

DEFENSE CONTRACT AUDIT AGENCY
Management Discussion and Analysis
FY 2017



A COMMITMENT TO EXCELLENCE

DEFENSE CONTRACT AUDIT AGENCY
FY 2017 MANAGEMENT DISCUSSION AND ANALYSIS

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MESSAGE FROM THE DIRECTOR

I am pleased to present the Defense Contract Audit Agency's (DCAA) Management Discussion and Analysis for the fiscal year (FY) 2017. DCAA's mission is to provide audit and financial advisory services to Department of Defense (DoD) and other federal entities responsible for acquisition and contract administration. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

The Management Discussion and Analysis provides executive-level information on the Agency's mission and vision, organization and structure, performance results, financial highlights, system control and legal compliance. We accomplish these in an effective and efficient manner through continuous process improvement.

The DCAA team is committed to organizational excellence and sound financial management. I am pleased to report that DCAA received its 16th consecutive unmodified audit opinion on its financial statements. These audit results not only show that DCAA's financial statements are a reliable reflection of the Agency's financial position, but are also an integral component of the Agency's annual Statement of Assurance.

Anita F. Bales
Director

ABOUT DCAA

Prior to 1965, each branch of the military had separate contract audit functions and regulations. Contractor and government personnel recognized the need for consistency, and Secretary of Defense, Robert S. McNamara instituted “Project 60” in May 1962, to examine whether it was feasible to centrally manage contract administration and audit activities. An outcome of this study was the decision to establish a single contract audit capability – the “Defense Contract Audit Agency.” DCAA began providing audit and financial advisory services to government contract officials on July 1, 1965.

The Agency’s primary function is to conduct contract audits and related financial services for the Department of Defense and other federal entities responsible for acquisition and contract administration. Specifically, DCAA helps determine whether costs are allowable, allocable, and reasonable. DCAA provides recommendations to government officials on contractor cost assertions for specific products and services. With these recommendations, contracting officers are better able to negotiate prices and settle contracts for major weapons systems, services, and supplies.

OVERVIEW

Mission

As a key member of the government acquisition team, we are stewards of taxpayer dollars who deliver high quality contract audits and services to ensure that warfighters get what they need at fair and reasonable prices. 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.

Organization and Structures

In FY 2017, we realigned 337 offices throughout the United States, Europe, the Middle East and Asia to a new organizational structure. Our new structure has four Corporate Audit Directorates organized by major contractors, three geographical regions primarily focused on small and midsized contractors, and a field detachment focused on classified work.

Headquarters is located at the Andrew T. McNamara Headquarters Complex, Fort Belvoir, Virginia. Principal elements of Headquarters are the Director, Deputy Director, General Counsel, Office of Inspector General, and the Assistant Directors for Operations, Policy and Plans, Integrity and Quality Assurance, and Human Capital and Resource Management.

Regional offices are located in Smyrna, Georgia; Irving, Texas; and La Palma, California. The Field Detachment is located in Reston, Virginia. Each region is staffed with 800 to 1,000 employees to serve 2,000 to 3,000 contractors. The field detachment has 400 employees to serve 750 contractors.

Corporate Audit Directorates (CADs) are located in Lowell, Massachusetts; McLean, Virginia; St. Louis, Missouri; and Fort Worth, Texas. Each CAD directs and administers the DCAA mission at select major defense contractors.

Branch Offices are strategically located within the regions and are responsible for the majority of contract audit services within their assigned geographical areas. Branch offices often have smaller suboffices to ensure adequate audit coverage.

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 largest major industrial manufacturers that the Government buys from, such as Lockheed Martin, Dyncorp, and General Dynamics.

Liaison auditors provide assistance to acquisition, contract administration, and contract audit personnel for DoD and non-DoD procurement or contract administration offices. Some auditors provide financial advisory service at select procurement offices. This service improves the quality of audit information for decision-makers by providing confidence about the reliability and relevance of financial information.

DCAA assists acquisition personnel by:

- Evaluating contractor submitted forward pricing proposals;
- Providing contracting officers with accounting and financial advisory services useful to negotiations;
- Verifying the propriety and acceptability of costs charged by contractors to flexibly priced government contracts; and,
- Deterring inefficient contractor practices through detection and correction, preventing excessive costs and contract prices.

