

DEFENSE CONTRACT AUDIT AGENCY
Management Discussion and Analysis
FY 2018



A COMMITMENT TO EXCELLENCE

DEFENSE CONTRACT AUDIT AGENCY
FY 2018 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) 2018. 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 17th 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.

//signed//
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 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. As stewards who look out for taxpayers’ interests, we conduct high quality contract audit services to ensure the government is paying fair prices for what it buys.

Organization and Structures

DCAA has the following organizational structure:

Headquarters is located at the Andrew T. McNamara Headquarters Complex, Fort Belvoir, Virginia. Principal elements of the 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. A 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 sub-offices 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 the 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;
- 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. DCAA has an authorized workforce of 4,895 with 4,711 employees currently onboard. About 89 percent of DCAA employees are auditors, and 11 percent are professional support staff in various fields including administrative support, budget, human resources, information technology, and legal. Roughly 93 percent of employees have a bachelor's degree, with 42 percent having a master's or higher level degree. In addition, 35 percent of the workforce have a professional certification such as Certified Public Accountant (CPA), Certified Fraud Examiner (CFE), Certified Internal Auditor (CIA), and Certified Information System Auditor (CIS).

Management and Performance Challenge

To help ensure the quality and efficiency of audit operations, DCAA issued additional guidance on the 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 termination 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 2018, we completed six initiatives under four goals dealing with communication strategy, centralization, succession planning, 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 2018, DCAA examined \$409.6 billion in contract costs, issued 3,717 audit reports, continued to focus on incurred cost work, identified \$3.2 billion in net savings, and produced a return on investment of about \$5.00 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.

FINANCIAL

Appropriated Funding

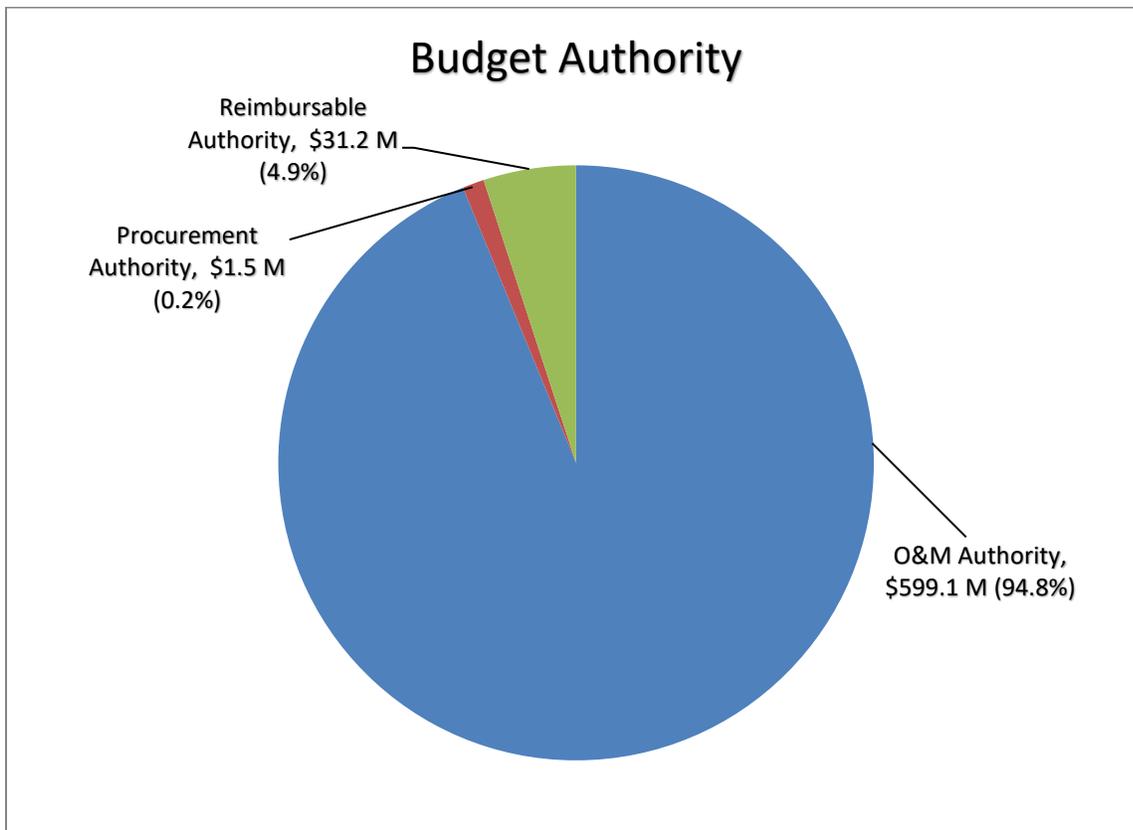
DCAA has four sources of funding. Appropriated funds are comprised of an Operation and Maintenance (O&M), Procurement, and Defense Acquisition Workforce Development Fund (DAWDF). Additionally, DCAA has reimbursable funding authority. Reimbursement revenue supplements the O&M Fund.

