

Recommendation 71: Adopt a professional practice guide to support the contract audit practice of DoD and the independent public accountants DoD may use to meet its contract audit needs, and direct DoD to establish a working group to maintain and update the guide.

Problem

DCAA provides professional services and skilled advice to DoD contracting officers. With the introduction of independent public accountants (IPAs) into these oversight functions, the quality and consistency of advice contracting officers receive will depend on the quality and consistency of how oversight professionals interpret and apply foundational standards that guide their work.

Background

Although professional standards are common in the auditing profession, none of them have been developed or interpreted for the unique purpose of federal government contract oversight. DCAA's *Contract Audit Manual* provides a good foundation, but it lacks the collaborative inputs, perspectives, and interpretations of knowledgeable professionals outside DCAA and the government. This point is important because IPAs and other qualified professional services firms are playing an increasingly important role in the government's oversight of federal government contractors.

Discussion

Because professional standards generally establish principles rather than rules, they are subject to interpretation. DoD's oversight professionals will benefit from a uniform, collaborative interpretation of certain professional standards as they apply to government contract oversight. Without a professional practice guide (PPG), contracting officers will be underserved and likely confused by inevitable inconsistencies among audit and advisory reports issued by DCAA, DCMA, and IPAs. Professional standards of importance that require a collaborative interpretation on how to apply the standards in the contract oversight environment include (among many others) materiality, risk, internal controls, independence, objectivity, sufficient evidence, and reliance on the work of others.

Conclusions

The Section 809 Panel's *Volume 1 Report* concluded that a PPG would be beneficial and supplemental to existing guidance for professionals involved in the business of government contract auditing. As written by the Section 809 Panel, the PPG (see Attachment 6-1) provides information on how to interpret and apply specific auditing concepts for government contract audits to assist government auditors, private-sector auditors, contracting officers, and other stakeholders involved in the audit process. Although these concepts are established in auditing literature, the PPG focuses on how the concepts can be applied for the unique purpose of federal government contract oversight. A working group of subject-matter experts in contract auditing developed the guide for the panel. The team included members from key stakeholder communities, including Section 809 Panel representatives, DCAA, GAO, AICPA, DCMA, and industry. Members of the team worked collaboratively to consider and address concerns that have been raised by Congress and others.

The PPG provides the requisite guidance to address Congress's direction to the Section 809 Panel in the FY 2018 NDAA, Section 803, with respect to numeric materiality. The PPG sets forth clear materiality

guidelines that help oversight professionals plan their work and provide the information contracting officers need to make reasonable business decisions. What may be material to a particular business decision will be influenced by a variety of qualitative and quantitative considerations, recognizing that the contracting officer's role is to manage DoD's risk, rather than avoid it. The cost of DoD's oversight, including adverse effects on the timeliness of decision making, must be balanced with expected benefits of that oversight. The Cost Accounting Standards (CAS) Board's administrative regulations establish a variety of *qualitative* materiality considerations appropriate for and applicable to any business decision affecting contract costs/prices.

Besides materiality, the PPG addresses an internal controls framework for audits of contractor accounting systems. As discussed below, adoption of the internal controls framework for review of accounting systems requires amendments to statute and the DFARs, and the Section 809 Panel provides the appropriate language in support of the amendments.

In the Section 809 Panel's *Volume 1 Report*, Recommendation 14 provided for DCAA to incentivize contractor compliance and manage risk efficiently through robust risk assessment. The PPG provides a risk model that should be employed by DCAA. Although, DCAA has historically used a risk-based approach to determine which contractors are subject to incurred cost audits, as part of the PPG working group, DCAA has embraced an expanded risk model to include additional risk factors that further refine and improve the process.

The *Volume 1 Report* noted that DCAA plays an important role within DoD's system of acquisition internal controls. When these controls are operating effectively and efficiently, they provide DoD reasonable assurance that contract prices and cost reimbursements are *free of material unallowable costs*. This concept, established by the COSO Internal Control Framework and incorporated into GAO's *Standards for Internal Control in the Federal Government* (i.e., *Green Book*), is fully compatible with the FAR guiding principle of shifting focus from *risk avoidance* to *risk management*. To accomplish the desired outcome of both the federal government's internal control framework and the FAR's Guiding Principles, it is important to recognize DCAA's role in developing and embracing the enhanced risk model.

Implementation

Legislative Branch

- Direct DoD to adopt the PPG as guidance in support of DoD's contract audit practice and the practice of IPAs that the Department may use in support of its contract audit needs. In adopting the PPG, the Congress should ensure that DoD establishes a collaborative process for future maintenance of the guide to include changes to the guide. Specifically, direct the Secretary of Defense to charter a PPG working group (PPGWG), chaired by DCAA/DCMA for the purpose of ensuring the same collaborative process is used for changes to the guide as was established by the Section 809 Panel. As part of this direction, the PPG does not take the place of federal regulations or auditing standards. Direct the Secretary of Defense to charter a working group similar to the Section 809 Panel, that is exempt from FACA, although the proceedings and decisions of the panel would be posted on the DCAA website.

Executive Branch

- Adopt the PPG as guidance in support of DoD’s contract audit practice and the practice of IPAs that the Department may use in support of its contract audit needs. In doing so, the Secretary of Defense should charter a PPGWG, chaired by DCAA/DCMA for the purpose of ensuring the same collaborative process is used for changes to the guide as was established by the Section 809 Panel. The process should ensure that the PPG stays current with changes in the practice and that changes to the guide are considered collaboratively by a group of experts in the field of contract auditing. Specifically, the Section 809 Panel recommends the following approach to long-term support of the PPG.
 - The Secretary of Defense should charter a PPGWG with five permanent representatives:
 - A representative of the DCAA appointed by the Director of DCAA.
 - A representative of the DCMA appointed by the Director of DCMA.
 - A representative of the U.S. GAO appointed by the Comptroller General of the United States.
 - A representative of industry nominated by CODSIA and agreed on by a majority of the representatives from DCAA, DCMA, and GAO.
 - A representative from the American Institute of Certified Public Accountants and agreed on by a majority of the representatives from DCAA, DCMA, and GAO.
- Rotate the committee chair position biennially between DCAA and DCMA. The chair is responsible for scheduling and recording proceedings and decisions made by working group members. The committee members do not have terms but changes to membership on the committee should be re-assessed by the collective members on an annual basis. The appointees from the DCAA, DCMA, GAO, and AICPA will be automatically removed from the working group should they leave their organizations. The working group will meet not less than semi-annually and otherwise as determined necessary by the members of the committee. The working group shall have an indefinite termination date.
- Administer the PPG at DCAA as follows:
 - Self-initiate minor revisions due to spelling and grammatical errors.
 - Make substantive changes as agreed on by a majority of the PPG working group members.
 - Maintain the most recent version of the PPG on the DCAA public website.
- Adopt substantive revisions based on a majority vote of working group members. Substantive revisions are defined as changes to the guides meaning, adding new context to existing concepts in the guide or adding or deleting information in the guide.

Implications for Other Agencies

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

Department of Defense

Professional Practice Guide

Audits and Oversight of
Defense Contractor Costs and
Internal Controls

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INTRODUCTION

The Section 809 Panel developed this Professional Practice Guide (PPG) as a supplement to existing guidance for professionals involved in Department of Defense (DoD) procurement contract auditing. A Section 809 Panel working group collaboratively developed this guide to provide additional information regarding how to interpret and apply specific auditing concepts for government contract audits to assist auditors, contracting officers, and other stakeholders involved in the audit process. It is intended to assist professionals with delivering high quality, consistent financial audit and advisory services to contracting officers.

Independent public accountants (IPAs) and other qualified professional services firms play an increasingly important role in the government's oversight of federal government contractors. Although professional standards are common across the auditing profession—applicable to both public and private organizations—these standards were not developed or interpreted for the unique purpose of federal government contract oversight. To address this need, the Section 809 Panel assembled a working group of subject matter experts in the fields of contract auditing and compliance, professional standards, and audit resolution. The Section 809 Panel wishes to thank the working group members for their dedication and generous contribution of time and energy toward the development of the guide. The working group consisted of representatives from the following organizations.

- Defense Contract Audit Agency
- Defense Contract Management Agency
- US Government Accountability Office
- American Institute of Certified Public Accountants
- Aerospace Industries Association
- Baker Tilly Virchow Krause, LLP

The working group evaluated a variety of professional standards to identify concepts that may benefit from collaborative interpretation as they apply in a contract oversight environment, including risk, materiality, audits of internal controls, independence, objectivity, sufficient evidence, and reliance on the work of others. Given the Section 809 Panel's limited statutory term, the working group prioritized its work to focus on risk, materiality, and audits of internal controls. Accordingly, these three concepts are addressed in this first edition of the PPG.

Although these concepts are well established in auditing literature, this guide focuses on how the concepts should be used for the purpose of federal government contract oversight. It describes how these concepts are to be applied in the context of government contract audits and provides practical examples and best practices to help auditors perform audits.

Maintenance

The Section 809 Panel recommends the Secretary of Defense charter and reconstitute a Professional Practice Guide Working Group, chaired by both DCAA and DCMA on a biennial rotation, to ensure the same collaborative process is used for changes and additions to the PPG as was established by the Section 809 Panel. The process should ensure that the PPG remains current and that additional topical areas are considered collaboratively by a diverse group of experts in the field of contract auditing and compliance. Specifically, the Section 809 Panel recommends that the Working Group should have five permanent representatives, including a representative from each of the following:

- Defense Contract Audit Agency (DCAA), appointed by the director of DCAA.
- Defense Contract Management Agency (DCMA), appointed by the director of DCMA.
- Government Accountability Office (GAO), appointed by the Comptroller General of the United States.
- Industry, nominated by *Council of Defense and Space Industry Associations* (CODSIA) and agreed on by a majority of the representatives from DCAA, DCMA, and GAO.
- American Institute of Certified Public Accountants, agreed on by a majority of the representatives from DCAA, DCMA, and GAO.

The chair of the Working Group (i.e., either DCAA or DCMA, biennially) is responsible for scheduling and recording proceedings and decisions made by Working Group. The Working Group members do not have terms, but membership may be assessed annually by the collective members and changes made based on this assessment. The appointees from DCAA, DCMA, GAO, and AICPA will be automatically removed from the Working Group should they leave their respective organizations. The Working Group will meet not less than semi-annually and otherwise as determined necessary by the members. The Working Group shall have an indefinite termination date.

The PPG will be made available to the public in the *Guidance* section of DCAA's website. New Editions of the PPG will be announced internally within DCAA by a Memorandum for Regional Directors, a copy of which will also be published promptly on DCAA's website.