The Defense Contract Audit Institute (DCAI) 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 is comprised of nearly 4,800 highly qualified employees. Approximately 89 percent of DCAA employees are auditors, and the remaining 11 percent work in a variety of occupations including administrative support, accounting, budget, human resources, security, information technology, and legal. Approximately 93 percent have a bachelor's degree and 42 percent have an advanced degree. In addition, about 29 percent are Certified Public Accountants or Certified Fraud Examiners.

Management and Performance Challenge

To help ensure the quality and efficiency of audit operations, DCAA issued additional guidance on low risk incurred cost process, final voucher reviews, advisory services and the requirement for prime contractors to perform cost and price analysis. Additional training was given to the workforce pertaining to judgmental selections and statistical sampling, commercial item acquisitions, the cost monitoring process, fixed-price incentive contracts, and negotiation

memorandums. DCAA also created adequacy tools for auditors used when engaged to perform terminations audits.

DCAA's aim is to continue to provide 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

The 2016-2020 strategic plan outlines several efficiencies and important changes to deliver a higher level of customer service, greater audit efficiencies, and a clear commitment to the one government team. During 2017, we completed six initiatives under four goals dealing with communication strategy, centralization, succession plan, and developmental opportunities among others. We also assigned new champions on three initiatives dealing with delivering quality products, engagement with industry and knowledge sharing.

Goals, Objective, and Results

During FY 2017, DCAA examined \$281.0 billion in contract costs, issued 3,452 audit reports, continued to focus on incurred cost work, identified \$3.5 billion in net savings, and produced a return on investment of about \$5.2 to \$1. Although there are no specific goals for savings and return on investment, the results do provide indicators of the value of DCAA audit services to the U.S. taxpayer.

FINANCIAL

Appropriated Funding

DCAA has four sources of funding. Appropriated funds are comprised of an Operation and Maintenance (O&M) Fund, Procurement Fund, and Defense Acquisition Workforce Development Fund (DAWDF). Additionally, DCAA has reimbursable funding authority. Reimbursement revenue supplements the O&M Fund.

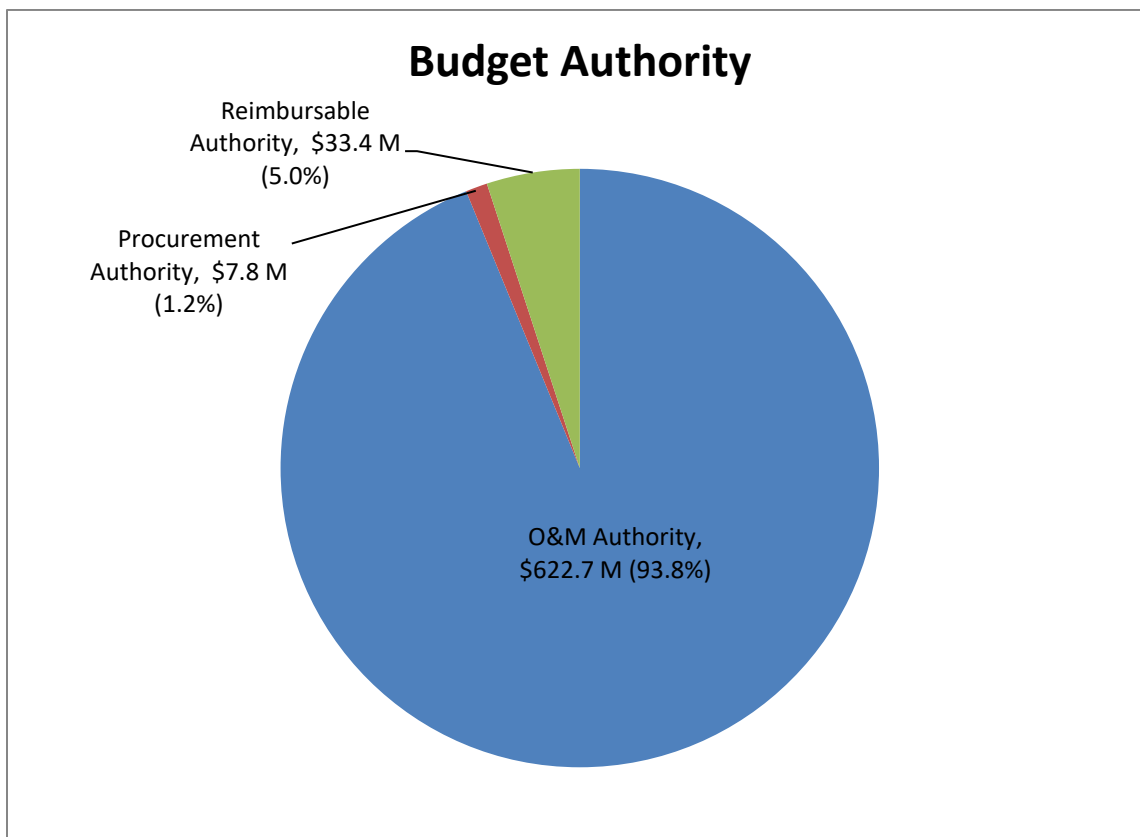
O&M funds pay for goods and services used during the normal course of business in the fiscal year appropriated. Examples of expenses include civilian salaries and benefits, travel, information technology, leased office space, training and education, recruiting, and business assets. The FY 2017 O&M funding of \$622.7 million was \$32.7 million or 5.5% above the prior year level.

