

**Evaluating the Defense Contract Auditing Process
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Subcommittee on Oversight and Investigations
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Chairman Hartzler, Ranking Member Moulton, and Members of the Subcommittee, thank you for the opportunity to appear before you this morning. I am here on behalf of the National Defense Industrial Association (NDIA), the nation's oldest and largest defense industry association, comprised of nearly 1,600 corporate and 80,000 individual members.

Industry recognizes that the audit responsibilities of the Defense Contract Audit Agency (DCAA) play an essential role within the Department of Defense's (DoD) acquisition oversight structure and that it operates within a broader set of controls to manage DoD's activities throughout the contracting lifecycle. I would like to make clear that many of the observations that follow have their genesis in the evolution of DCAA from the organization stood up in 1965 to serve as an advisory function for Contracting Officer (CO) decision making to one that has been reconfigured to serve solely as enforcers of their own process requirements without a nexus to the CO decision making process.

NDIA, like many other industry associations, has called for a repeal of the Budget Control Act of 2011 and increases in defense spending proportional to the security threats facing our nation. Industry, taxpayers, DCAA, Congress, and most importantly our armed forces, thus all have a common interest in a properly configured and efficient oversight framework focused on risk based processes and procedures that allow the DCAA to perform their primary role of assisting COs to make decisions.

NDIA has identified the following five key elements that have significant effect on the defense contract auditing process.

1. DCAA Mission

Per their website, DCAA provides audit and financial advisory services to DoD and other federal entities responsible for acquisition and contract administration. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. DCAA's purpose and mission is thus to act as a subject matter financial advisor to COs on matters related to the transactional as well as contract oversight and closeout processes.

Industry is concerned that DCAA has lost focus of their purpose within the Defense Acquisition System over the past decade and has become much more closely tied with the Inspector General function than needed or desired to fulfill their statutory oversight role. DCAA is not a profit center, but their Annual Reports to Congress highlight that the measure of mission success is that their audit activities provide a large return on investment (ROI) by identifying a large number of adverse audit findings rather than on executing their primary advisory functions. We also question whether the agency can inherently be truly independent and objective in their audit responsibilities (both Generally Accepted Government Accounting Standards [GAGAS] requirements) while continuing to emphasize success based upon ROI.

DCAA asserts that their ROI to the taxpayer in Fiscal Year (FY) 2015 was \$4.80 per dollar spent. While such a figure may seem to be a favorable side effect of performing their central advisory mission, that value computation does not accurately measure all "costs" to the acquisition system for functions that go unfulfilled or delayed, or the costs for companies to maintain and achieve nearly perfect internal controls associated with business systems in order to avoid a DCAA allegation of a significant deficiency (see item 2 below) because of the Agency's perceived very low threshold for materiality. Nevertheless, ROI, appears to be held out to federal stakeholders as the reason for DCAA's existence. The pronounced shift in the agency's focus has crept well beyond its statutory mission over time and, accordingly, DCAA's mission should be reoriented away from a strict process compliance framework fixated on ROI to one directed at helping decision-makers determine fair and reasonable prices for products and services provided to the warfighter.

2. Implications of DCAA Audit Behavior for Industry

NDIA believes that a lack of professionalism, as defined by GAGAS, from DCAA auditors, has borne costs on government and industry through a lack of incorporation of materiality in their judgments. Our members' perception of DCAA's standard of perfection with respect to internal controls (e.g., to avoid allegation of business system significant deficiencies) vs. controls that provide reasonable assurance for business systems, is that it is the enemy of timeliness and affordability. While perfection is admirable, often the high costs involved with achieving a level of perfection to avoid

DCAA's allegations outweigh the associated benefits of having a perfect internal control for an issue that may never be a catalyst for increased costs to the government. Audits should be based on risk and ultimately a reasonable assurance for reliance. Further, there should be clarity on the materiality of potential identified deficiencies and whether they are in fact significant relative to the ultimate effect on Contractor Business Systems in order to avoid this perceived "perfection" standard that we contend is currently in place.

The materiality issue also affects Cost Accounting Standards (CAS) noncompliance assessments as often allegations of CAS noncompliance issues are asserted by the agency without appropriate consideration of whether the assessments are in fact material. This can create extensive administration in resolution of the issue for the contractor, the Defense Contract Management Agency (DCMA), and DCAA years after the fact. Many of these issues consume valuable resources in the contract disputes process. Using clear and objective criteria would reduce the backlog of non-compliance allegations and assist in lowering the large backlog of contracts currently requiring closeout across industry.

