DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PPD 730.5.17.2 August 26, 2004
04-PPD-048(R)

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

SUBJECT: Audit Guidance on Removing Requirement to Compute Z-Score and Certain Cash Flow Ratios during Financial Condition Risk Assessments

At the June 2004 DCAA Executive Steering Committee (ESC) meeting, the Financial Capability Ad Hoc Team, championed by the Mid-Atlantic Region and established as part of Strategic Plan Objective G3-03-3, presented several recommendations that were adopted. Two of the accepted recommendations result in the (i) removal of the requirement to compute the Z-Score, and (ii) removal of the requirement to compute two cash flow ratios - Cash Flow Return on Assets and Cash Flow Adequacy. As a result, FAOs are no longer required to compute the Z-Score or these two cash flow ratios in current or future financial capability reviews. These changes will be incorporated into the January 2005 edition of the CAM, as well as updated in the APPS for activity codes 17600 – Financial Capability and 17610 – Financial Capability, Modified Financial Condition Risk Assessment.

Based upon their analysis, the team determined that the results of the Z-Score bankruptcy prediction model provided only an additional assurance of the results of the key ratio analyses performed. The team also determined that the results of the Z-Score computations were often misinterpreted and/or misunderstood by our customers, and noted that the Z-Score model is somewhat dated in that it does not address current business practices, such as the use of just-in-time inventory. Further, use of the Z-Score required additional auditor documentation and working paper explanation that added little value to the overall financial condition assessment.

With regard to the recommendation to remove the two cash flow ratios used during both the modified and detailed financial condition risk assessments, the team reviewed the key financial ratios described in CAM 14-304d(2), and their use in FY 2003 financial capability reviews. As a result of this analysis, the team determined that the use of these two ratios duplicated the results of the other calculated ratios and added little additional value in determining the subsequent need for either a detailed financial condition risk assessment or a financial capability audit.

Accordingly, computation and analysis of the Z-Score, the Cash Flow Return on Assets ratio, and the Cash Flow Adequacy ratio are no longer required as part of the financial capability reviews. Auditors should continue computing and analyzing the remaining recommended ratios described in CAM 14-304d(2).

Questions concerning this memorandum should be directed to Ms. Debbie Neville, Program Manager, Policy Programs Division, at (703) 767-2278.

/Signed/
Robert DiMucci
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