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Acronyms

AICPA	American Institute of Certified Public Accountants
DCAA	Defense Contract Audit Agency
OMB	Office of Management and Budget



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

OCT 29 2010

Director
Defense Contract Audit Agency

Branch Manager
South Bay Branch
Defense Contract Audit Agency

Partner
Deloitte & Touche LLP

Board of Trustees
The Aerospace Corporation

Vice President, Chief Financial Officer and Treasurer
The Aerospace Corporation

SUBJECT: Report on Quality Control Review of Deloitte & Touche, LLP and Defense Contract Audit Agency FY 2008 Single Audit of The Aerospace Corporation
(Report No. D-2011-6-002)

We are providing this report for your information and use. We considered management comments on a draft of this report when preparing the final report. As the cognizant Federal agency for The Aerospace Corporation (Aerospace), we performed a review of the Deloitte & Touche and the Defense Contract Audit Agency (DCAA), single audit and supporting working papers for the audit period October 1, 2007, through September 30, 2008. The purpose of our review was to determine whether the audit was conducted in accordance with auditing standards¹ and the auditing and reporting requirements of Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," (Circular A-133). Appendix A contains additional background, scope and methodology for the review.

The Deloitte & Touche office in Los Angeles, California performed the audit of the financial statements. Deloitte & Touche and the DCAA South Bay Branch Office in Gardena, California performed a coordinated audit of the research and development program cluster. Appendix B presents the research and development compliance requirements and the division of audit responsibility between Deloitte & Touche and DCAA for the audit period ended September 30, 2008.

¹ Auditing standards include both Government Auditing Standards and the American Institute of Certified Public Accountants' audit standards.

Background. Aerospace is a nonprofit, Federally Funded Research and Development Center, sponsored by the United States Air Force, and headquartered in El Segundo, California. Aerospace also provides technical support to space-related programs managed by other Federal agencies, international organizations, and foreign governments when in the national interest.

Aerospace expended \$804.4 million in Federal awards for the fiscal year ended September 30, 2008, under one Federal program, the research and development cluster. Of the \$804.4 million, \$748.3 million was expended for Department of Defense programs.

Review Results. DCAA did not comply with Circular A-133 reporting requirements. As a result, DCAA must revise its FY 2008 Circular A-133 report on compliance and internal control to include findings on the fraud disclosed by Aerospace management and a significant deficiency related to internal control over compliance with the cash management requirements. We also identified deficiencies in the performance of fraud risk assessment procedures, information technology internal control testing and working paper documentation that need to be corrected in future audits.

The **Deloitte & Touche** audit of the financial statements and the research and development program cluster generally met auditing standards and Circular A-133 requirements.

Aerospace complied with Circular A-133 reporting requirements. However, Aerospace will have to resubmit the FY 2008 Circular A-133 reporting package and data collection form to the Federal Audit Clearinghouse upon receipt of the revised DCAA audit report.

Management Comments and DoD IG Response. DCAA and Aerospace agreed to take the recommended actions. Management comments were responsive and conform to requirements; no additional comments are needed. DCAA management comments are included in their entirety at the end of this report.

Finding

Performance, Reporting and Documentation of the Federal Program Audit.

DCAA did not plan and perform sufficient fraud risk assessment procedures and they failed to properly evaluate a deficiency in internal control with cash management requirements in accordance with auditing standards and Circular A-133 requirements. As a result, the auditors did not comply with Circular A-133 reporting requirements because they did not report a disclosed fraud and a significant deficiency in internal control over compliance with cash management requirements as findings in the FY 2008 single audit report. In addition, DCAA did not perform all the planned testing of key information technology internal controls and did not adequately document their working papers to support its conclusions for the compliance

requirements tested and the scope of audit procedures performed by the DCAA Field Detachment office².

Fraud Risk Assessment Procedures. DCAA did not perform sufficient fraud risk assessment procedures during the planning and performance of the audit. The Circular A-133 audit program procedures were limited to evaluating the fraud risk indicators identified in the DoDIG “Handbook on Fraud Indicators for Contract Auditors.” As documented in the audit working papers, the evaluation of the fraud indicators was based solely on information in the permanent files and auditor experience with Aerospace. Based on this evaluation, the auditor concluded that there were no indications of potential fraud which would require additional audit procedures.

OMB Circular A-133 requires that the single audit be performed in accordance with government auditing standards applicable to financial statements, which incorporate the American Institute of Certified Public Accountants (AICPA) auditing standards. AICPA auditing standard, AU §316, “Consideration of Fraud in a Financial Statement Audit,” requires the auditor to plan and perform the audit to obtain reasonable assurance that material misstatements and noncompliance, whether caused by error or fraud, are detected. Specifically, as a means of obtaining information needed to identify fraud risk areas, the standard requires, among other procedures, inquiries during the planning process of the organizations’ management to determine if they have knowledge of any fraud or suspected fraud affecting the entity. The standard also requires auditors to design and perform procedures in response to identified fraud and fraud risks.