Reimbursable funds are paid by non-DoD agencies for DCAA audit services. The Office of under Secretary of Defense, Comptroller (OUSDC) sets reimbursable authority annually.

DCAA executed \$32.3 million in FY 2017 reimbursable authority which was \$33.4 million or negative 4.1% below prior year level.

Procurement funds pay for mission essential and automated data processing equipment. DCAA typically uses procurement funds for high-dollar network and information technology components. In FY 2017 procurement funding was \$7.8 million.

DAWDF funds are used to recruit and train acquisition personnel. The Office of the Under Secretary of Defense for Acquisition, Technology and Logistics [OUSD (AT&L)] provided DAWDF funding of \$16.5 million. These funds are part of OUSD (AT&L)'s financial reporting and not shown on DCAA's financial statements. The DAWDF funding has been a valuable program for DCAA, allowing us to grow, train, and sustain the audit workforce.



Analysis of the Financial Statements

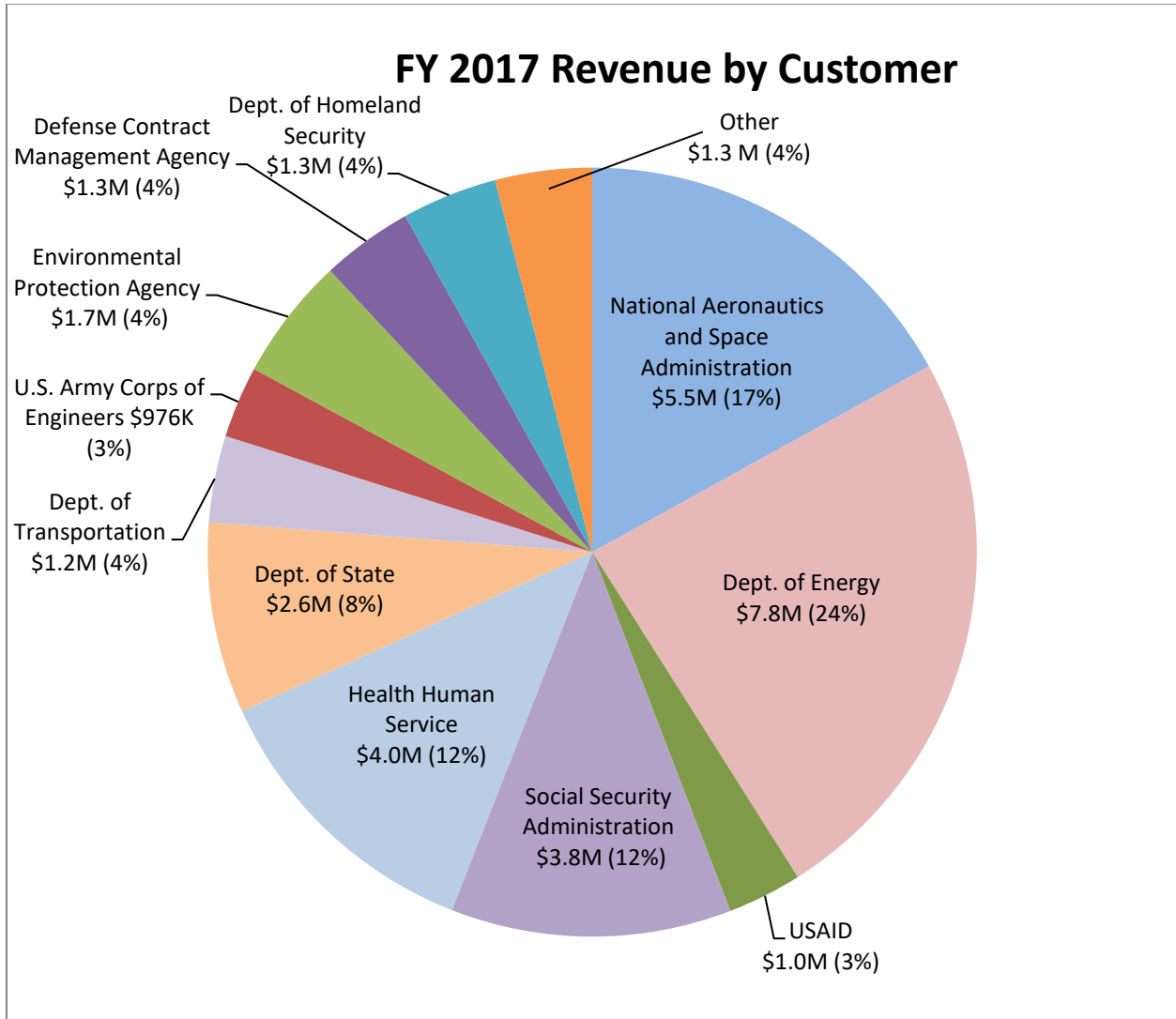
The following tables and graphs summarize information about the Agency's financial condition.

