



**DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAS 730.3.B.2.4

August 22, 2013
13-PAS-017(R)

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

SUBJECT: Audit Guidance on Documenting Significant Judgments Relevant to the Audit Report Opinion

Why is it important for the audit team to document significant judgments?

The audit team makes judgments throughout the audit that will affect its overall outcome. During the planning phase, the audit team makes judgments about audit risk, selection of appropriate audit procedures, and understanding the entity and its environment, including its internal controls. It is important that the audit team document these judgments in developing an overall strategy for the expected conduct and scope of the audit. In addition, some of the most significant judgments made during the audit process relate to determining the audit opinion. Therefore, auditors must clearly document, in the summary Working Paper A, their rationale and significant judgments supporting the audit opinion.

What are the different types of audit report opinions?

Auditing standards characterize audit report opinions as either unmodified (i.e., unqualified) or modified (i.e., qualified, adverse or disclaimer).

When does the audit team issue an unqualified opinion?

The audit team issues an unqualified opinion when they have obtained sufficient appropriate evidence to be **reasonably** sure (not absolute assurance) the subject matter, as a whole, is free of material noncompliances and the audit team has applied all the procedures considered necessary.

When does the audit team issue a modified (i.e., other than unqualified) opinion?

The audit team issues a modified opinion when there is a reservation. A reservation occurs when the audit team discloses material noncompliances or there are unresolved risks of material noncompliances. There are two types of reservations:

- Reservation about the Subject Matter – Occurs when the audit team discloses a material noncompliance (e.g., contractor's claimed depreciation expenses do not comply with CAS 409):

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- This type of reservation will result in either a qualified or adverse opinion depending on materiality and pervasiveness.
- The audit team should issue a **qualified** opinion when they have disclosed noncompliances that are material but not pervasive.
- The audit team should issue an **adverse** opinion when they have disclosed noncompliances that are both material and pervasive.

- **Reservation about the Engagement – Occurs when the audit team is unable to obtain sufficient appropriate evidence (i.e., unable to apply all the procedures considered necessary in the circumstances). Reservations about the engagement can originate from the contracting officer (e.g., time constraints), the contractor (e.g., access to records), or internally within DCAA (e.g., lack of assist audits).**
 - This type of reservation will result in either a qualified or disclaimer of opinion depending on materiality and pervasiveness.
 - The audit team should issue a **qualified** opinion when they are unable to obtain sufficient appropriate audit evidence (i.e., not all planned audit procedures could be completed) and its potential effects are material but not pervasive.
 - The audit team should **disclaim** an opinion when they are unable to obtain sufficient appropriate audit evidence (i.e., not all planned audit procedures could be completed) and its potential effects are material and pervasive. In this case, the audit team concludes that the possible effects of the unresolved risks of noncompliances are not only material but also pervasive. Note: Auditors should not disclaim an opinion if they have sufficient evidential matter that warrants expressing an adverse opinion. For additional details on disclaiming an opinion, refer to MRD 13-PAS-018(R), dated August 22, 2013.

The following table illustrates the decision process for selecting the appropriate modified opinion:

Nature of Reservation	Auditor Team’s Professional Judgment About the Pervasiveness of the Reservation	
	Material but not Pervasive	Material and Pervasive
Subject Matter	Qualified opinion	Adverse opinion
Engagement	Qualified opinion	Disclaimer of opinion

What does pervasive mean?

Reservation about the Subject Matter – In this context, pervasive means the reservation affects a substantial portion of the subject matter under audit and is generally not confined to specific cost elements. For example, suppose that while performing an incurred cost audit the audit team discloses that the contractor:

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- Claimed unallowable travel costs
- Did not provide supporting documentation for consultant and legal fees
- Claimed subcontract costs that were never paid
- Claimed labor costs for unqualified personnel

The first two noncompliances may be material but would generally not be pervasive, even when combined depending on significance. However, the third noncompliance could be material and pervasive if the subcontracts were substantial. Another factor to consider is whether the contractor used subcontracts as a basis to allocate indirect costs. Even if not pervasive by itself, the audit team should consider whether the impact of **all** noncompliances combined is pervasive when selecting the audit opinion.

Reservation about the Engagement – In this context, pervasive means that the possible impact of the audit procedures not performed can affect a substantial portion of the subject matter under audit and is generally not confined to specific cost elements. For example:

Suppose there was no real-time testing of labor (MAAR 6) in the year the audit team is performing an incurred cost audit. Labor expenses are usually substantial and not confined to specific cost elements. Does this mean labor expenses are always pervasive?

Based on this example, the decision on selecting the appropriate opinion depends on whether the possible effects of the audit procedures not performed are pervasive, not whether labor expenses are pervasive in and of themselves. It also will depend on whether the audit team could apply alternate procedures on labor. If a contractor had only two cost-type government contracts with the same customer, then the lack of real-time testing of labor would likely result in a qualified opinion.

To illustrate further, suppose now that there was no real-time testing of labor and the contractor has an even mix of commercial, fixed price and cost type contracts. Assume also that the commercial contracts were operating in loss positions, the contractor is under indictment for labor fraud, and the audit team was unable to perform alternate procedures.

Based on these circumstances, the inability of the audit team to perform labor testing procedures has much greater significance (i.e., much more pervasive).

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Opinion

Further Assistance

Refer to CAM Section 2-400 (Reporting Standards) for additional guidance on selecting the appropriate audit report opinion. 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/

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