related policies and procedures or other internal controls related to the development of those elements or areas identified for evaluation. For the most part, with the proper planning, you should be able to obtain and document your understanding of those during the walk-through. Generally, you will not need to do a detailed review of the contractor's policies and procedures. However, in some cases, in addition to the contractor's explanation, you may also need to do a general review of some of the applicable policies and procedures to obtain a sufficient understanding. Some contractors, especially smaller contractors, may not have formal written policies over all applicable areas but instead may have relevant established practices. The objective is to gain an understanding of the applicable key processes and the related policies and procedures (formal or informal) or other internal controls so that they can be considered in designing/tailoring audit procedures to meet the objectives of the audit.

The key processes and related policies and procedures that are identified as having an impact on the elements/areas identified for evaluation should be considered in section D below when tailoring audit procedures to achieve the objectives of the assignment.

(C) Relevant Reported Deficiencies. Review prior system audits, flash reports, limited scope audits on internal controls, and permanent file data to identify any deficiencies that may have an impact on the elements/areas being evaluated. Auditors should consider how the identified deficiencies will impact the design of audit procedures related to the elements/areas as discussed

in section D.

(D) Tailoring Audit Procedures. An essential part of obtaining and documenting your understanding of internal control is what you do with it. Based on your understanding of the relevant internal controls and all the other information gathered related to the particular element/area (e.g., your understanding of the basis for the significant cost element, potential inadequacies or noncompliances, relevant processes and related policies and procedures or other internal control, and relevant reported deficiencies) you should design audit procedures to achieve the objectives of the audit as it relates to this element/area. That means adding, deleting, and/or modifying audit steps. There should be a clear link between the risk assessment and the audit procedures. You should consider cross-referencing this section to the -01 working papers where audit steps have been tailored.

Other Sources of Information

Prior Audits

Auditors may be able to rely in part on the understanding of internal controls documented in prior system audits. In addition, the understanding of internal controls documented in other recent audits may also be helpful. If the auditor uses work from a prior audit, the auditor should ensure that the documented understanding is relevant to the significant elements/areas to be evaluated in the current audit and may need to make additional inquiries or perform additional procedures to ensure that the understanding is still current.