The Consolidated Statement of Net Cost presents the annual costs of operating programs. The net cost of each specific program operation equals the program's gross costs less any earned revenue. Section 893 of the 2016 National Defense Authorization Act (NDAA) prohibited DCAA from providing audit support to non-Defense Agencies/reimbursable customers. This mandate has affected a decrease in DCAA reimbursable revenue. The following table presents

DCAA's major cost categories for the fiscal years ended September 30, 2016 and September 30, 2017.

| Consolidated Statement of Net Cost | | | | |
|---|----------------|----------------|-----------------|----------------|
| \$ in millions | | | | |
| | FY 2017 | FY 2016 | Dollar Change | % Change |
| Gross Costs | | | | |
| Personnel Payroll | \$392.7 | \$397.4 | (\$ 4.7) | (1.2%) |
| Personnel Benefits | 127.8 | 135.6 | (7.8) | (5.8%) |
| Purchased Goods & Services | 87.2 | 72.1 | 15.1 | 20.8% |
| FECA Tax | 27.6 | 27.7 | (0.1) | (0.2%) |
| Total Gross Costs | \$635.3 | \$632.8 | \$ 2.5 | 0.4% |
| Less: Earned Revenue | (\$ 32.3) | (\$ 26.9) | (\$ 5.4) | 20.1% |
| Net Cost of Operations | \$603.0 | \$605.9 | (\$ 2.9) | (0.5%) |

The graph below shows DCAA’s FY 2017 earnings by major customer.



The Consolidated Balance Sheet provides a snapshot in time, descriptions of Agency “assets,” “liabilities,” and the difference, which is known as “net position.” Below is a list of DCAA’s major balance sheet categories as of September 30, 2017, September 30, 2016, and a comparison between the two.

Consolidated Balance Sheet as of September 30, 2017
\$ in millions

| | FY 2017 | FY 2016 | \$ Change | % Change |
|----------------------------|----------------|----------------|------------------|-----------------|
| Assets | | | | |
| Fund Balance with Treasury | \$145.0 | \$ 95.3 | \$ 49.7 | 52.2% |
| Accounts Receivable | 5.2 | 3.9 | 1.3 | 33.3% |
| Other Assets | <u>0.1</u> | <u>2.7</u> | <u>(2.6)</u> | <u>(96.3%)</u> |
| Total Assets | \$150.3 | \$101.9 | \$ 48.4 | 47.5% |