Overview

The PPG provides information on how to interpret and apply specific auditing concepts to audits of government contract costs and compliance-related internal controls. This guide will assist government auditors, private-sector auditors, contracting officers, contractors, and other stakeholders better understand the audit process.

Financial and business system oversight of defense contractors is a crucial function of DoD's system of acquisition internal controls. This oversight function performs both preventive and detective control activities, designed to reasonably ensure DoD's contractors comply with a variety of contract requirements. These contract requirements allow DoD's procuring and administrative contracting officers to exercise good stewardship of taxpayer dollars, as well as deliver timely, high-quality goods and services to warfighters and accomplish other operations critical to DoD's mission.

The PPG recognizes, in Chapter 1, that a more robust *risk assessment* process will allow DoD to deploy its limited resources more effectively. The PPG further recognizes, in Chapter 2, that DoD can deploy its resources more efficiently, without harming effectiveness, through a common understanding of *materiality*. Finally, in Chapter 3, the PPG recognizes that a common framework will streamline and bring consistency to DoD's *audits of contractor systems of internal control* over government contract compliance.

This guide recognizes that systems of internal control are not expected to provide absolute assurance that specified objectives are met. The costs of attaining absolute assurance are generally greater than the benefits attained from such assurance, and there are inherent limitations in any system of internal control due to factors such as human error and the uncertainty inherent in judgment. This first edition of the PPG focuses on this axiom with respect to both DoD's system of acquisition internal control and contractors' systems of internal control over government contract compliance.

Chapter 1, *Incurred Cost Risk Assessment*, establishes guidance that DCAA will use to focus its limited resources when auditing costs incurred by contractors on flexibly priced defense contracts. This chapter implicitly acknowledges that (a) DCAA is an important element of DoD's system of acquisition internal controls, (b) DCAA does not have sufficient resources to audit every DoD contractor, and (c) adding more oversight resources would likely produce diminishing returns relative to the increased cost. The risk assessment process also incentivizes larger contractors to achieve or maintain compliant cost accounting and effective accounting system internal controls, such that they can reduce their assessed risk profile and, thus, audit frequency.

Chapter 2, *Engagement Materiality Framework*, addresses Congress's direction to the Section 809 Panel in the FY 2018 NDAA, Section 803, with respect to numeric materiality for audits of incurred cost. This chapter sets forth clear materiality guidelines that help oversight professionals plan their work and provide the information contracting officers need to make reasonable business decisions. What may be material to a particular business decision will be influenced by a variety of qualitative and quantitative considerations, recognizing that the contracting officer's role is to manage DoD's risk, rather than avoid risk. The cost of DoD oversight, including adverse effects on timeliness of decision making, must be balanced with expected benefits of that oversight. Guidance in this chapter should be used in conjunction with the Cost Accounting Standards Board's (CASB's) administrative regulations (48 CFR 9903.305) that establish a variety of materiality considerations appropriate for any DoD business decision concerning contract costs/prices.

Chapter 3, *Audits of Internal Controls over Government Contract Compliance*, introduces a body of professional standards based on an internal control audit framework and developed to address the requirements of Sarbanes-Oxley Act (SOX) Section 404(b). This framework serves as the means by which DoD will obtain reasonable assurance that contractors have effective internal controls over their business systems as they relate to government contract compliance. Internal control audits will be the basis for assessing adequacy of defense contractor accounting systems. These audits are well established and understood by the auditing profession. They will also provide more useful, relevant information to the acquisition team, contracting officers, and contractors.

References to the *Government Auditing Standards* 2018 Revision in this guide refer to attestation engagements and performance audits performed once the 2018 revision becomes effective. For attestation engagements, it is for periods ending on or after June 30, 2020. For performance audits, it is for audits beginning on or after July 1, 2019. For all engagements performed prior to the respective effective dates of the 2018 revision, the auditor should refer to the 2011 revision of the *Government Auditing Standards*.

CHAPTER 1: RISK ASSESSMENT

The Need for Risk Assessment

DoD's system of acquisition internal controls is subject to the same economic constraints as those faced in other government agencies, organizations, and corporations. Increasing resources become necessary to achieve desired risk levels approaching zero (i.e., absolute risk avoidance).

DCAA serves many roles within DoD's system of acquisition internal controls. Chief among them is DCAA's role as auditor of costs incurred by, and reimbursed to, commercial companies that perform flexibly-priced defense procurement contracts. DoD cannot reimburse commercial companies for their contract performance costs unless they comply with contract terms and conditions.

Each year, thousands of commercial companies incur costs while performing flexibly-priced defense contracts. Accordingly, this Chapter establishes a risk assessment framework intended to focus DCAA's finite resources such that DoD's risk is appropriately managed.

Risk Assessment Framework

The foundation for this risk assessment framework rests on the materiality concepts introduced in Chapter 2 of the PPG, insofar as it aligns increasing risk levels with the annual costs incurred by contractor business units (as represented on annual final indirect cost rate proposals, also referred to as incurred cost proposals (ICPs)). As annual costs increase, so does the likelihood of being audited.

The risk assessment framework also takes into consideration several qualitative factors that may either increase or decrease the likelihood of being selected for audit. The risk assessment framework provides incentives for contractors to achieve or maintain compliant cost accounting and internal controls over government contract compliance. It also provides disincentives for those contractors who have not.

The risk assessment framework provides for three levels, or *strata* of risk: low, medium, and high. These levels are based on a contractor business unit's Auditable Dollar Volume¹ (ADV). Within each risk strata, contractor ICPs fall within specified ranges of ADV and may be selected for audit based on the stratum's criteria. Each stratum is also affected by specific risk questions that affect the frequency of the contractor being audited. This aligns audit frequency with the performance of the contractor with regards to the history of questioned costs and status of business systems. The questions differ for each stratum but relate to the following risk factors:

- The significance of historic questioned costs.
- The existence of specific Department concerns.
- The status of the business systems.
- The existence of uncorrected system deficiencies (if any).
- The existence of significant accounting or organizational changes (e.g., merger).

For contractors with final indirect cost rate proposals for which total incurred cost on DoD flexibly priced contracts is equal to or greater than \$1 Billion of ADV, DoD will conduct an audit regardless of the above factors. For all other final indirect cost rate proposals, the frequency of audit should decrease

¹ADV is the sum of all of the costs on flexibly-priced contracts for a contractor during a given fiscal year

provided the risk factors are met. The risk assessment framework is provided below and available on the DCAA website.

Table 1. Risk Assessment Framework

	Low Risk Strata	Medium Risk Strata	High Risk Strata
	< 100M	\$100M-\$500M	> \$500M
Sampling Notes	N/A	\$100M–\$250M: Audit every 5 th year if not selected during sampling process > \$250M–\$500M: Audit every 4 th year if not selected during sampling process.	\$1B or more: Audit > \$500M–<\$1B, if the answer to each of the question below is No, the contactor’s ICP will move to the medium risk category with the possibility of being sampled for audit in that year. Must be audited every other year.
Risk Assessment Protocol	For contractors with < \$5M ADV, answer questions 1 and 2 below. For contractors with \$5M to <\$100M ADV, answer all three questions below. 1) Assess the risk of incurred cost proposal using the questions (below). 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.	For contractors with \$100M–\$250M in ADV, was a determination letter used to close the prior four contractor fiscal years? (A YES response indicates proposal must be audited regardless of initial risk.) For contractors with > \$250M–\$500M in ADV, was a determination letter used to close the prior three contractor fiscal years? (A YES response indicates proposal must be audited regardless of initial risk.) 1) Assess the risk of incurred cost proposal using the six questions (below). 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.	For contractors with > \$500M and <\$1B in ADV, was a determination letter used to close the prior contractor fiscal year? (A YES response indicates proposal must be audited regardless of initial risk.) For contractors with \$1B or more in ADV, an audit must be conducted every contractor fiscal year. 1) Assess the risk of incurred cost proposal using the six questions below. 2) If risk assessment identifies no areas of concern, the incurred cost proposal placed into sampling strata for chance of being selected. 3) If risk assessment identifies area of concern, the incurred cost proposal will be audited.
Risk Assessment Results	ICPs with ADV <5M placed in low risk strata sampling universe for sampling if the answers to questions 1 and 2 below are NO. Note: The regional Audit Manager must approve the performance of an audit. ICPs with ADV \$5M – <100\$M in low risk strata sampling universe if the answers to all the questions below are No.	ICPs with ADV of \$100M–\$500M placed in medium risk sampling universe for sampling if the answers to all six questions below are NO.	ICPs with ADV of > \$500M–\$1B placed in medium risk sampling universe for sampling if the answers to all six questions below are NO.
Question 1	Are there significant Questioned costs in the last completed incurred cost audit?	Are there significant Questioned costs in the last completed incurred cost audit?	Are there significant Questioned costs in the last completed incurred cost audit?
Question 2	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?	Are there any Department concerns from the DCMA, COR, PCOs, or DCAA, etc. with a significant impact on this ICP?
Question 3	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?	Does the contractor have a preaward accounting system survey that resulted in an <i>unacceptable</i> opinion, or a disapproved accounting system due to a postaward accounting system audit?
Question 4	N/A	Does the contractor have any business system deficiencies relevant to incurred costs for the year subject to audit?	Does the contractor have any business system deficiencies relevant to incurred costs for the year subject to audit?
Question 5	N/A	Does the contractor have any significant account practice changes in the year subject to audit?	Does the contractor have any significant account practice changes in the year subject to audit?
Question 6	N/A	Has the contractor experienced significant organizational changes in the year subject to audit?	Has the contractor experienced significant organizational changes in the year subject to audit?

CHAPTER 2: MATERIALITY IN AUDITS OF INCURRED COSTS

This chapter presents guidelines and a framework for determining materiality for use in audits of incurred costs. However, this framework and the recommended materiality thresholds are not a substitute for professional judgment.

Materiality and Significance in Incurred Cost Audits

The term *incurred cost audit* means an audit of charges to the government by a contractor under a flexibility priced contract.² These charges are reported annually by contractor business units, in a final indirect cost rate proposal (also referred to as an incurred cost proposal), as required by FAR 52.216-7. This proposal represents the subject matter of the incurred cost audit. The risk to the government and others who rely on this information is that amounts are materially misstated due to contractors' noncompliance with contract terms or federal regulations. If the incurred cost proposal is not materially compliant and complete, it could adversely affect decision making by those who use the information.

