

## Recommendation 10: Replace system criteria from DFARS 252.242-7006, Accounting System Administration, with an internal control audit to assess the adequacy of contractors' accounting systems.

### Problem

The DoD is not obtaining timely assurance that internal controls for defense contractors' accounting systems are properly designed and functioning.<sup>1</sup> Ensuring effective internal controls is one of the most efficient ways to protect the government's interest, reduce risk, and improve performance.

### Background

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission has developed an Internal Control—Integrated Framework (May 2013) that has gained broad acceptance in the private sector and is widely used around the world.<sup>2</sup> COSO is a private-sector initiative that was jointly sponsored by the American Accounting Association (AAA), American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), Institute of Management Accountants (IMA), and the Institute of Internal Auditors (IIA).<sup>3</sup> COSO is dedicated to providing thought leadership through the development of a comprehensive framework and guidance on internal control, enterprise risk management, and fraud deterrence designed to improve organizational performance and oversight and to reduce the extent of fraud in organizations. Its integrated framework of internal controls enables organizations to develop systems of internal control that adapt to changing business and operating environments, mitigate risks to acceptable levels, and support sound decision-making and governance of the organization.

The federal government has developed a similar framework that adapts the COSO Internal Control—Integrated Framework principles and addresses the unique government environment in the *Standards for Internal Control in the Federal Government* (GAO-14-704G), which is commonly referred to as the *Green Book*.<sup>4</sup> The U.S. Comptroller General developed the *Green Book* to set forth the internal control standards for federal entities. The *Green Book* defines the standards through components and principles and explains why they are integral to entities' internal control system.

Internal control also is defined as a process used by management to help an entity meet its objectives. Internal control helps an entity run its operations efficiently and effectively, report reliable information about its operations, and comply with applicable laws and regulations. Intended users of the *Green Book* are program managers, independent public accountants conducting audits of federal expenditures, and IG staff conducting financial or performance audits. Assurance of an effective

---

<sup>1</sup> DCAA, email to Section 809 Panel Staff, December 18, 2017. The email indicated that DCAA completed eight accounting system audits in FY 2016.

<sup>2</sup> Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control—Integrated Framework, Executive Summary*, i, accessed October 30, 2017, <https://www.coso.org/Documents/990025P-Executive-Summary-final-may20.pdf>.

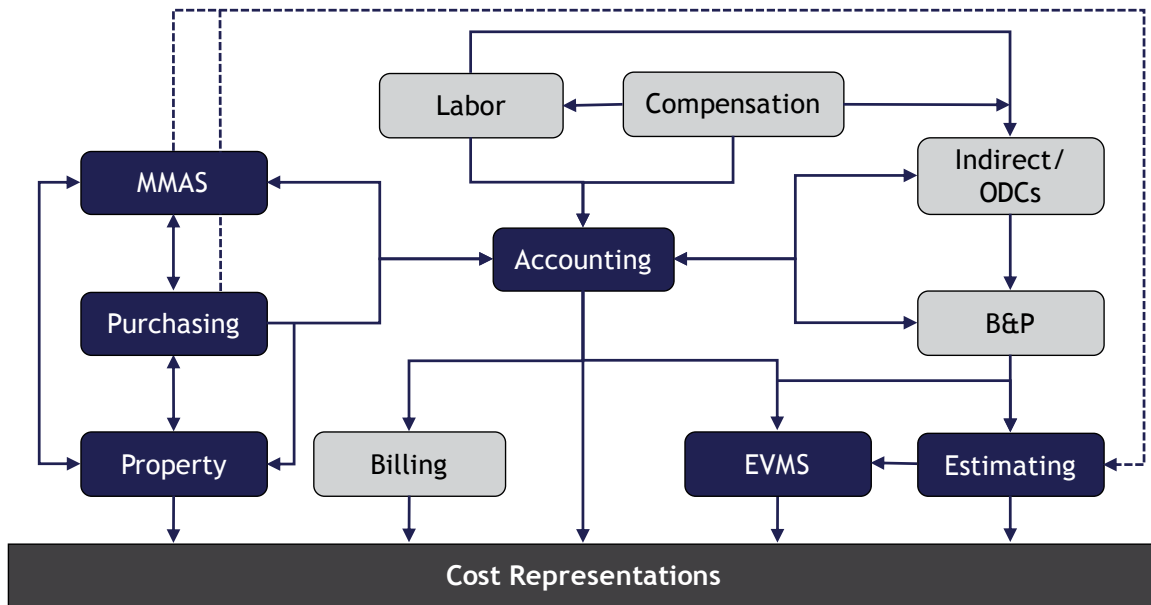
<sup>3</sup> "Guidance on Internal Control," COSO: Committee of Sponsoring Organizations of the Treadway Commission, accessed October 30, 2017 <https://www.coso.org/Pages/ic.aspx>.