DCAA did not design and perform additional procedures when they became aware of an identified instance of fraud during the review of internal control over compliance with the activities allowed or unallowed and allowable costs/cost principles requirements. DCAA was informed by the Director of Internal Audit of a disclosed fraud involving a full-time employee who worked for another government contractor while employed by Aerospace for a period of several years. There was no indication in the audit documentation that DCAA considered designing and performing procedures in response to this identified risk of labor mischarging as required under auditing standards. We discussed this issue with the audit supervisor and were advised that the auditors determined the identified fraud to be an isolated incident not indicative of a systemic internal control risk and therefore, they did not believe that additional effort was warranted. However, there was no documented evidence to support the DCAA conclusion. At a minimum, we believe that the auditors should have designed, performed, and documented additional procedures to assess the potential significance of this specific risk and the existence and effectiveness of internal controls designed to prevent and detect this risk of labor mischarging.

Neither the DCAA Contract Audit Manual Chapter 4-700 “Responsibilities for Detection and Reporting of Suspected Irregularities”, Chapter 13 “Audits at Educational Institutions, Nonprofit Organizations, and Federally Funded Research and Development Centers,” nor the DCAA standard A-133 audit program contain sufficient guidance or procedures to ensure that auditors

² DCAA Field Detachment Offices perform contract audits related to sensitive compartmented information and special access programs.

perform procedures on the consideration of fraud in a single audit in accordance with auditing standards.

Reporting Fraud in the Circular A-133 Audit Report. The DCAA auditors did not report the identified fraud as an audit finding in the single audit report schedule of findings and questioned costs in accordance with Circular A-133 reporting requirements. Circular A-133 §__.510(a)(6) states that the auditor shall report “known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards.”

Based on our review of the DCAA Contract Audit Manual Chapter 13 “Audits at Educational Institutions, Nonprofit Organizations, and Federally Funded Research and Development Centers,” we were unable to find any guidance specific to reporting fraud in accordance with OMB Circular A-133 requirements.

The working papers support that DCAA verified that the fraud was under investigation. Therefore, the main focus of our quality control review was the lack of disclosure in the DCAA audit report of the known fraud and DCAA’s failure to follow standards and design additional steps related to the known fraud.

Evaluation and Reporting of a Deficiency in Internal Control over Compliance with Cash Management Requirements. DCAA did not properly evaluate and report a finding in internal control disclosed during the review of the internal control over compliance with the cash management requirements.

OMB Circular A-133 §__.510 (a)(1) requires the auditor to report significant deficiencies in internal control over compliance as an audit finding in the Federal awards section of the schedule of findings and questioned costs.

DCAA relied on the internal control testing performed in the FY 2008 direct billing review for the review of cash management requirements. The objectives in the direct billing review included determining whether Aerospace had effective controls to ensure that award costs billed to the government on a reimbursement basis reflected actual incurred cost. The auditor identified and tested four key internal controls intended to prevent noncompliance with this requirement. One of the key controls tested was that billing requests contained the appropriate level of management approval as required under Aerospace policies and procedures. The auditors sampled sixteen billings and found that three billings were not approved by management prior to requesting reimbursement from Federal agencies. All the exceptions were for web invoice and phone automated billings for Department of Justice, National Aeronautics and Space Administration, and National Science Foundation grants. DCAA discussed the exceptions with the Aerospace representative who acknowledged that management approvals were not obtained for web invoice and phone automated billings and the representative stated that this would be corrected for future billings.

In evaluating whether to report the identified deficiency, the auditor noted that Aerospace had a compensating control, the Monthly Account Reconciliation Report, wherein managers approve

the reconciliation of costs billed to the general ledger. DCAA stated that they considered this [control] sufficient to satisfy the requirement for management approval prior to submitting reimbursement requests. There was no documentation in the DCAA working papers to explain how the Monthly Account Reconciliation, an after-the-fact procedure, compensated for the lack of approval required prior to reimbursement requests. In addition, there was no documentation to support that the auditors performed any testing of the compensating control to ensure its operating effectiveness.

The AICPA auditing standard AU §325A.14 states that an effective compensating control limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or a material weakness. These standards also state that to rely on a compensating control to mitigate the severity of a control deficiency, the compensating control should be tested and evaluated as to its operating effectiveness.

We requested additional information and documentation to support the auditors' reliance on the compensating control. However, DCAA did not provide any documentation to support the basis for their acceptance of the Monthly Account Reconciliation as a compensating control or provide support for the actual testing of the control. As a result, the lack of management approval of billings prior to requesting reimbursement from Federal agencies should have been reported as a significant deficiency in the audit report in accordance with Circular A-133 requirements.

Performance and Documentation of Planned Testing of Information Technology Internal Controls. DCAA did not complete the testing of key information technology controls as planned and the documentation did not provide a clear understanding of the audit work performed or the procedures relied on. Auditing standards require auditors to obtain an understanding of information technology controls that are relevant to planning the audit and, when there is an expectation that the auditor will rely on those controls, require the auditor to perform tests of the controls to determine their operating effectiveness.