The objectives of an incurred cost audit are to (a) provide assurance that contractors' incurred cost proposals can be relied on to settle final indirect cost rates and (b) communicate any misstatements that may affect contract cost reimbursements. Contract costs that do not comply with contract terms, federal regulations, or agreements are referred to in audits of contract costs as *misstatements*. An incurred cost audit is designed to identify material (or significant, as explained below) misstatements, based on both quantitative considerations (amount) and qualitative considerations (nature).

A material misstatement, as used throughout this guide, means misstatements, including omissions, individually or in the aggregate, that could reasonably be expected to influence relevant decisions of intended users that are made based on the subject matter. Materiality, by definition, is more than just a number and is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment.³

Audits of incurred costs can be performed using standards for performance audits (GAO, *Government Auditing Standards* 2018 revision), and standards for attestation examination engagements (AICPA, *Professional Standards*, Statements on Standards for Attestation Engagements). The definition of materiality is drawn from the attestation examination standards but is not limited to only these types of engagements. For the remainder of this document use of *materiality* is based on this definition. The Government Auditing Standards define *significance* for performance audits (FY 2018 Yellow Book, paragraph 8.15) as

The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors. Such factors include the magnitude of the matter in relation to the subject matter of the audit, the nature and effect of the matter, the relevance of the matter, the needs and interests of an objective third party with knowledge of the relevant information, and the matter's effect on the audited program or activity. Professional judgment assists auditors when evaluating the significance

² The term 'flexibly priced contract' has the meaning given the term 'flexibly-priced contracts and subcontracts' in part 30 of the Federal Acquisition Regulation (section 30.001 of title 48, Code of Federal Regulations).

³ Paragraph A15 of AT-C section 205, *Examination Engagements* (AICPA, Professional Standards, AT-C sec. 205)

of matters within the context of the audit objectives. In the performance audit requirements, the term significant is comparable to the term material as used in the context of financial statement engagements.

The definition of *significant* for performance audits is similar to the definition of *materiality* for attestation examination engagements. For purposes of this document, these terms may be used interchangeably.

Both the terms *materiality* and *significance* refer to characteristics of the subject matter that are important, or relevant, to the users of the information. The terms *significant cost element* or *significant account* in this chapter refer to items that require further evaluation, and possibly testing, due to the potential of material misstatements based on quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer. During the planning and fieldwork phase of the audit, *significance* is used in the context of a potential risk of misstatement (quantitative or qualitative) in a cost element or account that is more than clearly trivial. During the reporting phase of the audit, *material* or *significant* misstatements will affect the auditor's opinion or conclusion.

Compatibility of Commercially Accepted Standards for Risk and Materiality

The commercial concepts of risk and materiality are compatible with the objectives of contract cost auditing. They represent auditors' professional responsibility to determine *what matters* (i.e., the risk that costs do not comply with contract terms and federal regulations) and *how much matters* (i.e., materiality) in the context of a particular audit. What and how much matters depends on the use of the audited information.

With respect to financial statement audits of for-profit companies, the owners, potential investors, and banks use audited financial information to make investment and lending decisions. With respect to contract cost audits, contracting officers use audited financial information to negotiate contract prices, reimburse contract costs, and evaluate a contractors' compliance with contract terms. To ensure the integrity of information on which economic decisions will be made, organizations (in the context of financial statements of for-profit companies) and contracting officers (in the context of procurement contracts) use auditors to provide assurance on that information.

Commercial standards of risk and materiality conceptually apply to contract cost audits, yet the process in which they are applied is viewed through the lens of contracting officers and their responsibility to expend public funds fairly and reasonably. Auditors' evaluation of what matters (i.e., risk or significance) is made in the context of the engagement type and contracting officers' (or other government customers') needs. The auditors' assessment of what matters is also a necessary precondition to determining how much matters (i.e., materiality).

Materiality in the Context of Contract Cost Audits

The concepts of materiality and significance expressly acknowledge that some degree of imperfection is acceptable to the users of financial information. This point is emphasized throughout the commercial and government auditing standards, regulations for the oversight of financial markets, FAR and the Cost Accounting Standards (CAS). This chapter discusses materiality, consistent with commercial standards, as a guide to help auditors when performing audits of incurred contract costs.

Materiality, in the context of contract costs, represents the government’s acknowledgement, consistent with the Federal Acquisition System’s Guiding Principles, that there is an acceptable level of imprecision when determining or settling fair and reasonable contract prices. *Material* misstatements, individually or in aggregate, would reasonably be expected to influence the economic decisions of the government.⁴ *Immaterial* misstatements would not adversely affect the economic decisions of the government as a buyer of goods and services in the commercial marketplace.

Commercial standards of risk and materiality provide for both *qualitative* and *quantitative* considerations. In the context of government contract costs, an auditor is concerned with both the nature (i.e., quality) and the amount (i.e., quantity) of a cost.

Audits of incurred contract costs generally focus on cost allowability and the completeness of contractors’ cost representations. Contract cost auditors evaluate contractors’ cost accounting and presentation for compliance with contract terms, FAR Part 31 cost principles (and CAS, as applicable), and other agreements between contractors and the government (e.g., advance agreements). Auditors are encouraged to discuss quantitative and qualitative materiality considerations with contracting officers or other government customers to obtain their perspectives on what is important to them. For example, auditors may be informed by contracting officers of the importance of a certain aspect of the information, such as a cost element or account, which auditors may take into consideration in their determination of materiality.

Definitions

For the purposes of this PPG, the terms below are defined as follows:

Table 2. Audit Terminology

Term	Definition
Total Subject Matter Amount	The incurred cost claimed on flexibly priced contracts during the fiscal year. It includes different categories of contract cost such as labor, materials, other direct costs, indirect costs, and is adjusted for certain types of contracts and activity such as commercial contracts. The FY 2018 NDAA, Section 803, defines <i>incurred cost audit</i> as an audit of charges to the government by a contractor under a flexibly priced contract. See Appendix B for additional information.
Accounts	Records used to group same or similar types of financial transactions during a fiscal period. An expense account’s balance at the end of a fiscal period reflects the total dollar amount of transactions recorded to that account. For example, a labor expense account will include individual transactions associated with amounts paid to employees.
Cost Element	Represents the summation of accounts of a similar character and type that is included in the total subject matter. For example, the direct materials cost element is comprised of all material costs on government contracts, and may include, for example, accounts for direct purchases, allocations from company owned inventory, and allocations for material factors. The cost element is similar to a line item in financial statements.

⁴ The FY2018 NDAA, Section 803, defines *numeric materiality standard* as “a dollar amount of misstatements, including omissions, contained in an incurred cost audit that would be material if the misstatements, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the Government made on the basis of the incurred cost audit.”

Term	Definition
Significant Cost Element or Account	Represents a cost element or account that requires further evaluation and testing due to quantified materiality, qualitative characteristics, other risk factors, variability, or stated concerns of the contracting officer, and is applicable to any type of engagement performed. Significance is relevant in the planning and reporting phases of the audit.
Materiality	In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence relevant decisions of intended users that are made based on the subject matter. Materiality is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment. ⁵
Quantified Materiality	The numeric representation of materiality that is calculated based on the total audit subject matter. It is used in planning to identify significant cost elements. Quantified materiality is similar to planning materiality used in financial statement audits.
Adjusted Materiality	The amount or amounts set by the auditor at less than quantified materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the incurred cost proposal, taken as a whole. It also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Adjusted materiality is similar to performance materiality used in financial statement audits.
Quantitative Materiality Factors	Quantitative factors relate to the magnitude of misstatements or questioned costs relative to the reported amounts for those aspects of the subject matter, if any, which are expressed numerically or otherwise related to the numeric values. ⁶
Qualitative Materiality Factors	Risk and qualitative materiality factors are understood in the context of the subject matter as relating to, or measured by, the quality of subject matter rather than its quantity. Qualitative materiality factors can include whether the misstatement affects compliance with laws or regulations, the result of an intentional act (i.e., fraud), and importance to the users of the information regardless of dollar amount. ⁷ For planning purposes, the auditor may design audit procedures to address risk of potential material noncompliance related to these qualitative factors. For reporting purposes, and after completion of fieldwork, the actual misstatements should be evaluated for significance based on these qualitative factors in addition to quantitative factors.
Nominal Reporting Amount	The nominal reporting amount is an amount at which any adjustment (misstatements or noncompliance) taken individually would be immaterial regardless of other factors. It is used during the reporting of results to determine the impact of certain qualitative amounts that are significant based on nature but so small in value they are still considered immaterial. Regardless, although not included in the audit report, these items are separately communicated to the contracting officer in a summary of misstatements. The nominal reporting amount is similar to the nominal amount used in financial statement audits.
Misstatement	When the contract costs that are billed, or reported, to the government do not comply with contract terms and federal regulations such as FAR and CAS. The primary source of misstatements for incurred cost audits is cost type (FAR 31.205), contract clauses, cost reasonableness, and cost allocation (FAR 31.201 to 31.204 or CAS if applicable). When a misstatement is identified, it is typically referred to as a noncompliance that can be measured as a dollar amount of questioned contract costs.

⁵ Paragraph A15 of AT-C section 205

⁶ Paragraph A19 of AT-C section 205

⁷ Paragraph A18 of AT-C section 205

Engagement Materiality Framework

The Engagement Materiality Framework describes the process for calculating and using materiality throughout the audit process and is organized by phases of the audit, as follows:

Table 3. Engagement Materiality Framework

Audit Phase	Engagement Materiality Framework Step
Planning	1) Calculate quantified materiality
Planning	2) Identify significant cost elements
Planning	3) Identify significant accounts within significant cost elements
	4) Consider the use of adjusted material in sampling and tolerable error
	5) Determine the nature, timing, and extent of audit procedures on significant cost elements and accounts considering risk and materiality.
Fieldwork	6) Perform testing procedures and document results.
Conclusion and Reporting	7) Evaluate misstatements based on quantitative and qualitative materiality characteristics.
	8) Report or communicate misstatements, in compliance with Government Auditing Standards.

Step 1: Calculate Quantified Materiality

Quantified materiality relates to the magnitude of misstatements relative to reported amounts for those aspects of the subject matter, if any, that are expressed numerically or otherwise related to numeric values. Use of quantified materiality is appropriate for audits of incurred cost because the total subject matter can be measured as a numeric value. Quantified materiality is used in the planning phase of the audit to identify significant cost elements and affects use of adjusted materiality during fieldwork (Engagement Materiality Framework Step 3). The process to calculate qualified materiality includes the following:

- **Define Total Audit Subject Matter:** The audit subject matter is expressed numerically, and for purposes of the materiality calculation, includes the total subject matter upon which an auditor will be expressing an opinion and providing assurance.
- **Calculate Quantified Materiality:** Quantified materiality is based on auditor judgment and is influenced by industry benchmarks, reasonableness, and the needs of the users of the information. It represents the amount, or percentage, of the Total Audit Subject Matter that can be misstated and influence the decisions of those who use the information.