Relative to business systems, there are also major implications for small businesses. Ensuring small businesses have sufficient opportunity to compete for prime contracts is a major public policy goal in federal procurement. Having a DCAA-approved accounting system has increasingly been used as an evaluation criterion for major small business government-wide contracting vehicles, such as One Acquisition Solution for Integrated Services (OASIS) and Alliant II. Small businesses are less likely to have had an audit of their accounting system, which undermines competition and stunts the growth of new entrants to the federal marketplace. Furthermore, the costs of DCAA compliance, as well as the business disruptions from audits, particularly when there are multiple audits, is much more significant on small businesses as a percentage of revenue and resources.

Another major burden from DCAA's approach to audit practices is in records retention. Federal Acquisition Regulation (FAR) 4.7 sets forth the government's record retention policy for various types of records for different oversight purposes, but the insistence of audit staff for contractors to provide access to original documents long after the retention period has expired is inconsistent with the rules and does not align with the practice of moving more records into the "cloud". Where such demands are not met, DCAA has been identifying contractors as having elevated risk, even where contractor imaging processes have been tested and approved by DCAA for compliance.

3. How to Measure "Success" in the Defense Contract Audit Process

A core issue for DCAA is how to measure success. Based on a review of DCAA's annual report to Congress, it appears that the amount of costs it questions, and its ROI are its

most valuable measures of success. While on its face, that may make sense, overemphasis on those numbers runs counter to DCAA's role in the acquisition system and provides perverse incentives for the workforce. Audit quality is based solely on the process used to plan, perform, and report an audit. It is process based, rather than outcome based. Success should be measured in quality audits that meet the expectations of COs in a timely manner. NDIA understands that an overemphasis on the speed of audits was partially to blame for poor audit quality identified in Government Accountability Office reports from 2008 and 2009, a caveat for designing and implementing proper performance metrics. However, absent any goals for timely audits and reporting requirements that do not completely encapsulate DCAA's performance, there is a concerning erosion of accountability.

NDIA is concerned by the metrics included in DCAA's Annual Reports to Congress and the DoD Inspectors General (IG) Semiannual Reports. Review of this data makes clear that the number of audits completed per auditor continues to decrease. Further, while DCAA reported an 18% reduction in incurred cost proposals (ICP) pending audits or awaiting adequacy determinations on hand in its FY 2015 report to Congress, it failed to include the dollar value of those submissions. This was included in each of the previous four reports and showed a continual increase in value since FY 2011, despite the number of ICPs pending audit or awaiting adequacy determinations decreasing by over 50% in that time frame.

Industry is concerned that DCAA's reporting on the backlog is not telling the full story. The fact that many of our larger members have open rates dating back four to five years suggests that DCAA may have simply closed out the lower risk, lower dollar value contractor ICPs, which had the effect of reducing the number of audits in its backlog. Additionally, although DCAA recently indicated that the backlog is under 18 months in order to perform non-DoD audit services, we understand that the Agency does not count submissions until they are two years old since DCAA audits two years concurrently, so it considers within two years as the "current year." It appears that a weighted average of ICPs based upon their dollar value would have been a more effective metric as to whether this 18 month backlog goal had been achieved, as this should have a more direct impact on reducing the dollar volume of contracts across industry that still require closeout (due to awaiting final indirect rate year settlements).

Although we acknowledge that performance data provided by DCAA and DoD IG provides an incomplete picture, and it does not adequately measure DCAA performance, by DCAA's own standards, the agency is not performing well. DCAA achieved "major success" in fulfilling its initiatives in FY 2011 and described FYs 2012 and 2013 as "very successful" according to reports from those years. Since FY 2013, however, DCAA's return on investment fell from \$7.30 per dollar spent to \$4.80 per dollar spent. Its sustention rate on post-award DoD audits dropped from 50.2% to 31.6% over that time as well. The FY 2013 report noted that its percentage of 9.8 of

questioned costs as a total of dollars examined was “[a]n indicator of DCAA’s effectiveness in using its risk-based approach.”¹ Fast-forwarding to the FY 2015 version of the report, that metric was no longer highlighted, and was only 4.5%.

