

Testimony

of

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before the

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On Oversight and Investigations

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Chairwoman Hartzler, Representative Moulton, and members of the Subcommittee, thank you for the opportunity to appear before you today. I am pleased to provide you with an overview of DCAA's contract audit mission and responsibilities. I will discuss DCAA's current operations to include pace and schedule of audits and current ideas on acquisition reform.

Background

DCAA is a distinct agency of the Department of Defense (DoD) that reports to the Under Secretary of Defense (Comptroller). The DCAA mission is to perform the necessary audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting, thereby protecting the taxpayer's interest and supporting the warfighter. Our charter was intentionally developed to permit DCAA to provide these same contract audit services to other Federal agencies.

Government officials draw on DCAA audit findings throughout the acquisition process. With these recommendations, contracting officers are better able to negotiate prices and settle contracts for major weapons systems, services, and supplies. At the front end, DCAA's findings can directly impact the price that the government pays for contracted work. Even after a contract is underway, DCAA findings may address instances where the government overpaid contractors for work, uncover potential fraud or misuse of funds, and impact future contract prices by addressing inadequacies early on. Before officially closing out a flexibly price contract, DCAA assesses whether the contractor's claims for final annual incurred costs during contract performance are allowable and reasonable according to applicable acquisition regulations and contract provisions. This final task in the contract audit process ensures that no excess costs were charged to the Government.

DCAA Contract Audit Effort

To carry out its mission, DCAA has about 4,500 employees at 300 offices around the world. More than 85 percent of DCAA's personnel are auditors. In FY 2016, DCAA examined \$286.7 billion in contract costs, issued 4,269 audit reports, identified over \$9.9 billion in audit exceptions, reported \$3.6 billion in net savings, and produced a return on investment of about \$5.70 to \$1. These savings are actual dollar reductions in contract prices or payments to the Government based on contractor overpayments. In addition to making steady progress on the incurred cost backlog, the Agency also continued to conduct other audits to help contracting officers establish fair and reasonable prices and reduce the risk of contractor overpayments.

Today, I would like to highlight forward pricing and incurred cost, which represent the majority of our work and where we have made significant improvements resulting in better processes, higher performance, and increased value for our customers.

Forward Pricing

We get the highest return on investment (ROI) from forward pricing audits, which have netted the government an average of \$3 billion per year. These savings represent actual reductions in negotiated contract prices for the goods and services the government is buying. We continually seek feedback on our forward pricing process to improve our value to our customers, and we have executed several initiatives that have increased efficiency and improved communication. As a result of these actions, we have cut our response time by 20 percent over the last five years and established a consistent practice of proactive, early engagement with contracting officers, which has demonstrably improved audit effectiveness. Customer feedback

from approximately 200 surveys a year consistently reflects high satisfaction ratings with audit timeliness, accuracy, communication, and overall satisfaction. In addition, our commitment to early and ongoing communication with contracting officials at all levels allows us to identify the highest risk contract actions and perform the right audit services to meet their needs.

We have put a particular emphasis on the highest risk forward pricing rates because they generally represent the major portion of the contract dollars. We have been highly proactive with the Defense Contract Management Agency (DCMA) to reinvigorate our audit processes to make recommended forward pricing rates available to the contracting officer. This collaboration has led to quicker settlements on fair and reasonable prices, which has sped up the overall acquisition process.

DCAA has also focused on delivering our product to the contracting officers as promised, which is essential to help the acquisition community keep the contract award process on track. We have seen our on-time rate improve by roughly 50 percent in the last five years.

We are consistently seeking out new ways to improve internal processes, communication, and timeliness of audits without compromising audit quality.

Incurred Cost

Incurred cost audits return less ROI than Forward Pricing, but they carry substantial intrinsic value across our entire portfolio of audits. Incurred cost audits are critically important in the acquisition process, and we audit the incurred cost proposal to ensure that all direct and indirect costs are compliant with contract terms and government acquisition regulations. Beyond ensuring compliance, however, incurred costs give us pertinent information that increases our efficiency on many other audits. For example, an incurred cost audit can reveal poor accounting practices including noncompliance with Business System requirements and Cost Accounting

standards. They also provide valuable historical information necessary to close out contracts and establish forward pricing rates that we rely to negotiate new fixed price contracts.