Commercially accepted practices for determining quantitative materiality involve the application of percentages to elements of financial information. For example, a financial statement auditor may use 5 percent of net income, or 0.5 percent of net assets, as a benchmark for quantitative materiality. If net income is \$1,000,000, then, in an auditor's judgement, misstatements of more than \$50,000 (5 percent) individually, or in the aggregate, would likely influence the economic decisions of financial statement users. If net income is \$100,000,000, then misstatements of more than \$500,000 (5 percent) individually, or in the aggregate, would likely influence the economic decisions of financial statement users.

As the examples above show, commercially accepted materiality benchmarks tend to maintain their proportionality as financial values increase. This proportionality occurs because financial statement users need assurance that the financial statements fairly represent a company's financial position in accordance with GAAP. It is not necessarily the dollar value of misstatements that matters to financial statement users; rather, it is whether the financial statements fairly represent the company's performance within an acceptable margin of imperfection.

Recommended materiality thresholds are provided below that are consistent with industry norms and acceptable for use in incurred cost audits. The practical application of quantified materiality is not limited to these thresholds as auditor judgment with consideration of qualitative factors, risk, and variability have an impact.

The materiality thresholds recommended below adjust (by algebraic equation) downward as the amount of cost subject to audit increases. Because contract audits involve contractors' costs that may be reimbursed with public funds, applying a static benchmark could produce unacceptably large materiality thresholds. For example, 5 percent of \$100,000 (or \$5,000) is perceived much differently than that same percentage applied to \$1,000,000,000 (or \$50,000,000). In this instance, it would be more appropriate to use a threshold of 0.5 percent for \$1,000,000,000 because the resulting materiality threshold of \$5,000,000 is more aligned with the government's economic decision-making responsibility.

Recommended Materiality Thresholds for Incurred Cost Audits

Table 4. Incurred Cost Audit Proposals Subject Matter

Subject Matter Cost	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B	> \$1B
Materiality Amount	\$5,000	\$28,117	\$158,686	\$889,140	\$2,973,018	\$5,000,000	<i>Varies</i>
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%	0.50%

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

- Materiality Threshold = \$5,000 x ((Total Subject Matter / \$100,000) ^ .75)

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

- Materiality Threshold percentage of 0.50 percent

Quantified materiality does not change due to the type of engagement performed (e.g., examination or performance audit). Professional judgments about quantitative materiality are made in light of contract dollars subject to audit (i.e., engagement subject matter) and are not affected by the level of assurance. Materiality is based on the needs of those who use the information irrespective of the type of engagement performed.

The application of quantified materiality neither limits auditor judgment nor places restrictions on what an auditor can test based solely on dollar value. Rather, the quantified materiality amount is

intended to create a consistent threshold that helps an auditor calibrate the nature, timing, and extent of audit procedures relative to the unique risks and qualitative considerations of each engagement. It is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter of the practitioner's professional judgment.⁸

The example below illustrates a basic quantified materiality calculation. The total subject matter represents all costs for flexibly priced contracts (i.e., engagement subject matter), whether direct or indirect, of \$200,500. The total subject matter is then multiplied by the quantified materiality formula to compute the materiality amount used during the audit.

Figure 1. Illustrative Basic Quantified Materiality Calculation

$$\$8,425 = \$5,000 \times ((\$200,500/\$100,000) \wedge .75)$$

The quantified materiality amount is \$8,425, which is 4.2% of the total engagement subject matter (\$8,425/\$200,500).

Incurred Cost Submission:	Total
Direct Labor	\$100,000
Direct Materials	\$50,000
Other Direct Costs	\$10,000
Overhead	\$20,000
<hr/>	
G&A Expense	\$20,500
<hr/>	
Total Subject Matter (a)	\$200,500
Materiality Threshold (b)	4.2%
Materiality (c)	\$8,425

Step 2: Identify Significant Cost Elements

A significant cost element is identified by quantified materiality, qualitative materiality characteristics, and other risk factors. The process for determining a significant cost element is as follows:

- **Quantified Materiality:** The auditor should identify all cost elements equal to or greater than quantified materiality as significant.
- **Risk and Qualitative Factors:** The auditor should consider risk and qualitative factors for all cost elements less than quantified materiality. Cost elements may still be considered significant and subject to testing procedures based on risk factors and qualitative characteristics such as a

⁸ Statements on Standards for Attestation Engagements (SSAE) Number 18; AT-C 205.A15.

history of identified misstatements, nature of particular costs, and needs of the users of the audited information.

- **Variability:** The auditor may use judgment and incorporate variability, or unpredictability, in the selection of cost elements to test. For example, an auditor has elected to not test a cost element for the last 2 years due to an immaterial balance. In the current year, and to ensure variability and unpredictability in the testing approach, the auditor may select the cost element for testing. This prevents a pattern from forming and discourages the contractor from recording misstatements in cost elements that have a history of not being tested.

The following example compares the quantified materiality amount of \$134,200 to the cost elements within the subject matter. The materiality amount was calculated by including the total subject matter of \$8,036,024 in the materiality threshold equation. The associated materiality threshold percentage is 1.67 percent ($\$134,200/\$8,036,024$). In the example, an auditor would identify the cost elements of direct labor, direct materials, subcontracts, overhead, and general and administrative costs as significant based on quantified materiality.

Table 5. Comparison of Quantified Materiality to Cost Elements

Cost Element	Amount	> Materiality of \$134,200
Direct Labor	\$2,441,657	YES
Travel	\$54,092	NO
Direct Materials	\$188,716	YES
ODC	\$11,175	NO
Subcontracts	\$3,329,051	YES
Indirect Overhead	\$1,138,408	YES
G&A (Value Added)	\$872,925	YES
Total Subject Matter	\$8,036,024	
Materiality Threshold	1.67%	
Materiality	\$134,200	

A *YES* in the table above means that the cost element is significant and should be further evaluated at the account level, but it does not automatically mean the entire amount will be tested. An auditor is responsible for auditing significant costs elements based on materiality or other factors, but the nature, timing, and extent of audit procedures may vary based on auditor judgment.

The cost elements that are less than the quantified materiality amount may be tested due to qualitative materiality characteristics, other risk factors, or if, in an auditor's judgment, they may contain immaterial misstatements that could be material in the aggregate. The following examples illustrate an auditor's potential qualitative considerations relative to the travel cost element, which is less than the quantified materiality amount. In this example, the auditor did not identify qualitative or risk concerns for the ODC cost element, which is also less than the quantified materiality amount:

- The contractor's travel cost element has a history of misstatements, which have been investigated in the past, and is a stated concern of the contracting officer. If the user of the information (i.e. the contracting officer) considers a particular cost element to be significant based on qualitative facts and circumstances, then an auditor may evaluate it at the account level in the same manner as any other significant cost element.
- The contractor's travel cost element has no history of misstatements, and the contracting officer did not express any concerns in this area. However, the travel cost element was not tested in the prior 2 years. The auditor could test the travel cost element to ensure variability and unpredictability in the audit approach, regardless of whether the risk and qualitative characteristics indicate no testing may be appropriate.

The body of work necessary to support the opinion, or audit conclusions, is generally met with the testing of cost elements and accounts with values greater than materiality or adjusted materiality. The use of qualitative or other risk factors to identify significant cost elements should be based on actual, objective, and measurable facts and circumstances such as history of questioned costs, and needs of the users of the audited information. Absent these objective factors, the auditor is expected to adhere to materiality thresholds. The auditor should document the justification for deviating from the materiality thresholds. See Appendix A for unique considerations regarding indirect costs.

Step 3: Identify Significant Accounts

A significant account is identified by adjusted materiality (as explained below), qualitative materiality characteristics, and other risk factors. The process for identifying significant accounts is as follows:

- (1) **Adjusted materiality:** The auditor should identify all accounts equal to or greater than adjusted materiality as significant.
- (2) **Risk and Qualitative Factors:** The auditor should consider qualitative factors for all account balances less than adjusted materiality. Accounts may still be considered significant and subject to testing procedures based on risk and qualitative factors such as a history of misstatements, sensitivity, and needs of the users of the audited information.
- (3) **Variability:** The auditor should incorporate an element of variability in the selection of accounts to test. For example, an auditor elected not to test an account for the last 2 years due to an immaterial balance. In the current year, and to ensure variability and unpredictability of the testing approach, an auditor may select the account for testing. This prevents a pattern from forming and discourages the contractor from recording misstatements in accounts that have a history of not being tested.

An auditor will use *adjusted materiality* to identify significant accounts subject to audit evaluation. Quantified materiality represents the total amount the subject matter can be misstated without misleading the users of the information. Adjusted materiality is less than quantified materiality. Unless quantified materiality is adjusted at the account level, an auditor would have limited ability to identify immaterial misstatements that, in the aggregate, become material or are material by their nature even if immaterial in amount.

Adjusted materiality is used at a more discrete level in the books and records and is applied to accounts that make up the cost elements. For purposes of selecting accounts for audit testing, adjusted materiality can be stated as 20 percent to 80 percent of quantified materiality based on audit risk, the nature (or sensitivity) of transactions relative to specific cost allowability criteria, other substantive procedures performed (i.e., whether controls are tested), and the needs of the users of audited information.

The following are key concepts with the application of adjusted materiality:

- Adjusted materiality is applied to the accounts within significant cost elements.
- Once an account is selected, an auditor will test the transactions that sum to the account balance.
- Adjusted materiality is determined separately for each significant cost element.

See Appendix A for guidance on how to calculate adjusted materiality for indirect costs where the government's participation is less than 100 percent.

Adjusted materiality can be used as tolerable error (or tolerable misstatement) for the purpose of statistical sample selection (see the Step 4, Engagement Materiality Framework). The following table provides examples of justifications for degrees of adjustment to the quantified materiality for the purpose of calculating adjusted materiality:

Table 6. Justifications for Degrees of Adjustment to the Quantified Materiality

Percent Adjustment	Examples
(80%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element has a history of material misstatements in multiple accounts. ▪ The contractor is unwilling to correct prior-year material misstatements in subsequent proposals. ▪ The contractor is currently in litigation for historical costs in the same cost element and accounts. ▪ The contracting officer has significant concerns regarding the cost element that increase the sensitivity and importance.
(50%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element and multiple accounts have a history of material misstatements. ▪ Management is responsive with correcting misstatements in subsequent proposals. ▪ The contracting officer has concerns regarding the cost element that increase the sensitivity and importance.
(20%) Reduction in Quantified Materiality	<ul style="list-style-type: none"> ▪ The cost element and accounts have limited to no instances of historical material misstatements on an aggregated basis. ▪ The reduction is to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds total quantified materiality.

