

DEFENSE CONTRACT AUDIT AGENCY
Management Discussion and Analysis
FY 2023



A COMMITMENT TO EXCELLENCE

DEFENSE CONTRACT AUDIT AGENCY
FY 2023 MANAGEMENT DISCUSSION AND ANALYSIS

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MESSAGE FROM THE DIRECTOR



I am pleased to present the Defense Contract Audit Agency's Management Discussion and Analysis (MD&A) for FY 2023. Our MD&A provides executive-level information on the Agency's mission and vision, organization and structure, performance results, financial highlights, systems, controls, and legal compliance.

In FY 2023, DCAA realized a return on investment of \$5.1 to each \$1. The Agency examined \$351.8 billion in contract costs, issued 2,312 audit reports, and identified \$3.5 billion in net savings. In FY 2023, DCAA began a concerted effort to examine internal processes to move the Agency forward into a 21st century Audit Agency. These efforts are in two categories, workforce, and audit process, and include eight initiatives. Workforce initiatives focus on personnel processes such as improvements to hiring practices and supervisor training. Audit initiatives include examining our audit programs' relationship to GAGAS and integration of our business information technology systems. The goal of these efforts is to better support our customers with more responsive and flexible audit services. Many of these initiatives will be completed in FY 2024. To manage and synchronize the entire effort, DCAA stood up a Strategic Initiative Group.

In FY 2023, DCAA completed several significant actions. The contract for a new management information system to better plan and manage our audit workload was finalized. This new system is now being configured by the vendor and will be in use across the Agency in FY 2024. DCAA also continued to leverage our Chief Digital and Artificial Intelligence Office (CDAO) to improve the Contractor Submission Portal by automating reminders and connecting to the Defense Contract Management Agency to eliminate redundant processes at the contractor level. The Audit Leveraging Tool, a solution incubated by Operations and crafted in the field, was implemented agency-wide in FY 2023. This tool streamlines the audit process by visualizing audit relationships, thereby eliminating redundancy and maximizing the utilization of completed work. All of these actions will increase the efficiency and effectiveness of the audit process and improve the agility and customer service of DCAA.

DCAA's sound financial management and organizational controls underpin all our mission requirements and contribute to our success. I am pleased to announce that DCAA received its 22nd consecutive unmodified audit opinion on its financial statements reflecting the importance we place in these areas.

Our focus on both mission accomplishment and sound financial management have enabled our success and will continue to do so into the future.

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Terri L. Dilly
Director

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ABOUT DCAA

DCAA's mission is to conduct contract audits and provide accounting and financial advisory services regarding contracts and subcontracts to all DoD Components responsible for procurement and contract administration. DCAA may also provide contract audit services to other federal agencies, as appropriate. DCAA only audits and provides financial information and advice on proposed or existing contracts and contractors; it has no internal audit responsibilities in DoD. DCAA's role in the financial oversight of government contracts is critical to enable DoD to maximize their buying power in defense contracting. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. DCAA has no role in determining which companies are awarded defense contracts.

DCAA's work supports the 2022 National Defense Strategy's key priorities of defending the homeland, deterring strategic attacks and aggression, and building a resilient joint force and defense ecosystem. DCAA audits and financial advisory services enable contracting officials to make necessary investments to deter current and future threats while minimizing the resources required. DCAA's outreach to small business owners strengthens and diversifies the defense ecosystem by enhancing their understanding of requirements and audit processes. Through outreach to industry, we strive to learn their challenges and, when possible, ease the burden of defense contracting.

DCAA has been performing this important mission, to provide cost oversight of Defense contractors, since its founding in 1965. Over the years, the Agency has transformed based on changes in contracting guidance, the contractor base, and technology but maintained its focus on the mission. The Agency's contract audits and advisory services are independent, professional reviews of financial representations made by defense contractors, and DCAA helps determine whether contract costs are allowable, allocable, and reasonable.