Liabilities

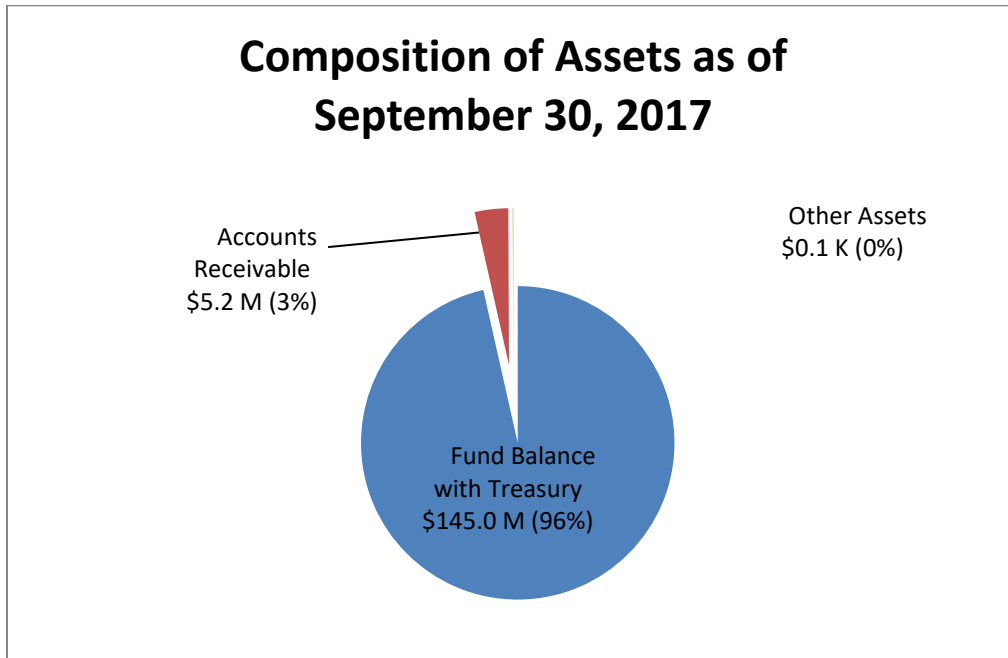
| | | | | |
|--------------------------|----------------|----------------|---------------|-------------|
| Employment Benefits | \$ 17.6 | \$ 18.5 | (\$ 0.9) | (4.9%) |
| Accrued Payroll & Leave | 16.6 | 16.0 | 0.6 | 3.8% |
| Payroll Tax Payable | 3.4 | 3.2 | 0.2 | 6.2% |
| Accounts Payable | 12.3 | 6.5 | 5.8 | 89.2% |
| Unfunded FECA Liability | 4.0 | 4.2 | (0.2) | (4.8%) |
| Unfunded Leave | <u>38.6</u> | <u>38.1</u> | <u>0.5</u> | <u>1.3%</u> |
| Total Liabilities | \$ 92.5 | \$ 86.5 | \$ 6.0 | 6.9% |

Net Position

| | | | | |
|----------------------------------|----------------|----------------|---------------|----------------|
| Unexpended Appropriations | \$ 99.4 | \$ 57.4 | \$42.0 | 73.2% |
| Cumulative Results of Operations | <u>(41.6)</u> | <u>(42.0)</u> | <u>0.4</u> | <u>(1.0%)</u> |
| Total Net Position | \$ 57.8 | \$ 15.4 | \$42.4 | 275.3% |