The following example illustrates how to calculate adjusted materiality: Based on professional judgment, an auditor elects to reduce the quantified materiality by 20 percent (see Figure 2). If the adjusted materiality is reduced by 20 percent, the remainder represents 80% of the quantified materiality amount (100 percent - 80 percent = 20 percent reduction). The adjustment materiality is calculated by multiplying the quantified materiality of \$1,025 by 80 percent (100 percent - 20 percent), for an adjusted materiality amount of \$820.

Figure 2. Calculated Adjusted Materiality Illustration

Quantified Materiality	\$1,025
Adjustment (less):	(20 percent)
Adjusted Materiality:	\$820

Use of materiality to identify significant amounts becomes more relevant at the account level in the books and records, which make up cost elements. The higher the level aggregation of costs, the more likely that the cost will be selected.

The table below illustrates the practical application of materiality at lower levels of cost in the books or records, or at the account level. The quantified materiality is compared to the cost elements rather than the account level (as indicated by *N/A*), whereas adjusted materiality is compared at the account level (as indicated by *N/A* at the cost element level). Please note that, even if the direct material cost element is greater than quantified materiality, it may not be necessary to test each account in the cost element.

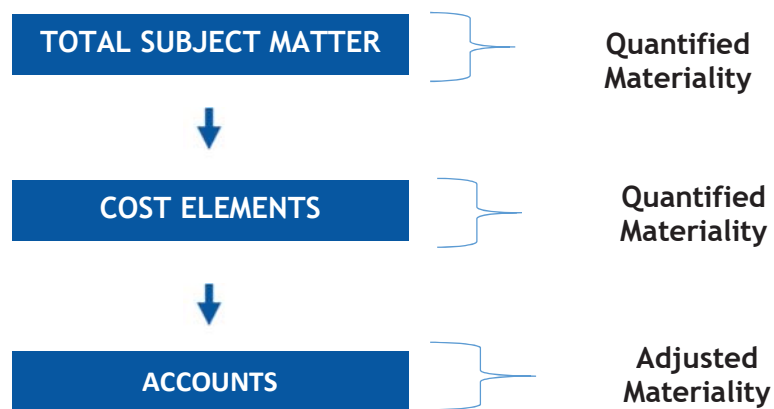
Application of adjusted materiality at the account level identifies three of the six accounts as being material and, thus, needing to be tested. The body of work necessary to support an audit is generally met when an auditor tests cost elements and accounts with values greater than quantified or adjusted materiality. Cost elements and accounts with balances below adjusted materiality (i.e., those with a *NO* response below) may still be subject to testing based on an auditor's judgment, risk factors, qualitative factors, or variability.

Table 7. Application of Materiality at Lower Levels of Cost

Category	Description	Amount	> Materiality \$1,025	> Adjusted Materiality \$820
Subcontracts	Cost Element	\$750	NO	N/A
Direct Materials	Cost Element	\$5,000	YES	N/A
Direct Materials Acct X1	Account	\$850	N/A	YES
Direct Materials Acct X2	Account	\$450	N/A	NO
Direct Materials Acct X3	Account	\$980	N/A	YES
Direct Materials Acct X4	Account	\$500	N/A	NO
Direct Materials Acct X5	Account	\$350	N/A	NO
Direct Materials Acct X6	Account	\$1,870	N/A	YES

Think of it as follows:

Figure 3. Application of Materiality at Lower Levels of Cost



An auditor may combine accounts of the same or substantially similar nature when applying adjusted materiality. For example, a contractor records engineering labor in separate general ledger accounts by project, but the combination of these accounts results in a homogenous amount that is subject to the same audit criteria. Although the contractor separated these like costs into separate accounts for operational or cost accounting purposes, an auditor may combine them for assessing adjusted materiality and testing purposes if that approach makes sense for the audit.

Step 4: Statistical Sampling and Consideration of Tolerable Error Based on Adjusted Materiality

An auditor may use adjusted materiality when determining the tolerable misstatement (or tolerable error) for statistical sample size determination.

An incurred cost audit cannot be completed *effectively and efficiently* by testing 100 percent of all transactions in the subject matter. For this reason, the auditing profession uses statistical sampling to test a representative portion of a transaction population that is sufficient to determine whether the total population is fairly stated.

Although statistical sampling techniques are outside the scope of the document, an important element of statistical sampling is *tolerable misstatement*. Tolerable misstatement represents the total amount of error an auditor is willing to accept in the statistical sample. When auditors use statistical sampling, they are incorporating materiality into the audit. See the AICPA Statistical Sampling guide for additional information.

There is an interrelationship between adjusted materiality, tolerable misstatement, and audit sampling. By using adjusted materiality (converted to a percentage of the transaction population value) as tolerable misstatement, statistical sample sizes will be commensurate with the size of the population in relation to the overall subject matter, audit risk, and materiality. The higher the tolerable misstatement, the lower the sample size.

In practice, an auditor will remove transactions greater than adjusted materiality from the population and test 100 percent of these amounts separately. The remainder of the transactions within the

population would then be subject to the statistical sampling process. If the value of the remaining population (after removing transactions with values greater than adjusted materiality) is less than adjusted materiality, then an auditor may judge it immaterial and forego further statistical sampling. Generally, when the remaining population has an aggregate value greater than adjusted materiality, the transactions will be subjected to audit procedures. This process accounts for the aggregated nature of misstatements to the overall assessment of adjusted materiality.

Steps 5 and 6: Determine the Nature, Timing, and Extent of Audit Procedures; Perform Audit Procedures; Document Results

These steps represent the planning process and fieldwork related to the nature, timing, and extent of audit procedures based on the risk of material misstatement and the Audit Risk Model (inherent risk, control risk, and detection risk), if applicable. The concepts of quantified materiality and adjusted materiality should be considered, as set forth in this chapter, in this part of the audit process.

The auditor should document the basis for materiality and the method of determining materiality.

Step 7: Reporting Audit Results

An auditor can use quantified materiality as a guide for determining the existence of one or more material misstatements when forming an audit opinion, or audit conclusion, on the subject matter. An auditor will summarize all misstatements and compare them individually, and in the aggregate, to quantified materiality.

For example, in the instances of an attestation engagement if the aggregate amount of identified misstatements is less than quantified materiality, then an auditor may issue an unqualified opinion provided, however, that no *quantitatively immaterial* misstatements are *qualitatively material*. If the aggregate of all misstatements is greater than quantified materiality, or if one or more misstatements are qualitatively material, an auditor will issue a qualified or adverse opinion, as applicable. This same process can be used to evaluate scope limitations and disclaimer of opinion.

A few key points for attestation engagements include the following:

- If misstatements individually or in the aggregate exceed quantified materiality, they will result in a qualified opinion, but not necessarily an adverse opinion. An adverse opinion is appropriate if material misstatements are so pervasive that the subject matter, taken as a whole, is not reliable.
- The dollar value of some misstatements may be greater than the value of the underlying misstated transaction. For example, a misstated direct labor cost may draw allocable indirect costs. In this instance, an auditor should evaluate the fully-absorbed value of the misstatement relative to quantified materiality.
- The dollar value of some misstatements may be less than the value of the underlying misstated transaction. Indirect cost misstatements should be adjusted for participation percentages to normalize the amount to account for the proportion of the cost that is allocated to a contractor's work outside of the engagement subject matter. For example, an auditor identifies a \$500,000 misstatement in an indirect cost pool with a government participation percentage of 20 percent.

The actual effect of the misstatement on the engagement subject matter (i.e., indirect costs allocated to the government contracts) is \$100,000 ($\$500,000 * 20$ percent). In this instance, an auditor should evaluate the value of the indirect cost misstatement, after adjustment for government participation, relative to quantified materiality.

- Although qualitative factors are discussed below, it is important to emphasize that some misstatements may be considered material and affect the audit opinion regardless of dollar value.

Quantified materiality is based on the presumption that misstatements, individually or in the aggregate, that exceed that amount would influence the judgment of a reasonable person using the audited financial information with knowledge of the uncorrected misstatements.

An auditor's assessment of materiality requires consideration of both quantitative and qualitative factors in the context of the *total mix* of information available to the users of the audited financial information. As a result, qualitative factors, such as the existence of expressly unallowable costs or evidence of irregularities, could be material facts within the *total mix* of information regardless of dollar value.

The following table sets forth examples of qualitative considerations unique to incurred costs audits that may result in quantitatively immaterial misstatements being considered material and, in turn, affect the audit opinion or audit conclusion. The information below is intended to be illustrative of relevant qualitative factors, rather than exhaustive.

Table 8. Examples of Qualitative Considerations Unique to Incurred Costs Audits

Qualitative Factor	Explanation
Expressly Unallowable Indirect Costs	According to FAR 52.242-3, the inclusion of expressly unallowable indirect costs, when identified, explicitly contradicts the contract terms and subjects the contractor to penalties. The pervasive existence of this form of misstatement creates a higher level of sensitivity and risk when reporting audit results. The determination of a material misstatement is at the auditor's judgment, but generally these misstatements should be evaluated for materiality with less emphasis on the quantified materiality.
Specific Contract Terms	The audit criteria applicable to audits of incurred costs represent contract terms that incorporate specific elements of the FAR, CAS, and so forth. In addition to these regulations, certain contracts may have unique clauses, such as cost limitations on certain activities and the disallowance of certain types of costs such as overtime. Because these unique clauses establish the specific desires of a particular government customer, quantitatively immaterial but pervasive misstatements in this regard may be viewed as material to that customer.

Other relevant qualitative factors may relate to the audit subject matter and the needs of the acquisition community. For example, a contractor may have significant restructuring costs, purchase accounting for an acquisition, overseas operations, or other issues that have qualitative considerations that differ from the ones identified above but are just as relevant. The nominal reporting amount can be considered for reporting misstatements due to qualitative factors.

Step 8: Report or Communicate Misstatements

The auditor should report or communicate, as appropriate, both material and immaterial misstatements to the contracting officer in accordance with Government Auditing Standards (FY 2018 Yellow Book, paragraphs 7.46 and 9.38):

When auditors detect instances of noncompliance with provisions of laws, regulations, contracts, and grant agreements that do not warrant the attention of those charged with governance, the auditors' determination of whether and how to communicate such instances to audited entity officials is a matter of professional judgment.

