

DEFENSE CONTRACT AUDIT AGENCY
Management Discussion and Analysis
FY 2019



A COMMITMENT TO EXCELLENCE

DEFENSE CONTRACT AUDIT AGENCY
FY 2019 MANAGEMENT DISCUSSION AND ANALYSIS

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MESSAGE FROM THE DIRECTOR

I am pleased to present the Defense Contract Audit Agency's (DCAA's) Management Discussion and Analysis (MD&A) for FY2019. 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.

DCAA provides audit and financial advisory services to the Department of Defense (DoD) and other federal entities that are 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 DCAA team is committed to organizational excellence and sound financial management. I am pleased to report that DCAA received its 18th consecutive unmodified audit opinion on its financial statements. These audit results not only demonstrate 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.

A handwritten signature in black ink, reading "Anita F. Bales". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

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 the 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 our 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 Structure

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 that works on classified matters 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; and Fort Worth, Texas, with one CAD co-located between St. Louis, Missouri, and

Chicago, Illinois. 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.

Financial Liaison Advisors (FLAs) are trained, experienced auditing professionals who are assigned to buying commands and provide assistance to acquisition, contract administration, and contract audit personnel. FLAs enhance communication with procurement officials and facilitate issue resolution. In addition, FLAs assist procurement officials in employing DCAA services more efficiently and effectively. Internally, FLAs enhance DCAA's understanding of specific acquisition issues by communicating command needs, concerns, and processes that impact field offices.

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. For FY2019, DCAA had 4,554 authorized work-years. 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 93 percent of employees have a bachelor's degree, with 44 percent having a master's or higher level degree. In addition, 34 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 System Auditor (CIS).

DCAA's Assistance to the Acquisition Community. 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, and thereby, preventing excessive costs and contract prices.

Management Initiatives

To help ensure the quality and efficiency of audit operations, DCAA issued additional guidance on using materiality thresholds in incurred cost audits; identifying expressly unallowable costs;

remedying incomplete or inadequate cost or price analyses; and, implementing procedures on audits for incurred subcontract and inter-organizations transfer costs. Additional training provided to the workforce pertained to the incurred cost risk assessment and audit risk model, business system audits, and selected areas of cost. DCAA also implemented the 2018 National Defense Authorization Act requirement to use Independent Private Auditors to conduct incurred cost audits. In FY2019, DCAA awarded task orders for 101 such audits to be performed by Independent Private Auditors.

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 ensure delivery of a higher level of customer service, greater audit efficiencies, and a clear commitment to the "one government" team. During 2019, we completed four initiatives under three goals pertaining to delivering quality products, engagement with industry, and critical thinking. We also began developing the Agency's 2021-2025 strategic plan.

Goals, Objectives, and Results

During FY2019, DCAA examined \$365.24 billion in contract costs; issued 2,948 audit reports; continued to focus on incurred cost audits; identified \$3.7 billion in net savings; and, produced a return on investment of about \$5.50 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 five sources of appropriated funding that includes Operation and Maintenance (O&M); Research, Development, Test, and Evaluation (RDT&E); Procurement; Defense Acquisition Workforce Development Fund (DAWDF); and, reimbursable funding authority. Reimbursement revenue from civilian agencies supplements the O&M Fund.