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 2018 O&M funding of \$599.1 million was \$23.5 million or 3.8% below the prior year level due to the congressional cut.

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. In FY 2018, DCAA received \$31.2 million in reimbursable authority, which was \$2.2 million (-6.6%) below the 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 2018 procurement funding totaled \$1.5 million.

DAWDF funds are used to recruit and train acquisition personnel. The Office of the Under Secretary of Defense for Acquisition, Technology and Logistics [OUSAT&L] provided DAWDF funding of \$20.2 million. These funds are part of OUSAT&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.



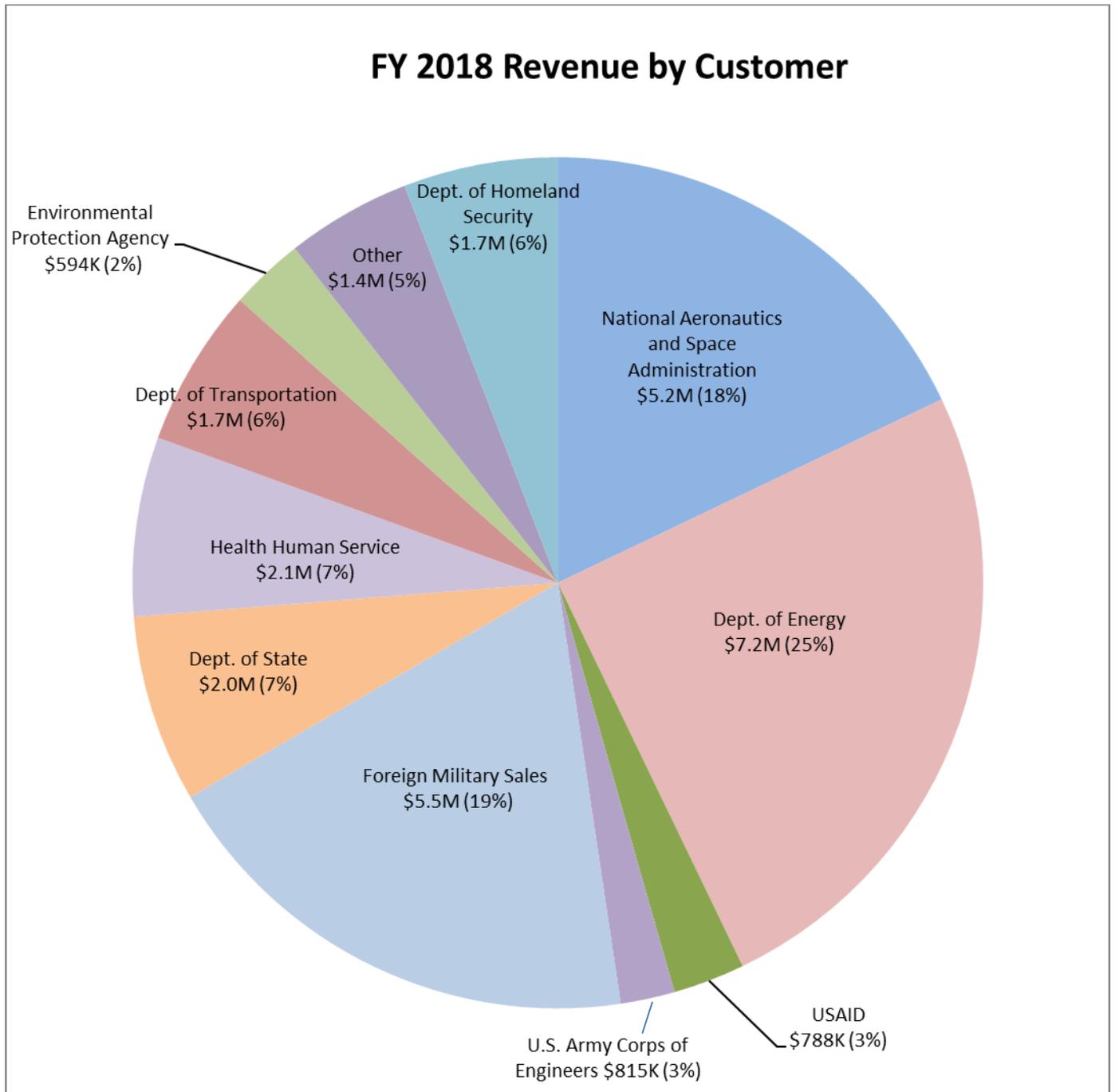
Analysis of the Financial Statements

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. The following table presents DCAA's major cost categories for the fiscal years ended September 30, 2017, and September 30, 2018.

