

# Report to Congress on FY 2012 Activities at the Defense Contract Audit Agency

U.S. Department of Defense

March 29, 2013





## DEFENSE CONTRACT AUDIT AGENCY

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OFFICE OF THE DIRECTOR

March 29, 2013

Congressional Defense Committees:

I am pleased to submit DCAA's annual Report to Congress for Fiscal Year 2012 pursuant to 10 U.S.C. §2313a. This report provides an overview of DCAA's critical mission and outlines Agency audit performance in FY 2012. Specifically, it provides information regarding the number of audit reports completed by DCAA, the priority given to each type of audit, and the length of time to complete audits. This report also provides recommendations to address significant deficiencies identified by DCAA during the conduct of contract audits in FY 2012. Finally, it summarizes significant activities at DCAA and their impact on the Agency's progress.

DCAA's mission is vital to ensure that our warfighters receive the best value for critical equipment and services. FY 2012 was a very successful year for DCAA. We examined over \$150 billion in defense contractor costs and issued over 6,700 audit reports. These reports recommended \$12.4 billion in cost reductions. Overall, our efforts assisted contracting officials achieve \$4.2 billion in documented savings to the Government. Based on these savings, the return on taxpayers' investment in DCAA was approximately \$6.70 for each dollar invested.

Our success in FY 2012 was a result of our commitment to the workforce and audit process. The main focus of our Agency-wide efforts was twofold: improving the quality of our audits, and supporting and enhancing our workforce. I believe we had major success on both fronts. I am extremely proud of our employees for their work in ensuring that our warfighters receive the best value for critical equipment and services. They continue to demonstrate the importance of conducting independent contract audits, identifying potential cost discrepancies, and providing recommendations to support acquisition officials.

At the present time I am concerned about the impact that the FY 2013 hiring freeze and budget constraints will have on our plans for the future. However, I am confident that the progress we made in FY 2012 has laid the groundwork to continue providing critical value to the warfighter and taxpayer, and I look forward to the future with great anticipation of how DCAA can serve the Department of Defense with even greater effectiveness.

Respectfully,

A handwritten signature in black ink, reading "Patrick J. Fitzgerald", is centered below the text "Respectfully,".

Patrick J. Fitzgerald

**TABLE OF CONTENTS**

**1. DEFENSE CONTRACT AUDIT AGENCY MISSION ..... 1**

**2. ORGANIZATIONAL STRUCTURE AND STAFFING ..... 2**

**3. FY 2012 AUDIT PERFORMANCE ..... 3**

**4. SIGNIFICANT DEFICIENCIES AND RECOMMENDED ACTIONS TO IMPROVE  
THE AUDIT PROCESS ..... 9**

**5. SIGNIFICANT FY 2012 ACTIVITIES AND THEIR IMPACT ..... 13**

## **1. DEFENSE CONTRACT AUDIT AGENCY MISSION**

DCAA provides audit and financial advisory services to Department of Defense (DoD) and other federal entities responsible for acquisition and contract administration. DCAA's role in the financial oversight of government contracts is critical to ensure DoD gets the best value for every dollar spent on defense contracting. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. In serving DoD, DCAA protects the public interest, and its work benefits the American taxpayer and our armed forces.

DCAA's primary function is to conduct contract audits and related financial advisory services. Contract audits are independent, professional reviews of financial representations made by defense contractors. Specifically, DCAA assists in determining whether contract costs are allowable, allocable, and reasonable. DCAA conducts audits in accordance with Generally Accepted Government Auditing Standards (GAGAS), a set of standards that ensures that audit conclusions are well supported by evidence. The type and extent of DCAA's audit work varies based on the type of contract awarded, but its audit services are generally limited to acquisitions under Federal Acquisition Regulation Part 15 (Contracting by Negotiation). DCAA audits only contractors; it has no internal audit responsibilities in DoD.

DCAA auditors examine and review contractor accounts, records, and business systems. DCAA's goal is to evaluate whether contractor business practices and procedures are in compliance with the Federal Acquisition Regulation (FAR), the Defense Federal Acquisition Regulation Supplement (DFARS), and other applicable government laws and regulations. Based on its findings, DCAA provides recommendations and advice to government officials who are responsible for acquisition and government contract administration. These officials select contractors to perform government-funded work and negotiate prices for products and services for our warfighters. DCAA has no direct role in determining which companies are awarded defense contracts; rather, it provides recommendations to government officials on contractor cost assertions regarding specific products and services.

The scope of DCAA's influence is significant. DCAA provides definitive recommendations to contracting officers that impact negotiations with nearly 7,500 contractors in a typical year. Contracting officers are better able to negotiate prices and settle contracts for major weapons systems, services, and supplies using DCAA recommendations.

## 2. ORGANIZATIONAL STRUCTURE AND STAFFING

**A. Organizational Structure.** DCAA assumed contract audit responsibility from individual services for all DoD entities 48 years ago on January 8, 1965. Today, DCAA consists of over 5,000 employees located at over 300 office locations throughout the United States, Europe, the Middle East, Asia, and the Pacific. To manage the geographically dispersed and complex work, DCAA is organized into six regions which include a Field Detachment that handles classified work:

**Headquarters** is located at the Andrew T. McNamara building, Fort Belvoir, Virginia. Principal elements of Headquarters are the Director, Deputy Director, General Counsel, Internal Review Directorate, and the Assistant Directors for Operations; Policy and Plans; Integrity and Quality Assurance; and Resources.

**Regional offices** are located in Irving, Texas; Smyrna, Georgia; Philadelphia, Pennsylvania; Lowell, Massachusetts; La Mirada, California; and Chantilly, Virginia. Each region directs and administers the DCAA audit mission at over 50 locations near the contractor base.

**Branch Offices** are strategically situated within the regions and are responsible for the majority of contract audit services within the assigned geographical area. Branch offices often have smaller suboffices to ensure adequate oversight of contractors.