OVERVIEW

Mission

Together with our acquisition partners, we increase warfighter capabilities by delivering high quality audits and financial services to achieve fair and reasonable prices that protect taxpayer dollars. Our mission statement clarifies our commitment to getting the most value for every dollar spent on defense contracts. We operate as a member of the acquisition community that works together to equip and serve our service members in uniform. As stewards of taxpayers' interests, we conduct high-quality contract audit services to enable DoD to maximize their buying power in defense contracting.

Organization and Staffing

Organizational Structure. DCAA's organizational structure consists of a Headquarters, four Corporate Audit Directorates organized by major contractors, three geographical Regions primarily focused on other large, mid-sized, and small contractors, and a Field Detachment focused on classified work. DCAA has about 230 offices located throughout the United States, Europe, and the Middle East.

Headquarters is located at Fort Belvoir, Virginia. Principal elements are the Director, Deputy Director, General Counsel, Office of Inspector General, Operations Directorate, Policy and Quality Directorate, and Human Capital and Resource Management Directorate.

Regional Offices/Field Detachment are in Smyrna, Georgia; Irving, Texas; Lone Tree, Colorado; and Reston, Virginia. Each region directs and administers the DCAA audit mission at locations near the contractor base. Each region is staffed with about 600 employees and serves 1,200 to 1,800 contractors. Regions are structured with subordinate branch offices, strategically located to provide audit coverage within their assigned geographical areas. The Field Detachment has nearly 475 employees to serve 600 contractors.

Corporate Audit Directorates (CAD) are in Lowell, Massachusetts (General Dynamics/RTX); McLean, Virginia (Northrop Grumman); St. Louis, Missouri (Boeing); and Irving, Texas (Lockheed Martin/BAE). Each CAD is staffed with about 300 employees that serve their designated major defense contractors.

Resident offices are established at specific contractor locations of both regions and CADs where the 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 the government buys from.

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

Defense Contract Audit Institute, located in Atlanta, Georgia, provides specialized contract audit training for DCAA's audit staff, and leadership and interpersonal skills training to new supervisors and other Agency employees.

DCAA's Professional Workforce. For FY 2023, DCAA had 4,030 authorized personnel. About 88 percent of DCAA employees are auditors and 12 percent are professional support staff in various fields, including administrative support, budget, human resources, information technology, and legal support. Roughly 92 percent of employees have a bachelor's degree, with 45 percent having a master's or higher-level degree. In addition, 26 percent of the workforce have a professional certification such as Certified Public Accountant (CPA), Certified Fraud Examiner (CFE), Certified Internal Auditor (CIA), or Certified Information Systems Auditor (CISA).

Management Initiatives

To help ensure the quality and efficiency of audit operations DCAA routinely reviews and updates, as necessary, DCAA issued guidance. In 2023, DCAA updated guidance on real-time audits of labor and purchase existence and consumption (formerly known as Mandatory Annual Audit Requirements 6 and 13) and on audits of forward pricing proposals and forward pricing rate proposals. Additionally, DCAA updated guidance relating to audits of incurred cost, Cost Accounting Standards, terminations, Requests for Equitable Adjustment, contractor business systems, and Truth in Negotiations. In accordance with the 2018 NDAA, DCAA awarded 124 audits to Independent Public Accounting firms.

DCAA continued its digital transformation journey with a series of initiatives designed to improve operational efficiency and enhance customer experience. The organization migrated a significant portion of its IT infrastructure to cloud-based platforms. This transition resulted in reduced on-premises hardware and maintenance costs, with the added benefit of scalability and flexibility to adapt to changing business needs. The agency enhanced its already robust data analytics capabilities with the implementation of centralized data models. DCAA created an internal Chief Digital and Artificial Intelligence Office (CDAO). The CDAO is responsible for capability exploration, digital optimization and governance, and enterprise platforms. In its inception year, the CDAO developed custom applications to optimize business processes; designed a data governance program; and automated processes to streamline audit communications, gather and present customer feedback, and perform system maintenance and quality checks for its audit management software. Together, these projects have significantly improved our ability to engage and serve our stakeholders.