The DCAA planning and risk assessment documentation clearly indicate that the auditors planned to rely on computer-based data in the performance of the single audit. The documentation identified five specific key information technology system internal controls areas that DCAA planned to test to determine if the information system controls were effective and could be relied upon. The five control areas were: edit checks; exception reporting; access controls; reviews of input and output data; and computer general controls and security controls. Based on the audit documentation and several discussions with the supervisory auditor, the auditors conclusions on information technology controls were based on reliance on work performed by Deloitte & Touche in the FY 2008 financial statement audit and on the following additional DCAA audits: "ODC and Indirect Cost IT Controls" performed in FY 2005; "Accounting System IT Controls" and "Billing System IT Controls" audits performed in FY 2006; two FY 2008 floorcheck audits and an ongoing FY 2008 direct billing evaluation.

Circular A-133 requires annual testing of controls; therefore, the testing performed in the FY 2005 and FY 2006 reviews do not fulfill the current audit requirement. We discussed this with the supervisory auditor who advised us that, although not clearly documented in the audit working papers, the FY 2005 and 2006 review information was provided only for historical

purposes. In addition, we were unable to find documentation in the FY 2008 floorchecks and billing system reviews to provide any support for testing key information technology internal controls. Therefore, based on our review of the documentation, the only adequate source of reliance was the audit work performed by Deloitte & Touche.

DCAA did review and document the procedures and results of the Deloitte & Touche audit of the Aerospace information technology system internal controls. The supervisory auditor explained that DCAA relied on the Deloitte & Touche audit for testing of the five key controls. However, based on our independent review of the Deloitte & Touche audit and the DCAA audit documentation, we found no evidence of testing for two of the five key controls: edit checks and exception reporting key controls. We discussed this with the supervisory auditor who advised us that, in hindsight, the DCAA FY 2008 approach was incorrect and they did not have to rely on these two control areas [to gain reliance on the integrity of information produced by the Aerospace financial system].

Working Paper Documentation. DCAA did not adequately document the internal controls tested for the cash management and special tests and provisions requirements, the criteria used for activities allowed or unallowed and allowable costs/cost principles compliance testing, and the coordination of the scope of audit work performed by the DCAA Field Detachment office. In addition, the audit file contained a voluminous amount of work papers, many of which simply duplicated the same information. Although we acknowledge that the auditors believed that they were providing a good audit trail, we found the format and content of the working papers lacked clarity and contributed to instances of inconsistencies between working papers and the lack of required information in other working papers. As a result of the documentation inadequacies, we spent considerable time obtaining verbal explanations and reviewing additional information provided by the auditors in order to determine if there was sufficient evidence to support the audit conclusions on the four compliance requirements audited by DCAA.

Auditing standards require that audit documentation be appropriately detailed to provide a clear understanding of the work performed and the significant audit judgments and conclusions reached. The documentation should be in sufficient detail to enable an experienced auditor to understand the nature, timing, and extent of audit procedures and the evidence obtained and its source.

Cash Management and Special Tests and Provisions Internal Control Documentation. The DCAA auditors did not adequately document the internal controls they relied on to support conclusions on the adequacy of controls for the cash management and special tests and provisions requirements. Specifically, the working papers state that the auditors planned to rely, in part, on internal controls tested in the review of activities allowed or unallowed and allowable costs/cost principles requirements. However, the working papers did not provide a link to the specific controls tested that would satisfy the internal control objectives for the cash management and special tests and provisions requirements. The auditors subsequently provided a cross-reference to the controls tested for activities allowed or unallowed and allowable costs/cost principles controls that DCAA relied on to support the audit conclusions. Without this cross-reference we would not have been able to determine the

adequacy of the procedures performed or the evidence obtained to support the auditor's conclusions.

Testing Compliance for Activities Allowed or Unallowed and Allowable Costs/Cost Principles Compliance Requirements. The DCAA auditors did not adequately document the review of compliance for the activities allowed or unallowed and allowable costs/cost principles requirements. Specifically, the documentation did not identify the specific cost principle criteria used to review costs for allowability; did not provide the basis for the judgment that internal control exceptions noted during floorchecks were not considered significant; and did not document the procedures performed and the results of those procedures to verify the existence of employees not present during the floorchecks. In addition, the auditors did not document that they verified the timecard authorizations within the electronic timekeeping system. The auditors subsequently provided additional explanations and documentation to support their conclusions.

Field Detachment Coordination. The DCAA working papers did not adequately document, as required by government auditing standards and DCAA policy, the coordination with DCAA Field Detachment or clearly identify the audit work performed by the Field Detachment auditors. DCAA Instruction No. 7643.1, "Audit Coordination Between Regional and Field Detachment Offices," dated July 27, 2007, requires the Branch Manager and supervisory auditor to maintain adequate written documentation of the coordination with Field Detachment during audit planning and performance.