**Resident offices** are established at contractor locations when the amount of audit workload justifies the assignment of a permanent staff of auditors and support staff. These offices allow auditors to work on location with the largest major industrial manufacturers that the Government buys from, including Boeing, Lockheed Martin, and Raytheon.

**DCAA liaison activities** are conducted at DoD acquisition or contract administration offices to directly communicate and coordinate audit processes with acquisition, contract administration, and contract audit personnel.

**B. Staffing.** DCAA has a highly professional workforce. About 90 percent of employees have at least a bachelor's degree, 30 percent of employees also have a degree beyond the baccalaureate level, and 25 percent of employees are Certified Public Accountants or have other professional certifications. As shown in Figure 1, about 87 percent of DCAA employees are auditors. The remaining 13 percent are professional support staff individuals who work in a variety of occupational fields including administrative support, budget, human resources, information technology, and legal.

**Figure 1 – DCAA Workforce at September 30, 2012**

|                            |              |               |
|----------------------------|--------------|---------------|
| Auditors                   | 4,492        | 86.7%         |
| Professional Support Staff | 689          | 13.3%         |
| <b>Total</b>               | <b>5,181</b> | <b>100.0%</b> |

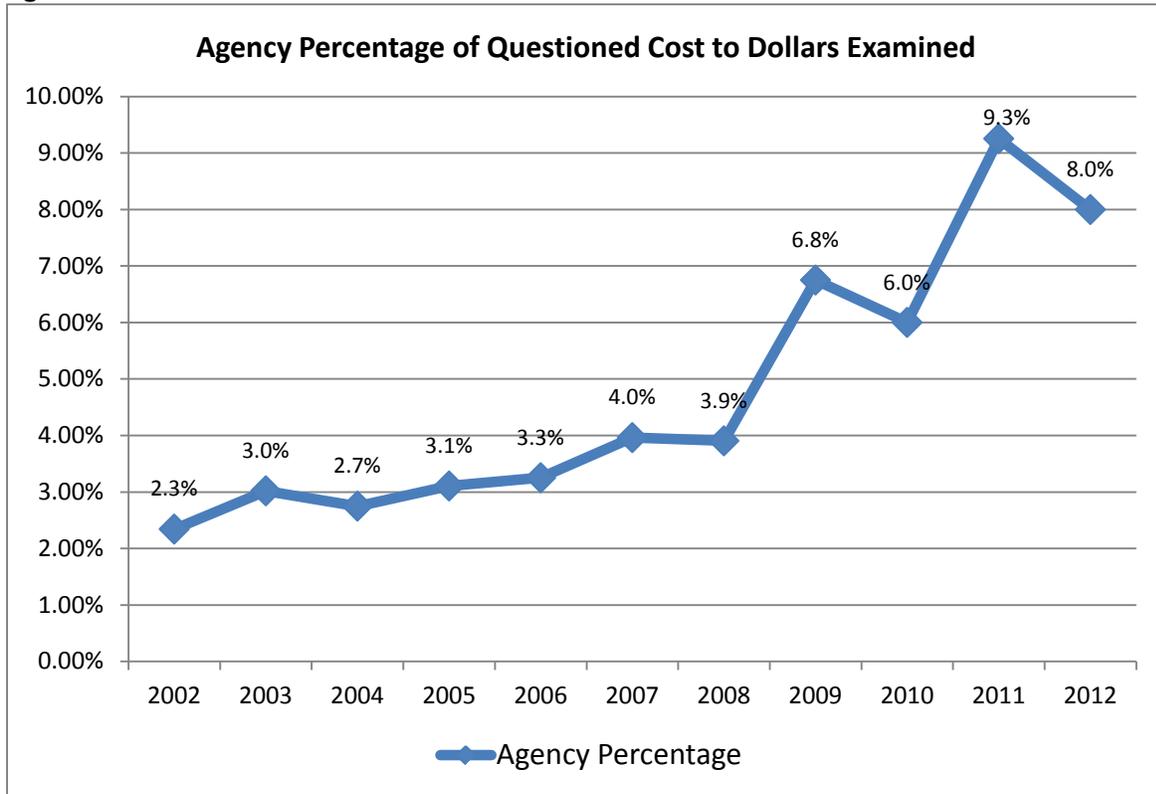
**Figure 2 – DCAA Certifications and Advanced Degrees**

|                                   |       |       |
|-----------------------------------|-------|-------|
| Certified Public Accountants      | 1,272 | 24.6% |
| Other Professional Certifications | 193   | 3.7%  |
| Advanced degrees                  | 1,611 | 31.1% |

### 3. FY 2012 AUDIT PERFORMANCE

In fiscal year 2012, DCAA examined roughly \$154 billion in defense contractor costs, issued about 6,700 audit reports, and recommended reductions in proposed or claimed contractor costs of \$12.4 billion. A key indicator of DCAA's effectiveness is the increasing ratio of DCAA questioned cost to dollars examined during recent years as depicted in Figure 3.

Figure 3



The increase in questioned costs has paid off in net savings. For example, between 2002 and 2009, DCAA averaged \$2.5 billion in annual net savings; however, over the last 3 years, DCAA's net savings has averaged \$3.5 billion, an increase of 40 percent. In 2012, DCAA identified about \$4.2 billion in net savings to the Government. Based on these net savings, the return on taxpayers' investment in DCAA was approximately \$6.70 for each dollar invested. Importantly, this \$6.70 return represents actual savings that DoD can reinvest in various ways to help the warfighter.

**A. Audit reports completed in FY 2012.** DCAA conducts a variety of different audits. Each audit that DCAA completes, whether it is before or after contract award, supports government officials who negotiate prices and settle contracts for major weapons systems, services, and supplies using DCAA recommendations. When conducting an audit, DCAA evaluates whether contractor business practices and procedures are in accordance with the FAR, DFARS, Cost Accounting Standards (CAS) and other applicable government laws and regulations. Contracting officers may also request an independent financial opinion on specific elements of a contract, or an assessment of compliance with specific acquisition regulations or contract terms, contractor's business system, and the like. DCAA typically categorizes these types of requests as "Special" or "Other" audits.