For incurred cost audits, the need for communicating immaterial information is important because it can result in the transfer of funds between the contractor and government. For example, \$5,000 of questioned direct cost not only may impact the audit opinion or conclusion, but also represents an amount that may be recovered by the government. These amounts should be communicated to the contracting officer to facilitate appropriate disposition.

CHAPTER 3: AUDITS OF INTERNAL CONTROL OVER GOVERNMENT CONTRACT COMPLIANCE

Government Perspective on the Importance of Internal Controls

For government officials to manage programs and contracts effectively, they must be able to rely on information produced by the contractor. The ability of contractors to produce materially accurate information depends on the design and operating effectiveness of their business system internal controls. Without internal controls, it could be difficult for contractors to produce reliable and timely information. Although no internal control system can provide absolute assurance that the information will never include material errors or misstatements, an effective system of internal controls over contractor business systems can substantially reduce the risk of error and misstatements.

Obtaining timely assurance that contractors have effective internal controls is an essential component of all cost-effective compliance frameworks. Consideration of how recently a business system audit was performed and the results is a critical part of the DoD's own system of acquisition internal controls. Effective contractor internal controls permit most additional audits and reviews to be performed more efficiently and timely. Obtaining assurance about internal controls effectiveness is one of the most efficient ways to protect the Government's interest, reduce risk, and improve timeliness.

Defining Internal Controls

Internal controls are the responsibility of the contractor. The auditor will test the internal controls and provide an opinion, or conclusion, on whether they are suitably designed and operating effectively.

Internal controls are defined as a process, affected by the entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.⁹ This definition emphasizes the achievement of objectives. For companies or organizations with Government contracts, the objective is to bill, or report, contract costs in compliance with contract terms and federal regulations. The relationship between objective, risks, and internal controls is as follows:

- An objective defines what the contractor wants to achieve,
- A risk represents a situation, circumstance, or event that the contractor wants to avoid (i.e., an occurrence that results from not achieving the objective), and
- Internal control activities are procedural steps designed and performed to prevent, or detect and correct, the occurrence of a risk such that the objective is achieved.

An internal control framework should generally address five components: control environment, risk assessment, control activities, information and communication, and monitoring activities. However, the extent of implementation by the contractor is dependent on size and complexity and is explained in greater detail in the subsection on Internal Controls Frameworks. These components are introduced in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control—

⁹The Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control—Integrated Framework (May 2013)

Integrated Framework (May 2013) framework and have been recognized and accepted by the AICPA, and the Government Accountability Office.

The only way to determine if internal controls are suitably designed and operating effectively is to test them. It is not appropriate to presume that a contractor has effective internal controls based on the results of audits that do not test internal controls. The existence of a material misstatement in an audit of contract costs does indicate an internal control deficiency. However, the converse is not true. The absence of a material misstatement does not provide the requisite assurance regarding the effectiveness of a contractor's systems and internal controls. The severity of an internal control deficiency is determined by assessing the likelihood that it will result in a material misstatement and is not contingent on whether a material misstatement has occurred. While the contractor may bill or report costs that comply with contract terms in any one period, if the contractor's internal controls are ineffective, the internal controls cannot provide reasonable assurance that a material mistake, fraud, or management override will be prevented or detected and corrected timely. An accounting system that lacks effective internal controls has a greater likelihood of billing or reporting costs that are not compliant with contract terms and federal regulations.

Internal Control Frameworks

The type of internal control framework and the extent of adoption is at the discretion of the contractor. The Committee of Sponsoring Organizations (COSO) of the Treadway Commission has developed an Internal Control—Integrated Framework (May 2013) which has gained broad acceptance in the private sector and is widely used around the world. 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*.

An internal controls framework assists management, board of directors, external stakeholders, and others interacting with the entity in their respective duties regarding internal control without being overly prescriptive. It does so by providing both understanding of what constitutes a system of internal control and insight into when internal control is being applied effectively¹⁰. For accounting system audits related to government contract costs, the auditor does not test the internal controls framework, but rather, tests the internal controls. Regardless, it is important to acknowledge the fact that the internal controls and framework are, by definition, inter-related and a poorly implemented framework may result in ineffective internal controls.

Whether or not a contractor adopts an internal control framework often relates to a contractor's size and complexity. Contractors design and implement control activities relative to their own risks, size, complexity and other relevant factors. For example, a large public company may have adopted an internal control framework (e.g. COSO) to define and meet its control objectives. In contrast, a smaller company with less complex operations may not be aware of formal internal control frameworks, but nevertheless have internal controls commensurate with its size, complexity, and other relevant factors. Auditors are encouraged to understand the contractor's business, the environment in which it operates, the software systems it uses for accounting purposes, how accounting-related business processes are

¹⁰ COSO Internal Control – Integrated Framework, Executive Summary, May 2013

performed, and the contractor's employees either responsible for or participating in those processes. This chapter creates no requirement that the contractor adopt the COSO or any other internal controls framework.

For every contractor, regardless of size, each component of an internal control framework (e.g. control environment, risk assessment, control activities, etc.) will likely be reflected in the manner by which management runs its business (regardless of whether or not management has consciously or formally adopted an internal control framework). Because every business is unique, the auditor should approach an internal control audit using an internal control framework as a means to understand each contractor's unique accounting system controls. Auditors should not expect contractor internal controls to function identically or even at the same level for every company.¹¹

Concept of Reasonable Assurance

The contractor is responsible for designing and operating effective business processes and internal controls to, provide reasonable assurance that the cost information is reliable and complies with contract terms and federal regulations, as applicable. The concept of "reasonable assurance" recognizes that the cost of achieving greater assurance will, at some point, exceed the benefit of the higher assurance. This concept is acknowledged in the Federal Acquisition Regulation Guiding Principles¹². The concept of reasonable assurance as it relates to systems of internal control also recognizes that it is not possible to declare with absolute certainty that an error or misstatement will not occur. For example, the system is operated by people and people inevitably make mistakes, systems breakdown, and organizations change. In addition, intentional misconduct, like fraud and collusion, can prevent controls from working as intended regardless of how well the controls were designed.

For the auditor, evaluating whether or not a contractor's accounting system internal controls provide reasonable assurance is inherently dependent on each contractor's unique facts and circumstances. In this regard, Public Company Accounting Oversight Board's (PCAOB) definition of reasonable assurance is instructive. In the context of an internal control audit over financial reporting, reasonable assurance means that there is a remote likelihood that material misstatements will not be prevented or detected and corrected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. This concept can be applied to audits of contractor accounting system internal controls relative to the criteria contained in DFARS 252.242-7006, Accounting System Administration.

Contractor Internal Controls

The internal controls and business processes are the responsibility of the contractor. This section is designed to provide information on certain aspects of the contractor's internal controls and the scaling of risk.

The objective of the accounting system is to record, accumulate, and summarize financial transactions related to financial reporting, performance reporting, and government contracts (i.e. costs comply with

¹¹ COSO Internal Control over Financial Reporting – Guidance for Smaller Public Companies, dated June 2006

¹² FAR 1.102-2(c)(2), "To achieve efficient operations, the [Federal Acquisition] System must shift its focus from "risk avoidance" to one of "risk management." The cost to the taxpayer of attempting to eliminate all risk is prohibitive."

contract terms and federal regulations). This objective statement is broad and refers to the entire accounting system. The accounting system includes many different types of costs (e.g. labor, materials) that represent different operational activities and distinct business processes. For example, the business processes and internal controls for labor cost are different when compared to other cost elements such as travel.

Contractor Objectives and Business Processes

The contractor will design and implement business processes that achieve operational and financial objectives. The accounting system, as defined at DFARS 252.242-7006, is the collection of 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.

The accounting system should be designed to meet the contractor's objectives and incorporate the necessary internal control activities to reasonably assure that those objectives are met. Whether the contractor's accounting system is already established, or is in the process of being newly implemented, the following diagram illustrates how to evaluate a business process and identify its internal controls.

Figure 4. Evaluating a Business Process and Identifying Internal Controls



- **Objectives:** Through business process walkthroughs and inquiries, the auditor identifies the contractor's objectives related to operations, reporting (e.g., financial statements, incurred cost proposals) and compliance. The overall objective for government contracts is for costs to be billed, or reported, to the government in compliance with contract terms and federal regulations.
- **Risk Assessment:** The process for identifying and analyzing risks forms the basis for determining how risks should be managed to achieve the entity's objectives.¹³ The risk assessment process consists of
 - considering the business processes, *or how things are done*,
 - identifying the risks that the objective will not be achieved,
 - estimating the significance of the risks,
 - assessing the likelihood of the risks occurring, and

¹³ Risk Assessment definition from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control – Integrated Framework* (2013).

- deciding what actions to implement to address those risks.
- **Internal Control Activities:** The contractor will implement internal control activities based on the risk assessment and business process to mitigate the risk of not meeting the objectives.

Contractor Objectives for Government Contracts and Scaling of Risk

In simplified terms, risk is the inverse of an objective. The following are the different categories of risk from the perspective of the accounting system:

- **Accounting System Criteria and Risk:** The Accounting System Criteria represents the overall objectives of an accounting system. The associated risk, or the potential for not meeting these objectives, is global across the entire contractor for government contracts and applicable to every cost element billed or reported to the Government.
- **Process Objectives and Risks:** Process risks are defined at the process level. They are based on the Accounting System Criteria but defined in the context of the costs and business process.

The Accounting System Criteria are the benchmarks used to measure whether the objective has been achieved. If the system has implemented internal controls that mitigate the risks of the Accounting System Criteria not being met, the contractor and the government can state the system was suitably designed to mitigate the risks of noncompliance with the overall objective.