The DCAA coordination matrix documents an audit scope for Field Detachment that differs from the scope reported in the Field Detachment audit report, dated July 16, 2009. The coordination matrix indicates that Field Detachment was responsible for the direct cost testing of the activities allowed or unallowed and the allowable costs/cost principles; cash management; and special tests and provisions compliance requirements, while the audit report states that the auditors reviewed other direct costs, which includes direct travel, professional fees (consultants and contract labor), special purpose plant equipment, and other direct costs. The working papers do not document the reason(s) for the scope change. In addition, we could not determine from the working papers whether the Field Detachment was responsible for performing audit procedures only on awards under their cognizance or whether the Field Detachment scope also included awards under the South Bay Branch Office cognizance. As a result, we were unable to determine if there was a gap in audit coverage that would impact the adequacy of the DCAA opinion. Through discussions with the Branch Office and Field Detachment supervisory auditors, we determined that, although not clearly documented, the Field Detachment scope included other direct costs for all Aerospace awards and the Branch scope included direct costs for all Aerospace awards.

Conclusion: The deficiencies disclosed by our review indicate that DCAA management needs to implement more effective quality control procedures for the Circular A-133 audits and provide additional training in auditing standards and OMB Circular A-133 requirements to auditors performing OMB Circular A-133 audits.

Recommendations and Management Comments

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1. **We recommend that the Director, Defense Contract Audit Agency:**
 - a. **Revise the Defense Contract Audit Agency Circular A-133 standard audit program to include the procedures required by the American Institute of Certified Public Accountants' Statements on Auditing Standards §316, "Consideration of Fraud in a Financial Statement Audit."**
 - b. **Revise the DCAA Contract Audit Manual Chapter 13, "Audits at Educational Institutions, Nonprofit Organizations, and Federally Funded Research and Development Centers (FFRDCs)," to include guidance on performing fraud risk assessment procedures and reporting in the Circular A-133 audit report.**

DCAA Comments. The Director, DCAA agreed to take the recommended actions. Management comments are included in their entirety at the end of this report.

2. **We recommend that the Branch Manager, South Bay Branch, Defense Contract Audit Agency**
 - a. **Revise the FY 2008 Defense Contract Audit Agency audit report to include the findings related to the fraud identified by Aerospace management and the significant deficiency in internal control over compliance with cash management requirements in the schedule of findings and questioned costs.**
 - b. **Forward the revised report to the Aerospace Corporation for submission to the Federal Audit Clearinghouse.**
 - c. **Strengthen existing or implement additional quality control procedures for Offices of Management and Budget Circular A-133 audits to ensure that future audits comply with auditing standards and Circular A-133 requirements for the planning, performance and documentation of the audit.**
 - d. **Provide staff performing Circular A-133 audits formal training in the application and implementation of auditing standards in meeting Circular A-133 audit requirements.**

DCAA Comments. The Branch Manager, South Bay Branch, DCAA agreed to take the recommended actions. Management comments are included in their entirety at the end of this report.

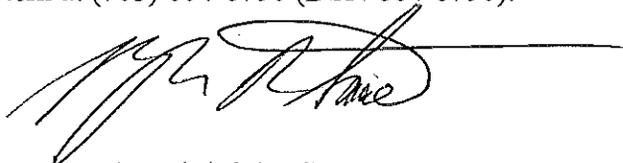
3. **We recommend that the Vice President, Chief Financial Officer, and Treasurer, The Aerospace Corporation, within 30 days of receipt of the revised report from the DCAA, file the revised FY 2008 Circular A-133 reporting package and Data Collection Form with the Federal Audit Clearinghouse and notify the DoD Office of Inspector General upon completion.**

The Aerospace Corporation Comments. The Aerospace Corporation did not provide formal comments to the draft report. However, The Vice President, Chief Financial Officer, and Treasurer, The Aerospace Corporation agreed in an email to take the recommended actions.

Other Matters of Interest. The DCAA Contract Audit Manual Chapter 13, "Audits at Educational Institutions, Nonprofit Organizations, and Federally Funded Research and Development Centers," section 700, "OMB Circular A-133 Audits and Reports," should be updated to reflect the current terminology on communicating matters related to internal control in accordance with OMB Circular A-133 reporting requirements. Specifically, effective with the June 26, 2007 Federal Register changes to OMB Circular A-133, the term "reportable condition" has been replaced with "significant deficiency" to conform with current auditing standards.

DCAA Comments. The Director, DCAA agreed to take the recommended actions. Management comments are included in their entirety at the end of this report.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Ms. Janet Stern at (703) 604-8750 (DSN 664-8750).

A handwritten signature in black ink, appearing to read 'R. Stone', with a long horizontal line extending to the right.