The incurred cost audits, particularly the incurred cost backlog, have received a lot of attention by several organizations concerned about us getting the backlog current. First, it is important to understand the root cause of the backlog. Specifically, during 2000-2009, defense contract spending increased in support of the Gulf war, but DCAA resources remained the same (Figure 1). Because we didn't have sufficient audit staff to perform all the new work, we dedicated our limited resources to high risk defense procurements and deferred incurred cost audits, the only audits that could be postponed without significant risk to the taxpayer or the warfighter.

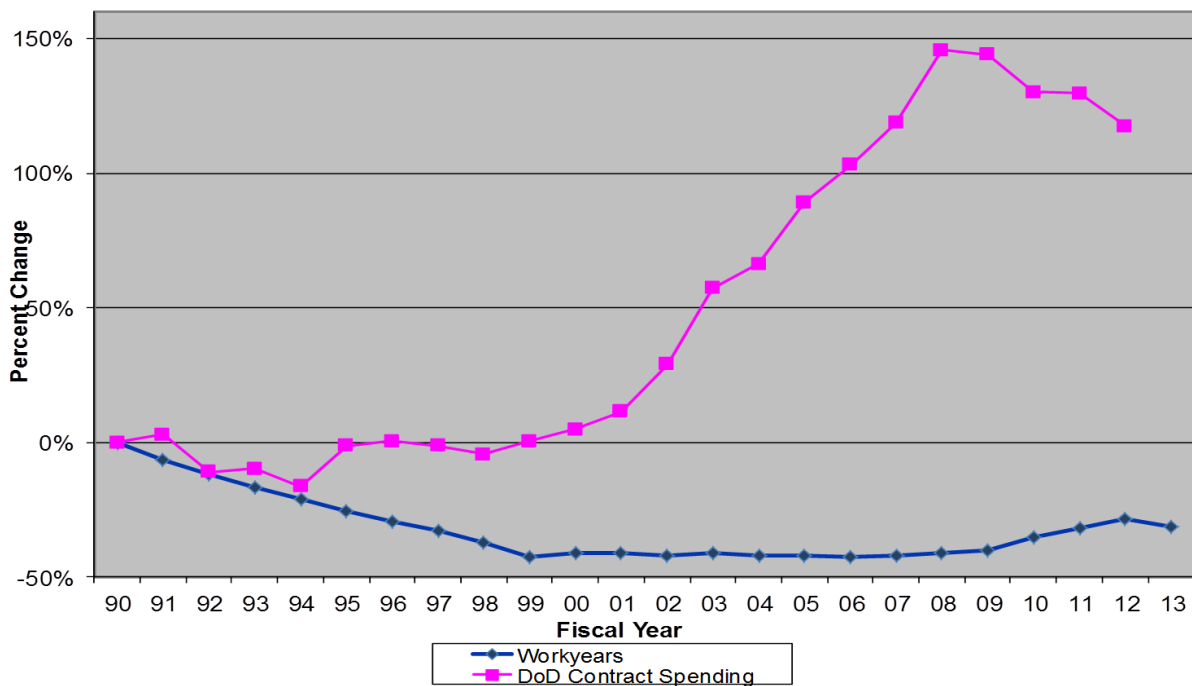


Figure 1.
DoD Contract Spending (2012 Constant Dollars) Vs. DCAA Staffing Percent Change from 1990

As a result, by the end of FY 2011, DCAA had an estimated backlog of about 21,000 contractor incurred cost submissions on hand with a total value of about \$333 billion. To address

this backlog, DCAA developed an action plan for more efficient audits, including executing a four-prong strategy to eliminate the backlog. The four-prong approach included the following:

1. A comprehensive low risk incurred cost sampling process. Contractors that have less than \$250 million in incurred costs on flexibly priced contracts and have been determined to be low risk are audited on a sampling basis, similar to the IRS process. Contractors that have been identified as high risk undergo an incurred cost audit every year.
2. Multi-year audits. Instead of auditing only one incurred cost year at a time, DCAA began auditing two or more years during the same audit. This process has been extremely efficient, reducing our labor costs by 40 percent over separate single-year audits for the subject years.
3. Dedicated audit staff. To maintain our momentum on reducing the backlog, we dedicated auditors to incurred cost work and ensured that they could not be shifted to other work.
4. Additional resources. We obtained additional resources to close the resource gap that occurred between 2000 and 2009.

