

Evaluating the Defense Contract Auditing Process, Part 2

Written by Nick Sanders
Wednesday, 12 April 2017 00:00

Continuing our discussion of recent [testimony](#) before the House Armed Services Committee (HASC) Subcommittee on Oversight and Investigations. Part 1 of this two-part discussion focused on DCAA [Director Bale's testimony](#), in which we asserted that DCAA continues to be in denial that its management decisions over the past decade have in any way led to a problematic status quo in desperate need of change. Instead, DCAA continued its hoary tradition of requesting *more*—more budget, more auditors—to meet the workload that it has *already* significantly reduced through bureaucratic tricks, such as pushing work that it used to perform to the Defense Contract Management Agency (DCMA), as well as arbitrarily deciding which assignments it will actually audit and which assignments it will not.

In this Part 2, we are going to discuss testimony from three industry representatives, one from the Professional Services Council (PSC), one from Finance Executives International (FEI), and the other from the National Defense Industrial Association (NDIA). Their written testimony painted an entirely different picture of DCAA than Ms. Bale's written testimony did—a picture in which significant reforms were urgently needed to address the mess that DCAA mismanagement has gotten the defense acquisition system into.

Let's start with David Berteau, President and CEO of the PSC. His written testimony can be found [here](#). He offered some thoughts and recommendations regarding DCAA, including—

As one of our member companies characterized it, *DCAA should focus on being an auditing agency, not a collection agency*. This is reflected, in part, in DCAA's annual Report to Congress on its Fiscal Year 2015 Activities which focuses on its 'return on investment' – for every dollar spent by DCAA, some significant amount of government spending was avoided and a portion of contractor spending was 'questioned' – leaving the impression that the agency's work is essential to fiscal responsibility. While it is easy for an auditor to 'question' a contractor's cost, as we see time and time again, 'questioned' costs never equal 'sustained' costs. Contractors will even agree to a 'sustained' cost number simply because it is too expensive to continue to dispute it and to forego additional, undisputed payments on invoices for work already performed. ... PSC believes that we need to restore the authority and confidence of the contracting officers and program managers to make the decisions that they believe are in the best interest of the government, based on the advice they receive from the multiple resources available to them, including DCAA.

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(As always, we are adding emphasis unless otherwise noted.)

With respect to DCAA's recent initiatives to perform "incurred cost" audits more quickly, Mr. Berteau testified that—

For too many of our member companies, including those who have DCAA resident auditors in their facilities, auditing of multiple years has only multiplied the annual request by the number of years to be covered. Rather than drawing a single sample from three years, for example, DCAA has been drawing the same sample size for each of the three years. It should not be surprising that such an approach is not yielding any acceleration in the audit or the closing of open years. But it does add significantly to the amount of 'questioned costs' because of the cumulative effect of the multi-year review. PSC believes that DCAA could dramatically streamline and accelerate their multi-year reviews, and we'd be happy to work with them on ways to do that.

He also attempted to smooth any ruffled feathers by stating—

There is a concern raised by some that using the private sector to help reduce the backlog of incurred costs means that DCAA workload will drop and that auditors might have to be terminated. PSC does not share that view; we have no objective of reducing the size of the DCAA audit workforce. *Given other backlogs and of the vital nature of making the right initial contract award decisions, we believe there are other areas of work where these experienced incumbent DCAA auditors can be used.*

As we noted earlier, these experienced staff can be assigned to high visibility proposal audits or to the more complex cases. They can also supervise and mentor junior DCAA staff and manage the work being performed by third parties.

In essence, then, he told Congress that if DCAA were properly managed and the workload had been properly prioritized, then DCAA's workload could be handled with available staff—leaving senior staff available to both supervise and mentor the junior staff. This would be especially true if DCAA focused its attentions on where it could add value to the acquisition lifecycle, and allowed independent third-parties to perform some of the existing workload. He testified that—

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In our view, expanding third-party audits will do more than free up experienced staff for more important functions. It will also help the government become a smarter buyer and will improve acquisition outcomes. No one benefits from unnecessary delays in any phase of the acquisition lifecycle. ...