Randolph R. Stone
Deputy Inspector General
for Policy and Oversight

Appendix A. Quality Control Review Process

Background, Scope and Methodology

The Single Audit Act, Public Law 98-502, as amended, was enacted to improve the financial management of State and Local Governments and nonprofit organizations by establishing one uniform set of auditing and reporting requirements for all Federal award recipients required to obtain a single audit. Circular A-133 establishes policies that guide implementation of the Single Audit Act and provides an administrative foundation for uniform audit requirements of non-Federal entities administering Federal awards. Entities that expend \$500,000 or more are subject to the Single Audit Act and the audit requirements in Circular A-133 and therefore must have an annual single or program-specific audit performed under Government Auditing Standards and submit a complete reporting package to the Federal Audit Clearinghouse.

We reviewed the Deloitte & Touche, LLP and Defense Contract Audit Agency FY 2008 single audit of The Aerospace Corporation and the reporting package that was submitted to the Federal Audit Clearinghouse on July 30, 2009, using the 1999 edition of the “Uniform Quality Control Guide for the A-133 Audits” (the Guide). The Guide applies to any single audit that is subject to the requirements of Circular A-133 and is the approved President’s Council on Integrity and Efficiency³ checklist used for performing quality control reviews. We performed the review from September 2009 through August 2010. The review focused on the following qualitative aspects of the single audit:

- Qualification of Auditors,
- Independence,
- Due Professional Care,
- Planning and Supervision,
- Internal Control and Compliance testing,
- Schedule of Expenditures of Federal Awards, and
- Data Collection Form.

Prior Quality Control Reviews

Since October 1, 2006, we have performed two quality control reviews each of DCAA and Deloitte & Touche OMB Circular A-133 audits. All four audits contained deficiencies resulting in findings and recommendations on audit planning/coordination, performance, and

³ The President’s Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency combined into the Council of the Inspectors General on Integrity and Efficiency in accordance with the Inspector General Reform Act of 2008.

documentation. Unrestricted IG DoD reports can be accessed at <http://www.dodig.mil/audit/reports>.

IG DoD Reports

IG DoD Report No. D-2009-6-007, "Report on Quality Control Review of Deloitte & Touche, LLP FY 2007 Single Audit of Battelle Memorial Institute and Subsidiaries" June 29, 2009

IG DoD Report No. D-2008-6-002, "Quality Control Review of FY 2006 Single Audit of Syracuse Research Corporation," January 25, 2008

IG DoD Report No. D-2007-6-007, "Review of South Carolina Research Authority's FY 2005 Single Audit Performed by Deloitte and Touche, LLP" July 25, 2007

IG DoD Report No. D-2006-001-002, "Report on Quality Control Review of the PricewaterhouseCoopers LLP and the Defense Contract Audit Agency Office of Management and Budget Circular A-133 Audit Report of the RAND Corporation, Fiscal Year Ended September 29, 2002" December 16, 2005

Appendix B. Compliance Requirements*

OMB Circular A-133 Compliance Requirements	Applicable		Not Applicable
	DCAA	Deloitte	
Activities Allowed/Unallowed	X		
Allowable Costs/Cost Principles	X		
Cash Management	X		
Davis-Bacon Act			X
Eligibility			X
Equipment and Real Property Management		X	
Matching, Level of Effort, Earmarking		X	
Period of Availability of Federal Funds		X	
Procurement, Suspension, and Debarment		X	
Program Income			X
Real Property Acquisition and Relocation Assistance			X
Reporting		X	
Subrecipient Monitoring			X
Special Tests and Provisions	X		

*The auditors determine whether a compliance requirement is applicable or not to the audited organization.

Defense Contract Audit Agency Management Comments



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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OFFICE OF THE DIRECTOR

October 12, 2010

MEMORANDUM FOR DEPARTMENT OF DEFENSE, OFFICE OF INSPECTOR
GENERAL, DEPUTY INSPECTOR GENERAL FOR AUDIT
POLICY AND OVERSIGHT

ATTENTION: Mr. Randolph R. Stone

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft
Report, *Quality Control Review of the Deloitte & Touche, LLP and Defense
Contract Audit Agency FY 2008 Single Audit of The Aerospace Corporation*, dated
September 9, 2010 (Project No. D2009-DIP0AC-0302.000)

Thank you for the opportunity to respond to the subject draft report, *Quality Control
Review of the Deloitte & Touche, LLP and Defense Contract Audit Agency FY 2008 Single Audit
of The Aerospace Corporation*. The following are DCAA's comments and responses to each of
the recommendations impacting DCAA.

DoDIG Recommendation 1.a: We recommend that the Director, Defense Contract Audit
Agency, revise the Defense Contract Audit Agency Circular A-133 Standard Audit Program to
include the procedures required by the American Institute of Certified Public Accountants'
Statements on Auditing Standards Section 316, "Consideration of Fraud in a Financial Statement
Audit."

DCAA Response: Concur. By January 2011, DCAA will revise the A-133 Standard Audit
Program to include the procedures required by the American Institute of Certified Public
Accountants' Statements on Auditing Standards Section 316, "Consideration of Fraud in a
Financial Statement Audit." DCAA will also add additional procedures on reporting identified
fraud, in accordance with OMB Circular A-133 Section .510(a)(6) and GAGAS Section 5.10.