Importantly, government officials draw on DCAA audit findings throughout the acquisition process. 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 contract completion, DCAA assesses if the contractor’s final annual incurred costs claimed for contract performance are allowable and reasonable in accordance with applicable acquisition regulations and contract provisions prior to the contract being officially closed out, which prevents excess costs charged to the Government.

The total number of audit reports completed by DCAA in FY 2012 and total dollar value of questioned and unsupported costs are depicted in Figure 4.

**Figure 4 – Audit Reports Completed by DCAA in FY 2012**

| <b>Type of Audit Report</b> | <b>Number of Audit Reports</b> | <b>Dollar Value of Questioned Costs (Millions)*</b> | <b>Dollar Value of Unsupported Costs (Millions)**</b> |
|-----------------------------|--------------------------------|---|---|
| 1. Forward Pricing          | 1,811                          | \$ 9,859  | \$ 17,605   |
| 2. Special Audits           | 1,937                          | \$ 831  | N/A**   |
| 3. Incurred Cost            | 1,795                          | \$ 1,538  | N/A**   |
| 4. Other Audits             | 1,173                          | \$ 173  | N/A**   |
| <b>Total</b>                | <b>6,716</b>                   | <b>\$ 12,401</b>                                    | <b>\$ 17,605</b>                                      |

\* Questioned Costs are costs the auditor considers not acceptable for negotiating a reasonable contract price or not acceptable for reimbursement under existing contracts.

\*\* Unsupported Costs denote instances where the contractor has not provided specific evidence or documentation to support assertions related to the cost of future work. Unsupported costs are not applicable in the case of Incurred Cost Audits, Special Audits, and Other Audits, because the contractor is not making a claim about the cost of future work. Any potential cost discrepancies identified by DCAA in the case of Incurred Cost Audits, Special Audits, and Other Audits are classified as “Questioned Costs” where the contractor has not provided adequate documentation to support a claim about the actual costs the contractor has incurred.

**1. Forward Pricing.** Forward Pricing Audits are generally completed *before* contract award where DCAA evaluates a contractor’s estimate of how much it will cost the contractor to provide goods or services to the Government. Accurate contract prices are the starting point for fair and reasonable prices throughout the acquisition process as subsequent costs are often based on the initial estimated contract costs. In FY 2012, DCAA issued 1,811 forward pricing reports, and identified over \$9.8 billion in cost discrepancies.

**2. Special Audits.** Special Audits can be conducted *before or after* contract award. Most of the reports in this category are issued in response to requests from contracting officers who need an independent financial opinion on specific elements of a contract or on a contractor’s accounting business system in order for the contract work to proceed—making special audits a high priority.

Special Audits conducted *after* contract award primarily address circumstances where contracts are adjusted for changes or are partially or fully terminated before completion. These circumstances represent complex and high-risk audits where DCAA must carefully evaluate the cost of original contract work from the changed scope of work. In FY 2012, DCAA issued 1,937 special reports and identified \$831 million in questioned costs.

**3. Incurred Cost.** Incurred Cost Audits determine the accuracy of contractor's annual allowable cost representations. When a contract price is not fixed, DCAA conducts an incurred cost audit *after* contract award to determine the accuracy of contractor cost representations. DCAA expresses an opinion as to whether such costs are allowable, reasonable, and applicable to the contract, based on government accounting and acquisition provisions. Incurred cost audits allow the contracting officer to recover the questioned costs before the contract is officially closed out, which prevents excess payments by the Government. In FY 2012, DCAA issued 1,795 incurred cost reports, covering 2,735 incurred cost years, and identified \$1.5 billion in questioned costs.

**4. Other Audits.** Other audits primarily consist of audits performed *after* contract award and can be requested by a contracting officer or initiated by DCAA. DCAA typically initiates this type of audit when there is potential for a high risk, such as where the contractor has inadequate business systems. The majority of the audit effort in this category focuses on adequacy of the contractor's Cost Accounting Standards Disclosure Statement, compliance with Cost Accounting Standards, assessment of contractor Cost Impact Statements for noncompliances, review of contractor business systems, and contractor compliance with the Truth in Negotiation Act. Other Audits also include real-time testing of labor and material costs—verification of current actual cost and price data that cannot be confirmed in the following year—allowing DCAA to immediately notify the contracting officer of any deficiency before the contract is closed out. In FY 2012, DCAA issued 1,173 Other Audits, and identified \$173 million in questioned costs.