DCAA's aim is to continue providing contracting officers with high-quality and timely audit reports, advice, and negotiation support to establish fair and reasonable contract prices. During contract performance, DCAA auditors continue to verify that results and outputs of contractor business systems comply with applicable rules, regulations, and contract terms.

PERFORMANCE

Strategic Plan

DCAA's 2021-2025 Strategic Plan has three goals focused on strengthening alliances with our customers and strategic partners, delivering flexible and responsive products and services to our customers; and recruiting, cultivating, and retaining a highly skilled, flexible, and empowered workforce. This plan acknowledges the ever changing budgetary and security landscape that demands we operate at peak efficiency to reduce the cost of acquisition while increasing speed to ensure our warfighters get what they need when they need it. In FY 2023, Agency executives conducted a holistic review of the Agency to identify strengths, weaknesses, opportunities, and threats, which led to the development of many new initiatives. Eight of these initiatives were prioritized and are now being worked with the goal of completing in FY 2024.

Goals, Objectives, and Results

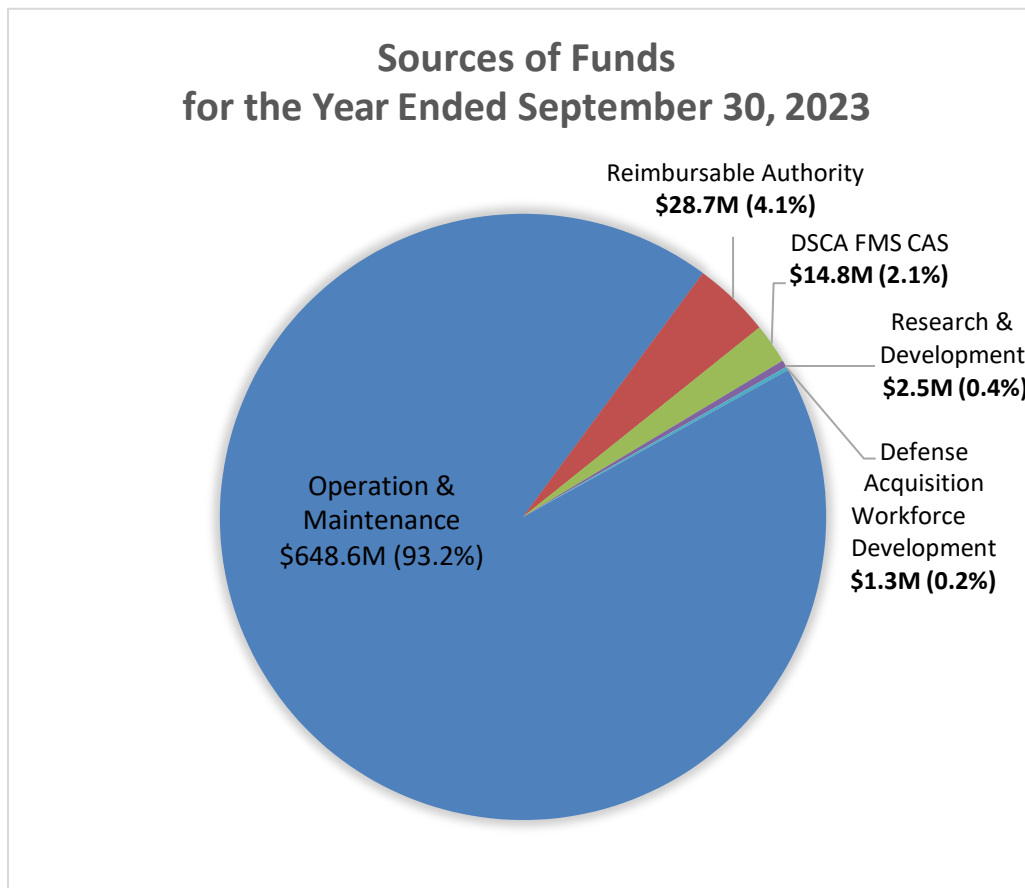
During FY 2023, DCAA examined \$351.8 billion on 2,312 audit reports issued, identified \$3.5 billion in net savings, and produced a return on investment of about \$5.1 per \$1 spent. Although there are no specific goals for savings and return on investment, the results provide a significant indication of the value of DCAA's audit services to the U.S. taxpayer.