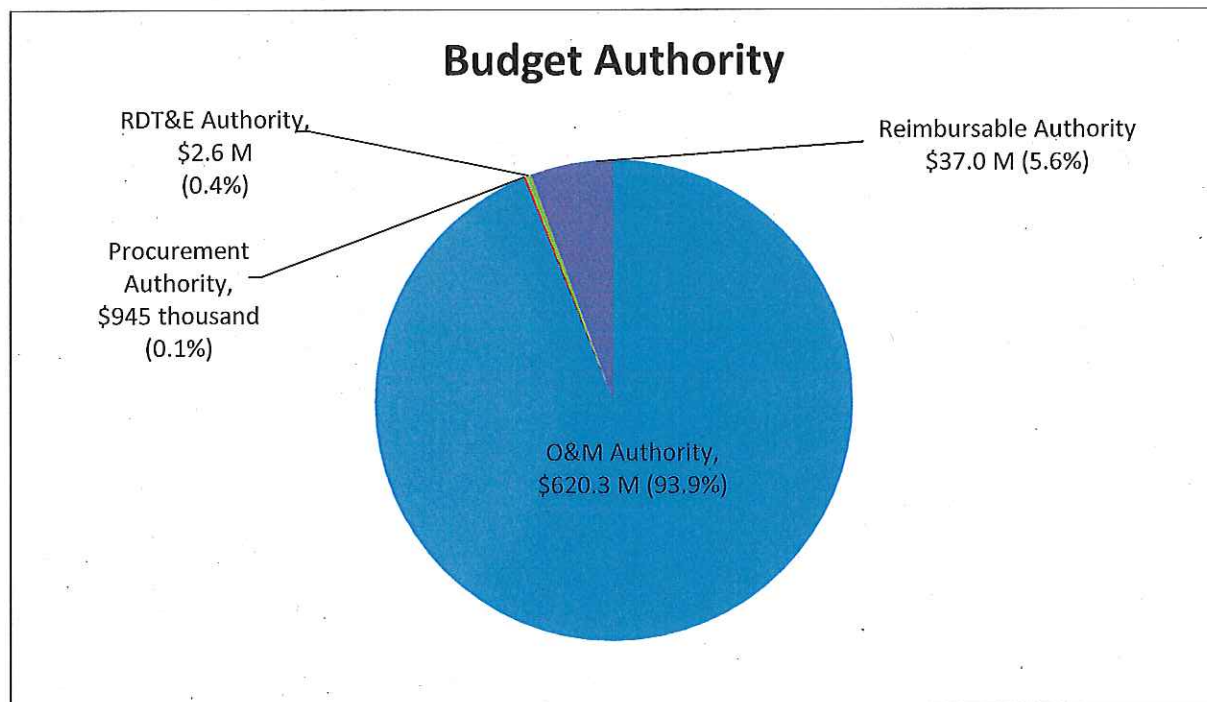
O&M funds pay for goods and services used during the normal course of business in the fiscal year appropriated. Examples of expenses include civilian salaries and benefits, recruiting, training and education, travel, information technology, leased office space, and business assets. The FY2019 O&M funding of \$620.3 million was \$21.2 million or 3.5% above the prior year's level.

Research, Development, Test, and Evaluation (RDT&E) funds is a new source of funding for FY2019. The \$2.6 million allocation is required for the development of a prototype of software with the capability to streamline the assembly, transmission, routing, processing, and tracking of the large volume of contractor submissions received annually by the federal government; this funding was also used for redesign of the DCAA Management Information System (DMIS).

Procurement funds totaling \$945 thousand are used to support the life-cycle replacement of the wireless infrastructure. The components will replace those that are technologically obsolete and out of warranty.

DAWDF funds are used to recruit and train acquisition personnel. The Office of the Under Secretary of Defense for Acquisition and Sustainment [OUSD (A&S)] provided DAWDF funding of \$14.3 million. These funds are part of OUSD (A&S)'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.

Reimbursable funds are paid by non-DoD agencies for DCAA audit services. The Office of Under Secretary of Defense, Comptroller (OUSD(C)) sets reimbursable authority annually. In FY2019, DCAA received \$37.0 million in reimbursable authority, which was \$5.8 million (18.7%) above the prior year level.