This four-pronged approach was in full operation by the end of FY 2012. DCAA has made solid, consistent progress since 2011 towards eliminating the incurred cost backlog. However, our progress has been adversely affected by our inability to sustain the fourth prong of the strategy. DCAA's inability to maintain a steady level of staffing has presented a major barrier and hindered our ability to successfully accomplish our mission. To perform and sustain the full complement of contract audits that pose the greatest risk to the government, DCAA needs to

have a stable and well-qualified workforce that can deliver on its mission. Since reaching our target in 2012, DCAA has seen significant staffing fluctuations (Figure 2).

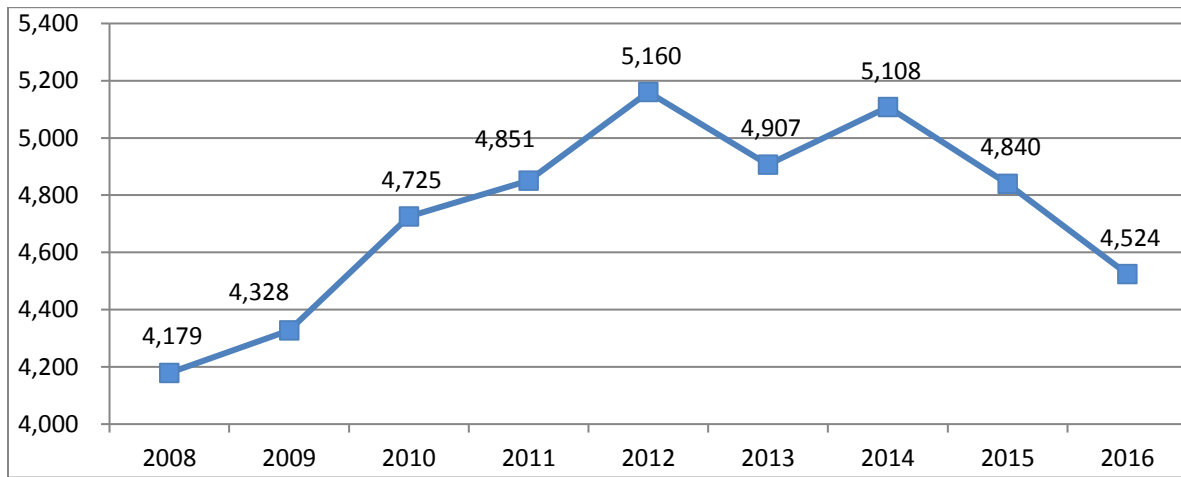
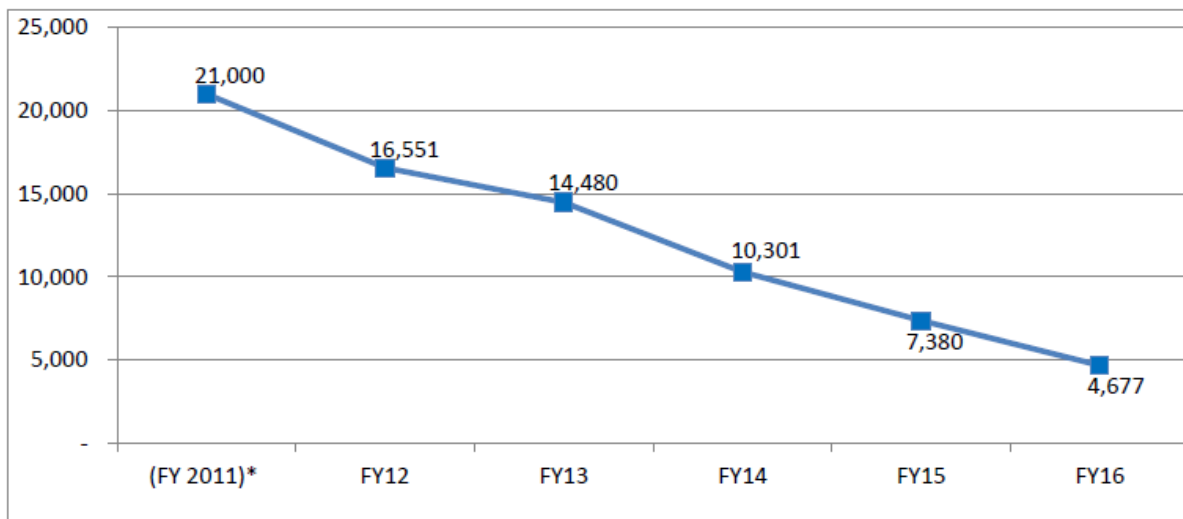