DoDIG Recommendation 1.b: We recommend that the Director, Defense Contract Audit
Agency, revise the DCAA Contract Audit Manual Chapter 13, "Audits at Educational
Institutions, Nonprofit Organizations, and Federally Funded Research and Development Centers
(FFRDCs)," to include guidance on performing fraud risk assessment procedures and reporting
in the Circular A-133 audit report.

DCAA Response: Concur. By January 2011, DCAA will update the Contract Audit Manual,
Chapter 13, to provide guidance on performing fraud risk assessment procedures and reporting in
the A-133 audit report, in accordance with OMB Circular A-133 and AICPA Auditing Standard
316 requirements.

PPD 225.4 (D2009-DIP0AC-0302.000)

October 12, 2010

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report, *Quality Control Review of the Deloitte & Touche, LLP and Defense Contract Audit Agency FY 2008 Single Audit of The Aerospace Corporation*, dated September 9, 2010 (Project No. D2009-DIP0AC-0302.000)

DoDIG Recommendation 2.a: We recommend that the Branch Manager, South Bay Branch, Defense Contract Audit Agency revise the FY 2008 Defense Contract Audit Agency audit report to include the findings related to the fraud identified by Aerospace management and the significant deficiency in internal control over compliance with cash management requirements in the schedule of findings and questioned costs.

DCAA Response: Concur. The FAO will issue by December 31, 2010 a supplemental FY 2008 report to include the findings related to the fraud identified by Aerospace management and the significant deficiency in internal control over compliance with cash management requirements in the schedule of findings and questioned costs.

DoDIG Recommendations 2.b: We recommend that the Branch Manager, South Bay Branch, Defense Contract Audit Agency forward the revised report to the Aerospace Corporation for submission to the Federal Audit Clearinghouse.

DCAA Response: Concur. The FAO will provide the Aerospace Corporation a copy of the supplemental report for submission to the Federal Audit Clearinghouse.

DoDIG Recommendations 2.c: We recommend that the Branch Manager, South Bay Branch, Defense Contract Audit Agency strengthen existing or implement additional quality control procedures for Office of Management and Budget Circular A-133 audits to ensure that future audits comply with auditing standards and Circular A-133 requirements for the planning, performance and documentation of the audit.

DCAA Response: Concur. By December 31, 2010, the FAO will re-evaluate its quality control procedures specifically as they relate to A-133 audits and develop enhancements as necessary to ensure future audits are planned, performed, documented, and reported in compliance with all applicable auditing standards and Circular A-133 requirements. Current quality control procedures, developed in accordance with Western Region Instruction No. 7640.7, require that OMB Circular A-133 audit assignments and reports be reviewed and approved by the regional audit manager (RAM) prior to report issuance. Additionally, management will immediately begin requiring a peer review be conducted on A-133 audit working papers by a supervisory auditor or FAO special assistant for quality independent of the A-133 audit to ensure planned audit steps are performed and appropriately documented.

DoDIG Recommendations 2.d: We recommend that the Branch Manager, South Bay Branch, Defense Contract Audit Agency provide staff performing Circular A-133 audit formal training in the application and implementation of auditing standards in meeting Circular A-133 audit requirements.

DCAA Response: Concur. The FAO will ensure that auditors and supervisors performing OMB Circular A-133 compliance audits have training in the application and implementation of

PPD 225.4 (D2009-DIP0AC-0302.000)

October 12, 2010

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report, *Quality Control Review of the Deloitte & Touche, LLP and Defense Contract Audit Agency FY 2008 Single Audit of The Aerospace Corporation*, dated September 9, 2010 (Project No. D2009-DIP0AC-0302.000)

auditing standards in meeting Circular A-133 audit requirements in accordance with GAGAS 3.40 and DCAA MRD 08-PPD-031(R), dated October 2, 2008 by December 31, 2010. The FAO will present the specific DoDIG findings to auditors performing A-133 audits by November 30, 2010.

Please see the enclosed Western Region, DCAA, Responses to the DoDIG Draft report for more detailed responses to DoDIG Recommendation 2.

DoDIG Other Matters of Interest: The DCAA Contract Audit Manual, Chapter 13, Audits at Educational Institutions, Nonprofit Organizations, and Federally Funded Research and Development Centers, Section 700, "OMB Circular A-133 Audits and Reports," should be updated to reflect the current terminology on communicating matters related to internal control, in accordance with OMB Circular A-133 reporting requirements. Specifically, effective with the June 26, 2007 Federal Register changes to OMB Circular A-133, the term "reportable condition" has been replaced with "significant deficiency" to conform with current auditing standards.

DCAA Response to DoDIG Other Matters of Interest: DCAA will update the Contract Audit Manual, Chapter 13, Section 700 for the change in terminology on communicating matters related to internal control, in accordance with OMB Circular A-133 reporting requirements.