It makes good sense to expand the appropriate use of independent auditors, as an effective and efficient solution that can be implemented quickly and seamlessly to address not only the current incurred cost audit backlog, but also other aspects of government accounting. Here are some of those other aspects. *PSC remains concerned regarding the workforce turnover at DCAA, and the stability, experience, and morale of the workforce as a result*

. ... Private sector contract support can help address the demand for timely incurred cost reviews and contract closeouts without hiring, training and increasing federal staff. A benefit to using a strong independent contractor base is the ability to increase or decrease staff levels to address spikes and shortfalls and to respond quickly to auditing needs. Contractors can dial up as needed and dial down once the issue is addressed; many well-seasoned government accounting firms have an experienced and available workforce – often former DCAA staff – that can respond quickly. This way, the government only pays for what it needs, not for a permanent workforce.

Next, we'll discuss the testimony of Mr. James Thomas, Assistant Vice President of Policy, NDIA. His testimony was consistent with that offered by Mr. Bertreau, so we'll focus on the "nuggets" that leapt out at us. (All points that follow are exact quotes from written testimony.) He wrote—

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I would like to make clear that many of the observations that follow have their genesis in the evolution of DCAA from the organization stood up in 1965 to serve as an advisory function for Contracting Officer (CO) decision making to one that has been reconfigured to serve solely as enforcers of their own process requirements without a nexus to the CO decision making process.

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Industry is concerned that DCAA has lost focus of their purpose within the Defense Acquisition System over the past decade and has become much more closely tied with the Inspector General function than needed or desired to fulfill their statutory oversight role. *DCAA is not a profit center, but their Annual Reports to Congress highlight that the measure of*

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mission success is that their audit activities provide a large return on investment (ROI) by identifying a large number of adverse audit findings rather than on executing their primary advisory functions.

We also question whether the agency can inherently be truly independent and objective in their audit responsibilities (both Generally Accepted Government Accounting Standards [GAGAS] requirements) while continuing to emphasize success based upon ROI.

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NDIA believes that a lack of professionalism, as defined by GAGAS, from DCAA auditors, has borne costs on government and industry through a lack of incorporation of materiality in their judgments. Our members' perception of DCAA's standard of perfection with respect to internal controls (e.g., to avoid allegation of business system significant deficiencies) vs. controls that provide reasonable assurance for business systems, is that *it is the enemy of timeliness and affordability*

. While perfection is admirable, often the high costs involved with achieving a level of perfection to avoid DCAA's allegations outweigh the associated benefits of having a perfect internal control for an issue that may never be a catalyst for increased costs to the government. Audits should be based on risk and ultimately a reasonable assurance for reliance. Further, there should be clarity on the materiality of potential identified deficiencies and whether they are in fact significant relative to the ultimate effect on Contractor Business Systems in order to avoid this perceived 'perfection' standard that we contend is currently in place.

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Industry is concerned that DCAA's reporting on the backlog is not telling the full story. The fact that many of our larger members have open rates dating back four to five years suggests that DCAA may have simply closed out the lower risk, lower dollar value contractor ICPs, which had the effect of reducing the number of audits in its backlog. Additionally, although DCAA recently indicated that the backlog is under 18 months in order to perform non-DoD audit services, we understand that the Agency does not count submissions until they are two years old since DCAA audits two years concurrently, so it considers within two years as the 'current year.'

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Although we acknowledge that performance data provided by DCAA and DoD IG provides an incomplete picture, and it does not adequately measure DCAA performance, *by DCAA's own standards, the agency is not performing well.*

... Its sustention rate on post-award DoD audits dropped from 50.2% to 31.6% over that time as well. The FY 2013 report noted that its percentage of 9.8 of questioned costs as a total of dollars examined was '[a]n indicator of DCAA's effectiveness in using its risk-based approach.' Fast-forwarding to the FY 2015 version of the report, that metric was no longer highlighted, and was only 4.5%.

