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**EVALUATING THE DEFENSE CONTRACT  
AUDITING PROCESS**

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HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT  
AND INVESTIGATIONS

OF THE

COMMITTEE ON ARMED SERVICES  
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTEENTH CONGRESS

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## **EVALUATING THE DEFENSE CONTRACT AUDITING PROCESS**

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HOUSE OF REPRESENTATIVES,  
COMMITTEE ON ARMED SERVICES,  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,  
*Washington, DC, Thursday, April 6, 2017.*

The subcommittee met, pursuant to call, at 9:00 a.m., in room 2212, Rayburn House Office Building, Hon. Vicky Hartzler (chairwoman of the subcommittee) presiding.

### **OPENING STATEMENT OF HON. VICKY HARTZLER, A REPRESENTATIVE FROM MISSOURI, CHAIRWOMAN, SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**

Mrs. HARTZLER. Good morning. This hearing will come to order. I welcome our subcommittee members and witnesses testifying before us today.

Over the last 15 years, the Department of Defense [DOD] has become increasingly reliant on the use of government contractors. When used properly, this public and private partnership can both improve our national security and at the same time preserve limited government resources. But this work requires competent and timely oversight.

To that end, financial audits of defense contracts can play a vital role in ensuring that expenditures paid by the government for goods and services are fair and reasonable. It also ensures that taxpayers are getting the best bang for their buck.

Within the Department of Defense, the Defense Contract Audit Agency, or DCAA, is charged with this critical mission. Today's hearing seeks to learn more about where the auditing process is working and identify any shortcomings with current accounting efforts. I am always looking for productive ways to improve government performance. I look forward to hearing from our witnesses about their feedback on the current auditing system.

At the outset, I have several overarching questions about how the audit process is working within DCAA. In particular, for years DCAA has had a significant backlog of incurred cost audits. These audits are meant to identify instances where the government might have overpaid. However, as I understand it, it has been taking on average more than 2 years from the time DCAA receives the information necessary to conduct an incurred cost audit to the date the audit report is issued.

These delays can create problems for government contract managers. Their efforts to recover improper costs are slowed. It also means managers do not have important financial information available soon after an expenditure takes place when the information is

most important. From a business perspective, this delay can also create economic burdens. I look forward to hearing from our panel of industry experts on how these delays impact the private sector.

I also have questions about how efficiently DCAA is performing these incurred cost audits. Although they account for the most significant portion of total costs audited each year, these audits only account for a relatively small amount of reported savings. I want to understand how much these audits are costing American taxpayers compared to the return from that cost.

On a related note, I am interested to hear from our witnesses about how DCAA audit practices compare to what is commercially acceptable in the private sector. Perhaps there are lessons to be learned outside of government that could improve defense contract audit performance.

The bottom line is simple: We all want a fair, efficient, and timely auditing process that works for all interested parties. I look forward to everyone's views this morning in addressing this important topic.

But before I introduce the witnesses, I turn to Mr. Moulton, the Oversight and Investigations Subcommittee ranking member, for any opening remarks that he would like to make.

[The prepared statement of Mrs. Hartzler can be found in the Appendix on page 29.]

**STATEMENT OF HON. SETH MOULTON, A REPRESENTATIVE  
FROM MASSACHUSETTS, RANKING MEMBER, SUBCOMMITTEE  
ON OVERSIGHT AND INVESTIGATIONS**

Mr. MOULTON. Thank you, Madam Chairwoman.

The topic of our hearing today should be important to anyone concerned about accountability, efficiency, and transparency in our multibillion-dollar defense sector.

The Defense Contract Audit Agency is the government organization charged with auditing the \$287 billion in defense contracts that the Pentagon and other agencies make with private businesses every year. That makes it one of the main organizations whose job it is to ensure that the taxpayers' defense dollars are well spent and not stolen, wasted, or otherwise abused. DCAA also helps the government negotiate more competitive prices from the private sector.

These roles, in which DCAA holds a public trust, are important to keep in mind as we discuss the pace of DCAA's auditing process. According to their annual report, DCAA currently has a backlog of incurred cost audits that it needs to reduce to ensure defense contracts are not unnecessarily delayed. But as we try to reduce this backlog, we should also be wary of exactly what proposals are made to do so and anything that could undermine the public trust.