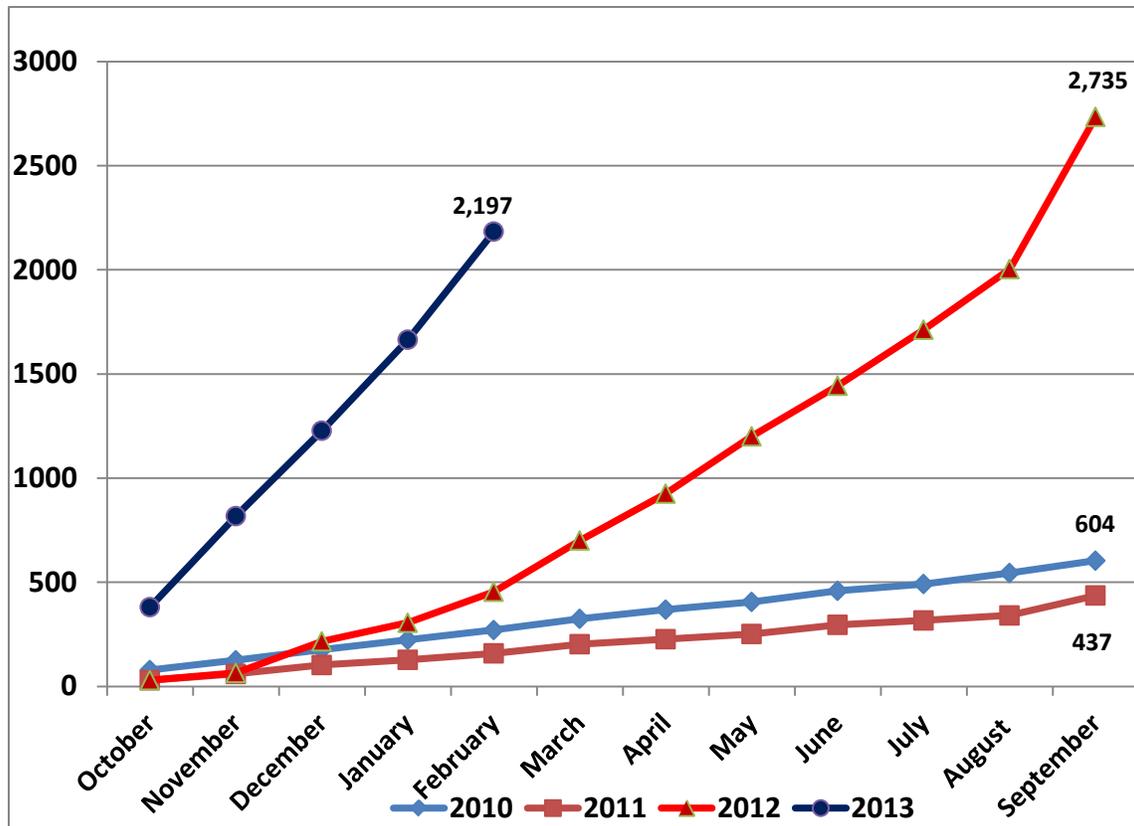
**B. Pending Audits.** DCAA's management information system does not formally separate audits into a "pending" category. However, DCAA considers contractors' adequate annual incurred cost submissions awaiting final DCAA action as pending. A contractor is required to submit a certified incurred cost submission of its costs incurred for each year of contract performance where the contract price is not fixed at time of contract award. Incurred cost submissions may be provided to DCAA at any time and can cover a range of prior fiscal years. For example, DCAA could receive a submission in FY 2012 for contract work completed in FY 2008. This submission would then become part of DCAA's FY 2012 pending incurred cost audits.

After receiving an annual incurred cost submission, DCAA auditors will review it to determine if the submission and supporting data are adequate and in accordance with FAR 52.216-7(d)(2)(iii). If the submission is not adequate, it is returned to the contractor for correction and resubmission. When a submission is determined to be adequate, it becomes part of DCAA's list of "pending" incurred cost audits.

At the end of FY 2012, DCAA had about 17,000 adequate annual contractor incurred cost submissions on hand with a total value of about \$333 billion. Additionally, DCAA was either awaiting receipt of, or had not made an adequacy determination for approximately 9,000 incurred cost submissions with a total value of about \$377 billion. This backlog was the result of a conscious decision to defer incurred cost audits. DCAA made this decision because contract spending increased while DCAA staffing levels remained fairly constant between FYs 2000 and 2009; consequently, DCAA did not have the staff to perform all the work it had to do. Incurred cost audits were one of the few areas that could be deferred. To address this backlog, DCAA developed an action plan in FY 2011 that consisted of four strategies—dedicated incurred cost audit teams, multi-year audits, low-risk sampling, and workforce growth. This

approach was in full operation by the end of FY 2012. As a result, DCAA had a significant increase in completed incurred cost years during FY 2012, and further increases in early FY 2013 (Figure 5).

Figure 5 – Incurred Cost Years Completed



Based on prior DoD budget guidance, DCAA planned to increase its staffing from about 4,900 employees in FY 2011 to about 5,600 employees by FY 2016 and to use this increased staffing to perform incurred cost audits to reduce the number of pending incurred cost submissions. The increase in staffing was on track in FY 2012, but subsequent budget constraints impacted this staffing increase in early FY 2013.

**C. Prioritization of Audits.** DCAA uses a risk-based planning process to ensure audit resources are focused on the highest-payback areas to DoD, the warfighter, and the taxpayer. When prioritizing work, DCAA plans its audits based on the highest-risk areas to the Government. This means that DCAA does not automatically prioritize audits based solely on the type of audit being conducted. Rather, DCAA examines the risk factors involved in each individual audit—whether it is a Forward Pricing, Special Audit, Incurred Cost, or Other Audit—when prioritizing audit work. Contracts considered “high-risk” typically involve significant costs, poor contractor performance in the past, or circumstances where there may be less incentive to control costs such as on cost-type contracts.

In FY 2012, the highest priority audits were those related to Overseas Contingency Operations (OCO) and to Forward Pricing. In both categories, the audits were time sensitive, carried significant risk factors, and would have significantly impacted the Government and/or the contracting process had they been deferred. OCO audits include both Forward Pricing and Incurred Costs audits, and they represent one of the highest-risk contracting areas to DoD. A foreign contractor is subject to the same laws and rules as a contractor in the U.S. but might not be fully familiar with them. This circumstance requires more scrutiny

to ensure that the prices the Government pays for contracted work are fair and reasonable. For example, DCAA may encounter situations where contractor and subcontractor proposals are not subject to true competition due to foreign contractor relationships, or U.S.-based contractors may not adequately implement the same level of internal controls in a contingency operation setting. A significant portion of the costs the Government is paying for OCO includes subcontracted work—a historically high-risk area. In FY 2012, DCAA audited roughly \$6.4 billion for OCO contracts and recommended about \$1.1 billion in reductions. Additionally, the majority of all Forward Pricing audits were a high priority for DCAA in FY 2012. These audits are extremely time sensitive because they must be completed before contract negotiations occur to be of value to the contracting officer.