Questions regarding this memorandum should be directed to Ms. Esther Fischer, Chief, Policy Programs Division at (703) 767-2297.


Patrick J. Fitzgerald
Director

Enclosure:
DCAA Western Region Response



WESTERN REGION
DEFENSE CONTRACT AUDIT AGENCY
16700 VALLEY VIEW AVENUE, SUITE 300
LA MIRADA, CALIFORNIA 90638-5833

IN REPLY REFER TO

RS-4 225.4

October 6, 2010

MEMORANDUM FOR DIRECTOR, DCAA

ATTENTION: PPD (Esther Fischer)

SUBJECT: Response to DoDIG Preliminary Review Results – Report on Quality Control
Review of Deloitte & Touche, LLP and Defense Contract Audit Agency FY 2008
Single Audit of the Aerospace Corporation (Project No. D2009-DIP0AC-0302.000)

We have reviewed the subject DoDIG draft report findings and recommendations regarding DCAA FY 2008 Single Audit of the Aerospace Corporation. The DoDIG's overall conclusion was that DCAA did not comply with Circular A-133 reporting requirements. Our response to the DoDIG findings and recommendations as they relate to the South Bay Branch Office follows:

RESPONSE TO DoDIG DRAFT RECOMMENDATIONS:

DoDIG Recommendations 2a: *We recommend that the Branch Manager, South Bay Branch Office, Defense Contract Audit Agency, revise the FY 2008 Defense Contract Audit Agency audit report to include the findings related to the fraud identified by Aerospace management and the significant deficiency in internal control over compliance with cash management requirements in the schedule of findings and questioned costs.*

DCAA Response: Concur. The FAO will issue by December 31, 2010 a supplemental FY 2008 report to include the findings related to the fraud identified by Aerospace management and the significant deficiency in internal control over compliance with cash management requirements in the schedule of findings and questioned costs.

During our FY 2008 OMB Circular A-133 audit of the Aerospace Corporation, the FAO was informed that an instance of potential fraud was identified and reported to the DoDIG by Aerospace. The FAO's interpretation of the requirements of Circular A-133 was that the potential fraud was not required to be reported. Paragraph 510(a)(6) of the circular states:

This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.

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The auditors confirmed that Aerospace took appropriate action and reported the potential fraud to those charged with governance as required. Therefore, the FAO concluded at the time that the requirement for additional reporting was not required under GAGAS 5.18. Nevertheless, the report will be revised as recommended.

In addition, the FAO has initiated corrective actions during its audit of the Aerospace FY 2009 OMB Circular A-133 audit in response to IG comments provided during the course of the FY 2008 QCR review. The FAO has included the procedures required by the American Institute of Certified Public Accountants' Statements on Auditing Standards Section 316, "Consideration of Fraud in a Financial Statement Audit" and will report identified fraud in accordance with OMB Circular A-133 Section .510(a)(6) and GAGAS Section 5.10, if applicable.

DoDIG Recommendations 2b: *We recommend that the Branch Manager, South Bay Branch Office, Defense Contract Audit Agency forward the revised report to the Aerospace Corporation for submission to the Federal Audit Clearinghouse.*

DCAA Response: Concur. The FAO will provide the Aerospace Corporation a copy of the supplemental report for submission to the Federal Audit Clearinghouse.

DoDIG Recommendations 2c: *We recommend that the Branch Manager, South Bay Branch Office, Defense Contract Audit Agency, strengthen existing or implement additional quality control procedures for Office of Management and Budget Circular A-133 audits to ensure that future audits comply with auditing standards and Circular A-133 requirements for the planning, performance and documentation of the audit.*

DCAA Response: Concur. By December 31, 2010, the FAO will re-evaluate its quality control procedures specifically as they relate to A-133 audits and develop enhancements as necessary to ensure future audits are planned, performed, documented, and reported in compliance with all applicable auditing standards and Circular A-133 requirements. Current quality control procedures, developed in accordance with Western Region Instruction No. 7640.7, require that OMB Circular A-133 audit assignments and reports be reviewed and approved by the regional audit manager (RAM) prior to report issuance. Additionally, management will immediately begin requiring a peer review be conducted on A-133 audit working papers by a supervisory auditor or FAO special assistant for quality independent of the A-133 audit to ensure planned audit steps are performed and appropriately documented.

DoDIG Recommendations 2d: *We recommend that the Branch Manager, South Bay Branch Office, Defense Contract Audit Agency, provide staff performing Circular A-133 audit formal training in the application and implementation of auditing standards in meeting Circular A-133 audit requirements.*

DCAA Response: Concur. The FAO will ensure that auditors and supervisors performing OMB Circular A-133 compliance audits have training in the application and

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implementation of auditing standards in meeting Circular A-133 audit requirements in accordance with GAGAS 3.40 and DCAA MRD 08-PPD-031(R), dated October 2, 2008, by December 31, 2010. As of August 31, 2010, the entire FAO staff has completed formal training in GAGAS developed by the Defense Contract Audit Institute (DCAA's training facility). The FAO will present the specific DoDIG findings to auditors performing A-133 audits by November 30, 2010.

