

March/April 2009

• Issue 7, Vol. 2



Government Contractors Council



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## The GovCon Report



### Articles

## DCAA Policy Revision – Audit Opinion Related to Contractor Internal Controls

By [Mike Steen](#), Senior Manager, [Beason Nalley](#)

As DCAA continues to reassess various audit policies as an unstated by-product of the GAO July 2008 Report on DCAA (GAO-08-087; *Allegations that Certain Audits at Three Field Offices did not Meet Government Auditing Standards*), on December 19, 2008, DCAA revised its audit guidance on its audit opinions on contractor internal control systems (08-PAS-043(R)). In addition to revising the potential audit opinions from three to two, the document also clarifies what constitutes a significant deficiency/material weakness.

The most obvious and notable change is the elimination of the “middle” audit opinion, that is, the opinion that the applicable system of internal controls was “inadequate in part”. Thus, from this point forward, the only audit opinions DCAA will issue will be “adequate” or “inadequate.” This “pass” or “fail” approach for the applicable system or subsystem proceeds from the fact that DCAA never audits or expresses an opinion on a contractor's total system of internal controls. Chapter five of DCAA's Contract Audit Manual delineates DCAA's somewhat artificial ICAPS approach, which separates a contractor's system of internal controls into as many as ten subsystems. In the context of DCAA's ten ICAPS audits, a contractor could have five adequate systems and five inadequate systems or any combination adding to the total number of applicable systems.

DCAA policy as to what constitutes a significant deficiency is for the most part contained in DCAA policy memo 08-PAS-011(R), dated March 3, 2008. That memo redefined a significant/reportable internal control deficiency to be consistent with changes in Government Auditing Standards. Essentially, a deficiency is significant/reportable if it results in a reasonable possibility that unallowable costs will be charged to the Government and the potential unallowable cost is not clearly immaterial. The December 19, 2008 memo mentioned earlier adds further clarification that “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 - even when the control objective does not have a direct relationship to charging cost to Government contracts”. Further, DCAA policy states that “it will not be necessary to demonstrate actual questioned cost to report a significant deficiency”.

The control objectives used by auditors to gauge the adequacy of a set of internal controls are those created by DCAA, used by DCAA field auditors in the ICAPS audits and available on DCAA's website ([www.dcaa.mil](http://www.dcaa.mil)) in the “Standard Audit Programs” submenu. They are loosely linked by DCAA to FAR or CAS, but rarely an explicit requirement of FAR or CAS. Nonetheless, DCAA field auditors have been and will continue to apply DCAA control objectives; if any are missing from contractor policies or in actual application, the audit opinion will state that the system is “inadequate”. This indicates DCAA's apparent conclusion that contractor's systems cannot be relied upon to reasonably assure that unallowable costs will not be charged to Government contracts. Of note, DCAA has and will continue to express these opinions for all applicable ICAPS systems, despite the fact that only a few of the ten “systems” actually require the approval or disapproval of the contracting officer.

The December 19, 2008 policy memo also eliminated any DCAA reporting of “suggestions” to improve the system. The reason given is that such reporting is not required by Generally Accepted Government Auditing Standards (GAGAS) and has caused confusion in the past. Based upon the GAO July 2008 Report on DCAA, we suspect that the only confusion was in reconciling DCAA's role in reporting suggestions to improve the system with GAGAS requirements for auditor independence. Nonetheless, DCAA will no longer provide such suggestions. Furthermore, it is unlikely that DCAA will advise a contractor on any specific solutions to a reported deficiency (all to avoid any third party perceptions that the auditor may ultimately be auditing his/her own work).

DCAA's December 19, 2008 policy, in combination with its March 3, 2008 policy, will have a very predictable effect; that is an increase in the number of DCAA audit reports expressing an opinion that a particular system is inadequate. For a contractor who has previously experienced these audits and not modified any procedures or practices as a result of prior DCAA audits (i.e. chosen to live with “inadequate in part” and/or “suggestions to improve the system”), the next round of audits will report any and all of these as significant internal control deficiencies which will now result in an “inadequate” system opinion. In other words, a pre-existing set of facts and circumstances will now be recast as significant internal control deficiencies solely as a result of changes in DCAA audit

policies. Similarly, if a future draft audit report cites four control objective deficiencies and the contractor clearly corrects three, the system will still be deemed inadequate.

There appears to be some relief in the context of DCAA's statement that these ICAPS audits are limited to "major contractors," defined as those contractors with annual incurred costs of \$90 million or more on flexibly-priced government contracts. Unfortunately, this does not appear to be the case, since DCAA policy permits one or more ICAPS audits to be performed based upon a "risk assessment" of a non-major contractor. Additionally, DCAA has concurrently issued a second policy memo, 08-PAS-041(R), dated December 19, 2008, which applies to "limited scope" audits, defined as an audit which focuses on an internal control deficiency (or deficiencies) identified through an audit other than an internal control audit. This policy contains no qualifiers in terms of limiting its applicability to major contractors. In that context, any contractor could be the subject of a limited scope internal audit resulting in an audit report citing the contractor for inadequate internal controls.

Whether by design or serendipity, the policy on limited scope audits serves to reconcile DCAA's internal control reporting with GAGAS requirements by requiring that the auditor gain an understanding of internal controls for any and all audits. Thus, as a by-product of any audit, including an audit which gains a limited or piecemeal understanding of one or more internal controls, DCAA will apparently be reporting any documented internal control deficiency and opining that the applicable system is inadequate with or without any demonstration of any tangible harm to the government.

Regardless of any perceived flaws in DCAA's audit policy, a contractor, particularly a major contractor, but any contractor which has been subject to one or more ICAPS audits, must anticipate and prepare for these audits. In fact, all contractors must recognize the newly created risk of internal control issues stemming from DCAA's new policy on limited scope internal control audits. To "assist" a contractor, DCAA does make its "control objectives" publicly available and DCAA does advise major and large non-major contractors of its annual audit plan for ICAPS audits.

At the very least, a contractor subject to ICAPS audits must perform a "gap analysis" to determine if it will "pass" the audit. With the new DCAA policy, any gap will equal a "failed system" in the redefined "adequate" or "inadequate" system opinion, which is analogous to a simplistic compliance measured as "pass" or "fail". There simply are no "critical" or "non-critical" criteria in this overly simplistic brave new world.

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Mike Steen is a Senior Manager with [Beason Nalley](#). He can be reached at [msteen@beasonnalley.com](mailto:msteen@beasonnalley.com).

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The Government Contractors Council Report is a monthly newsletter distributed by the Greater Washington Government Contractors Council, an initiative of the Fairfax County Chamber of Commerce for Washington, DC metropolitan area government contractors.

Fairfax County Chamber of Commerce  
8230 Old Courthouse Road Suite 350  
Vienna, VA 22182  
P: (703) 749-0400 • F: (703) 749-9075  
[www.fairfaxchamber.org](http://www.fairfaxchamber.org)