Consolidated Statement of Net Cost				
\$ in millions				
	FY 2018	FY 2017	Dollar Change	% Change
Gross Costs				
Personnel Payroll	\$433.3	\$392.7	\$ 40.6	10.3%
Personnel Benefits	143.2	127.8	15.4	12.1%
Purchased Goods & Services	102.0	87.2	14.8	17.0%
FECA Tax	31.9	27.6	4.3	15.6%
Total Gross Costs	\$710.4	\$635.3	\$ 75.1	11.8%
Less: Earned Revenue	(\$ 28.6)	(\$ 32.3)	\$ 3.7	(11.4%)
Net Cost of Operations	\$681.8	\$603.0	\$ 78.8	13.0%

The graph below shows DCAA’s FY 2018 revenue by major customer.



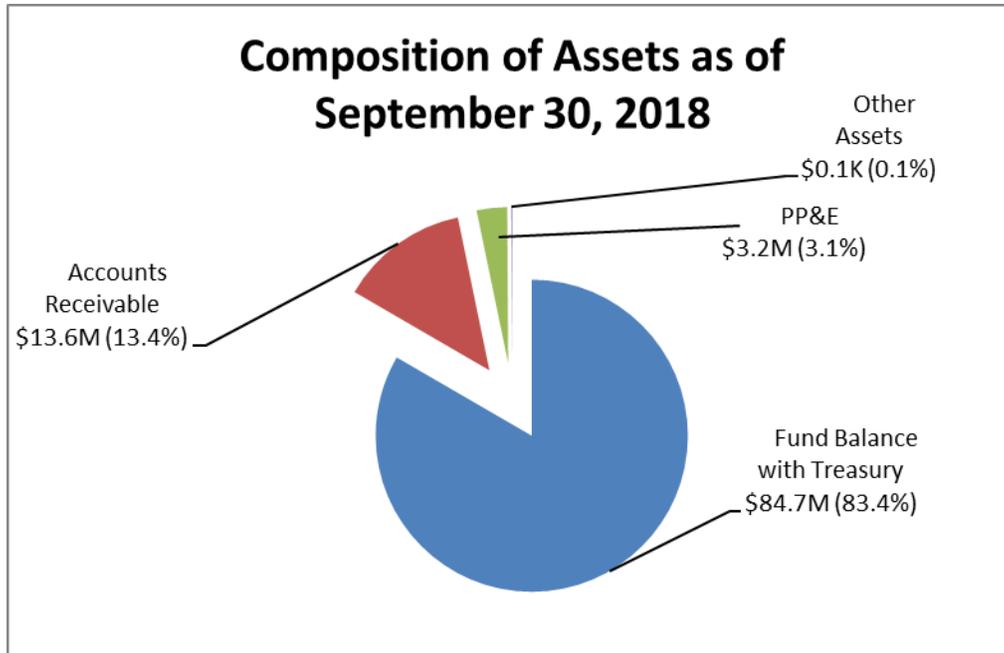
The Consolidated Balance Sheet provides a snapshot in time, descriptions of Agency “assets,” “liabilities,” and the difference, which is known as “net position.” Below is a list of DCAA’s major balance sheet categories as of September 30, 2018, September 30, 2017, and a comparison between the two.