DCAA met the statutory requirement to complete incurred cost audits within one year of submission and continues to find ways of being more efficient in executing these audits. The Agency also placed special emphasis in Forward Pricing Audits.

FINANCIAL

Appropriated Funding

DCAA has five sources of appropriated funding that include Operation and Maintenance (O&M); Research and Development (R&D); Defense Acquisition Workforce Development (DAWD); Defense Security Cooperation Agency (DSCA) direct funding; and reimbursable funding provided by non-defense agencies. The total allocated funding for FY 2023 was \$696.1M.



O&M appropriation pays for goods and services used during the normal course of business in the fiscal year appropriated. Examples of expenses include civilian salaries and benefits, recruiting, training and education, travel, information technology, leased office space, and business assets.

R&D appropriation finances research, development, test, and evaluation efforts performed by contractors in the development of equipment, material, or computer application software. This includes services, equipment, components, materials, end items and weapons used in such efforts.

DAWD appropriation is used to recruit and train acquisition personnel. This appropriation is part of the Office of the Under Secretary of Defense for Acquisition and Sustainment [OUSD (A&S)] financial reporting and is not shown on DCAA's financial statements. The DAWDA appropriation has been a valuable program for DCAA, allowing us to grow, train, and sustain the audit workforce.

DSCA's appropriated funds are provided directly to DCAA to pay for Foreign Military Sales (FMS) Contract Audit Support (CAS) work accomplished by the Agency.

Reimbursable work is paid by non-DoD agencies for DCAA's audit services. DCAA's largest customers include Foreign Military Sales, Department of Energy, NASA, Department of State, and Department of Homeland Security.

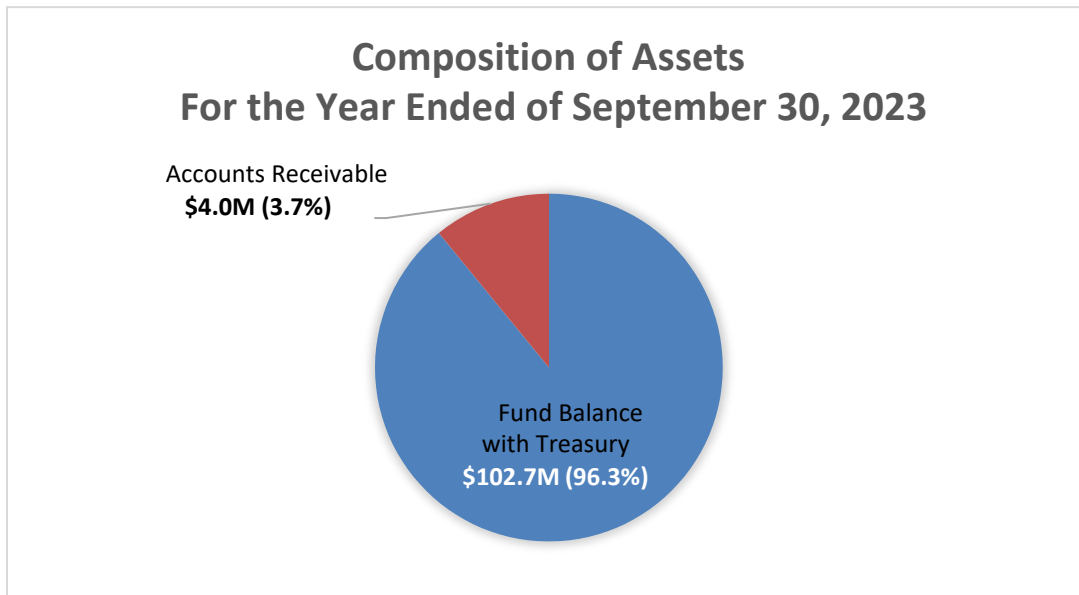
Analysis of the Financial Statements

The following tables and graphs summarize information regarding the financial statements.