Figure 2. DCAA staffing FY2008-FY2016

Sequestration, furloughs, hiring freezes, and other funding limitations have prevented the Agency from hiring to its authorized staffing level for several years. These circumstances, in turn, continue to impact subsequent Agency budgets through Congressional marks that are largely based on DCAA's under execution of authorized funding levels. We repeatedly find that these staffing upheavals negatively affect workload projections, delay training plans, and disrupt the professional development pipeline critical for meeting the high risk needs of our customers. For example, based on our trajectory on eliminating the Incurred cost backlog (Figure 3), we were planning to be fully current by 2018. However, the passage of the 2016 NDAA (Section 893), which prohibited DCAA from receiving reimbursements from non-DoD agencies, necessitated a hiring freeze that interrupted our progress. Because of that hiring freeze, together with the additional hiring freeze for FY 2017, we are currently reassessing our projections to determine how these events will impact our target dates.

Finally, it is important to note that our timeliness also requires cooperation and information from contractors, which can sometimes be challenging on both sides.

Regardless of the challenges we have faced, our strategies have clearly been effective. We closed out FY 2016 with the backlog down to 4,677 incurred cost years, representing a 75 percent reduction of the backlog.



* Baseline

Figure 3. Incurred Cost Backlog Reduction FY2011-FY2016

We request the help of Congress to ensure that we can hire and maintain a stable staffing level necessary to execute the audits vital for protecting the government’s interests.

Acquisition Reform

We value the Committee’s commitment to improving the acquisition process. DCAA also upholds that commitment, and we consider process analysis, optimization, and improvements as fundamental in executing our mission to serve the warfighter and protect the taxpayer. We

appreciate the opportunity we have had to review acquisition reform and to provide information about what DCAA is already doing, the progress we have made, and the ways we can best help achieve your objectives. I'd like address several areas with the Committee today, including our risk-based approach to audits, materiality thresholds, for the requirement for GS-14 managers to be CPAs, the potential role of Independent Public Accounting (IPA) firms, and mandated timelines for Incurred Cost.

Risk-based Approach and Materiality

One of the acquisition reform ideas call for providing detailed criteria for defining materiality and for DCAA to develop a risk-based approach to audits. DCAA has a comprehensive risk-based approach, and I'm happy to provide you more information on our processes.

DCAA assesses risk at two levels, which allows us to target our resources on the work that provides the most value. The first step is conducting a risk assessment to determine whether the audit engagement represents a significant risk to the Government. We worked with the acquisition community to establish dollar thresholds to identify the point at which an audit is necessary to protect the Government's interests. For pricing actions, the Department established the thresholds in Table 1.

Table 1. Forward Pricing Proposal Audit Threshold

Contract Type	Audit Threshold
Fixed-price Proposals	Greater than \$10 Million
Cost-type Proposals	Greater than \$100 Million

The difference in these thresholds represents the risk inherent in different types of proposals. For example, Cost-type proposals pose a lower risk because they are subject to

Incurring cost audits; therefore, the threshold is higher. Fixed-price proposals are not subject to Incurring Cost audits, so there is more risk to the Government if we do not identify unreasonable prices before the contract is awarded. Neither of these thresholds, however, are absolute. If a contract poses a higher risk based on other factors, DCAA will work with the contracting officer and perform the necessary audit services to address the risk.

Incurring cost proposals for flexibly-priced contracts are put into three categories based on dollar value and assessed risk to determine if the proposal will be audited to protect the Government's interest.

1. All proposals exceeding \$250 million in incurred costs in a fiscal year must be audited.
2. Proposals less than or equal to \$250 million in a fiscal year will be assessed for risk, and any high-risk proposals will be audited.
3. The remaining proposals less than or equal to \$250 million that are determined to be low risk and adequate will be randomly selected for audit.

Having determined which proposals will be audited, we move to the second step of our process. In this step, DCAA assesses risk of the different cost elements within the proposal to determine the degree to which that element needs to be audited to prevent the potential for overpayment on government contracts. To make their determinations, auditors assess various risk factors such as previous experience with the contractor, reliability of contractor systems, and type of contract. The assessment is also based on how material each segment is to the overall proposal. Auditors consider materiality when evaluating elements of cost and then assess the findings for an overall material impact. The auditor only reports findings or noncompliances if they will have a significant material effect on contract costs.

We are consistently reviewing our risk-based processes to ensure our risk assessments are valid. For example, we confer annually with the Government Accountability Office to review our low risk sampling process and make adjustments where necessary. In general, however, we find few anomalies that challenge our confidence in our low-risk approach.