4. DCAA Management

According to GAGAS, “leadership of the audit organization is ultimately responsible for the system of quality control.”² Within DCAA this is undermined by greater autonomy granted individual auditors in recent years. Historically, DCAA operated with a chain-of-command structure that more effectively directed, supervised, and managed its audit objectives, but that is no longer the case. A 2009 Audit Guidance Memorandum from DCAA that instructed individual auditors to take significant and sensitive issues directly to the DoD IG³ is of particular concern. This increased autonomy likely aids DCAA’s high remarks in the Federal Employee Viewpoint Survey, but may also explain its high turnover amongst early careers employees reflected in Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics Human Capital Initiatives data, in comparison to the overall defense acquisition workforce.

DCAA’s regional structure has also frustrated contractors through inconsistent audit practices. The recent reductions in the number of DCAA regions and establishment of more Centralized Audit Responsibilities for the largest DoD contractors is a good start and should continue to help build more consistent positions. However, this will not be effective without greater two-way, face-to-face communication between DCAA and contractors including audit planning, performance, and reporting.

5. DCAA Workforce

As previously mentioned, auditing is a process function. GAGAS standards on professionalism stress objectivity, and do not imply unlimited responsibility, nor infallibility for the individual auditor. Moreover, GAGAS states, “Professional judgment does not mean eliminating all possible limitations or weaknesses associated with a specific audit, but rather identifying, assessing, mitigating, and explaining them.”⁴ Industry experience often does not reflect this. Rather, often we experience individual auditors lacking professional judgment trying to “find something” no matter

¹ “Report to Congress on FY 2013 Activities at the Defense Contract Audit Agency.” Accessible at: http://www.dcaa.mil/DCAA_FY2013_Report_to_Congress.pdf

² Generally Accepted Government Accounting Standards (GAGAS) 3.86, Accessible at: <http://www.gao.gov/products/GAO-12-331G>

³ DCAA Memorandum for Regional Directors (MRD) entitled, “Audit Guidance on Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials,” dated March 13, 2009. Accessible at: [https://www.crowell.com/pdf/09-PAS-004\(R\)-MRD_Unsatisfactory-Conditions-Govt-Officials.pdf](https://www.crowell.com/pdf/09-PAS-004(R)-MRD_Unsatisfactory-Conditions-Govt-Officials.pdf)

⁴ GAGAS 3.68

how immaterial. This is likely driven by DCAA's focus on dollars questioned and ROI at the highest levels. While this seems admirable on the surface, we contend that an auditor's success should be based on their adherence to GAGAS and the utility of their findings. Audits timelines, auditor productivity, and a sustention rate of 31.6% for post-award audits do not reflect this.

Emphasis on "finding something" regardless of whether it is sustained or not, which often times can be the case because it is simply cheaper for industry to settle, is a major perverse incentive eroding the professionalism of the workforce. For instance, at one public accounting firm, early career auditors are assessed for year-end bonuses and promotion potential based on their audit quality from supervisor assessments and peer review. Based on results, managers within the firm collectively make decisions. DCAA should be structured such that the professionalism and output of individual auditors can be evaluated to ensure auditors are accountable and properly supervised in accordance with GAGAS requirements.

Industry is also concerned by the insular nature of DCAA's training, which appears to shun outside views. Less experienced auditors lack professional judgment, and instead are highly proficient in DCAA policies and procedures, or in other words, know what the words say, but not what they mean or the spirit of why they were created. Further, on-the-job training is undermined by the aforementioned autonomy of individual auditors, making it difficult for supervisors to mentor. Greater engagement with industry through external training (both personal and technical) would also be beneficial to foster professionalism and enhance technical capabilities.

NDIA Suggestions for Future Action

Reevaluate the DCAA Mission, Organization and Management, and Responsibilities and Functions provided in DoD Directive 5105.36. Establish a working group of government and industry acquisition and auditing professionals to align mission objectives with the statutory audit-records requirements. Task the working group with 1) determining necessary contract audit, accounting, and financial advisory services needed by the Department, 2) establishing definable and measurable auditing criteria, materiality, and acceptable time frames by audit type, and 3) Identifying which agencies, organizations, or companies are best suited to provide the necessary and timely accounting and financial advisory services for the Department. For example, the effect of competing for the providing of advisory services may inherently improve the service (in all aspects) provided to the respective COs as companies and agencies must demonstrate superior performance in order to continue to perform this role for the Department.