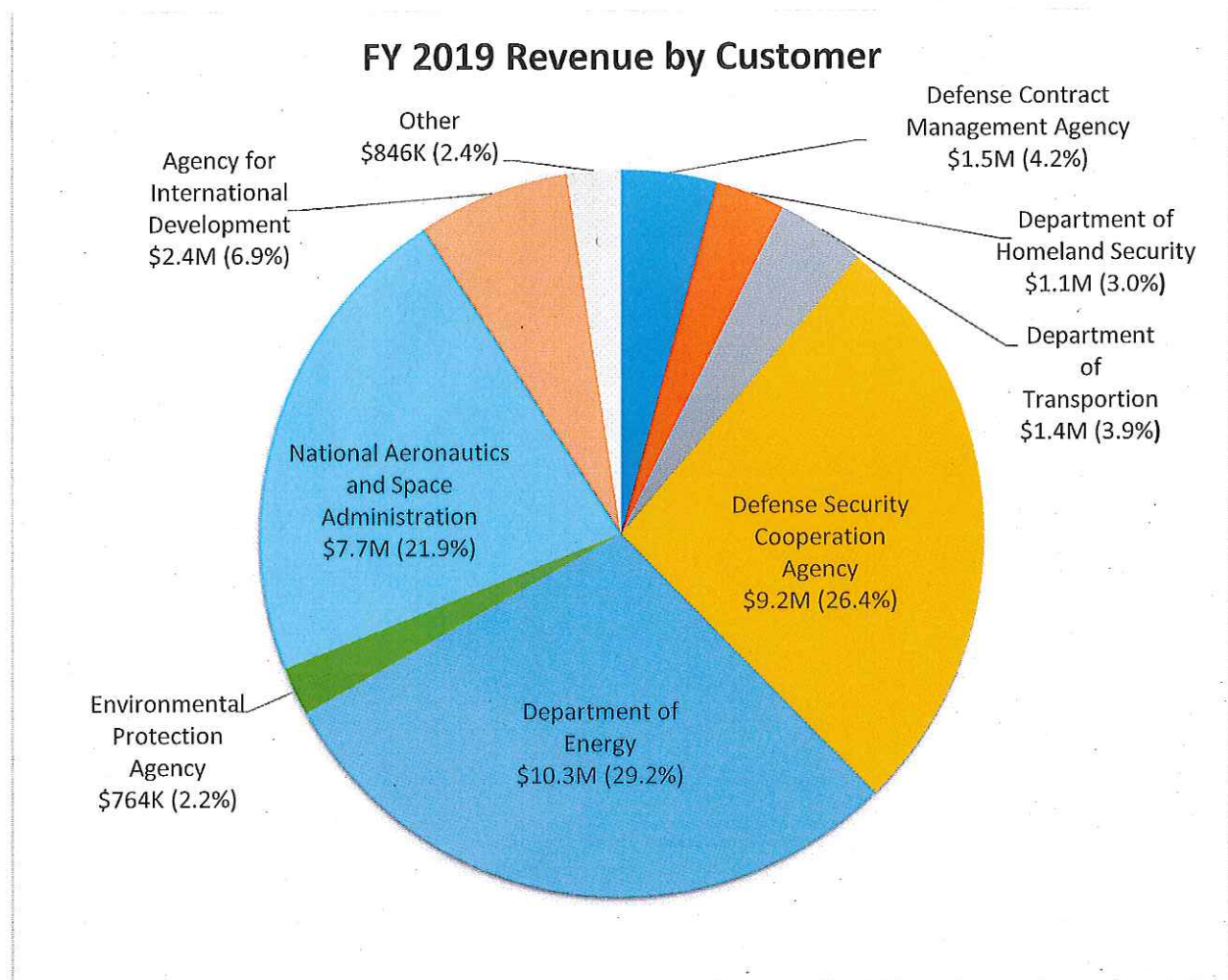
Analysis of the Financial Statements

The following tables and graphs summarize information regarding 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, 2019, and September 30, 2018.

Consolidated Statement of Net Cost				
\$ in millions				
	FY2019	FY2018	Dollar Change	% Change
Gross Costs				
Personnel Payroll	\$408.1	\$415.9	(\$ 7.8)	(1.9%)
Personnel Benefits	174.9	181.7	(6.8)	(3.7%)
Purchased Goods & Services	74.9	82.2	(7.3)	(8.9%)
FECA Tax	29.2	30.6	(1.4)	(4.6%)
Total Gross Costs	\$687.1	\$710.4	(\$ 23.3)	(3.3%)
Less: Earned Revenue	(\$ 36.1)	(\$ 28.6)	(\$ 7.5)	26.2%
Net Cost of Operations	\$651.0	\$681.8	(\$ 30.8)	(4.5%)

The graph below shows DCAA's FY2019 revenue by major customer.