One thing under consideration is proposals to privatize the functions of DCAA and hand this important work over to private auditors. I am a strong believer in public-private partnerships, and I have personally advocated for them in many sectors, including transportation projects in which I have worked.

In this case, however, I caution that early estimates suggest privatization could cost the taxpayers about 30 percent more, and we would also be positioning a small number of auditing companies to

oversee defense contractors with whom there would likely be conflicts of interest. Obviously, the history of Enron and the financial crisis suggest we have to be very careful in this situation.

We should also keep in mind the origin and state of DCAA's backlog as we develop defense reform policies. DCAA first developed a backlog when the number of defense contracts and expenditures ballooned during the wars in Iraq and Afghanistan.

DCAA has certainly made mistakes. In 2010, it recognized this problem, hired 400 additional workers, and adopted new strategies to begin reducing the backlog. Those efforts have, in fact, succeeded so far. And as you can see from the graph of the backlog presented in the testimony, it has been shrinking by about 4,000 contracts per year to the point where about 4,677 are left in the queue. When the pace has slowed more recently, it has been due to sequestration and now President Trump's hiring freeze.

This evidence suggests that we can make a lot of progress on this backlog by properly resourcing DCAA's mission, mitigating the impact of sequestration and hiring freezes, and ensuring DCAA has enough capacity to cope with an unexpected increase in defense spending.

I look forward to the testimony this morning to understanding better how we can make reforms and improve the process and, ultimately, preserve the important mission that DCAA does for our taxpayers and for our defense.

Madam Chair.

[The prepared statement of Mr. Moulton can be found in the Appendix on page 31.]

Mrs. HARTZLER. Thank you, Mr. Moulton.

Today, we are going to have two panels. First, we will get to visit with and hear from the director of the DCAA, and then our second panel will be from the private sector. And we look forward to both those testimony.

And we do have votes a little after 10, and so hopefully, we can get both panels in and get this hearing wrapped up.

But I really am pleased to recognize Ms. Bales, Ms. Anita Bales, director of the Defense Contract Audit Agency. And members have already been provided with her biography.

So thank you for being here, Ms. Bales, and we will welcome your opening statement.

**STATEMENT OF ANITA F. BALES, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, UNDER SECRETARY OF DEFENSE (COMPTROLLER)**

Ms. BALES. Thank you. Chairwoman Hartzler, Representative Moulton, and members of the subcommittee, thank you for the opportunity to appear before you today.

You have my written statement. And now in my opening, I would like to highlight points related to our processes for incurred cost audits and for bringing in independent public accounting firms to conduct incurred cost audits.

The incurred cost audits have received a lot of attention by several organizations concerned about us getting the backlog down. I would like to recap that the backlog resulted from significant in-

creases in defense spending post-9/11 while DCAA staffing remained stagnant.

To address the backlog, the agency came up with a comprehensive approach. Despite the staffing challenges, we have reduced the backlog 75 percent over the past 5 years. We expected to be current by the end of fiscal year 2018, but need to assess the impact of the current hiring freeze.

Let me expand on two of those initiatives. First, the use of multi-year audits has reduced our audit time by 40 percent over single-year auditing. Because of the efficiency obtained through multiyear audits, we would see this as a methodology we would like to continue after we resolve the backlog.

Second, implementing low-risk sampling allowed us to reduce the number of audits we conduct. Based on risk and materiality, we only audit a small percentage of low-risk submissions. Using our low-risk procedures over the past 5 years, we closed over 14,000 incurred cost years without an audit.

I believe part of the desire to use IPAs [independent public accounting firms] is a belief they are more efficient based on people's experience with their financial statement audits.

That brings me to our first concern: Contracting audit is different from financial statement auditing. A financial statement auditor attests that the financial statements fairly present the financial position of the company in accordance with Generally Accepted Accounting Principles, or GAAP. For contract auditing, GAAP standards are only part of the equation. DCAA auditors also have to evaluate the costs are in accordance with statutory cost accounting standards and the Federal Acquisition Regulations.

The risk the financial auditor faces is a material misstatement in the company's financial statements. The risk the contract auditor faces is the payment of improper cost. The materiality associated with those risks is different.

Let me illustrate the risk and materiality aspect through my experience doing financial statement audits. I worked on an audit of a balance sheet, and applying materiality levels we determined that if a line item wasn't at least \$100 million, it was not material and we wouldn't audit it.