The following table shows the interrelationship among the objective, Accounting System Criteria, and the risks of not achieving the objective:

Table 9. Interrelationships among Objective, Accounting System Criteria, and Risk of Not Achieving Objective

Accounting System Criteria	Risk
(1) Classification of direct costs and indirect costs in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Contract costs are not properly classified as direct and indirect in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(2) Identification and accumulation of direct costs by contract in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Direct contract costs are not identified and accumulated to the correct contract in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(3) Methods to accumulate and allocate indirect costs to contracts in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Indirect costs are not accumulated and allocated to contracts in accordance with contract terms, FAR, CAS, and other regulations, as applicable.
(4) General ledger control accounts that accurately reflect all transactions recorded in subsidiary ledgers or other information systems that either integrate or interface with the general ledger including, but not limited to, timekeeping, labor cost distribution, fixed assets, accounts payable, project costs, and inventory.	The general ledger does not reflect transactions recorded in subsidiary ledgers or other information systems that integrate or interact with the general ledger.
(5) Adjustments to the general ledger, subsidiary ledgers, or other information systems bearing upon the determination of contract costs (e.g. adjusting journal entries, reclassification journal entries, cost transfers, etc.) for reasons that do not violate contract terms, FAR, CAS, and other regulations, as applicable.	Adjustments made to the general ledger from whatever source violate contract terms, FAR, CAS, or other regulations, as applicable.
(6) Identification and treatment of unallowable costs in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Unallowable costs are not identified in the accounting system and not properly resolved in accordance with contract terms, FAR, CAS, or other regulations, as applicable.
(7) Billings prepared in accordance with contract terms, FAR, CAS and other regulations, as applicable.	Billings are not prepared in accordance with contract terms, FAR, CAS, or other regulations, as applicable.
Objective: The contractor bills and reports costs that comply with contract terms and government regulations such as FAR and the CAS, if applicable.	

To implement internal control activities, the risks must be defined and understood in the context of the business processes and costs. Business processes and internal controls are designed to mitigate the risks of noncompliance with the Accounting System Criteria. The level and nature of the documentation will vary based on the size of the contractor and the complexity of the control.

Contractor Risk Assessment and Internal Control Activities

This section refers to contractors' assessment of risk and the implementation of internal controls for their own processes. The auditors' risk assessment process, performed as part of the internal controls audit, is different and discussed in a section below.

Contractors are responsible for assessing risk and implementing internal controls to address those risks. The risk assessment links global risks of not meeting the Accounting System Criteria to business processes, process risk, and internal control activities. If contractors have documented risk assessment

to meet the criteria of the accounting system, this may be useful to the auditor and should be requested. The risk assessment process, formality, and its associated documentation is at the discretion of the contractor. It is possible for a contractor to have effective internal controls without formally documenting a risk assessment.

A common method used in the risk assessment process is to ask the question, *What can go wrong?* in the context of the government risks and the accounting system. The basis for this question is the inherent in the Accounting System Criteria for government contract risk. When contractors design the business process, this question may be asked, and the internal control activities designed to mitigate the risk. Likewise, auditors will follow a similar process when evaluating design of contractors' internal controls, but it is important to make the distinction that business processes and internal controls are the sole responsibility of contractors. Auditors' role is to evaluate the effectiveness of contractors' internal controls in mitigating the risks. The internal controls audit is a useful tool for the contractor in determining whether the internal controls are sufficient.

An internal control activity is defined as an action established through policies and procedures that helps ensure management's goal of achieving its objectives and mitigating the risks is attained.

There are different types of internal control activities:

- Manual internal control activities are performed by the contractor personnel using the software application or on hard copy documents; for example, the review and sign-off of a journal entry.
- Automated internal control activities are imbedded in software applications used to process business transactions. For example, the feature in the timekeeping system that limits the charge codes to certain personnel based on work location and position title.
- Manual and automated internal control activities can be either preventative or detective in design and operation.
- Information Technology General Computer Controls, which apply to many applications affect compliance with the Accounting System Criteria and internal controls.
- If contractors outsource a significant business process, such as processing payroll or another service, the internal controls over this service should be evaluated as part of the overall internal controls assessment.
- Entity-level controls function at higher levels in the organization; are generally not process or cost element specific; and include controls over the control environment, monitoring, and controls over management control. For example, a business unit general manager reviews actual indirect cost rates compared to provisional indirect rates.
- Process-level internal control activities are designed and placed in operation at the business process and cost element level. For example, the review and approval of a timesheet is a process level internal control for the labor cost element.

Auditors and Testing of Internal Controls

The objective of an internal controls audit of the accounting system is to determine if internal controls are effective in mitigating the risk of the noncompliance with contract terms and federal regulations. The audit subject matter is the contractor internal controls related to government contract risk and the audit criteria is defined by the Accounting System criteria.

The definition of the accounting system is broad and includes all costs that are recorded, accumulated, and reported (i.e. billed to government contracts) by the contractor, but this does not mean the auditor must test every aspect of the contractor accounting system:

- The auditor should focus on the government contract compliance risks (i.e., Accounting System Criteria).
- The auditor should focus on testing the internal controls related to material, or significant, cost elements.
- The auditor should test the internal controls that are the most effective at mitigating the risks of noncompliance. These are generally referred to as *key internal controls*.

Additionally, considering internal control in the context of a comprehensive internal control framework, such as Standards for Internal Control in the Federal Government or COSO Internal Control—Integrated Framework can help auditors to determine whether underlying internal control deficiencies exist as the root cause of findings.¹⁴

During the planning phase of the audit, the auditor should obtain an understanding of the significant cost elements billed, or reported, through the accounting system and associated contractor business processes and internal controls. The auditor should request the contractor risk assessment (if available) and discuss with the contractor. Significant cost elements are determined based on dollar value (quantitative), qualitative characteristics, or importance to the contracting officer.

The contractor's accounting system and business processes may be complex. The top-down approach can be used in the planning phase of the audit to align auditors' efforts with significant costs to the government. The approach begins with the identification of significant cost elements in the contractor billing or final indirect cost rate proposal (e.g., incurred cost proposal). For each significant cost element, auditors focus on the entity-level controls and work down to the accounts, business processes, and process-level controls. The auditor verifies his or her understanding of the risks and business processes to address the risk of material noncompliance. This process is a holistic approach to internal controls in which auditors focus on the total process and other mitigating controls. It also allows for auditors to consider the materiality of the cost element and potential error when determining the severity of the internal control deficiency.

For a cost element, auditors obtain an understanding of the process and internal control activities by performing a walkthrough which traces the transactions through the accounting system. This

¹⁴ GAO, Auditing Standards revision 2018, paragraph 8.130.

walkthrough includes noting the reason for an action to record the cost, performance of the action that creates the costs, a description of how the action and the associated cost is tracked, and the internal control activities. The walkthrough is typically performed in the planning phase of the audit and is documented in a sequential order from the initial transactions to the accumulation of the cost on the books and records and can include multiple policies and procedures.

Not all internal controls are equal in importance. Auditors should identify key internal controls for each cost element and associated business process. Key internal controls are the primary means for providing reasonable assurance that contract costs comply with contract terms and federal regulations. If the key internal controls are designed and functioning, then the risks should be mitigated. In contrast, if the key internal controls are not functioning, then the compensating internal controls should be tested to ensure the risk is mitigated (mitigating internal controls). Every business process will have key and non-key internal controls. From an audit perspective, it is generally acceptable to only test key internal controls if the key controls are suitably designed and functioning.

Auditors should develop audit procedures to test the design and functioning (referred to as operating effectiveness in the attestation standards) of internal controls aligned with each of the accounting system criteria:

- **Internal Control Design:** The auditor should test the design effectiveness of controls by determining whether the contractor's controls, if they were operated as designed by persons possessing the necessary authority and competence to perform the control effectively, would satisfy the company's control objectives and effectively prevent or detect errors or fraud that could result in material noncompliance.
 - Procedures auditors perform to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.
- **Internal Control Operation:** Auditors should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.
 - A smaller, less complex contractor might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex contractor might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, auditors should evaluate whether those alternative controls are effective.
 - In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to government contract costs.

- Procedures auditors perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and reperformance of the control.

Contractor may have internal controls tested by different auditors during the year, such as financial statement auditors, internal auditors, and government auditors. The auditor performing the business system audit (the *primary* auditor) may use the work of other auditors; doing so can increase audit efficiency, and may reduce the contractor compliance burden, but has limitations. The primary auditor has the sole responsibility for the opinion, or conclusion expressed, and that responsibility is not reduced by using the work of other auditors. The primary auditor should determine that the work performed by others is sufficient and appropriate for use in the audit. The other auditors must be independent of the subject matter, competent, and objective. The mere fact that other auditors performed internal control testing does not automatically imply that the work can be used by the primary auditor. See the AICPA Professional Standards, *Standards on Attestation Engagements*, and GAO, *Government Auditing Standards 2018 revision*, for additional information on using the work of others.

Hierarchy of Internal Control Deficiencies

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct (a) impairments of effectiveness or efficiency of operations, (b) misstatements in financial or performance information, or (c) noncompliance with provisions of laws, regulations, contracts, or grant agreements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.¹⁵

A misstatement represents information provided to the government that does not comply with contract terms and applicable federal regulations, such as the FAR and CAS. A material misstatement could reasonably be expected to influence, and may adversely affect, the economic or management decisions of information users. A material misstatement will normally result in a material noncompliance because all misstatements are due to a noncompliance with contract terms or federal regulations. A *material noncompliance* is defined as:

A misstatement in the information provided to the Government (e.g. billings, incurred cost submissions, pricing proposals, etc.) that will materially influence, and may adversely impact the economic or management decisions of the users of the information.

For a compliance audit designed to test specific system related criteria, a deficiency can occur due to either internal control deficiencies or system shortcomings. A shortcoming pertains to a noncompliance

¹⁵ Paragraph .07 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, AU-C sec. 265).

with system criteria, and not necessarily internal controls, although it is unlikely one would exist without the other. For accounting systems, internal control deficiencies are categorized by severity as material weakness, significant deficiency, and other deficiency. The categorization is irrespective of the type of engagement (e.g., attestation, inspection) that is performed to test internal controls or compliance with a specific system criterion. The system deficiencies are as follows:

- **Material Weakness:** A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliance or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.
- **Significant Deficiency:** A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.
- **Other Deficiency:** A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that have a clearly trivial, or inconsequential, effect on the ability of the business system to detect and correct errors on a timely basis.

The *other deficiency* definition acknowledges the possibility that a system deficiency, or combination of systems deficiencies, may have a clearly trivial effect on the quality of information produced by the contractor's business system. Clearly trivial represents the inverse of *material* whether judged by any criteria of size, nature, or circumstances. Other deficiencies will not affect the audit opinion or conclusions and will not be included in the audit report. These deficiencies may be communicated to contracting officers using email or other communication methods.