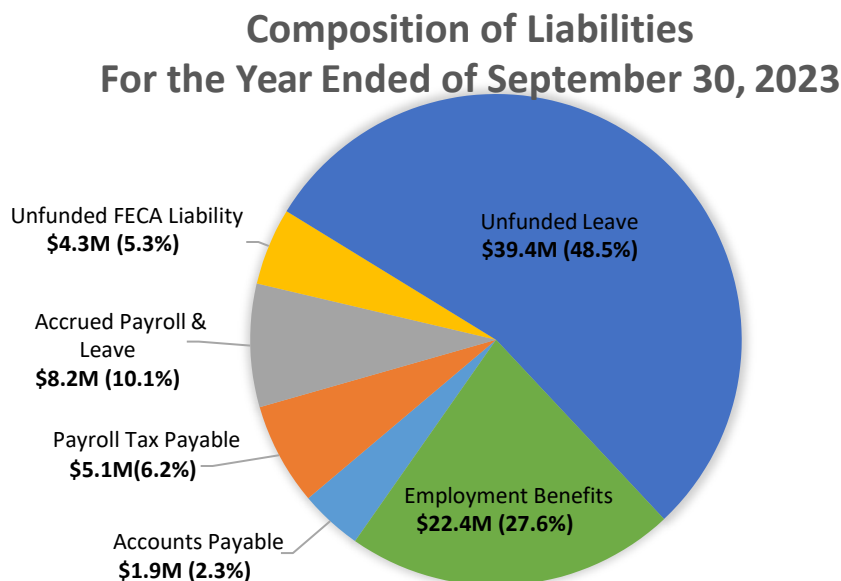
The Balance Sheet presents the total amounts available for use by DCAA (assets) against the amounts owed (liabilities) and amounts that comprise the difference (net position). DCAA's total assets are largely composed of Fund Balance with Treasury (FBwT) and accounts receivable. Below is a list of DCAA's major balance sheet categories as of September 30, 2023, September 30, 2022, and a comparison between the two.

	FY 2023	FY 2022	\$ Change
Assets			
Fund Balance with Treasury	\$102.7	\$78.3	\$24.4
Accounts Receivable	<u>4.0</u>	<u>8.2</u>	<u>(4.2)</u>
Total Assets	\$106.7	\$86.5	\$20.2
Liabilities			
Accounts Payable	\$ 1.9	\$ 3.0	(\$ 1.1)
Employment Benefits	22.4	15.8	6.6
Accrued Payroll & Leave	8.2	5.9	2.3
Payroll Tax Payable	5.1	4.9	0.2
Unfunded FECA Liability	4.3	3.7	0.6
Unfunded Leave	<u>39.4</u>	<u>39.5</u>	<u>(0.1)</u>
Total Liabilities	\$ 81.3	\$72.8	\$ 8.5

DCAA's Assets of \$106.7 million are comprised of the FBwT and Accounts Receivable. This amount is \$20.2 million more than last year's balance. \$24.4 million of this change is attributed to an increase in FBwT. It is funding available from which DCAA is authorized to make expenditures and pay amounts through appropriations.