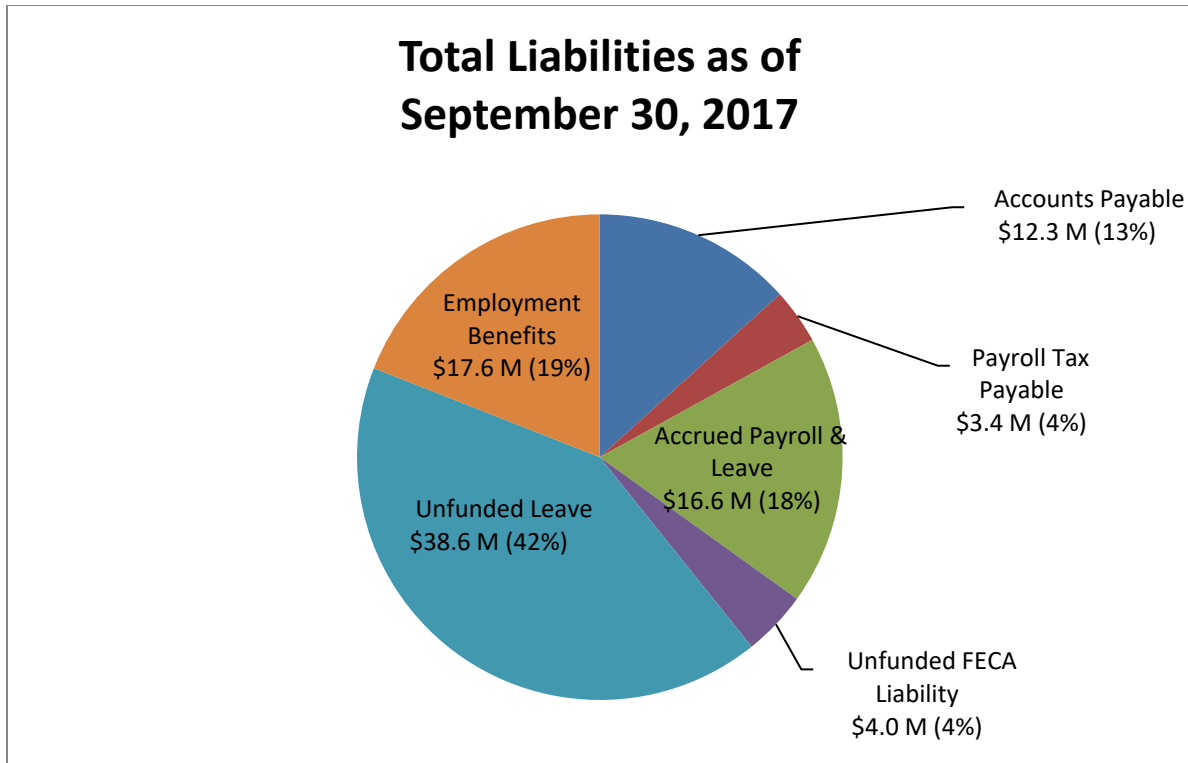
* Numbers may not be exact due to rounding.

DCAA's Assets of \$150.3 million are comprised of the Fund Balance with Treasury (FBWT), Accounts Receivable (AR), and "Other" Assets. This amount represents an increase of \$48.4 million or 47.5 percent greater than last year's balance. The increase is attributed to a \$44.6 million increase in appropriations received; a \$5.1 million change in cancelling appropriations; an increase of \$1.3 million account receivable; and offset by a decrease of \$2.6 million in advance payment for the purchase of assets.



* Numbers may not be exact due to rounding.

DCAA’s Liabilities of \$92.5 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 accrued leave. DCAA’s total liabilities increased by \$6.0 million.



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 amount of undelivered orders and unobligated balances of budgetary authority. Our net position increased by \$42.4 million, from \$15.4 million in FY 2016 to \$57.8 million in FY 2017. The increase is attributed to \$42.0 million increase in unexpended appropriation and an increase of \$0.4 million in cumulative results of operations when compared to September 30, 2016.

The Cumulative Results of Operations are presented in the Consolidated Statements of Changes in Net Position. DCAA had Financing Sources of \$626.2 million and Net Cost of Operations of \$605.9 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 of Cumulative Results of Operations was \$20.3 million, which is the difference between the Financing Sources and the Net Cost of Operations.

The following table presents comparative data for the Net Position and Results of Operations as of September 30, 2017 and September 30, 2016.

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

| | FY 2017 | FY 2016 | % Change |
|--|------------------|------------------|-----------------|
| Unexpended Appropriations | \$ 99.4 | \$ 57.4 | 73.2% |
| Cumulative Results of Operations | <u>(41.6)</u> | <u>(42.1)</u> | <u>(1.0%)</u> |
| Net Position: | \$ 57.8 | \$ 15.3 | 276.7% |
| | | | |
| Operations Beginning Balances | (\$ 42.0) | (\$ 62.3) | (32.5%) |
| Financing Sources | 603.4 | 626.2 | (3.6%) |
| Net Cost of Operations | 603.0 | 605.9 | (0.5%) |
| Net Change | <u>0.4</u> | <u>20.3</u> | <u>(97.9%)</u> |
| Cumulative Results of Operations: | (\$ 41.6) | (\$ 42.0) | (1.0%) |

Our 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 the provision of goods and services to other federal agencies. Our Net Cost of Operations for the year ended September 30, 2017, totaled \$603.0 million.

The FY 2017 Net Cost of Operations represents a decrease of \$2.9 million or 0.5 percent less than the FY 2016 Net Cost of Operations. Majority (81.9 percent) of FY 2017 annual net costs relates to Personnel Compensation (\$372.7 million) and Benefits (\$121.3 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 books and records in accordance with OMB Circular No. A-136 to the extent possible, using generally accepted accounting principles for Federal entities. The statements also are used to monitor and control budgetary resources, which are part of the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government.