Consolidated Balance Sheet as of September 30, 2018
\$ in millions

	FY 2018	FY 2017	\$ Change	% Change
Assets				
Fund Balance with Treasury	\$ 84.7	\$145.0	(\$ 60.3)	(41.5%)
Accounts Receivable	13.6	5.2	8.4	161.5%
Net General Property, Plant and Equipment	3.2	0.0	3.2	100.0%
Other Assets	<u>0.1</u>	<u>0.1</u>	<u>0.0</u>	<u>0.0%</u>
Total Assets	\$101.6	\$150.3	(\$ 48.7)	(32.4%)
Liabilities				
Accounts Payable	\$ 8.5	\$ 12.3	(\$ 3.8)	(30.9%)
Employment Benefits	21.4	17.6	3.8	21.6%
Accrued Payroll & Leave	12.7	16.6	(3.9)	(23.5%)
Payroll Tax Payable	8.7	3.4	5.3	155.9%
Unfunded FECA Liability	5.0	4.0	1.0	25.0%
Unfunded Leave	<u>39.0</u>	<u>38.6</u>	<u>0.4</u>	<u>1.0%</u>
Total Liabilities	\$ 95.3	\$ 92.5	\$ 2.8	3.0%
Net Position				
Unexpended Appropriations	\$ 51.3	\$ 99.4	(\$48.1)	(48.3%)
Cumulative Results of Operations	<u>(45.0)</u>	<u>(41.6)</u>	<u>(3.4)</u>	<u>8.2%</u>
Total Net Position	\$ 6.3	\$ 57.8	\$51.5	(89.2%)

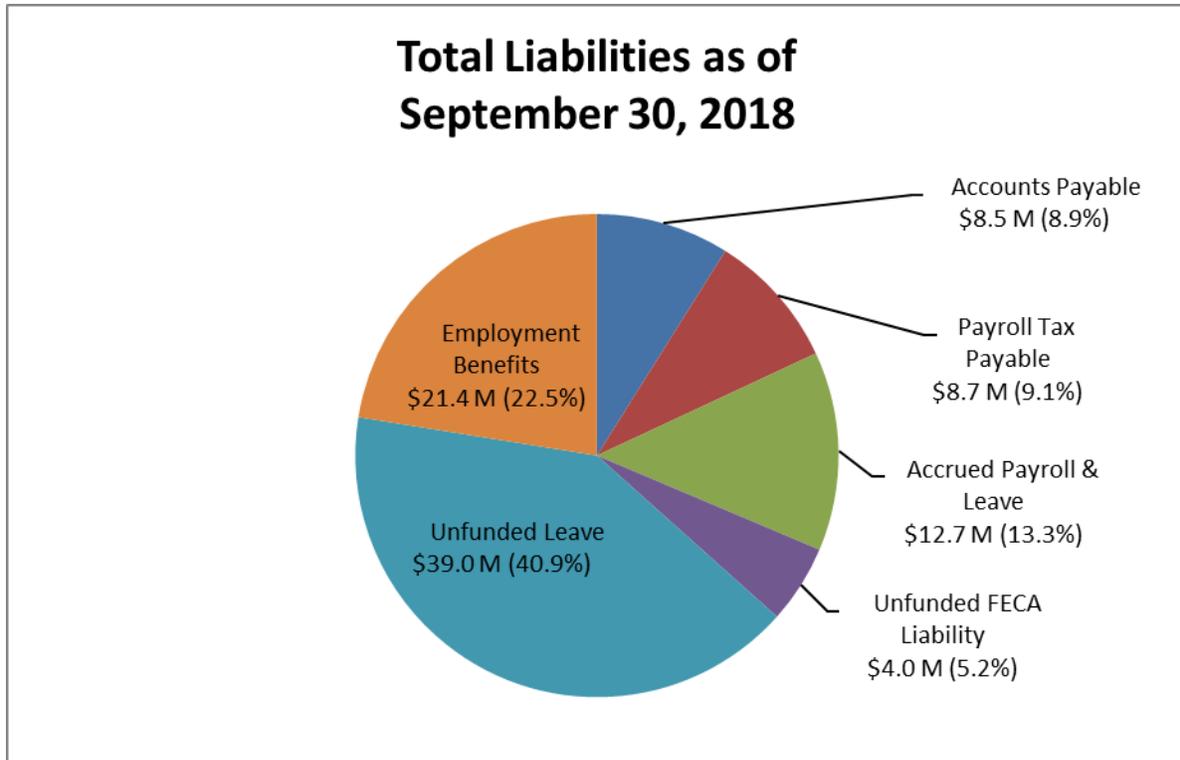
* Numbers may not be exact due to rounding.