Not all deficiencies rise to the level of a material weakness. Auditors should evaluate the deficiency in the context of the overall system, materiality, whether it is systematic or pervasive, and the existence of mitigating controls. These factors are described below:

- **Materiality:** To be a material weakness, the internal control deficiency can result in a material noncompliance which could reasonably be expected to influence, and may adversely impact, the economic or management decisions of the users of the information. For example, the auditor identifies several internal control deficiencies in the travel cost process. The travel costs are immaterial in relation to other costs at the contractor and generally represent a small percentage of costs billed or reported. In this instance, the travel costs will never result in a material weakness, because it is impossible for an immaterial cost element to have a misstatement that rises to the level of a material noncompliance. The internal control deficiencies should be evaluated for categorization as a significant deficiency or other deficiency.
- **Systematic and Pervasive:** One of the factors in determining whether a system deficiency is material depends on whether it is systematic or pervasive. Some internal control deficiencies

have a limited impact to one or only a few cost elements and will not result in a material noncompliance. When the control deficiency affects only one type of cost (e.g., labor or material cost), the severity is evaluated based on the materiality of that specific cost element. Another factor is the frequency of occurrence based on whether the root cause of the deficiency represents a unique situation or one that occurs frequently.

- **Mitigating Controls:** If the auditor discovers an internal control deficiency, the next step is to determine if there are other controls that are designed and in operation to mitigate the risks related to the deficient internal control. If this is the case, the severity of the internal control deficiency should be evaluated against the existence of other internal controls and may be determined as having no impact on the overall system.

Reporting Requirements for Internal Control Deficiencies

Contracting officers will use internal controls audit results to determine if the accounting system is approved or disapproved. The key factor in this determination is whether the business system is acceptable and materially complies with the Accounting System Criteria. An acceptable business system is defined as a contractor business system that materially complies with the criteria of the applicable business system clauses and does not contain a material weakness that would affect the ability of DoD officials to rely on information produced by the system.

When auditors identify findings, they should plan and perform procedures to develop the criteria, condition, cause, and effect of the findings to the extent that these elements are relevant and necessary to achieve the audit objectives.¹⁶ The report should provide enough information to allow the contracting officer to make an informed decision. Stating something is wrong and providing no supporting information is not sufficient. Contracting officers need to be informed of the finding, but the cause and effect provide the information necessary to determine the next course of action. The effect takes into account materiality, whether the finding is systematic or pervasive, and mitigating controls. The following provides a summary of the report note elements:

- **Criteria:** The Accounting System Criteria (see above) applicable to the overall accounting system and significant cost elements. Criteria identify the required or desired state or expectation with respect to the program or operation and provide a context for evaluating evidence and understanding the findings, conclusions, and recommendations in the report. For internal controls, the criteria should be framed in the context of the cost element, business process, and accounting system criteria.
- **Condition:** The condition is a situation that exists and is discovered during the audit. For a system deficiency, the condition is due to either internal controls or other shortcomings in the system. For example, the auditor sampled 50 invoices for evidence of an approval control and identified 10 out of 50 as lacking approval.
- **Cause:** The cause is the factor or factors responsible for the deficiency. For internal controls, the cause can be due to the design or operation, and for shortcomings the cause could be due to a

¹⁶ GAO, FY 2018 Yellow Book, paragraph 7.19

noncompliance with a prescribed contract term or a deviation in the contractors documented policy and procedures. The cause is the factor or factors responsible for the difference between the condition and the criteria, and may also serve as a basis for recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria and inconsistent, incomplete, or incorrect implementation.

- ***Effect or Potential Effect:*** The effect or potential effect is the outcome or consequence resulting from the difference between the condition and the criteria. The severity of the system deficiency as a material weakness, significant deficiency, or other deficiency is correlated to the effect or potential effect. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

APPENDIX A: CONSIDERATION OF MATERIALITY AND INDIRECT COSTS

Indirect costs are allocated to contracts by using indirect cost rates, which represent a pool of indirect costs divided by a cost base of a contractor's direct and/or indirect activities. Indirect costs are, by definition, costs that cannot be directly allocated to contracts. A contractor's final indirect cost rate proposal (i.e., incurred cost proposal) contains several schedules that identify these pools and bases.

Participation Percent: Because indirect costs are not directly charged to contracts, they are allocated over a base of costs representing business activities that may include a mix of commercial and competitively award fixed price work, as well as flexibly-priced government contracts. Therefore, the indirect costs allocated to flexibly priced government contracts may be less than the total amount of the respective indirect cost pool(s). The participation percentage for each final indirect cost pool reflects the proportion of flexibly-priced government contract activity within the allocation base to the total of all activity in the allocation base. For example, if a general and administrative (G&A) cost base is \$1,000,000 and the cost of activity on flexibly priced government contracts is \$100,000 of the base, then the participation percent is 10 percent ($\$100,000/\$1,000,000$). This affects the audit approach for indirect costs because adjusted materiality should take into account the participation percent.

See the FAR and CAS for additional information on indirect costs and rates.

The following steps should be followed by an auditor when calculating adjusted materiality for indirect costs:

- The auditor will calculate quantified materiality and determine whether the indirect cost elements are significant.
- From the perspective of quantified materiality, the significance of indirect costs is based on the contribution of those costs to the total subject matter.
- If the specific indirect cost element is immaterial, then the auditor may perform limited procedures.

The example below includes direct and indirect cost elements with a total subject matter amount of \$8,219,400. The subject matter amount is the summation of all costs direct and indirect. Quantified materiality is calculated using the total subject matter and the materiality formula in this chapter, which results in a benchmark of \$136,490, or 1.66 percent of the subject matter ($\$136,490/\$8,219,400$). An auditor will compare the quantified materiality to the cost elements and determine whether they are significant. Using this approach, the cost elements of direct labor, subcontracts, overhead indirect costs, and G&A costs are considered quantitatively material. Note, an auditor may still consider certain quantitatively immaterial cost elements to be material based on their professional judgment concerning risk and qualitative factors.

Figure 5. Example with Indirect Costs

Incurring Cost Proposal		> Materiality \$136,490 (YES/NO)
Direct Costs:		
Direct Labor	\$ 5,000,000	YES
Direct Materials	\$ 100,000	NO
Other Direct Costs	\$ 80,000	NO
Subcontracts	\$ 1,000,000	YES
Indirect Costs:		
Overhead	\$ 1,112,400	YES
General and Administrative	\$ 927,000	YES
Total Subject Matter:	<u>\$ 8,219,400</u>	
Materiality Threshold:	\$ 136,490	

For the calculation of adjusted materiality, an auditor should revise quantified materiality for the indirect costs 'participation percent' to identify significant accounts. The table below compares the costs allocated to flexibly priced government contracts (i.e., subject matter) to the total costs in the pool, which, when divided together, yields the participation percent.

Table 10. Comparison of Costs Allocated to Flexibly Priced Government Contracts

Indirect Costs:	Total Subject Matter	Total Cost in Pool	Participation Rate
Overhead	\$1,112,400	\$11,124,000	10%
General and Administrative	\$927,000	\$11,587,500	8%

Based on the above calculation the government participation percent for overhead costs is 10 percent and G&A costs is 8 percent. An auditor may now revise the quantified materiality for the participation percent. This aligns the materiality for the engagement to the total cost in the pools. Because the government participates in these pools, 10 percent and 8 percent, respectively, misstatements (individually or in the aggregate) in the overhead and G&A pools would have to exceed \$1,364,898 and \$1,706,122, respectively, to yield a \$136,490 misstatement on flexibly priced government contracts.

Table 11. Revised Materiality Calculations

Indirect Costs:	Participation Percent	Materiality	Revised Materiality
Overhead	10%	\$136,490	\$1,364,898
General and Administrative	8%	\$136,490	\$1,706,122

The revised materiality amount for the overhead cost is calculated by dividing the quantified materiality of \$136,490 by 10 percent. The revised materiality amount for general and administrative cost is calculated by dividing the quantified materiality of \$136,490 by 8 percent.

- Calculate adjusted materiality using the revised quantified materiality (see above) and in the same manner as Step 3 of the Engagement Materiality Framework. The adjusted materiality will be used for the identification of significant accounts that comprise the indirect cost rate pool.

The following example uses a reduction of 20 percent to calculate adjusted materiality.

Table 12. Materiality Adjusted by 20 Percent

Indirect Costs:	Revised Materiality	Adjustment	Adjusted Materiality
Overhead	\$ 1,364,898	20%	\$ 1,091,918
General and Administrative	\$ 1,706,122	20%	\$ 1,364,898

- Based on adjusted materiality, determine which accounts are quantitatively material. Evaluate the accounts for factors such as risk, qualitative factors, and variability. Determine the nature, timing, and extent of testing.

The following example compares the adjusted materiality amount of \$1,091,918 to accounts in the overhead cost pool. This illustration lists only three accounts of many. Based on adjusted materiality, only the labor account is considered significant. The process for the general and administrative accounts is the same as the overhead accounts.

Table 13. Comparison of Adjusted Materiality to Accounts in Overhead Cost Pool

Overhead Pool Accounts	Amount	> Adjusted Materiality (YES/NO)
6001 Labor	\$ 3,000,000	YES
6002 Operating Supplies	\$ 900,000	NO
6003 Computer & Data Process Supply	\$ 100,000	NO
XXXX
	<u>\$ 11,124,000</u>	

Auditors are responsible for determining the nature, timing, and extent of audit procedures for the labor account. Note, auditors may consider accounts less than adjusted materiality to be significant based on their professional judgment of risk and qualitative factors.

APPENDIX B: TOTAL SUBJECT MATTER

From an audit perspective, the total subject matter is defined as the information on which the auditor provides an opinion (i.e., assurance) or conclusion. For incurred cost audits, the subject matter is defined as cost claimed on flexibly priced contracts during the year and includes different categories of cost such as labor, materials, other direct costs, and indirect costs. For time and material (T&M) contracts, the definition of flexibly priced contracts includes the material portion, but it is not uncommon to test both materials and labor (e.g., labor categories and labor hours) as part of the incurred cost audit due to audit efficiency.

Section 803 of the FY 2018 NDAA, defines *flexibly priced contract* the same as the term *flexibly-priced contracts and subcontracts* in FAR Part 30 (Section 30.001 of Title 48, CFR).

Total subject matter generally includes the following:

- The direct and indirect cost of flexibly priced prime contracts and subcontracts awarded by DoD.
- The direct and indirect costs of flexibly priced prime contracts and subcontracts awarded by an agency other than DoD and the agency has agreed to the audit.
- The amount billed on prime T&M contracts that are awarded by DoD.
- The amount billed on prime T&M contracts that are awarded by an agency other than the DoD and the agency has agreed to the audit.

Total subject matter generally excludes the following:

- The direct and indirect cost of flexibly priced contracts and subcontracts awarded by agencies other than DoD that have not agreed to the audit.
- The amount billed for prime T&M contracts awarded by agencies other than DoD that have not agreed to the audit.
- Amounts for contracts that are not flexibly priced such as firm-fixed-price contracts.
- Amounts for nongovernment activity such as commercial activities.