However, if we had been concerned about making payments, money actually going out the door that shouldn't, no company or government entity would say, it is only \$90 million, so that is okay. So that is the difference in the risk, in the materiality levels.

In addition, many expenses that are acceptable under GAAP are unallowable under CAS [Cost Accounting Standards] and FAR [Federal Acquisition Regulation]. The contract auditor has to take additional steps to prevent that risk of improper payment.

Another challenge IPAs may face that would be difficult to overcome is the efficiencies that DCAA can bring to bear through having the knowledge gained by doing other types of audits for contractors and for having access to all the contractors and subcontractors.

First, our work on each type of our audits, be it incurred costs, forward price, business systems, all of the different audits that are in our portfolio, inform our risk assessment on all other audits, al-



lowing us to do less work, bringing efficiencies in that will be lost if we don't do the incurred cost audits.

Second, subcontracts are a large part of most audits. Incorporating results of separate subcontractor audits into the prime contractor report is very efficient for us, because as one agency, we can share results and collaborate across our offices. If an IPA were to perform the prime contract incurred costs, the government would have to create new processes to facilitate the subcontractor audits among the IPAs.

Finally, 65 percent of all incurred cost audits involve auditor-determined annual indirect rates for incurred cost submissions. FAR distinguishes this function as inherently governmental.

In the coming year, I would like to continue to work with the committee to better understand its objectives and how to best achieve those. I will also ask that you give me the time to work with industry and the acquisition community on these acquisition reform ideas to include evaluating the appropriate use of IPAs and doing a cost-benefit analysis of performing single-year audits versus multiyear audits.

We have seen clear benefits. Multiyear audits reduce our audit time by 40 percent, and industry has responded favorably to the potential of reducing their resources as well. I want to better understand any detrimental effects of a 2-year inventory, and I will work with stakeholders to determine the costs and benefits of auditing one year at a time. However, at this point, I suggest that a 40 percent increase in efficiency makes a compelling case for gathering more information before discontinuing the multiyear process.

I commit to you that if a data-driven cost-benefit analysis demonstrates that single-year audits are more beneficial than multiyear audits, we will do single-year audits.

I would like to thank the committee for allowing me to share my thoughts. If investments are going to be made in additional resources, I would like the opportunity to restore and stabilize DCAA's staffing levels. I would like the opportunity to finish what we are so close to achieving.

I look forward to your questions, and if there are any additional questions after the industry panel, I would welcome the opportunity to answer those. Thank you.

[The prepared statement of Ms. Bales can be found in the Appendix on page 33.]

Mrs. HARTZLER. You bet.

Thank you very much, Ms. Bales. That was very interesting, especially your comments about the multiyear auditing, and that is encouraging, something to look into.

You mentioned materiality, and I wanted to hone in on that again. So what is the standard of materiality DCAA auditors use when conducting? Is it \$100 million? You used that example.

Ms. BALES. No. That example I used was when I worked for the Army, I did financial statement audits. And due to the magnitude of the assets and liabilities on the Army's balance sheet at that time—and that information is dated—\$100 million was the materiality level we used. And so if there was an asset on the balance sheet that was less than \$100 million, it could be entirely wrong

and not materially misstate the financial statements. So that is why we would not choose that line as one to audit.

But within DCAA, we don't do a standard percentage, because it depends on the risk level of the different cost elements that we would look at. We may have a cost element that we have experience with over the years and have not identified any discrepancies or questioned costs. We would look at that—we would make the decision whether we even want to look at that cost segment first, because we do a two-step risk evaluation.

First, which audits do we do. And that gets into, like, our low-risk sampling, because we have determined that certain companies and their incurred costs are low risk. We don't audit every one. We put them into a sample, and we only do a sample of the low risk. We believe doing the sampling is important, because it provides a deterrent effect. If there was the possibility that you would never be audited, what would creep into the incurred costs.

So that is the first step, is deciding which audits to do. And then when we start an audit, we start looking at the risk that involves the different cost segments, be it labor, material, subcontract costs, other direct, and determine where the risk is and decide which elements to audit and to the degree that we audit those.

Certain costs are more sensitive, so we would have a lower materiality level on those than we would ones that would flow down and end up not having as large an impact on the overall cost.

Mrs. HARTZLER. Okay. Very good.