DCAA's Assets of \$101.6 million are comprised of the Fund Balance with Treasury (FBwT), Accounts Receivable (AR), and net General Property, Plant and Equipment (PP&E). This amount represents a decrease of \$48.7 million or 32.4 percent less than last year's balance. The decrease is attributed to \$39.3 million in obligations not yet paid; a \$13.3 million change in unobligated balances; a net increase of \$7.6 million in non-FBwT budgetary account; and offset by increases of \$8.4 million account receivable and \$3.2 million in general property, plant and equipment.



* Numbers may not be exact due to rounding.

DCAA's Liabilities of \$95.3 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 accrued leave. DCAA's total liabilities increased by \$2.8 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. During 3rd quarter, FY 2018, the Agency was faced with a budget shortfall resulting from Congressional and undistributed budget cuts. This mandate caused a decrease in net position. Our net position decreased by \$51.5 million; from \$57.8 million in FY 2017 to \$6.2 million in FY 2018. The decrease is attributed to \$48.1 million decrease in unexpended appropriation and a decrease of \$3.4 million in cumulative results of operations when compared to September 30, 2017.

The Cumulative Results of Operations are presented in the Consolidated Statements of Changes in Net Position. DCAA had Financing Sources of \$678.4 million and a Net Cost of Operations totaling \$681.8 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 \$3.4 million, which is the difference between the Financing Sources and the Net Cost of Operations. The change is primarily attributed to a decrease in earned revenue.

The following table presents comparative data for the Net Position and Results of Operations as of September 30, 2018 and September 30, 2017.

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

	FY 2018	FY 2017	% Change
Unexpended Appropriations	\$ 51.3	\$ 99.4	(48.3%)
Cumulative Results of Operations	<u>(45.0)</u>	<u>(41.6)</u>	<u>8.2%</u>
Net Position:	\$ 6.3*	\$ 57.8	(89.2%)
Operations Beginning Balances	(\$ 41.6)	(\$ 42.0)	(1.0%)
Financing Sources	678.4	603.3	12.4%
Net Cost of Operations	681.8	602.9	13.0%
Net Change	<u>(3.4)</u>	<u>0.4</u>	<u>(890.9%)</u>
Cumulative Results of Operations:	(\$ 45.0)	(\$ 41.6)	8.2%

* Numbers may not be exact due to rounding.

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, 2018, totaled \$681.8 million.

The FY 2018 Net Cost of Operations represents an increase of \$78.8 million or 13.0 percent more than the FY 2017 Net Cost of Operations. Majority 81.2 percent of FY 2018 annual net costs relates to Personnel Compensation (\$415.8 million) and Benefits (\$137.4 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 are also 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

In FY 2018, DCAA converted to a new enterprise resource planning system, Defense Agencies Initiative (DAI) and DFAS prepared DCAA's financial statements based on data entered into the DAI. Prior to FY 2018, DFAS prepared 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. 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 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; the Agency's 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'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 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, 2018, 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 compliance 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
- Government Purchase Card Program
- 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 a modified 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.

Our evaluation of internal control process relied on several sources including internal reviews and audit by external firm. The best evidence of our success in institutionalizing internal controls comes from the fact that DCAA has earned 17 consecutive “unmodified opinions” on our financial statements from independent public auditors. DCAA had no Anti-Deficiency Action (ADA) violations for FY 2018, and no incomplete corrective actions from a prior year. Additionally, during FY 2018, 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.
- Improved the On-Boarding experience for DCAA new hires.
- Improved Customer Service.

As the Department faces decreasing budgets, DCAA will continue to be an essential component for getting the best value for every dollar spent to 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.