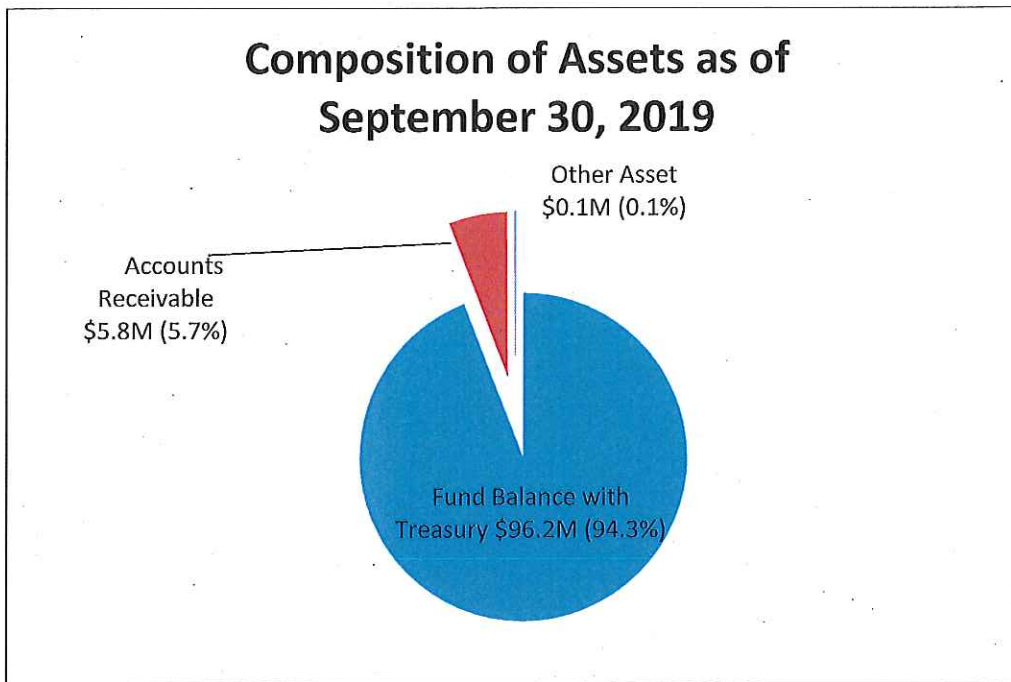


The **Consolidated Balance Sheet** provides a snapshot in time, descriptions of Agency “assets,” “liabilities,” and the difference, which is known as “net position.” Below is a list of DCAA’s major balance sheet categories as of September 30, 2019, September 30, 2018, and a comparison between the two.

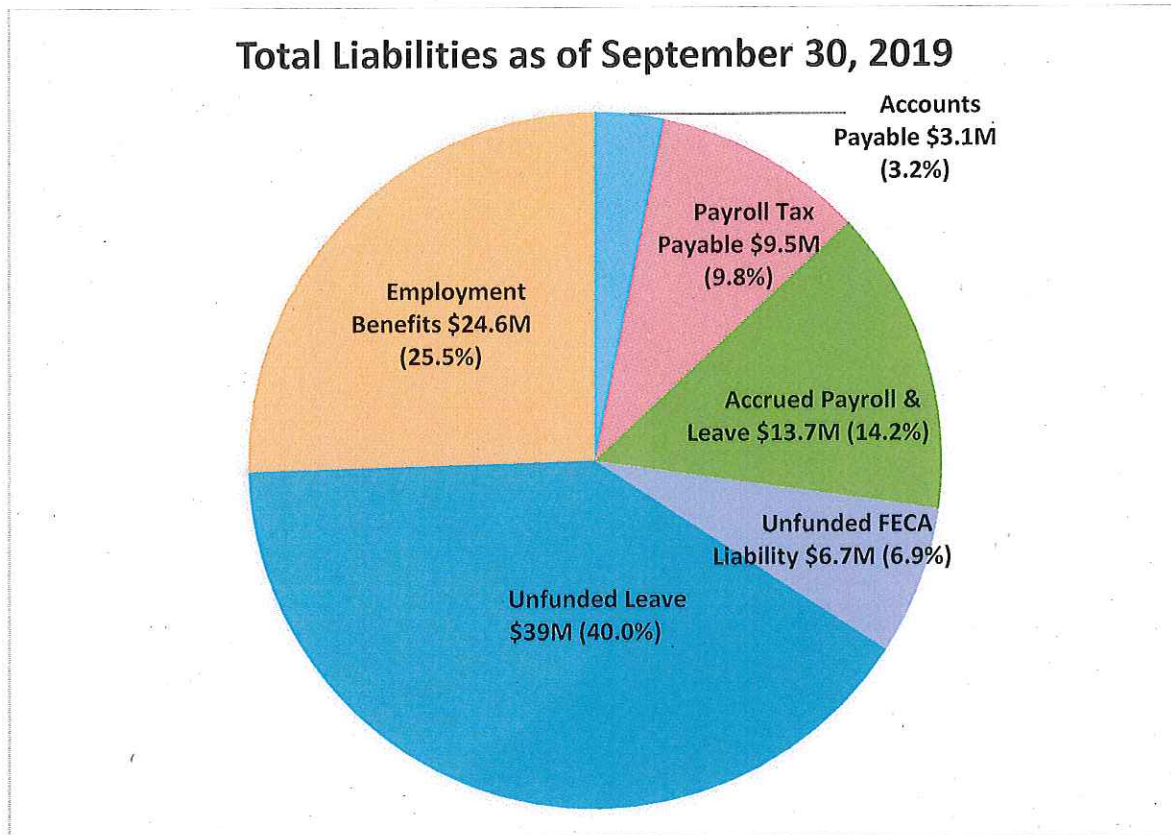
Consolidated Balance Sheet as of September 30, 2019
\$ in millions