So talk about your backlog. You mentioned that a little bit. And so as I understand it, in fiscal year 2011 the total value of the backlog inventory was \$414 billion and in fiscal year 2016 the total value and the backlog inventory is \$409 billion. So why has the incurred cost backlog not been reduced more in terms of the actual value of the audits that are pending?

Ms. BALES. The dollar value will continue to go up as we get additional incurred costs in every year. Every year we get about 5,000 additional incurred cost submissions, and the dollar value that comes in relates to the dollar value that is being contracted out over the past few years, because we will get an incurred cost audit that will have the dollars for that fiscal year for all contracts for that company. So part of the increase is also due to how much is out on contract.

The dollar value we have probably reduced—we started reducing the dollar value—I think you have a chart in the—if not in my testimony, in the report to Congress—that shows that, initially, we brought the numbers of incurred cost submissions down more quickly than we brought down the dollars.

And part of that goes to the multiyear auditing. We started with our multiyear auditing on the smaller contractors. So we were able to bring down the numbers of submissions faster than we were able to bring down the dollars. But we have now moved into doing multiyear audits, sometimes upwards of 4 years at our larger contracts, and you now see the backlog of dollars coming down faster.

Mrs. HARTZLER. Okay. Is it true that DCAA has issued approximately 14,000 low-risk memos to reduce the backlog?

Ms. BALES. Yes, that is true. That is the ones I referred to that we have closed without audit. We do a low-risk memo to close those out.

Mrs. HARTZLER. Sure. So how many audits were actually completed during that time?

Ms. BALES. That number is—I apologize for not having that—

Ms. HARTZLER. Sure. That is fine.

Ms. BALES. I think that number is around 4,000. But let me—I will confirm that and get back to you.

[The information referred to can be found in the Appendix on page 101.]

Mrs. HARTZLER. Okay. So you completed 4,000 and then just wrote off 14,000, and that is the way to reduce the amount of backlog quick.

Ms. BALES. Right. But that, it goes back into the risk assessment of doing that. And, you know, that is one of the things that we hear a lot, is, well, you audit everything and you don't consider risk. So as we went into the low-risk sampling, we did take a look at those submissions. And every submission we get in, we do an evaluation of the submission to help determine if it should be low risk or not.

Mrs. HARTZLER. Okay.

Ms. BALES. So we see what is in there. We also do other audits to say, you know, we have looked at vouchers that have come in, we do interim vouchers, which is kind of like a mini incurred cost. So if we don't have issues that are coming in on those vouchers, that is another reason we can determine those low risk. So if we haven't done an audit, it is not that we haven't done anything in evaluating that contractor's cost.

Mrs. HARTZLER. Very good. Thank you.

I have got more questions, but I will go to other members.

Ranking Member Moulton.

Mr. MOULTON. Thank you, Madam Chairwoman.

So as I mentioned in my opening statement, I think that as we all look at opportunities for Defense Department reform, one of the things that we are taking a serious look at is the role that the private sector plays and can play in the future in functions like this and functions, frankly, across the Department of Defense. There are a lot of places where the private sector is better equipped to do things than the military or the defense civilians, and we have done a lot of contracting out in recent years. But I just want to dive into that a little bit with you to better understand exactly what that would look like here.

One of the issues that has been brought up in, sort of, an early look at this is the potential for conflicts of interest. So can you just explain a little bit more what that means, what kinds of private auditors would be available to do this work, and why there might be this heightened risk?

Ms. BALES. Well, one of the issues that an auditor that—a company that would come in and potentially do the incurred cost audits, they could not audit any company that they do any other work for, because they would then be making a determination on their own costs, because their own costs would be part of what is in that contractor claim.

There is also the issue, potentially, of proprietary data. One of the things that our contractors are very concerned about is who sees their proprietary data. And I think this would be a question that industry would have to ask is—have to answer is how comfortable are they with sharing their proprietary data with folks that may be auditing their competitors. And, obviously, we audit the competitors, but our purpose is very much into the government interest.

Mr. MOULTON. Right. Sure. But there are a lot of—there are thousands of companies. There are plenty of auditors out there. Why is the issue that they be, you know, potentially auditing their competitors in this situation, whereas that is not the case in another typical industry?