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Industry is also concerned by the insular nature of DCAA's training, which appears to shun outside views. Less experienced auditors lack professional judgment, and instead are highly proficient in DCAA policies and procedures, or in other words, know what the words say, but not what they mean or the spirit of why they were created. Further, on-the-job training is undermined by the aforementioned autonomy of individual auditors, making it difficult for supervisors to mentor. Greater engagement with industry through external training (both personal and technical) would also be beneficial to foster professionalism and enhance technical capabilities.

Mr. Thomas concluded by making specific, actionable, recommendations that were summarized in one concluding sentence: "DCAA should place greater emphasis on improving its customer service role, and be held accountable to improve the quality and timeliness of its audit services for the benefit of government procurement and the warfighter." We couldn't agree more.

Turning now to the written testimony of Mr. John Panetta, National Secretary of FEI and member of FEI's Committee on Government Business (CGB) (and Sr. Director of Government Accounting for Raytheon) (and a former boss of mine—*Hi John!*), we find many of the same themes as expressed by the other two industry representatives. However, we were struck by the clarity, detail, and knowledge expressed by

[his testimony](#)

. We urge readers to download and review it in its entirety. As with Mr. Thomas' testimony, we'll pull some bullet points out and quote them, adding emphasis as we think appropriate.

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... contractors want incurred cost proposals to be audited in a timely fashion upon submission to enable the determination of final indirect cost rates 'as promptly as practical' as is required under current contract clauses and Federal Acquisition Regulations (FAR) [FAR 52.216-7(d)((2)(ii)]. While direct contract costs are billed as incurred, Contracting Officers (COs) most often will decrement indirect cost billing rates (e.g., overhead and G&A rates) so full reimbursement of these costs will not occur until audits are completed, rates are finalized and contracts are closed. Not only does this situation impact contractor cash flow for years, it generates non value added administrative cost and inefficiency in the acquisition system (i.e. continued maintenance of old systems, records, and documentation needed for untimely audits and the final negotiation of rates).

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From our perspective, DCAA had difficulty determining how to measure audit quality. How much testing was needed and how much documentation was required for the audit to be 'perfect'? *The standards of quality seemed to be constantly changing and auditors often didn't know what was expected. They started an audit using one audit program, but before completing the assignment, a revised audit program would be issued causing audits to be sent back for rework.* Working grade auditors (many of whom needed additional training and oversight) were increasingly empowered at this time while managers were correspondingly hindered in their efforts to supervise staff so that individual auditors would not be 'stifled' from reporting 'findings' that they perceived to be issues.

Any semblance of considerations for materiality vanished from within the agency. Audit time and budgets became seemingly unlimited, due dates virtually disappeared, and basic program/schedule management practices were abandoned.

Coupled with the constantly changing quality standards, very few incurred cost audit reports were issued and the backlog grew to the unmanageable level that we are faced with today. Any reports that were issued were generally incredibly long and packed with minutia.

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At the same time that DCAA was experiencing its audit performance difficulties, the FAR Council (at DCAA's urging) expanded the definition of an adequate incurred cost submission in the Allowable Cost and Payment Clause (FAR 52.216-7(d)) by identifying a list of 15 mandatory schedules and 15 supplemental data elements required for audit. *Even though many of the schedules were not relevant to the review of the indirect rates, DCAA used the FAR change as a justification to retroactively reject contractors' previously submitted and accepted incurred cost proposals.*

This action served to further delay the settlement of final rates by causing contractors to needlessly create complicated informational schedules.