DCAA assigns priority to Incurred Cost Audits, Special Audits, and Other Audits based on individual contract and audit risks to the Government. DCAA generally classifies Incurred Cost audits as lower priority because they are performed after contract award and a senior contractor official must certify to the allowability of the contractor’s claimed costs. However, specific Incurred Cost audits can be a high priority for DCAA if DCAA or the contracting officer identifies significant risk factors. Special Audits are a high priority when requested by contracting officers who need an independent financial opinion on specific elements of a contract or on a contractor’s accounting business system in order for the contract work to proceed. Additionally, Other Audits are a high priority when DCAA or the contracting officer deems it to be a high risk area such as where the contractor has inadequate business systems.

**D. Length of time to complete audits.** The timeline for an audit is based on audit type, dollars involved, level of risk, and needs of the requester. Therefore, DCAA does not have specific or mandatory time requirements for completing audits. Instead, DCAA assesses what is necessary to provide a quality, GAGAS-compliant audit, one that will provide value to the contracting officer in negotiating a fair and reasonable price for the Government. DCAA is working closely with Contracting Officers to set reasonable due dates based on what the audit requires and the needs of the buying commands. Based on this coordination, DCAA and Contracting Officers mutually set priorities, milestone plans, and agreed-to dates. Once these agreements are reached, DCAA assesses timeliness based on meeting those targets.

The table below (Figure 6) contains the average length of time for audit completion in FY 2012, followed by additional explanation for each audit type.

**Figure 6 – Average Length of Time to Complete Audits in FY 2012**

| Type of Audit Report | Elapsed Days |
|----------------------|--------------|
| 1. Forward Pricing   | 110          |
| 2. Special Audits    | 217          |
| 3. Incurred Cost     | 1,184        |
| 4. Other Audits      | 384          |

**1. Forward Pricing.** The time to complete a Forward Pricing audit is generally measured from the date of receipt of the audit request or, in some cases, from the date of receipt of an adequate proposal if received later than the request. In FY 2012, the average time between request and audit report issuance was 110 days.

**2. Special Audits.** The time to complete a Special Audit is generally measured from the date of receipt of the audit request to the date of the audit report issuance. In FY 2012, the average time between request and report issuance was 217 days.

**3. Incurred Cost.** The time to complete an Incurred Cost audit is measured from the time an adequate annual incurred cost submission is received until the date of the audit report issuance. The average time between the receipt of an adequate annual incurred submission and audit report issuance was 1,184 days. This high number is the result of DCAA working through submissions that had been sitting idle in the incurred cost backlog for years due to the continuing need to perform higher priority, higher risk audits within resource constraints.

**4. Other Audits.** The time to complete Other Audits is generally measured from the time audit work began to the date of the audit report issuance. In FY 2012, the average time between the start of the audit and audit report issuance was 384 days.

#### 4. SIGNIFICANT DEFICIENCIES AND RECOMMENDED ACTIONS TO IMPROVE THE AUDIT PROCESS

Contract auditing is a critical step in the acquisition process, and DCAA's independent audit opinions directly affect the value that the Government, taxpayer, and warfighter receive for contracted work. To ensure DCAA is providing the highest value to its acquisition stakeholders, it has identified deficiencies in the acquisition process, and recommended changes, and ongoing DCAA challenges.

**A. Adequacy of Contractor Forward Pricing Proposals.** Inadequate contractor proposals remain a significant barrier that DCAA faces in performing timely, high quality Forward Pricing audits. Proposal adequacy is critical for a timely response to the requestor, compliance with FAR and CAS, and effective support for a fair and reasonable prices. Without an adequate proposal, audits take more time, require non-value added audit resources, and lead to significant contracting vulnerabilities in negotiations.

**Proposed Regulatory Changes.** DCAA, together with DoD acquisition stakeholders on the Defense Acquisition Regulation (DAR) Council, are proposing regulatory changes to improve proposal adequacy. The finalization of the following DFARS cases will improve the timeliness of the acquisition process.

- **DFARS Case 2011-D042, Defense Federal Acquisition Regulation Supplement.** The DAR Council established this case to ensure adequacy of contract proposals. Specifically, the case calls for contractors to use a Proposal Adequacy Checklist—jointly established by DCAA, buying commands, and the Panel on Contracting Integrity—that provides instruction and codifies common expectations for auditors, contracting officials, and contractors. The proposal adequacy checklist ensures compliance with FAR Part 15.408 Table 15-2, Instructions for Submitting Cost/Price Proposals When Certified Cost or Pricing Data Are Required. On March 28, 2013, the Department published the final Rule to incorporate the proposal adequacy checklist into DFARS 215.408 and an associated solicitation provision at DFARS 252.215-7009.
- **DFARS Case 2012-D035, Defense Federal Acquisition Regulation Supplement.** The DAR Council established this case to ensure adequacy of Forward Pricing Rate proposals. Specifically, the case calls for contractors to use a Forward Pricing Rate Proposal Adequacy Checklist—jointly established by DCAA and the Panel on Contracting Integrity—that provides instruction and codifies common expectations for auditors, contracting officials, and contractors. This checklist will ensure forward pricing rate proposals comply with FAR Part 15.408 Table 15-2, Instructions for Submitting Cost/Price Proposals When Certified Cost or Pricing Data Are Required and DFARS 252.215-7002, Cost Estimating System Requirements. The Department expects issuance of the draft Rule for public comment this year.

**Challenges.** Barriers to the audit process that DCAA continues to face are insufficient commercial pricing documentation and the lack of express authority to review “data other than certified cost or pricing data.”