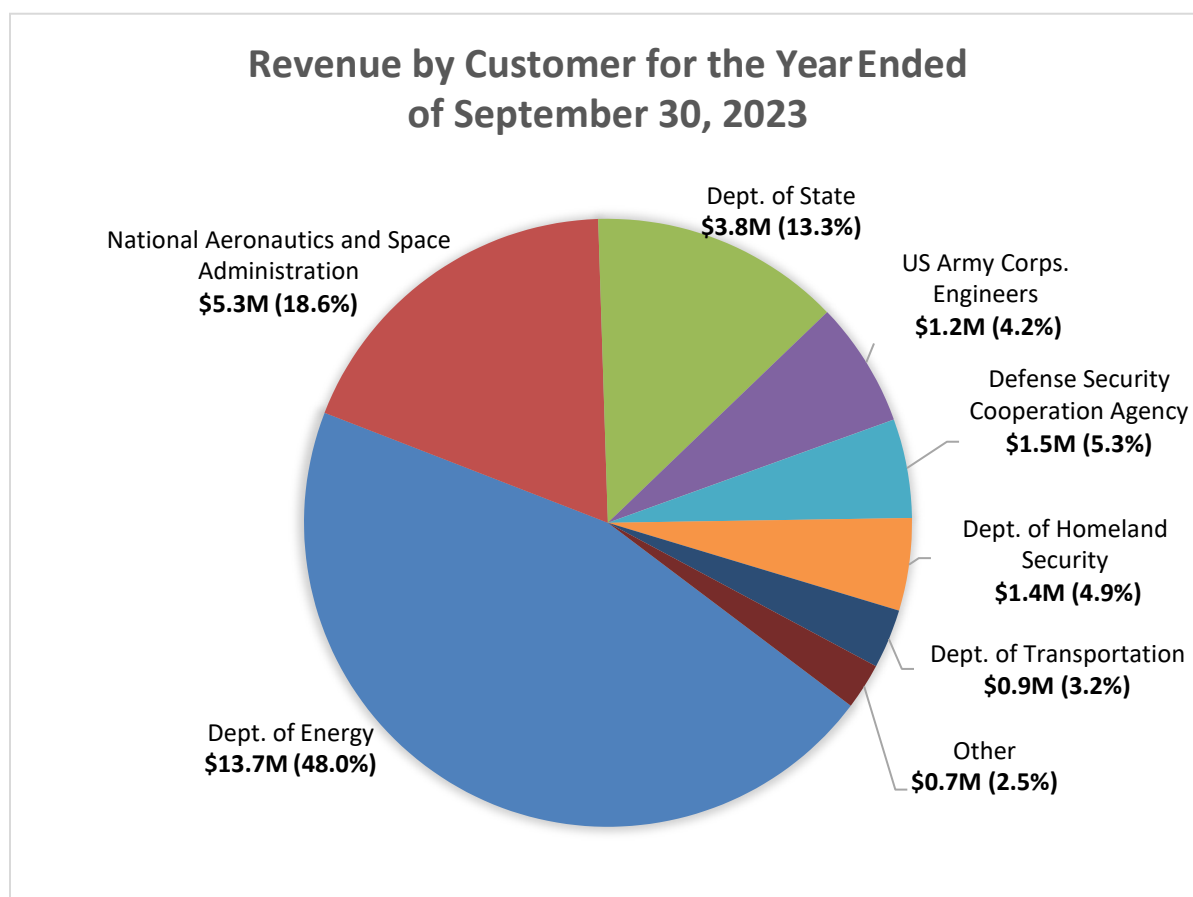
DCAA's Liabilities of \$81.3 million are classified as either funded (covered by current budgetary resources) or unfunded (covered by future budgetary resources). Funded liabilities include employer contributions to employee benefits, accounts payable, payroll taxes payable, and current accrued payroll. Unfunded liabilities consist primarily of employment benefits, estimated future Federal Employment Compensation Act (FECA) liabilities, and leave earned but not yet taken. DCAA's total liabilities increased by \$8.5 million.



The Consolidated Statement of Net Cost presents the annual costs of operating programs. The net cost of each specific program's operation equals the program's gross costs less any earned revenue. The following table presents DCAA's major cost categories for the fiscal years ended September 30, 2023, and September 30, 2022.

	FY 2023	FY 2022	\$ Change
Gross Costs			
Personnel Payroll	\$404.6	\$401.4	\$ 3.2
Personnel Benefits	179.0	144.8	34.2
Purchased Goods & Services	97.3	73.7	23.6
FECA Tax	<u>29.0</u>	<u>29.8</u>	<u>(0.8)</u>
Total Gross Costs	\$709.9	\$649.7	\$60.2
Less: Earned Revenue	(28.5)	(23.8)	4.7
Net Cost of Operations	\$681.4	\$625.9	\$55.5

The graph below shows DCAA's FY 2023 revenue by customer.