<sup>4</sup> GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G, accessed October 30, 2017, <http://www.gao.gov/assets/670/665712.pdf>.

internal control system provides management with added confidence that it can adapt to shifting environments, evolving demands, changing risks, and new priorities.

Accounting business systems make up much of the business systems in the DoD’s Contract Business Analysis Repository (CBAR). In addition to being the most prevalent contractor system, it is the most critical system for ensuring the government’s interests are protected. The accounting system is the central and integral internal control system that enables companies to successfully conduct business with the federal government.

**Figure 2-1. Business System Relationships**



FAR 16.301-3, Limitations, recognizes the criticality of the accounting system by requiring the contractor to maintain an adequate accounting system for determining cost applicable to contracts awarded on the basis of cost.<sup>5</sup> In addition, FAR subpart 32.5, Progress Payments Based on Costs, and FAR 32.503, Postaward Matters, contain multiple provisions requiring an adequate accounting system and controls.<sup>6</sup> Even prospective contractors wanting to do business with the federal government must have the necessary accounting and operational control structure to be deemed responsible in accordance with FAR 9.104-1, General Standards.<sup>7</sup>

This requires prospective contractors to demonstrate capability to meet the requirements outlined in the Standard Form 1408, Pre-Award Survey of a Prospective Contractor Accounting System.<sup>8</sup> This pre-award system review should not be confused with the reviews required by the DFARS Business System

<sup>5</sup> Cost-Reimbursement Contracts: Limitations, FAR 16.301-3.

<sup>6</sup> Progress Payments Based on Costs, FAR 32.5.

<sup>7</sup> Responsible Prospective Contractors: Standards, FAR 9.104-1.

<sup>8</sup> Defense Contract Audit Agency, *Preaward Survey of Prospective Contractor Accounting System, Version 6.13, dated April 2017*, accessed November 20, 2017, [http://www.dcaa.mil/Content/Documents/sap/17740\\_AP\\_NA.pdf](http://www.dcaa.mil/Content/Documents/sap/17740_AP_NA.pdf).

rule that test the design and capability of the system, as well whether the controls are in place and functioning properly.

## Findings

The Sarbanes–Oxley Act (SOX) established the first mandated audit of Internal Controls over Financial Reports (ICFR) to determine the effectiveness of controls (SOX 404(b)).<sup>9</sup> Most publicly traded companies, with the exception of those with a market capitalization of \$75 million or less, are required to have an annual audit of ICFR.<sup>10</sup>

As a result of SOX, in the last 15 years, industry organizations have established a framework with standards, objective criteria, and defined terminology. The Public Company Accounting Oversight Board (PCAOB) has established Auditing Standard 2201 (AS 2201), and the American Institute of Certified Public Accountants (AICPA) has developed AU-C Section 940 auditing standards. Both documents are titled *An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements*.<sup>11</sup> Refinements over the last 15 years have brought about reliable, consistent, and well-understood guidance for private-sector auditors.

## Conclusions

DoD should build on the established and well-understood internal control audit framework provided by SOX to cover DoD’s contractor accounting system requirements. SOX 404(b) serves as a foundation to help meet the government’s objectives to obtain assurance that contractors have effective internal controls for their business systems. Starting with this framework eliminates the need to develop uniquely defined criteria and terminology, which in turn reduces the time needed to make this framework operational.

DoD should use the SOX internal control audit framework and adapt it to meet the government’s objectives for contractor accounting-system oversight. Audits of internal controls designed to assess controls over financial reporting (the SOX mandate) cannot meet the government’s contracting audit needs without some adjustments to the scope of the engagement. Using the current audit of internal controls over financial reporting as a basis to certify that the government’s control objectives are adequately addressed and satisfy the intent of the current business is an insufficient approach because it would not address all of the relevant control objectives. The audit of ICFR addresses some of government’s objectives, but comes woefully short of addressing all of them.

Adapting the current internal control framework would address a shortcoming in the FY 2017 NDAA Section 893 (c)(1) that states “if a registered public accounting firm attests to the internal control

---

<sup>9</sup> Securities and Exchange Commission, Office of Economic Analysis, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, 3, accessed November 20, 2017, [https://www.sec.gov/news/studies/2009/sox-404\\_study.pdf](https://www.sec.gov/news/studies/2009/sox-404_study.pdf).

<sup>10</sup> Securities and Exchange Commission, *Final Rule – Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers, Effective Date: September 21, 2010*, accessed November 20, 2017, <https://www.sec.gov/rules/final/2010/33-9142.pdf>.