- **Commercial Pricing Documentation.** Contractors do not provide adequate commercial market sales of the same or similar items to support proposed commercial prices, especially for commercial claims based on the “offered for sale” or “of a type” language in the definition of a commercial item, as established in FAR 2.101, Definitions. To address these shortcomings, the Department made a legislative proposal for the FY 2013 Defense Authorization Bill to eliminate “of a type” and “offered for sale” language from the

commercial item definition. However, the FY 2013 Defense Authorization Act did not adopt the Department's legislative proposal, but it did enact Section 831, "Guidance and training related to evaluating the reasonableness of price." DCAA is hopeful that the guidance and training will address the concerns at the prime contract level. However, at the subcontract level, there remains significant risk related to price reasonableness of subcontract commercial items because Section 831 does not require the guidance and training as a contractual mandate of prime contractors. DCAA plans to engage the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics and recommend that its training include an emphasis on reducing the risk of excessive commercial prices at the subcontract level.

- **Authority to Review and Subpoena "Data Other than Certified Cost or Pricing Data."** The DCAA subpoena authority contained in 10 U.S.C. §2313 permits DCAA both access to and the authority to subpoena certified cost or pricing data, but it does not specifically provide similar authority for "data other than certified cost or pricing data" as defined in FAR 2.101. When a contracting officer determines that historical data is insufficient to determine the reasonableness of prices in a fixed-price contract for commercial items, FAR 15.403-3 permits the Government to obtain "data other than certified cost or pricing data" to assist in making that determination. Contractors have been reluctant to provide this information. While the FAR allows contracting officers to request data, there is currently no authority to compel production of that data. DCAA submitted a legislative proposal for FY 2013 that would expand the DCAA subpoena authority to "data other than certified cost or pricing data." That proposal was deferred, and we plan to resubmit it for FY 2014.

**B. Access to Contractor Records.** DCAA is required to perform audits in accordance with GAGAS. To perform high quality audits, DCAA must obtain sufficient evidence to provide a reasonable basis for the conclusions expressed in its audit reports. A key part of this evidence is pertinent contractor records. Access to records—including access to internal audit reports, online data, and contractor employees—continues to pose significant challenges to DCAA auditors.

- **Statutory Change – Internal Audit Reports.** The FY 2013 National Defense Authorization Act (NDAA), Section 832, requires DCAA to revise its guidance on access to defense contractor internal audit reports. The revised guidance will ensure DCAA appropriately documents requests for access to internal audit reports. Specifically, DCAA's documentation must include a written justification for report access, a copy of the request from DCAA to the contractor for access to such reports, and a record of response from the contractor. The revised guidance must also include appropriate safeguards and protections to ensure that auditors use the contractor internal audit reports appropriately. The NDAA provides that DCAA can use these internal audits to assess the reliability of the contractor's business systems and understand the contractor's internal controls, which DCAA does as part of every audit it performs. DCAA is disseminating the NDAA requirements through Agency formal training. Additionally, DCAA will issue guidance discussing the NDAA requirements, and will update the language in its Contract Audit Manual (CAM).

**Challenges.** Denial of access to contractor internal audit reports, contractor employees, and on-line data in contractor's systems is a continuing barrier relative to conducting audits.

- **Access to Contractor Internal Audit Reports.** Currently, Public Law 99-145, 10 U.S.C. §2313(b), authorizes the Director of DCAA to issue subpoenas when a contractor refuses to grant DCAA access to the records covered by the statute. In 1988, the United States Court of

Appeals, Fourth Circuit in the Newport News Shipbuilding<sup>1</sup> case, denied enforcement of a DCAA subpoena related to internal audit material. The Court ruled that DCAA's subpoena power in 10 U.S.C. §2313(b) is limited to negotiations, pricing, or performance of a particular contract. The ruling denied DCAA access to records of management reviews and internal audits, which the Court determined to be beyond the statutory provisions of DCAA's subpoena power.

DCAA must have access to relevant internal company materials to effectively accomplish its audit responsibilities. DCAA requires access to contractors' internal documents to determine that contractors are taking appropriate corrective action when a contractor identifies irregularities or mischarges, that a contractor is not overcharging the Government, and that a contractor has provided government officials appropriate contractor disclosures in compliance with the FAR. As part of its audit function, DCAA may require access to contractor reviews, inquiries, investigations, and internal audits in order to determine a contractor's compliance with the business system criteria, evaluate contractor internal control systems, and determine compliance with any applicable contract clauses or Federal or agency acquisition regulations. Specificity of the extent of DCAA's access to internal documents to verify the efficacy of contractor business systems, internal control systems, and compliance with applicable contract clauses or Federal or agency acquisition regulations will increase confidence in, and cost effectiveness of, DCAA's audit analysis.

The existing statutory change in the NDAA, noted above, will provide DCAA with the empirical data necessary to determine if problems truly exist with obtaining access to the internal audit reports necessary for DCAA to accomplish the Agency's mission. Once DCAA is able to obtain sufficient empirical data, we can determine whether amendments to 10 U.S.C. §2313 are necessary to specifically state that DCAA has access to reviews, and internal or external audits related to government contract costs or internal control over compliance with government regulations.

- **Access to Online Data.** The lack of access to contractor online data is another area where DCAA has recently had growing concern. Read-only access to the contractor's books and records would greatly assist DCAA to effectively plan and perform all of the audit effort at a contractor location. This is especially important at contractors with highly complex Enterprise Application Integrations environments and Enterprise Resource Planning systems.

Contractors are increasingly generating and storing accounting data and records in a digital environment. Whether it's an Electronic Timecard System, an Electronic Management Records system storing invoices/vouchers, or an automated General Ledger journal entry posting and reconciliation of accounting records within an enterprise accounting system, original accounting source data and records have become increasingly developed and available solely within electronic environments and formats. DCAA has always maintained that direct access to contractor original accounting "books of entry" or source records, whether manually or electronically generated, is authorized under FAR 52.215-2 Audit and Records—Negotiation. Nonetheless, many contractors have denied DCAA the read-only access to their electronic accounting systems data. Accessing these source records is

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<sup>1</sup> 10 U.S.C. §2313(a)(1) and (a)(2), the United States Court of Appeals, Fourth Circuit – U.S. v. Newport News Shipbuilding and Dry Dock Co, 837 F. 2d 162 (4<sup>th</sup> Cir. 1988) and 862 F. 2d 464 (4<sup>th</sup> Cir. 1988).

necessary for DCAA to efficiently perform its audit mission and support the Contracting Officer.

