



DEFENSE CONTRACT AUDIT AGENCY
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IN REPLY REFER TO

PAS 710.7

July 19, 2019
19-PAS-003(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA; CORPORATE AUDIT
DIRECTORS, DCAA; ASSISTANT DIRECTORS, HQ, DCAA

SUBJECT: Audit Guidance on Using Materiality in Incurred Cost Audits

This memorandum establishes audit policy for applying materiality in incurred cost audits. The newly implemented materiality guidance applies to incurred cost audits that are initiated after the date of this memorandum, and can be found at CAM 6-107. The incurred cost audit programs have also been updated to reflect the materiality guidance. The new guidance will ensure materiality concepts are consistently applied across the Agency.

Background

The policy complies with Section 803 of the fiscal year (FY) 2018 National Defense Authorization Act (NDAA), which requires the Agency to adopt commercially accepted standards of materiality for incurred cost audits.

Calculating the Quantitative Materiality Threshold

The use of a quantified materiality threshold is intended to facilitate a consistent approach that helps an auditor determine the nature, timing, and extent of audit procedures on those cost elements and accounts that are significant, or material, to the audit opinion.

To calculate the quantitative materiality threshold, the auditor should first determine the total subject matter of audit. The total subject matter of audit represents the information on which the auditor provides an opinion (i.e., assurance). The total subject matter of audit is generally Auditable Dollar Volume (ADV), plus amounts associated with assist audits (see CAM 6-107.2 for additional consideration when determining the total subject matter of audit).

The auditor should then calculate quantified materiality using one of the following formulas:

For Incurred Cost Proposal Audit Subject Matter from \$1 to \$1,000,000,000 use the following formula:

$$\text{Materiality Threshold} = \$5,000 \times ((\text{Total Subject Matter} / \$100,000) ^{.75})$$

For Incurred Cost Proposal Audit Subject Matter greater than \$1,000,000,000 use the following formula:

Materiality Threshold percentage of 0.50 percent

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Note: when entering the formula in Microsoft Excel, the quantified materiality formula for an audit with a \$1,000,000 total subject matter of audit appears as follows:

$$=5,000*((1,000,000/100,000)^.75)$$

The quantified materiality threshold in this example is \$28,117. See the enclosure for a worksheet that demonstrates the quantified materiality calculation above.

The following table depicts quantified materiality thresholds (both dollar amounts and percentages) at various subject matter amounts:

Quantified Materiality Thresholds for Incurred Cost Audits

Subject Matter Cost	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
Materiality Amount	\$5,000	\$28,117	\$158,114	\$889,140	\$2,973,018	\$5,000,000	Varies
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

Calculating Adjusted Materiality

Materiality requires the use of two separate thresholds: quantified materiality to identify significant cost elements, and adjusted materiality to identify significant accounts recorded in the significant cost elements. Adjusted materiality is less than quantified materiality and is applied to accounts within a cost element. For purposes of selecting accounts for audit testing, adjusted materiality can be stated as a reduction of the quantified materiality threshold by 20 percent to 80 percent based on auditor judgment.

Other Considerations

It is important to remember to use professional judgment when applying materiality concepts. Materiality considers both qualitative factors (e.g., customer concerns, prior findings, etc.) and quantitative factors. The relative importance of qualitative and quantitative factors when considering materiality in a particular engagement is a matter of the auditor’s professional judgment. The auditor should document the justification for deviating from the numeric materiality thresholds.

Available Training

DCAI and Policy developed a new E-Learning Course, *AUD112E – Materiality in Audits of Incurred Costs*, which became available July 19, 2019. All auditors should take the course prior to beginning an incurred cost audit. Policy is working with DCAI to ensure that other course materials are updated accordingly.

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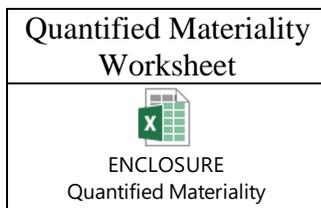
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Additional Questions

FAO personnel with questions regarding this memorandum should contact their regional or CAD offices. Regional/CAD personnel with questions regarding this memorandum should contact Mr. James Freeman, Program Manager at (571) 448-3477 or via e-mail at james.freeman@dcaa.mil.

/s/ Barbara Richon
/for/ Martha E. McKune
Assistant Director, Policy and Plans

Enclosure:
Quantified Materiality Worksheet



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