The following table presents comparative data for the Net Position and Results of Operations as of September 30, 2023, and September 30, 2022.

Change in Net Position and Cumulative Results of Operations
\$ in millions

	FY 2023	FY 2022	\$ Change
Unexpended Appropriations	\$ 92.4	\$ 73.7	\$ 18.7
Cumulative Results of Operations	<u>(67.0)</u>	<u>(60.0)</u>	<u>7.0</u>
<i>Net Position:</i>	\$ 25.4	\$ 13.7	\$ 11.7
Operations Beginning Balances	(\$ 60.0)	(\$ 55.3)	\$ 4.7
Financing Sources	674.4	621.2	53.2
Net Cost of Operations	681.4	625.9	55.5
Net Change	<u>(7.0)</u>	<u>(4.7)</u>	<u>2.3</u>
<i>Cumulative Results of Operations:</i>	(\$ 67.0)	(\$ 60.0)	\$7.0

Net Position represents the difference between assets and liabilities. Changes in the net position result from changes that occur within the Cumulative Results of Operations and Unexpended Appropriations. Unexpended appropriations represent the number of undelivered orders and unobligated balances of budgetary authority. Our net position increased by \$11.7 million; from \$13.7 million in FY 2022 to \$25.4 million in FY 2023. The increase is attributed to \$18.7 million change in unexpended appropriation and offset by decreases of \$7.0 million change in cumulative results of operations when compared to September 30, 2022.

Cumulative Results of Operations represent the net difference between expenses and losses, and financing sources (including appropriations used, imputed financing, transfer in/out, and other adjustments), since inception. DCAA had Financing Sources of \$674.4 million and a Net Cost of Operations totaling \$681.4 million. The Net Cost of Operations includes accrued expenses for annual leave liability, personnel benefits liability, and actuarial liability; Future appropriations will fund these liabilities. The Net Change was \$7.0 million, which is the difference between the Financing Sources and the Net Cost of Operations.

DCAA's Net Cost of Operations represents the difference between the costs incurred by our programs less associated revenues. We receive our funding through Congressional Appropriations and reimbursement for services provided to other federal agencies. Our Net Cost of Operations for the year ended September 30, 2023, totaled \$681.4 million. The FY 2023 Net Cost of Operations is \$55.5 million more than the FY 2022 Net Cost of Operations. The majority (82.2 percent) of FY 2023 annual net costs relate to Personnel Compensation (\$388.3 million) and Benefits (\$171.8 million).

Limitations of the Financial Statements

The Defense Finance and Accounting Service (DFAS), in collaboration with DCAA, prepares DCAA's financial statements. The principal financial statements report the Agency's financial position and results of operations, pursuant to the requirements of 31 U.S.C. 3515 (b). DFAS prepares the statements from the Agency's financial records in accordance with OMB Circular No. A-136 and uses generally accepted accounting principles for Federal entities. The statements are also used to monitor and control budgetary resources. The statements should be read with the understanding that they are for a component of the U.S. Government.

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

DCAA uses an enterprise resource planning system, Defense Agencies Initiative (DAI), and DFAS prepared DCAA's financial statements based on data entered in DAI. Departments and agencies under the Executive Branch did not produce annual financial statements until required by the Chief Financial Officers (CFO) Act of 1990.

The Federal Financial Management Improvement Act (FFMIA) of 1996 requires that audit reports state whether Agency financial management systems comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. Federal agencies must fully disclose financial data, including the costs of Federal programs and activities. DCAA continues to develop and implement improved business processes that support the accuracy and auditability of its financial statements.

DCAA's accounting system is adequate to ensure transactions are executed in accordance with applicable appropriations statutes. Reasonable assurance is provided to ensure that assets are properly acquired, used, and safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud.

Management Assurance

In its Annual Statement of Assurance (SoA) for FY 2023, DCAA provided reasonable assurance to the Secretary of Defense that the Agency's internal controls met the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982.