Specificity of the authority for direct and online access to contractor's data would improve both the audit and DCAA's ability to support the Contracting Officer. For example, direct, read-only online access would allow DCAA to respond more quickly to contracting officers because we could obtain the necessary data directly rather than having to repeatedly request the data from a contractor representative. Furthermore, the access would decrease the amount of costs and personnel resources needed by contractors to support audit requests for data. In addition, online access would advance DCAA audit efforts by allowing real time contract cost monitoring and continuous risk analysis, including the use of advanced data analytics. DCAA is continuing to determine what specific legislative proposal is necessary to ensure that DCAA has appropriate access to a contractor's online data.

- **Access to Employees.** DoD Directive 5105.36 requires the Agency to perform examinations in accordance with the Generally Accepted Government Auditing Standards (GAGAS). GAGAS requires the auditor to obtain sufficient, appropriate evidence to provide a reasonable basis for the conclusions expressed in the report. GAGAS also incorporates the requirements of the American Institute Certified Public Accountants Statements on Standards for Attestation Engagements, by reference. These standards require the auditor to select and apply procedures that will accumulate evidence sufficient to provide a reasonable basis for the level of assurance expressed in the audit report. DCAA strongly believes that having access to contractor employees to conduct interviews and observations is critical to ensure the high level of assurance required by GAGAS.

Some contractors have argued that DCAA's access to records does not include access to employees. DCAA believes that a change to the FAR is necessary in order to ensure DCAA has timely access to contractor employees when it is necessary to perform its audit activities. FAR 52.215-2(d), specifically gives the GAO rights to interview any officer or employee. Many contractors assert that DCAA does not have such access rights because DCAA is not specified in the statute. Because there is no specific language in FAR stating DCAA has access to interview employees, we plan to submit a legislative proposal to support DCAA's right of access to contractor employees and to avoid future confusion on DCAA's ability to interview employees.

## **5. SIGNIFICANT FY 2012 ACTIVITIES AND THEIR IMPACT**

DCAA made significant strides in FY 2012 in audit quality, audit efficiency, and workforce support. Following is a summary of those key activities and their impact.

### **Audit Quality**

With net savings of \$4.2 billion, DCAA's FY 2012 results are a clear indication that rigorous analysis and testing of contractor data in accordance with GAGAS provides significant returns for the taxpayer. Specific activities to improve quality included comprehensive, agency-wide supervisory training, targeted Field Assistant for Quality training, and increased transaction testing of contractor data. These and other quality efforts were key factors in notable increases in questioned costs over the last few years. This level of rigor provided the basis for the significant growth in net savings compared to previous years. DCAA's higher quality audits also create an important incentive for contractor compliance and a way to help contractors be better prepared for audits.

Another important component of DCAA's quality improvements has been the increased communication with its stakeholders. For example, throughout FY 2012, DCAA executives made a regular practice of visiting buying commands, meeting with industry officials, and attending conferences to discuss common acquisition challenges. Based on these interactions, DCAA has been able to help stakeholders better understand audit requirements, as well as address their specific questions about the audit process. Additionally, DCAA continues to execute the Rules of Engagement, which set out clear expectations for auditor communication with contractors and contracting officers. This increased communication ensures that we build quality into the audit early and throughout the audit process, saving time by addressing challenges immediately. Finally, DCAA has become more proactive in asking to attend negotiations, and contracting officers are seeing the benefit of this attendance. As a result, they are increasingly requesting that DCAA auditors attend negotiations to help support the government's position, uphold audit findings, and explain how data impacts audit conclusions.

### **Audit Efficiency**

An important area of focus in FY 2012 was audit efficiency. For example, DCAA's risk-based approach enables the most effective utilization of current staffing by focusing on audits that provide the most value in the acquisition process. This approach may result in fewer audit reports, but it pays back richly in net savings. The value is clearly evident based on historical trends. Between FYs 2002 and 2009, for example, DCAA averaged about \$2.5 billion in annual net savings; however, over the last 3 years, DCAA's net savings have averaged \$3.5 billion, an increase of 40 percent.

DCAA also increased efficiencies in the management of large contractors. In FY 2011, it consolidated the audit management for Raytheon, aligning all auditors and support staff under one region. Some of the benefits of this approach include reduced redundancies in contractor information requests, more comprehensive understanding of contractor business segments, easier access to contractor records, and more timely reporting of audit results. Based on this experience with Raytheon, DCAA began applying the model in FY 2012 to Northrop Grumman, which represents over \$20 billion in government sales. While the Northrop Grumman change is still in process, DCAA expects a similar level of success as it experienced at Raytheon.