We don't believe there is a need to further define a risk-based approach nor materiality because as shown we already implement these concepts in our methodologies. We also believe that defining materiality to the specificity being considered will be too limiting and will not allow our auditors to exercise their professional judgment to adjust to unique circumstances as required by all auditors' professional standards.

Introduction of Independent Public Accounting Firms

We have also reviewed a reform idea to allow independent public auditors (IPAs) to do audit work historically performed by DCAA. DCAA is better positioned to perform these audits because of their expertise in auditing to the unique requirements of Government contracts, and I believe that allowing IPAs to conduct these could have a significant negative impact on DoD contract administration and audit processes.

First, I would like to provide a brief overview of the differences between the type of audits traditionally performed by Independent Public Auditors and DCAA, each of which requires a unique set of skills. An IPA's expertise is predominately in tax work and financial statement audits. For example, a financial statement auditor knows the necessary audit procedures to conclude that financial statements fairly present the financial position of the company in accordance with Generally Accepted Accounting Principles (GAAP). In contrast, DCAA auditors are skilled in cost accounting and have a thorough knowledge of the Federal

Acquisition Regulations (FAR) and Cost Accounting Standards (CAS). Knowledge of FAR and CAS is a fundamental to auditing Government contracts. Based on their expertise, DCAA is able to develop unique auditing procedures to ensure that costs incurred and paid by the Government are allowable and allocable in accordance with the FAR and CAS.

In addition to the contract audit expertise of the DCAA workforce, we bring efficiencies to the audit process by having purview over an entire portfolio of contract audits for each contractor and an entire population of incurred cost submissions. First, all audits for a single contractor are interrelated during the acquisition process, and we use the information from other audits to assess risk on incurred cost proposals, which greatly reduces our efforts on the audit. For example, a DCAA paid voucher audit informs the auditor on key cost considerations to use when assessing incurred costs. In addition, having an IPA perform the incurred cost audits will lead to inefficiencies in DCAA's performance of the other contract audits. During the audit of the incurred cost audit, DCAA is able to gain insights into business systems and historical trends that help inform the risk for other audits DCAA performs like forward pricing audits. Secondly, because we receive all contractors' incurred cost submissions, we have been able to implement sampling of low risk submissions across that population. DCAA's other audit work at these contractors allows DCAA to rely on its knowledge of the contractor and sample low risk contractors, which results in only a small percentage of low-risk submissions undergoing an audit. Without historical knowledge of the contractors and access to the population from which to pull a sample, an IPA will not be able to make these low risk determinations and implement sampling. Additionally, there will be inherent inefficiencies when the audits transition from one IPA to another IPA when the IPA audit work is re-competed over the years. Therefore, there

will be an increase in audit effort. Over the past 5 years, we closed over 14 thousand incurred cost years without an audit based on our alternative low risk procedures.

Another incurred cost audit process that would be significantly impacted and contribute to inefficiencies is the audits of subcontracts that have to be done to support the prime contractor's incurred costs. Currently, DCAA facilitates the audit completion of several hundred subcontract incurred cost audits that are deemed high risk. Let me explain. When performing an incurred cost audit at a prime contractor, we identify the significant and high risk flexibly price subcontracts that also require audit. We request assistance from our cognizant DCAA office for that subcontractor, and they perform the audit because the subcontractors will not allow the prime contractor access to their proprietary data. We incorporate those results into the audit of the prime and then provide the audit results to the contracting officer for resolution. Since DCAA is the only audit agency for the Department and located worldwide, this process is very efficient. If an IPA were to perform the prime contract incurred costs, a new process would have to be established where DCMA would have to facilitate the assist audit process and potentially contract with several different IPAs to perform the subcontract audits, thereby increasing costs to the taxpayer due to these increased efforts. Processes would have to be developed for establishing agreements for IPAs to work together while also ensuring all contractor proprietary data is kept secure.

Finally, I would like to discuss the inherently governmental nature of the audit process. The work DCAA does for approximately 65 percent of all incurred cost audits has been classified as inherently governmental. These are the submissions for which DCAA determines the annual indirect rates using auditor determined procedures pursuant to FAR 42.705 and 42.705-2. The determination of indirect rates involves "determining whether contract costs are

reasonable, allocable and allowable,” which FAR Subpart 7.503(c) (12) (vii) lists as an inherently governmental function. This determination cannot be performed by a private auditor pursuant to the Government auditor determination procedure at FAR 42.705-2. Thus, all audits conducted by an IPA will introduce inefficiencies and require the contracting officer to perform significantly more contract administration effort as the final indirect cost rates must be determined by a contracting officer pursuant to the contracting officer determination procedure at FAR 42.705-1. While the other 35 percent of DCAA’s incurred cost work isn’t defined as inherently governmental because the rates are determined by the contracting officer through negotiation, DCAA plays a significant role in assisting the contracting officer in determining the allowable costs paid to the contractor. Because of the degree of involvement with the contracting officer in making final rate determinations, including providing negotiation support, our work in these areas contains characteristics of inherently governmental work.