	FY2019	FY2018	\$ Change	% Change
Assets				
Fund Balance with Treasury	\$ 96.2	\$ 84.7	\$ 11.5	13.6%
Accounts Receivable	5.8	13.6	(7.8)	(57.4%)
Net General Property, Plant and Equipment	0.0	3.2	(3.2)	(100.0%)
Other Assets	<u>0.1</u>	<u>0.1</u>	<u>0.0</u>	<u>0.0%</u>
Total Assets	\$102.1	\$101.6	\$ 0.5	0.5%
Liabilities				
Accounts Payable	\$ 3.1	\$ 8.5	(\$ 5.4)	(63.5%)
Employment Benefits	24.6	21.4	3.2	15.0%
Accrued Payroll & Leave	13.7	12.7	1.0	7.9%
Payroll Tax Payable	9.5	8.7	0.8	9.2%
Unfunded FECA Liability	6.7	5.0	1.7	34.0%
Unfunded Leave	<u>39.0</u>	<u>39.0</u>	<u>0.0</u>	<u>0.0%</u>
Total Liabilities	\$ 96.6	\$ 95.3	\$ 1.3	1.4%
Net Position				
Unexpended Appropriations	\$ 58.1	\$ 51.3	\$ 6.8	13.3%
Cumulative Results of Operations	<u>(52.6)</u>	<u>(45.0)</u>	<u>(7.6)</u>	<u>16.9%</u>
Total Net Position	\$ 5.5	\$ 6.3	(\$ 0.8)	(12.4%)

DCAA’s Assets of \$102.1 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 an increase of \$510 thousand or 0.5 percent greater than last year’s balance. The increase is attributed to \$9.7 million change in obligations not yet paid; a \$7.1 million change in non-FBwT budgetary accounts; a net decrease of \$5.3 million change in unobligated balances; and offset by decreases of \$7.8 million change in accounts receivable and \$3.2 million in general property, plant and equipment.



DCAA's Liabilities of \$96.6 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 \$1.3 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 decreased by \$776 thousand; from \$6.3 million in FY2018 to \$5.5 million in FY2019. The decrease is attributed to \$6.8 million increase change in unexpended appropriation and offset by decreases of \$7.6 million change in cumulative results of operations when compared to September 30, 2018.

The Cumulative Results of Operations are presented in the Consolidated Statement of Changes in Net Position. DCAA had Financing Sources of \$643.4 million and a Net Cost of Operations totaling \$651.0 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 \$7.6 million, which is the difference between the Financing Sources and the Net Cost of Operations. The change is primarily attributed to an increase in earned revenue.

The following table presents comparative data for the Net Position and Results of Operations as of September 30, 2019, and September 30, 2018.

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

	FY2019	FY2018	% Change
Unexpended Appropriations	\$ 58.1	\$ 51.3	13.3%
Cumulative Results of Operations	(52.6)	(45.0)	(16.9%)
Net Position:	\$ 5.5	\$ 6.3	(12.4%)
Operations Beginning Balances	(\$ 45.0)	(\$ 41.6)	8.2%
Financing Sources	643.4	678.4	(5.1%)
Net Cost of Operations	651.0	681.8	(4.5%)
Net Change	(7.6)	(3.4)	121.6%
Cumulative Results of Operations:	(\$ 52.6)	(\$ 45.0)	16.8%

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 services provided to other federal agencies. Our Net Cost of Operations for the year ended September 30, 2019, totaled \$651.0 million.

The FY 2019 Net Cost of Operations represents a decrease of \$30.8 million or 4.5 percent less than the FY 2018 Net Cost of Operations. The majority (84.4 percent) of FY 2019 annual net costs relate to Personnel Compensation (\$386.6 million) and Benefits (\$165.7 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 into the DAI. This system tracks budget execution; the DAI was not designed to capture the information necessary to create financial statements. 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 FY2019, 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 made 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.

Individual assurance statements from each Regional Director, Corporate Audit Director, and Headquarters Assistant Director served 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, 2019, 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, 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
- 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 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; and,

- 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 unmodified 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. However, 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 an audit by an external firm. The best evidence of our success in institutionalizing internal controls comes from the fact that DCAA has earned 18 consecutive "unmodified opinions" on our financial statements from independent public auditors. DCAA had no Anti-Deficiency Action (ADA) violations for FY2019, 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 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.