ADDITIONAL COMMENTS ON DoDIG DRAFT REPORT NARRATIVE:

DoDIG Findings:

Fraud Risk Assessment Procedures (page 2): *DCAA did not perform sufficient fraud risk assessment procedures during the planning and performance of the audit.*

FAO Comment: The audit team initiated corrective actions during its audit of the Aerospace FY 2009 OMB Circular A-133 audit in response to IG comments provided during its Quality Control Review (QCR). The team obtained and reviewed the Independent Public Accountants (IPA) review of fraud risk, communicated with the auditee, and evaluated the potential impact of fraud indicators to determine additional procedures to be performed. The FAO will continue to evaluate and enhance its procedures to adequately document the fraud risk during planning and performance and to design additional procedures as necessary for the FY 2010 A-133 audit in accordance with AU 316.

Reporting Fraud in the Circular A-133 Audit Report (page 3): *The DCAA auditors did not report the identified fraud as an audit finding in the single audit report schedule of findings and questioned costs in accordance with Circular A-133 reporting requirements.*

FAO Comment: See response above regarding the DoDIG Recommendation 2a.

Evaluating and Reporting of a Deficiency in Internal Control over Compliance with Cash Management Requirements (page 4): *DCAA did not properly evaluate and report a finding in internal control disclosed during the review of the internal control over compliance with the cash management requirements. In addition, DCAA did not adequately document rationale for its audit position or the testing of compensating controls.*

FAO Comment: The FAO will re-issue its report and include the deficiency as a significant internal control deficiency. The audit team will discuss the findings in this report at its team meetings to ensure that team auditors understand the requirements of A-133 as well as documentation requirements. The FAO will also provide additional training to all personnel involved in the A-133 audit to enhance work paper documentation.

Performance and Documentation of Planned Testing of Information Technology Internal Controls (page 5): *DCAA did not complete the testing of key information technology*

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controls as planned and the documentation did not provide a clear understanding of the audit work performed or the procedures relied on.

FAO Response: The FAO will re-evaluate the key controls for information technology testing and will enhance its documentation and review process to ensure that controls identified for testing are clearly identified and testing performed is adequately and clearly documented. When reliance is to be placed on the IPA work performed, documentation will clearly tie the work performed to the specific controls identified in our planning. The FAO is currently evaluating available training courses to enhance auditors' knowledge of and procedures for documenting and testing of internal controls.

Cash Management and Special Tests and Provisions Internal Control Documentation (page 6): *The DCAA auditors did not adequately document the internal controls they relied on to support conclusions on the adequacy of controls for the cash management and special tests and provisions requirements. Specifically, the working papers state that the auditors planned to rely, in part, on internal controls tested in the review of activities allowed or unallowed and allowable costs/cost principle requirements.*

FAO Comment: Based on comments provided during the course of the QCR review, the auditors enhanced the documentation in the Aerospace FY 2009 A-133 audit to include specific reference to controls identified and tested in the review of activities allowed or unallowed and allowable costs/cost principle requirements. The FAO has taken steps to identify and eliminate work papers which essentially duplicate other work papers. The FAO will continue to assess its work paper structure to maintain a clear audit trail without unnecessary duplication of information.

Testing Compliance for Activities Allowed or Unallowed and Allowable Costs/Cost Principles Compliance Requirements (page 6): *The DCAA auditors did not adequately document the review of compliance for the activities allowed or unallowed and allowable costs/cost principles requirements. Specifically the documentation did not identify the specific cost principle criteria used to review costs for allowability; did not provide the basis for the judgment that internal control exceptions noted during floorchecks were not considered significant; and did not document the procedure performed and the results of those procedures to verify the existence of employees not present during the floorchecks. In addition, the auditors did not document that they verified the timecard authorizations within the electronic timekeeping system.*

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FAO Comment: Based on comments provided during the course of the QCR review, the FAO initiated actions to enhance documentation procedures during the Aerospace FY 2009 A-133 audit. We will continue to enhance documentation and will provide additional training to all auditors involved in the A-133 audit process.

Field Detachment Coordination (page 7): *The DCAA working papers did not adequately document, as required by government auditing standards and DCAA policy, the coordination with DCAA Field Detachment or clearly identify the audit work performed by the Field Detachment auditors.*

FAO Comment: Based on comments provided during the QCR, the FAO had recognized the requirement to more clearly and specifically document the agreement reflecting the work to be performed by the Field Detachment auditors. All future audits will contain specific actions to be taken by Field Detachment as part of the documentation of coordination of the audits.

Please direct any questions concerning this memorandum to Ms. Patricia A. Wilson, Branch Manager, South Bay Branch Office, at (310) 965-7020.

/s/ Stephen T. Larkin
/for/ DONALD L. MULTINAX
Regional Director

Enclosure:

a/s



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Department of Defense