<sup>11</sup> Public Company Accounting Oversight Board, *Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Independence Rule and Conforming Amendments*, PCAOB Release No. 2007-005A, June 12, 2007, accessed November 20, 2017, [https://pcaobus.org/Rulemaking/Docket%2021/2007-06-12\\_Release\\_No\\_2007-005A.pdf](https://pcaobus.org/Rulemaking/Docket%2021/2007-06-12_Release_No_2007-005A.pdf). American Institute of Certified Public Accountants (AICPA), *AU-C Section 940 – An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, accessed November 20, 2017, <https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-c-00940.pdf>.

assessment of a contractor pursuant to section 404(b) of the Sarbanes-Oxley Act of 2002 allow the contractor ... to submit certified documentation ... that the contractor business systems of the contractor meet the business system requirements referred in subsection (b)(1) and to thereby eliminate the need for further review of the contractor business system by the Secretary of Defense.”<sup>12</sup>

The envisioned internal control audits will focus on assessing the key controls that ensure government objectives are being met. Auditors’ conclusions on the effectiveness of the key controls are essential information for contracting officers and contractors to evaluate whether the government’s interests are adequately protected. Specifically, auditors will evaluate whether key internal controls are in place and operating to do the following:

- Ensure a sound internal control environment and accounting framework.
- Appropriate classification of direct costs from indirect costs.
- Allocate indirect costs properly.
- Exclude unallowable costs.
- Confirm costs by contract.
- Reconcile subsidiary cost ledgers to general ledger accounts.
- Ensure periodic posting of books of account at least monthly for contract billings.
- Certify proper controls over adjusting entries.
- Ensure timekeeping and labor distribution controls are proper.
- Comply with contract terms.
- Ensure accordance with Cost Accounting Standards if applicable and GAAP.
- Monitor the internal control environment.

Under the internal control audit engagement, auditors will determine whether reasonable assurance exists that controls will prevent any significant or material mischarge from occurring. This is in contrast to the current evaluation criteria that determine compliance by using an inspection-like pass or fail for each of the 18 requirements. In many instances, the current engagement fails to consider a holistic view of the system of controls and the significance of a noncompliance and the likelihood that a significant noncompliance could actually occur.

Using the private-sector-established internal control audit framework can resolve a consistent complaint expressed in Section 809 Panel meetings with stakeholders that the accounting system criteria were not objective and measureable because of the current terminology used in the business system rule.<sup>13</sup> Internal control audits should be performed as the basis for assessing the adequacy of defense contractors’ accounting systems because these audits provide the following:

---

<sup>12</sup> Section 893 of FY 2017 NDAA, Pub. L. No. 114-328 (2016).

<sup>13</sup> Defense Industry officials, interview conducted July 25, 2017 by Section 809 Panel Team 4: Barriers to Entry. American Institute of CPAs, *DoD Comment Letter Finbal-AICPA*, <https://www.regulations.gov/document?D=DARS-2014-0047-0020>.

- An engagement framework used in the private sector that is well established and understood.
- More useful and relevant information to the acquisition team, contracting officer, and contractor.
- Clear and objective criteria for accounting system requirements.

The framework's standards and criteria would satisfy the FY 2017 NDAA Section 893 (a) requirement to develop "clear and specific business system requirements that are identifiable and made publicly available."<sup>14</sup>

## **Implementation**

### ***Legislative Branch***

- No statutory changes are required.

### ***Executive Branch***

- Revise DFARS 252.242-7006 to allow DoD use of internal control audits conducted by contractors for accounting system oversight.

### ***Implications for Other Agencies***

- There are no cross-agency implications for this recommendation.

---

<sup>14</sup> Section 893 of FY 2017 NDAA, Pub. L. No. 114-328 (2016).

- Revise DFARS 252.242-7006 to allow DoD to use internal control audits.

**252.242-7006 Accounting System Administration.**

As prescribed in 242.7503, use the following clause:

ACCOUNTING SYSTEM ADMINISTRATION (FEB 2012)

(a) *Definitions.* As used in this clause—

(1) “Acceptable accounting system” means a system that has an effective internal control structure ~~complies with the system criteria in paragraph (c) of this clause~~ to provide reasonable assurance that—

- (i) Applicable laws and regulations are complied with;
- (ii) The accounting system and cost data are reliable;
- (iii) Risk of misallocations and mischarges are minimized; and
- (iv) Contract allocations and charges are consistent with billing procedures.

(2) “Accounting system” means the Contractor’s system or systems for accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions, and may include subsystems for specific areas such as indirect and other direct costs, compensation, billing, labor, and general information technology.