Establish timely deadlines for the completion of incurred cost audits. DCAA needs to return to their historical practice (pre-2008) of completing timely audits. The optimal timeline would be 90 days from submission of incurred cost proposals. DCAA would have 30

days to reject the proposal as inadequate (if necessary) prior to beginning the audit, which would then be conducted and completed within 90 days. Once the audit is complete, COs could have 60-90 days to negotiate final incurred costs and indirect rate settlements. For reference, the Securities and Exchange Commission (SEC) requires a company's annual filing, Form 10-K, within 90 days (which incorporates an accounting firm's audit opinion regarding these statements). DCAA should focus objectives, audit programs, and audit techniques for compatibility with the timely completion of the work. Holding incurred cost audits to this timeline, which is proven effective for financial statement audits, would have the effect of significantly reducing costs at contractors (ultimately passed on to the government on their contracts) as personnel and records would be readily available thereby streamlining the audit process of these very current records.

Embrace the use of third party auditors for incurred cost and business systems audits. This is likely the only solution to eliminate the incurred cost audit backlog; however, it is not a complete solution. Once implementing regulations are finalized for Sections 820 and 893 of the FY 2017 National Defense Authorization Act, there will likely be more clarity in how interested public accounting firms will be in performing this work. Regardless, DCAA may still likely request working papers and backup materials on work performed by public accounting firms, which we believe is not necessary or appropriate. If each of these sections was expanded to include all contractors, especially those performing work on cost-reimbursable contracts, it would have greater effect. This would allow DCAA funds to be prioritized for forward pricing proposals, which notably, the America Institute of Certified Public Accountants would not allow public accounting firms to perform, as they are not permitted to opine on forward looking statements.

The Department of Transportation has accepted public accounting firm audits and opinions of indirect rate audits for years under American Association of State Highway and Transportation Officials (AASHTO) guidelines and audit requirements. From experience, these audits are efficient and cost effective, taking about 60 to 90 days start to finish. Other agencies have used public accounting firms for years to conduct audits.

Publish annual report card with assessment of DCAA services from DoD functions responsible for procurement and contract administration. Develop criteria attributes and a feedback mechanism for procurement and contract administration functions to provide DCAA with assessments on the quality, timeliness, relevance, and satisfaction with the services provided. This feedback would be highly beneficial in understanding how well DCAA is performing in its customer service role. We are not aware of any existing attempts to do this.

Enhance government-industry dialogue. Our members reported positive engagement with DCAA in the past, but note there has been little government-industry dialogue in the

last couple of years. Reinstating participation in “Integrated Product Teams” or a comparable dialogue of inquiry to facilitate the audit process and increase communication with auditees would help. It seems that independence has been used as the reason for not communicating with contractors. This is frustrating given that contractors want to comply and to be responsive to valid audit findings, but find themselves unclear in what actions would remediate a finding. Without open communication in the process, effective remediation is frequently delayed by lack of understanding on either or both parties. With open communication contractors can discuss effective remediation and feel comfortable their actions will resolve the audit finding. Dialogue would also be beneficial in training, particularly to teach auditors about standard business and accounting systems (e.g. SAP, Oracle, or Deltek) used by contractors, and how they work.

Employ dedicated oversight, not necessary legislation, to encourage improvements at DCAA. Industry would like to see greater use of commercial auditing practices in conducting and performing audits, including the incorporation of materiality in DCAA’s decision making, and recognition of timely completion of audit work. Industry is concerned that some of DCAA’s current annual reporting metrics have perverse incentives, but if they remain, metrics on auditor productivity, especially in comparison to the private sector, and cost borne on industry to achieve DCAA’s ROI should be incorporated. Unfortunately materiality is difficult to legislate, and relies primarily on the professionalism of the workforce; however, such materiality determinations are regularly applied in commercial auditing practices when examining and opining on company financial statements associated with SEC reporting. Similarly, designing metrics that adequately capture DCAA’s role in the Defense Acquisition System is difficult as well. Continued dedicated oversight and hearings such as these provide great benefit, however the views of other stakeholders, namely DCMA, should also be heard.

Strongly consider the recommendations of the Congressionally-established Section 809 Panel. The Section 809 panel will likely provide meaningful recommendations covering the defense contract audit process. Since their report is not likely to be released for nearly two years, although there is a possibility for interim recommendations, we recommend that Congress keep this in mind before taking any legislative action.

Conclusion

In summation, a combination of factors has led to the reorientation of DCAA’s mission over the last several years to the detriment of the operations of the Defense Acquisition System. Moving forward, DCAA should place greater emphasis on improving its customer service role, and be held accountable to improve the quality and timeliness of its audit services for the benefit of government procurement and the warfighter. We ask

that each of the “Suggestions for Future Actions” above be strongly considered as a viable path forward in achieving these objectives.