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DCAA's excessive implementation and ground rules for 'reliance on the work of others' results in the performance of non-value added, redundant steps during incurred cost and other DCAA audits. DCAA asserts that its purpose for evaluating an incurred cost proposal is not identical to that of the external auditor's evaluation of a company's financial statements; therefore the audit steps performed will rarely be exactly the same. That does not diminish the fact that the external auditors performed sufficient testing to obtain reasonable assurance that the financial statements were free of material misstatement due to error or fraud.

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Due to the age of the incurred cost proposals both under audit and still awaiting audit, contractors are forced to maintain discontinued business systems and store records that are no longer in use. As time passes, individuals who were most knowledgeable of the systems, practices and transactions under review often have left the company. This is also true for the responsible Government auditors and COs. New individuals must conduct research, including retrieving files from off-site storage facilities, to obtain an understanding of the issues at hand before responding to audit inquiries, all of which makes the task of supporting audits more difficult, time consuming and costly. Only through the establishment of a risk-based, time-phased audit process with a firm schedule, milestones and due dates will it be possible for DCAA to be successful addressing the current backlog and preventing a reoccurrence as well.

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DCAA attempts to create the basis of a 'quality' audit using alternative procedures to compensate for the lost opportunity of having not performed the necessary concurrent steps. *All of this leads to unreasonable and unnecessary levels of 'assurance' by DCAA (i.e. selecting inflated sample sizes). Additionally, DCAA establishes expectations that contractors will retain extensive non-financial supporting data such as resumes, detailed job descriptions, acquisition approvals, and statements of work, to support their alternative steps, adding to Contractors' cost to support these untimely audits.* ... since DCAA has not uniformly performed (and continues to not perform) these real-time reviews at many contractor locations, it now directs its auditors to request contractors to provide the original documents as part of the audit of the old incurred costs proposals.

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While the rest of the economy is moving to 'the Cloud', DCAA is asking for the paper.
... If DCAA truly believes that there is significant risk of contractors manipulating or falsifying source records (even after those contractors have completed extensive CPA/SOX audits), then it should perform real-time evaluations so that any issues may be raised, discussed, and resolved while all relevant data and information are readily available.

Mr. Panetta concluded by telling the HASC Subcommittee—

CGB supports initiatives to utilize independent public accounting firms to supplement performance of contract audit requirements, as is currently being done in other Government agencies (e.g., NASA and DOE). These public accounting firms can assist in the elimination of the significant backlog of open incurred cost proposals and ensure that the Government is able to remain current in their required audit activities. CGB also believes that use of independent public accounting firms for the evaluation of contractor business systems will introduce additional efficiencies into the acquisition process and provide an alternative for contractors and Contracting Officers who are currently awaiting DCAA audits. Furthermore, CGB believes that the introduction of competition to perform audit services regarding Government contract costs will serve as a catalyst to motivate DCAA to evolve from a culture of 'risk avoidance' to one of 'risk management' so that DCAA can fulfill its role as a member of the acquisition team.

Okay, let's wrap this up. In Part 1, we discussed the written testimony of Ms. Bales, who said things were fine and improving, and nothing needed to change except for adding more auditors because, otherwise, things would go to hell again. In Part 2, we discussed industry's contrasting viewpoints, in which representatives asserted that things were *not* fine, that improvement was incremental at best and illusory at worst—but that current initiatives were unsustainable in the long run. They asserted that no more auditors were necessary; and, in fact, with proper resource management and reliance on independent third-party auditors where appropriate, DCAA had sufficient auditors already in place to take care of their workload and even devote senior resources to mentorship and employee development efforts.

So which point of view will the HASC Subcommittee believe? What will the members of Congress (and their staffs) take away from the contradictory viewpoints? That remains to be seen. But given the current anti-regulation, anti-bureaucracy mood within The Beltway, we think the smart money would be on the industry viewpoints.

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Here is a link to a video of the testimony:

<https://www.youtube.com/watch?v=s3F5-CQ0e3A&feature=youtu.be>