

DCAA Does Materiality

Written by Nick Sanders
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I was going to write about the latest DCAA audit report and do a bunch of charts showing trends, but then DCAA issued [this MRD](#) entitled “Audit Guidance on Using Materiality in Incurred Cost Audits,” and it seemed a bit more important ... so here you go.

Section 803 of the 2018 National Defense Authorization Act (NDAA) had a lot to say about DCAA, most of them in relation to the then-current backlog of “incurred cost” audits. Among the requirements imposed by that public law was the following—

Not later than October 1, 2020, the Secretary of Defense shall comply with commercially accepted standards of risk and materiality in the performance of each incurred cost audit of costs associated with a contract of the Department of Defense.

In response to that direction, DCAA issued a MRD (link in the first sentence) that, for the first time, provided auditors with direction regarding how to assess materiality. This is important because, historically, contractors have complained about the lack of materiality in DCAA audit procedures. For example, contractors have complained publicly about having to spend thousands of dollars to chase down a receipt for \$53.00 (or something like that; we’re paraphrasing here). Of course, those anecdotal “thousands of dollars” were allowable overhead costs, so it was the Department of Defense that was footing the bill for the overzealous auditors’ demands.

But now DCAA has an official materiality standard. In the words of the MRD, “The use of a quantified materiality threshold is intended to facilitate a consistent approach that helps an auditor determine the nature, timing, and extent of audit procedures on those cost elements and accounts that are significant, or material, to the audit opinion.”

DCAA has provided its auditors with the following formula for calculating materiality for its incurred cost audits:

For values up to \$1 billion, use the formula $\$5,000 \times ((\text{Total Subject Matter} / \$100,000) ^{.75})$, which in Excel looks like: $=5,000*((1,000,000/100,000)^{.75})$. For an incurred cost proposal with an Auditable Dollar Volume (ADV) of \$1 million, the materiality threshold is \$28,117.

For ADV in excess of \$1 billion, the MRD directs auditors to use a materiality threshold of 0.50

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percent of the ADV value.

What does this mean?

First, it's not clear. We *think* it means that transactions below the materiality threshold will not be subject to audit procedures. That would seem to be reasonable. On the other hand, who knows? It may well depend on each individual auditor's approach to conducting the audit.

Second, it's not dispositive. By that we mean that the audit guidance permits auditors to adjust the materiality threshold based on auditor judgment. In the words of the MRD—

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

So while the materiality threshold may be a nice theoretical concept, it may actually mean close to nothing when applied during an incurred cost audit.

Finally, DCAA did the minimum it was required to do. (Actually, the agency did a bit less because it was supposed to tie the materiality threshold(s) to commercial audit standards; that did not seem to happen.) The NDAA required a materiality standard for incurred cost audits, and that's exactly what DCAA did. However, the audit agency did not impose a materiality threshold for its CAS-related audits or associated cost impact proposal audits. There is no materiality threshold for defective pricing or for MAAR audits. As was the case with "incurred cost" audits, a risk-based approach to audit procedures, using a quantified materiality standard, is needed.

Let's hope DCAA takes this precedential approach and applies it to other areas.

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