Ms. BALES. And I think that gets down to the level of proprietary data. One of the things that we find with our contractors is they are very trusting and know that we take care of very sensitive data in terms of their price relationships and cost relationships and what they charge different customers. We had a situation with one contractor where they were comfortable giving us the information, but it was very controlled, and we had to make a judgment on that. They didn't really even want to share that information with the contracting officer.

So I think that is the difference between sharing contract—auditors that might do their financial statement audits, which is very public information, versus doing audits that are in the contract arena, which has that very sensitive proprietary data.

Mr. MOULTON. Well, what are the private companies that could do this kind of contract auditing?

Ms. BALES. I would assume that the folks that are going to come in and look at this would be, you know, all of your—the public accounting firms. I think you will have to look at the different sizes that would—you know, some of the smaller ones would not be able to probably absorb an audit that relates to the really large contractors. I don't know in terms of the large contractors if they would really be able to come in and do this type of work or if it would conflict them out on other audits that they do.

Mr. MOULTON. Okay. But the important thing to understand is that, at least in your estimation, the big public accounting firms would have the capability to do this?

Ms. BALES. They would.

Mr. MOULTON. Okay. Even though it is different than the typical financial statement accounting?

Ms. BALES. Right.

Mr. MOULTON. Okay. That is very helpful.

When we are talking about the backlog, there is, obviously, some concern across DOD with the hiring freeze and the impact that that has been having on the work. Could you talk about whether that is an issue and how you are working around it at this point?

Ms. BALES. It is absolutely an issue for us, because we came into fiscal year 2017 lower on our end strength than we needed to complete the work years that we had planned for this year. And we were under a hiring freeze in fiscal year 2016 as a result of the 2016 NDAA [National Defense Authorization Act] that didn't allow us to do work for nondefense agencies, so that lowered the reim-

bursable dollars that we have in that fund about 10 percent of our workforce.

So we had to go into a hiring freeze to accommodate that reduction in funding in 2016. So we entered 2017 very low. And we wanted to hire back that loss from 2016 as well as our normal attrition. We were planning on hiring about 100 people a month, and we started doing that in the first quarter. It got turned on a little slower. And right now we aren't in a hiring freeze—we are in a hiring freeze—so we haven't been able to hire that in January, February, March, and still not hiring to date.

So we are really getting behind the power curve on our ability to execute the work years that we need to this year. And the later we hire in the year—at this point, there is probably no way that we can hire enough to complete the number of work years that we need to this year.

Mr. MOULTON. Okay. Great. Thank you very much. Thank you for being here.

Madam Chairwoman.

Mrs. HARTZLER. Thank you.

Mr. Scott from Georgia.

Mr. SCOTT. Thank you. Thank you, Madam Chair.

Ma'am, you will have to forgive me. I did not receive the testimony until 9:30 last night.

Ms. BALES. I apologize.

Mr. SCOTT. When was the testimony due?

Ms. BALES. It was due 48 hours before. And quite honestly, as it went through the approval process, it got kicked back to us.

Mr. SCOTT. And the approval process, that is through OPM [Office of Personnel Management]?

Ms. BALES. It is through our Pentagon and then over to OMB [Office of Management and Budget].

Mr. SCOTT. I am sorry. OMB is what I meant.

Ms. BALES. Yes.

Mr. SCOTT. Madam Chair, I hope we will start taking note of when we actually receive testimony.

Mrs. HARTZLER. Yes, absolutely.

Mr. SCOTT. It makes it very difficult to do a good job when you don't have the testimony prior to the meetings.

Ms. BALES. Sir, we were pushing as hard as we could.

Mr. SCOTT. I understand, ma'am. But there is a breakdown of management there that has to be fixed for us to do proper oversight. I don't blame it—and understand this, I don't blame you for it. It seems to be habit in most of our agencies today.

Second, I will tell you, I think you are exactly right. If you have a threshold of \$100 million, I think you are going to have an awful lot of stuff stop between \$85 and \$95 million. So I hope you will continue to audit it.

One thing I would also encourage that we never do is something in the auditing that has been done in health care, which is what is called RAC [Recovery Audit Contractor] audits, where auditors are actually paid a commission instead of a fee.

My question for you, though, is how do you measure success? What are the most important metrics, in your opinion, to evaluate your agency's performance?

