

DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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OFFICE OF THE DIRECTOR

PAS 730.3.B.2.4

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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

SUBJECT: PCAOB Rulemaking Docket No. 008 Proposed Auditing Standard - An Audit
of Internal Control Over Financial Reporting

Members and Staff of the Public Company Accounting Oversight Board (PCAOB):

The Defense Contract Audit Agency (DCAA), under the authority, direction, and control of the Under Secretary of Defense (Comptroller) is responsible for performing all contract audits for the Department of Defense (DoD), and for providing accounting and financial advisory services regarding contracts and subcontracts to all DoD Components responsible for procurement and contract administration. DCAA provides a wide variety of products and services to contracting officers including independent attestation audits of defense contractors' internal control systems. Many of the largest DoD contractors that DCAA audits are publicly traded and therefore would be required to implement the standards issued by the PCAOB.

DCAA audits are conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) which incorporate American Institute of Certified Public Accountants (AICPA) standards. The GAGAS also prescribe additional field work and reporting standards. DCAA makes every effort to exceed the minimum requirements of the standard setting bodies in providing timely and responsive audits, reports, and financial advisory services to DoD contracting officers and other customers. In addition, a significant percentage of DCAA auditors are certified public accountants.

With regard to the proposed standard on internal control audits, in many areas, DCAA auditing procedures mirror the proposed standard. At the largest DoD contractors, DCAA performs attestation engagements of the 10 internal control systems that most affect Government contracts (for example, billing systems). We believe that audit work performed by DCAA is a quality product, distinguished by the Agency's independence, integrity, and objectivity. As such, we are providing comments on the Board's question number 12 regarding using the work of management and others.

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12. To what extent should the auditor be permitted or required to use the work of management and others?

Paragraph 5 of the proposed standard states that auditors obtain reasonable assurance by evaluating the assessment performed by management and *others under the direction of management* (emphasis added). Paragraph 41 further directs the auditor to evaluate management's process for assessing the effectiveness of the company's internal controls including determining which controls in the process should be tested. The controls and evaluation criteria listed under paragraph 41 of the proposed PCAOB standard are an integral part of DCAA's fundamental requirements and responsibilities for obtaining and documenting an understanding of a contractor's internal controls, assessing control risk, and determining which controls should be tested.

If the extensive and independent testing of internal controls performed by DCAA is any guide, we believe that it is possible that other governmental audit organizations at the Federal or state levels may also produce audit work that meets the standards necessary to warrant reliance by the independent public accountants that are reporting on companies' internal controls over financial reporting.

Consequently, we recommend that the proposed standard be revised to allow audits of internal controls performed by government audit agencies to be included among management's potential sources of reliance. We believe strongly that if CPAs can consider the work of management and management-directed organizations in assessing the firm's internal controls, the CPAs can also consider audit work performed by independent third parties such as government auditors who have no potential conflicts of interest. Limiting the sources of reliance to only those internal to the firm potentially ignores a considerable body of relevant work performed by independent third parties, and could result in duplication of effort and increased audit costs.

Using the Defense Contract Audit Agency (DCAA) as an example, we find that:

- DCAA performs its audit for third party requestors, is not paid by or under the control of management, and is therefore unquestionably independent.
- DCAA's audit guidance for examining internal controls is based on the guidance published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The proposed standard is also based on the COSO framework.
- It is DCAA's policy that each relevant accounting or management system that has a significant impact on Government contract cost be audited on a cyclical basis.
- DCAA audits examine relevant assertions, express an opinion, and report on all significant deficiencies.
- All DCAA audits include consideration of the assessment of the risk of material misstatement due to fraud.

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- Defense contractors routinely place reliance on DCAA accounting and management system (internal control) reports as a means of verifying and validating that controls in place are functioning as intended, and of implementing corrective actions, when controls are not functioning or could be improved.

Finally, we noted that the Board's summary discussion and the proposed standard's text in paragraph 5 and paragraph 104 regarding "Using the Work of Management and Others" is inconsistent. Paragraph 5 specifically refers to the work of "others under the direction of management", while Paragraph 104 states "others" with no reference to management. Are "Others" in the context of paragraph 104 limited to those groups under the control of management as indicated by paragraph 5 or does it also encompass others that are outside of the scope of management's control, such as government agencies, as we recommend?

We appreciate the opportunity to provide comments on the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of a financial statement. Questions or comments regarding this commentary should be addressed to Ms. Deaune C. Volk, Program Manager, Auditing Standards Division, at (703)767-3233 or Ms. Mary L. Silva, Chief, Auditing Standards Division, at (703)767-3220.

/Signed/
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