The Agency has a rigorous system of internal financial and administrative controls to ensure effective management of the Agency's resources. This system provides the reasonable assurance required to certify that the objectives of the FMFIA are achieved. The FMFIA requires federal agencies to assess the effectiveness of internal controls for program, operational, and administrative areas, as well as accounting and financial management.

As an audit organization, DCAA is aware of the importance of management internal controls. As part of its quality control process, DCAA performed specific reviews during the past year to evaluate the adequacy and consistency in implementing audit and procedural guidance. Other

objectives of these reviews include identifying areas requiring additional policy coverage and determining the adequacy of existing coverage.

Internal Control Assessment and Results

DCAA continued to evaluate its system of internal accounting and administrative controls in effect during the fiscal year ending September 30, 2023, in accordance with the guidance in OMB Circular No. A-123, Management's Responsibility for Enterprise Risk Management and Internal Control. The objectives of the system of internal accounting and administrative controls for DCAA are to provide reasonable assurances for:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations, and
- Financial information systems compliance with the FMFIA.

DCAA and DFAS assessed internal control effectiveness over financial reporting according to the OMB Circular No. A-123, Appendix A, Management of Reporting and Data Integrity Risk, for the following:

- Fund Balance with Treasury
- Accounts Receivable
- Accounts Payable
- Government Purchase Card Program
- Financial Statement Compilation
- Federal Employees' Compensation Act Liabilities
- Government Travel Card Program
- Property Management Procedures
- Other Liabilities
- Appropriations Received
- Payroll

Financial reporting is not limited to financial statement reporting. Circular No. A-123, Appendix A, included within the definition of "financial reporting" other significant internal and external financial reports that could materially affect spending, budgetary, or other financial decisions. Appendix A prescribed a process for assessing internal controls over financial reporting. The process included:

- Evaluating internal controls by understanding management's attitude, awareness, and actions to include:
 - Integrity and ethical standards,
 - Commitment to competence,
 - Management philosophy,
 - Organizational structure, and
 - Assignment of authority and responsibility.

- Evaluating internal controls at the process, transaction, and application levels and obtaining knowledge of the organization's key processes by:
 - Performing process risk assessments regarding financial assertions of completeness, obligations and rights, valuation, existence, and occurrence, reporting and presentation, compliance with laws and regulations, and safeguarding of assets from fraud, waste, and abuse.
 - Identifying existing key controls intended to mitigate identified risk.
 - Assessing data quality in accordance with Digital Accountability and Transparency Act (DATA Act)
 - Assessing and testing the design and operation of internal controls over financial reporting; and,
 - Issuing an Annual Statement of Assurance on Internal Control over Reporting - Financial Reporting (ICOR-FR) as a subset of the Annual Federal Managers' Financial Integrity Act Statement of Assurance.

We conducted separate tests to assess the effectiveness of internal controls. No material weaknesses surfaced in the design or operation of the internal controls. DCAA reported an unmodified statement of assurance for internal controls over non-financial operations and integrated financial management systems in its annual FMFIA SoA.

The concept of reasonable assurance recognizes that (1) the cost of internal controls should not exceed the benefits expected to be derived and (2) the benefits include reducing the risks associated with failing to achieve the stated objectives. However, errors or irregularities may occur but remain undetected because of inherent limitations in any system of internal accounting and administrative control. These include limitations resulting from resource constraints, Congressional restrictions, and other factors.

Our evaluation of internal control processes relied on several sources, including internal reviews and an audit by an external firm. The best evidence of our success in institutionalizing internal controls comes from the fact that DCAA has earned 22 consecutive "unmodified opinions" on our financial statements from independent public auditors. DCAA had no Anti-Deficiency Action (ADA) violations for FY 2023, and no incomplete corrective actions from a prior year.

As the Department faces decreasing budgets, DCAA will continue to be an essential component for getting the best value for every dollar spent to protect the taxpayer and support our warfighters. Our strategic outlook is solid, and our central focus remains on delivering the highest quality products, serving our customers, and supporting our workforce.