

Recommendation 73: Revise the definition of business system deficiencies to more closely align with generally accepted auditing standards.

Problem

The definition of the term significant deficiency for contractor business systems in Section 893 of the FY 2011 NDAA and the DFARS does not align with generally accepted auditing standards for evaluating and reporting on internal control deficiencies. This lack of consistency creates confusion regarding the identification, severity, meaning, and resolution of deficiencies.

Background

The FY 2011 NDAA and DFARS definition for *significant deficiency* describes it as materially affecting DoD officials' and contractor's ability to rely on information produced by the business system that is needed for management purposes. The term in generally accepted auditing standards for a deficiency of this severity, that is, a deficiency that is material, is *material weakness*. Generally accepted auditing standards also use the term *significant deficiency*, but to describe a deficiency that is less severe than a *material weakness*. The use of the same term to mean different levels of severity of a deficiency creates confusion about the meaning of significant deficiency among contractors, independent public accountants performing SOX 404(b) audits, government auditors, and the acquisition community.

The FY 2011 NDAA and the DFARS regulations provide for only a significant deficiency, but in reality, the contractor business system could have a number of deficiencies that range from trivial to severe. Reporting deficiencies by different levels of severity, and in a manner that aligns with established auditing standards, will allow contracting officers to make informed decisions on the acceptability of the business system

Discussion

The FY 2011 NDAA, Section 893, and DFARS 252.242-7005, Contractor Business Systems, define *significant deficiency* as "a shortcoming in the system that materially affects the ability of officials of the Department of Defense and the contractor to rely on information produced by the system that is needed for management purposes." The term and its definition are mismatched relative to generally accepted auditing standards, which have a two-tiered approach to evaluating and reporting business system deficiencies. As shown here, the statutory and regulatory definition above better aligns with the private-sector, Public Company Accounting Oversight Board, *GAO Yellow Book*, and Securities and Exchange Commission definitions of material weakness:

Material weakness. A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements 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 a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those

charged with governance. (AICPA, Professional Standards, AU-C section 265, Communicating Internal Control Related Matters Identified in an Audit)

Financial statement audits and examination engagements conducted in accordance with GAO, Government Auditing Standards 2018 Revision, (paragraphs 6.29 and 7.42), refers to use of the terms material weakness reporting on internal control deficiencies. The paragraph also references the AICPA, Professional Standards, AU-C section 265, for consistent use of the terminology.

Conclusions

The definition for system deficiencies in the FY 2011 NDAA, Section 893, and DFARS regulation require revision to be more consistent with the definitions in generally accepted auditing standards that apply to different types of engagements (e.g., inspection, attestation, and performance).

Statutory Revision

In the FY 2011 NDAA, Section 893, the term *significant deficiency* and its definition need to be stricken and replaced with the term *material weakness* and its definition as follows:

- *Material Weakness*: A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances 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.

DFARS Revision

In the DFARS regulations (e.g., Accounting System Administration 252.242-7006, Contractor Business Systems 252.242-7005), the term *significant deficiency* and its definition should be stricken and replaced with the term *material weakness* and its definition. Additionally, the regulations should include new terms and their respective definitions for *significant deficiency* and *other deficiency*.

The definition of material weakness, significant deficiency, and other deficiency is applicable to any type of engagement (e.g., attestation, inspection) that is designed to test internal controls or compliance with a specific criterion. For an audit or inspection designed to test compliance with specific criteria, a deficiency can occur due to either internal control defect or a system shortcoming. A shortcoming in this regard would occur if a business system lacks a capability or element of functionality required by the system criteria. The revised DFARS language for business system deficiencies is as follows:

- *Material Weakness*: A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances 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 risks related to 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 prevent or detect and correct, material noncompliances on a timely basis.

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

The revisions introduce new terms, such as material noncompliance and misstatement and a new definitions for acceptable contractor business system that are not currently in the DFARS but are important to understanding the revised business system deficiency definitions. As a result, and in conjunction with the revised DFARS deficiency definitions, the following definitions should be added to the DFARS to enhance understanding and provide clarity to stakeholders:

- **Material Noncompliance**: 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.
- **Misstatement**: Information provided to the Government does not comply with contract terms and applicable federal regulations such as the Federal Acquisition Regulations (FAR) and Cost Accounting Standards (CAS).
- **Acceptable Contractor Business System**: Contractor business systems that comply with the criteria of applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely on information produced by the business system that is needed for management purposes.

Implementation

Legislative Branch

- Revise and replace the definition for *significant deficiency* in Section 893 of the FY 2011 NDAA, Section 893, with the new definitions of *material weakness*.
- Define *material weakness* as a deficiency, or combination of deficiencies, in internal control over risks related to government contract compliances or other shortcomings in the business 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.

Executive Branch

- Revise the Business System DFARS sections (for all systems with the significant deficiency defined) to replace the term *significant deficiency* with the new definitions of material weakness, significant deficiency, and other deficiency as follows:
 - Significant Deficiency: A deficiency, or combination of deficiencies, in internal control over risk related to Government contract compliance or other shortcomings in the business 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 business system that have a clearly trivial, or inconsequential, effect on the ability of the business system to prevent or detect and correct, material noncompliances on a timely basis.
- Define *material weakness* as a deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances or other shortcomings in the business 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.
- Revise the Business System DFARS sections (for all systems) to include the definitions:
 - Material Noncompliance: 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.
 - Misstatement: Information provided to the Government does not comply with contract terms and applicable federal regulations such as the Federal Acquisition Regulations (FAR) and Cost Accounting Standards (CAS).
 - Acceptable Contractor Business System (DFARS Revision): Means contractor business systems that complies with the criteria of applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely on information produced by the system that is needed for management purposes.

Implications for Other Agencies

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

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