Ms. BALES. So one of the things we obviously do is report our return on investment. I think that is important for our investors or taxpayers through Congress to know what they are getting for the dollars they spend on us. And currently, in fiscal year 2016, our return on investment was 5.7 to 1. And I will say those are actual realized benefits and dollars that don't go out on contract or money that we get back in through our incurred cost audits.

One of the things that we learned back in 2007, 2008, is you have to have a balanced set of metrics, because if you only measure, like, production, then you forget about quality. Or if you only measure return on investment, you may start doing things that drive unintended behavior, and we don't want to do that.

I know one of the rumors or myths out on the street is that our auditors get appraised for finding dollars. None of our auditors in any of their performance standards say, you get X amount of dollar savings and you are going to get an "exceed," you are going to get an award, you are going to get anything like that. What we measure our auditors on is that they do quality audits that meet the standards and that find what is appropriate.

One of the things that we do is we measure the amount of exceptions that we find on an audit, which is how many dollars do we question. But then we also balance that with how much do we sustain, because we don't want our auditors just questioning cost because it looks good to question. You have to have that balance of how much do we sustain.

So that is what we look for, is measuring—getting balanced measures. Part of it is dollar return. That is what, you know, obviously, we look at, is making sure we do fair and reasonable prices, and that is very easily measured in dollars.

We also look at our timing. So, obviously, the incurred cost backlog is not a good story as we look at our timing metric, but as we look at our forward pricing and we look at—we have brought down our elapsed time on that, we have brought down our elapsed time on most of our audits, and we also look for forward pricing, meeting what we promised the customer.

Mr. SCOTT. Can I ask you, obviously, you are auditing things that happen on our bases and equipment that we purchase.

Ms. BALES. Right.

Mr. SCOTT. Are your auditors actually on-site at the base permanently or do they simply go in as requested?

Ms. BALES. So our auditors, they go into the contractor facilities and do the audit versus doing the audits on base. So we have residencies at many of the large contractors, and then with our smaller contractors we have branch offices where they go out and go to the contractor facilities. Because while the expenditures for what we audit are used on base, what we audit is the contractor.

Mr. SCOTT. Thank you for your testimony, ma'am. I am out of time. But I do wonder if maybe it would be better to audit at the base level, would be a question if we have time I will come back to. But I yield the remainder of the time that I am out of.

Mrs. HARTZLER. Well, thank you, Mr. Scott.

Mr. Suozzi.

Mr. SUOZZI. Director, thank you so much for your time today. Would you say your main job is to try and root out waste, fraud, and abuse in the Department of Defense?

Ms. BALES. I would say it is to make sure that—absolutely. I mean, that is, I think, a job of any Federal employee, is to make sure we don't have fraud, waste, and abuse in our expenditures. And the way we do that is making sure that we are getting fair and reasonable prices for the goods that we—the Department expends with our contractors.

Mr. SUOZZI. So how many employees do you have in your department now?

Ms. BALES. We are currently around 4,500. It fluctuates.

Mr. SUOZZI. And in your view, what would be the ideal number of people to have in that department?

Ms. BALES. We have estimated, as we went through this, that if we could settle in around 5,000, that we would be able to do our portfolio of audits. One of the things that we did to reduce the incurred cost backlog was to go in and ask for more resources and put that in the budget. And we were able to get to about in between 5,000 and 5,100 a couple of times in between the sequestration and the hiring freezes. And if we could do that, we think we will be able to accomplish our incurred cost backlog and then accomplish incurred costs on a regular basis, as well as doing the other audit.

Mr. SUOZZI. You say you would like to see a 10 percent increase in your current employee level?

Ms. BALES. Yes. And that is what we have on hand. Currently, we have a higher budget than what we have on hand, as we said, because of the hiring freeze, so—

Mr. SUOZZI. So the incurred cost backlog, you say it is based upon the submissions. How do you get a submission in the first place? How does something get in the queue in your list of what is on the incurred cost backlog in the first place? What makes that list?

Ms. BALES. So every contractor that has flexibly priced contracts are required to submit an annual incurred cost submission 6 months after the end of their fiscal year. For us, that means we get most of ours in at 30 June, because most of the contractors, about 75 percent of them, have calendar year end as—

Mr. SUOZZI. So 100 percent of those are subject to audit?

Ms. BALES. If they have flexibly priced, yes. And they are subject to audit. And then we go in, again, as the low-risk process. Not all of them will get audited. We do the sampling.