CPA requirement for GS-14 managers

Another acquisition reform would require DCAA GS-14 managers to be CPAs (Certified Public Accountant) and at least one year of experience working on audits of Government contracts with either a defense contractor or qualified private auditor. Although we consider these qualifications in selecting a candidate, in our experience, they have not necessarily been good predictors of successful hires for GS-14 manager positions. Having a CPA or experience in industry doesn’t call for the same technical skills required to conduct contract audits nor indicate the ability to be a leader, and should not override these qualifications needed in our manager positions. If we do enforce these requirements, we will undoubtedly see a dramatic decrease in our applicant pool of otherwise well-qualified applicants.

Performance of Multi-year audits

Another reform calls for the incurred cost audit to be completed within one year after receipt of a qualified submission. As discussed above, DCAA has initiated a process improvement to perform multi-year incurred costs audits for many contractors where two years of a contractor's incurred costs are audited in one audit. This method reduces audit labor costs by 40 percent over separate single-year audits for the subject years and benefits contractors because less time is required to support the audits. The proposed requirement for completing these audits in one year would no longer allow DCAA to save the Government these resources in the future.

These efficiencies do not just make the best use of its resources DCAA, contractors also benefit because they spend less time on audits. Given that this process has not been in place for more than a few years, we have and continue to seek contractor input about its efficacy and usefulness. That said, we have received significant positive support from many of the contractors who have experienced it. Additionally, since 74 percent of contractor submissions are due on June 30 of each calendar year, requiring a 12 month timeframe for audits is not practical, as it does not allow for a normal workflow. The current language in FAR 4.804-1 already contains a timeframe of 36 months for closing out these types of contracts We believe the current FAR provisions support the acquisition process.

SUMMARY

I would like to conclude by asking the committee for sufficient time to work through the acquisition reform ideas and address the concerns I have raised. I am truly concerned about the inefficiencies associated with introducing IPAs into the contract administration process, and I

believe that the Committee should have a full understanding of how this change will impact the acquisition community.

In the coming year, I would like to thoroughly examine several issues. First, I want to work with the committee to better understand its objectives and how to best achieve them. Next, I propose that we reach out to industry, the Services, Defense Procurement and Acquisition Policy, DCMA and other stakeholders to ascertain the appropriate use of IPAs. Specifically, I want to better understand DCMA's perspective on how IPAs will impact their resources, and I want to better understand industry's perspective on the benefits they envision and any concerns they have about sharing proprietary data with several independent auditors as opposed to sharing it only with DCAA.

I would also like time to work with industry, the Services and DCMA on a cost benefit analysis of performing single-year audits vs. multi-year audits. As I stated in my testimony, we have seen clear benefits: multi-year audits reduce our audit labor costs by 40 percent and industry has responded favorably to the potential of reducing their resources as well. One of the key reasons offered for discontinuing multi-year audits is that two years of incurred cost inventory cannot be considered "current." I want to better understand any detrimental effects of a two-year inventory, and I will ask stakeholders to provide the costs and benefits of auditing one year at a time. At this point, however, I suggest that a 40 percent increase in efficiency makes a compelling case for gathering more information before discontinuing the multi-year process. Once we have obtained that information, I commit to you that if a data-driven, cost-benefit analysis demonstrates that single year audits are more beneficial than multi-year audits, then we will stop conducting multi-year audits.

I would like to thank the committee for allowing me to share our story. I am very proud of all our dedicated DCAA employees who continue to find more efficient and effective ways to execute our mission, support the warfighter, and protect taxpayer dollars. I know there have been concerns that we couldn't get the incurred cost backlog down fast enough. Our track record clearly indicates that, with the proper resources, we will get it down. The delays we have experienced directly correlate to fluctuations in staffing and inefficient processes that we have addressed and overcome. If investments are going to be made in additional resources, I'd like the opportunity to restore and stabilize DCAA staffing levels. I'd like the opportunity to finish what we are so close to achieving.