Another DCAA initiative to improve efficiency was the Cost Recovery Initiative (CRI), a joint effort with Defense Contract Management Agency (DCMA) that aggressively targeted outstanding audit report actions. For each of the outstanding audit actions, DCAA apprised DCMA of the audit approach, how the

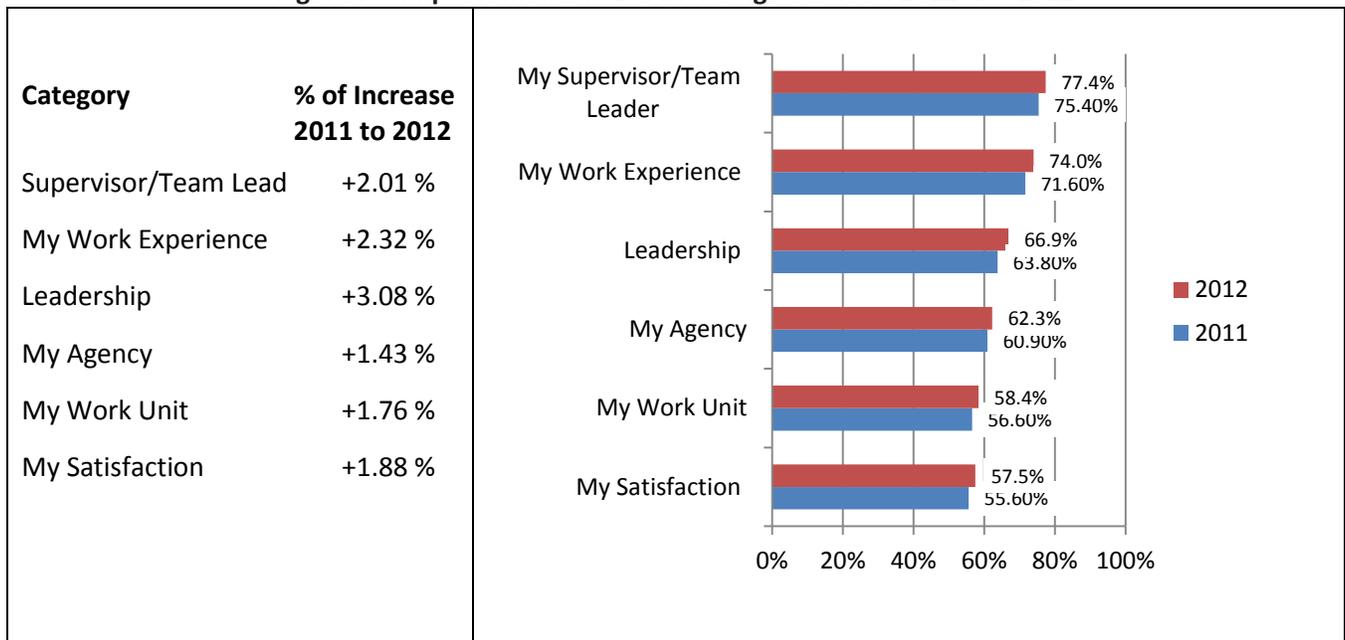
contractor’s accounting changes may impact how it charged the Government, and whether the contractor was appropriately progressing to resolve any noncompliance issues with Cost Accounting Standards (CAS). Through this initiative, DCAA and DCMA have already resolved nearly 500 of the 700 audits originally identified as requiring resolution and, as a result, contracting officers have requested over \$600 million be returned to the U.S. Treasury.

### Workforce Support

For the past three years, DCAA has emphasized initiatives to better support its workforce. An important part of that effort has been employee involvement, a critical source of knowledge and guidance. Nearly 250 employee volunteers from all levels across DCAA are participating in ad hoc committees to help execute the strategic plan, provide feedback, offer innovative ideas, and help establish best practices that directly impact Agency operations. During FY 2012, the Agency instituted many ad hoc team recommendations, including developing a formal coaching and mentoring program, instituting several key improvements to audit process and quality, improving communication with our stakeholders, adopting a revised Agency-wide telework policy, and clarifying the core values that comprise our agency. These teams exemplify DCAA’s commitment to One Agency, and they play a significant, ongoing role in achieving our strategic objectives.

This increased focus on supporting the workforce is having a positive impact on employee satisfaction. One key indicator of our progress is the results of the 2012 Federal Employee Viewpoint Survey conducted by the Office of Personnel Management. This survey is a tool that provides a snapshot of employees’ perceptions of whether, and to what extent, conditions characterizing successful organizations are present in their agencies. DCAA employees gave higher ratings for 71 of the 84 total questions (85 percent) compared to 2011, and in all 6 main categories of questions as shown in Figure 7.

**Figure 7 – Improvements in DCAA Ratings between 2011 and 2012**



The strong results for the questions that measured employee views in the first three categories were especially noteworthy because DCAA was criticized on these aspects of the workplace in the past. They are key elements for overall workforce satisfaction and critical to the Agency’s success in the future. It is clear from this survey that DCAA is making solid improvements across the board. With over 65 percent

of DCAA employees responding to this survey, it provided a broad consensus of agency-wide attitudes. Additionally, these results showed substantial and pervasive improvement from those in a similar survey in 2008, demonstrating the continual progress DCAA has made over the last few years.

DCAA is tasked with a tough and complex mission. The job it is asked to do—amidst competing demands and limited resources—is a difficult, but essential component of the acquisition process. As DoD budgets are increasingly constrained, the warfighter and the taxpayer will be even more reliant on DCAA to help get the best value for the critical equipment and services the Department needs to support our national defense. DCAA cannot do this alone, and it made important strides in 2012 to improve coordination with buying commands and contracting officers. DCAA will continue its commitment to increased communication, a clearer understanding of requirements, and a goal of operating as one government team. Ultimately, DCAA's success depends on the ability to serve its employees. The agency is fortunate to have an exceptional workforce that is dedicated to an important mission. DCAA will continue to seek out workforce feedback—and that of all its stakeholders—to help improve DCAA's service to the warfighter and taxpayer.

## ACRONYMS

|       |   |
|-------|---|
| CAM   | Contract Audit Manual                             |
| CAS   | Cost Accounting Standards                         |
| DAR   | Defense Acquisition Regulation                    |
| DCAA  | Defense Contract Audit Agency                     |
| DCMA  | Defense Contract Management Agency                |
| DFARS | Defense Federal Acquisition Regulation Supplement |
| DoD   | Department of Defense                             |
| FAR   | Federal Acquisition Regulation                    |
| GAGAS | Generally Accepted Government Auditing Standards  |
| NDAA  | National Defense Authorization Act                |
| OCO   | Overseas Contingency Operations                   |



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