(3) “Significant deficiency” means a shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes. In the context of an audit of internal control over a contractor’s accounting system, a significant deficiency is equivalent to a “material weakness,” which means a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material unallowable cost (see FAR 31.201-2, Determining allowability) or misstatement will not be prevented or detected on a timely basis

“Reasonable possibility”, as used in this definition of significant deficiency, means when the likelihood of an event is either “reasonably possible” or “probable,” as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies (“FAS 5”).

(b) *General.* The Contractor shall establish and maintain an acceptable accounting system. Failure to maintain an acceptable accounting system, as defined in this clause, shall result in the

withholding of payments if the contract includes the clause at [252.242-7005](#), Contractor Business Systems, and also may result in disapproval of the system.

(c) *System criteria.* The Contractor's accounting system shall be evaluated by an internal control audit that provides reasonable assurance that government reporting objectives are met. The auditor will evaluate whether key internal controls are in place and operating in order to — provide for —

(1) Ensure a sound Internal Control Environment and Accounting Framework ~~A sound internal control environment, accounting framework, and organizational structure;~~

(2) Appropriate classification of direct costs from indirect costs ~~Proper segregation of direct costs from indirect costs;~~

(3) Allocate indirect costs properly ~~Identification and accumulation of direct costs by contract;~~

(4) Exclude unallowable costs ~~A logical and consistent method for the accumulation and allocation of indirect costs to intermediate and final cost objectives;~~

(5) Confirm costs by contract ~~Accumulation of costs under general ledger control;~~

(6) Reconcile subsidiary cost ledgers to general ledger accounts ~~Reconciliation of subsidiary cost ledgers and cost objectives to general ledger;~~

(7) Ensure period posting of books of account at least monthly for contract billings ~~Approval and documentation of adjusting entries;~~

(8) Certify proper controls over adjusting entries ~~Management reviews or internal audits of the system to ensure compliance with the Contractor's established policies, procedures, and accounting practices;~~

(9) Ensure timekeeping and labor distribution controls are proper ~~A timekeeping system that identifies employees' labor by intermediate or final cost objectives;~~

(10) Comply with contract terms ~~A labor distribution system that charges direct and indirect labor to the appropriate cost objectives;~~

(11) Ensure accordance with Cost Accounting Standards if applicable and GAAP ~~Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account;~~

~~(12) Monitor the Internal Control Environment Exclusion from costs charged to Government contracts of amounts which are not allowable in terms of Federal Acquisition Regulation (FAR) part 31, Contract Cost Principles and Procedures, and other contract provisions;~~

~~—————(13) Identification of costs by contract line item and by units (as if each unit or line item were a separate contract), if required by the contract;~~

~~—————(14) Segregation of preproduction costs from production costs, as applicable;~~

~~—————(15) Cost accounting information, as required —~~

~~—————(i) By contract clauses concerning limitation of cost (FAR 52.232-20), limitation of funds (FAR 52.232-22), or allowable cost and payment (FAR 52.216-7); and~~

~~—————(ii) To readily calculate indirect cost rates from the books of accounts;~~

~~—————(16) Billings that can be reconciled to the cost accounts for both current and cumulative amounts claimed and comply with contract terms;~~

~~—————(17) Adequate, reliable data for use in pricing follow-on acquisitions; and~~

~~—————(18) Accounting practices in accordance with standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, Generally Accepted Accounting Principles.~~

(d) *Significant deficiencies.* (1) The Contracting Officer will provide an initial determination to the Contractor, in writing, of any significant deficiencies. The initial determination will describe the deficiency in sufficient detail to allow the Contractor to understand the deficiency.

(2) The Contractor shall respond within 30 days to a written initial determination from the Contracting Officer that identifies significant deficiencies in the Contractor's accounting system. If the Contractor disagrees with the initial determination, the Contractor shall state, in writing, its rationale for disagreeing.

(3) The Contracting Officer will evaluate the Contractor's response and notify the Contractor, in writing, of the Contracting Officer's final determination concerning—

(i) Remaining significant deficiencies;

(ii) The adequacy of any proposed or completed corrective action; and

(iii) System disapproval, if the Contracting Officer determines that one or more significant deficiencies remain.



(e) If the Contractor receives the Contracting Officer's final determination of significant deficiencies, the Contractor shall, within 45 days of receipt of the final determination, either correct the significant deficiencies or submit an acceptable corrective action plan showing milestones and actions to eliminate the significant deficiencies.

(f) *Withholding payments.* If the Contracting Officer makes a final determination to disapprove the Contractor's accounting system, and the contract includes the clause at 252.242-7005, Contractor Business Systems, the Contracting Officer will withhold payments in accordance with that clause.

(End of clause)