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

DFAS prepares DCAA's financial statements based on data entered into the Defense Business Management System (DBMS), a legacy accounting system. The DoD legacy accounting systems track budget execution; they are not designed to capture the information necessary to create financial statements. Departments and agencies under the Executive Office 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, among other things, that audit reports state if 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. DoD and DFAS have developed long-term strategies to replace legacy accounting systems such as DBMS. DCAA will convert to a new enterprise resource planning system, Defense Agencies Initiative (DAI) in FY 2018. DCAA is committed to implementing 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 budgetary and financial laws. 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 2017, DCAA provided reasonable assurance to the Secretary of Defense; internal controls met the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 (Public Law 104-208).

The Agency has a rigorous system of internal financial and administrative controls to ensure effective management of Agency 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 audit, DCAA made specific reviews and field visits during the past year to evaluate adequacy and consistency in the implementation of audit and procedural guidance. Other objectives of these reviews include identifying areas requiring additional policy coverage and determining the adequacy of existing coverage.

Individual assurance statements from each Regional Director, Corporate Audit Directorate Director, and Headquarters Assistant Director serve as the primary basis for the Agency's assurance that management controls are adequate. The statements are based on information from various sources such as the managers' knowledge of day-to-day operations and controls, program reviews, management initiated evaluations, and audits, reviews, and investigations performed by the DoDIG and the GAO.

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, 2017, in accordance with the guidance in OMB Circular No. A-123, Management's Responsibility for Enterprise Risk Management

Internal Control. The objectives of the system of internal accounting and administrative controls of 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 are compliant with FFMIA

DCAA and DFAS assessed internal control effectiveness over financial reporting according to the OMB Circular No. A-123, Appendix A, Internal Control over Financial Reporting (ICOFR), for the following:

- Fund Balance With Treasury
- Accounts Receivable
- Accounts Payable
- Financial Statement Compilation
- Federal Employees' Compensation Act Liabilities
- 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 with regard to 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 and testing the design and operation of internal controls over financial reporting.
- Issuing an Annual Statement of Assurance on Internal Control over Financial Reporting (ICOFR) 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 unqualified statement of assurance on internal control over non-financial operations and over 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. Moreover, errors or irregularities may occur but remain undetected because of inherent limitations in any system of internal accounting and administrative control, including those limitations resulting from resource constraints, Congressional restrictions, and other factors.

DCAA has internal controls that provide reasonable assurance that performance data and metrics are reliable and relevant. Procedures are in place that control access to DCAA's Management Information System (DMIS). Access to DMIS is through the Common Access Card (CAC). DMIS checks the user's network profile setting to determine the user's role and how the user will log in to DMIS. These login procedures control the level of access to the information system. Point-of-data entry edit checks, numerous data accuracy queries run throughout the year, and specific quarterly reviews performed by Headquarters, the Regions, and FAOs assure performance data and metrics are not significantly misstated for the period.

In addition to the point-of-data entry edit checks to reduce risk of data input errors, DCAA executes other rigorous data accuracy queries after entering the data to ensure performance data and metrics are accurate and reliable. These queries focus on data relationships to highlight significant amounts that, if erroneous, could materially affect reported statistics for the period. The Agency maintains consistent oversight of DMIS, from data entry through transaction processing and reporting.

Our evaluation of internal control process relied on several sources including internal reviews and audit by an external firm. The best evidence of our success in institutionalizing internal controls comes from the fact that DCAA has earned 16 consecutive "unmodified opinions" on our financial statements from independent public auditors. DCAA had no Anti-Deficiency Action (ADA) violations for FY 2017, and no incomplete corrective actions from a prior year. Additionally, during FY 2017, DCAA improved the quality of operations in several areas to include:

- Providing high quality technical and leadership training to DCAA staff to enhance the professional workforce.
- Improve the On-Boarding experience for DCAA new hires.

During this period, DCAA also centralized all of its support functions (i.e., Security, EEO, Regional Information Technology and facility management) to improve efficiency of operations and consistency of administrative procedures.

Summary

As the Department faces constrained budgets, DCAA will continue to be essential for getting the best value for every dollar spent to support our warfighters. DCAA's strategic outlook is solid, and our focus remains on delivering the highest quality audits; serving our customers; recruiting, developing and retaining a skilled workforce; and, supporting the Defense mission.