Mr. SUOZZI. But 100 percent of those type of contracts become on the list of incurred cost backlog?

Ms. BALES. Yes. Yes, sir.

Mr. SUOZZI. And is that a reasonable way of doing that, of looking at 100 percent of them? Is that a statute? Or is that a requirement?

Ms. BALES. It is a requirement.

Mr. SUOZZI. As a statute or is something you do, your department determined?

Ms. BALES. No. It is statutorily required that if you have fixed—flexibly priced contracts that you submit an incurred cost submission.

Mr. SUOZZI. Is that a good way of doing it, that all of them make the list?

Ms. BALES. I think yes, because as I go back to the deterrent effect, that if you have flexibly priced contracts and you can report—record costs, we are going to say we are going to reimburse you for all your costs, if no one is looking at what your costs are or there is not the chance that the cost that you submit will be looked at, there is that opportunity to put a lot of costs on. And it is one of those things. It is like we help folks be honest.

Mr. SUOZZI. Okay. You think it makes sense that 100 percent are on the list?

Ms. BALES. Yes.

Mr. SUOZZI. That is all I want to know, your expert opinion.

Do you issue an annual report of any kind that we could read—

Ms. BALES. Yes.

Mr. SUOZZI [continuing]. That says, hey, these are really good examples of things we should be trying to go after, these are good examples of waste, fraud, and abuse that we should be trying to attack?

Ms. BALES. We annually issue our report to Congress, and we also have—our audits in the DOD IG's [Department of Defense Inspector General's] report that would show examples of audits where we have found that.

Mr. SUOZZI. And when you say you issue it to Congress, who gets that?

Ms. BALES. All of the—the HASC [House Committee on Armed Services], the SASC [Senate Committee on Armed Services], the HAC [House Committee on Appropriations], and the SAC [Senate Committee on Appropriations].

Mr. SUOZZI. Okay. Let me see, the HASC, the HAC—

Ms. BALES. I figured this was one place I could use those acronyms.

Mr. SUOZZI. Okay. Well, I think, you know, as a practical matter, it would be good for us to hear ideas from you as to places you think that we can try and eliminate waste, fraud, and abuse in the Department of Defense, because I think in these difficult times when we are looking at increasing budget and scarce resources, we would all like to hear in very practical, straightforward terms: This is a good place to look.

Ms. BALES. Okay.

Mr. SUOZZI. Thank you very much.

Mrs. HARTZLER. Thank you, Mr. Suozzi.

So I had just a couple more questions here. So last year's NDAA required the DCAA to accept certain audit findings of indirect costs from commercial auditors. So has DCAA implemented this policy?

Ms. BALES. We have not yet. I think we have—the timeframe is, like, June that we have to start doing that. And I think part of that is determining how we are going to do that.

One of the things in terms of our professional standards is we can't just accept work from another auditor or auditing company



without doing certain things to know that we can rely on their work.

And, in addition we have been talking somewhat about the intent of that, and we are working through which of those do we accept. Because, quite frankly, the way that is worded—and we have put in a legislative proposal to clarify—is because it says cost type not even flexibly priced, as we talk about the intent, was it the intent that even our largest contractors would not be audited. Because some of those, as a percentage of revenue, even our—like, three of our top five defense contractors would not have incurred cost audits done by DCAA.

And we think that that, with the fact that we are sitting there at those facilities doing all of the other audits, that that would be more efficient than if we were to be able to go in and do those.

Mrs. HARTZLER. So you have put in a legislative request to get more clarification on that?

Ms. BALES. Right. Well, our legislative proposal that is requesting that we don't do that. And, really, as we see the legislative proposals and having the discussions for 2018, making sure that what we are asking to have in 2018 or proposing in 2018 doesn't conflict with that. But our proposal has come in to say if we could eliminate that.

Mrs. HARTZLER. Okay. So if private auditing companies took on a certain percentage of incurred cost audits how would DCAA audit teams be redeployed? And could staff currently allocated to performing incurred cost audits be tasked to work on other audit types?

Ms. BALES. Absolutely. And that is our plan in terms of as we—you know, the increase in workforce that we had, one of our goals and plans in how to get rid of the incurred cost was to dedicate those to doing incurred cost audits to eliminate the backlog. And then, as we got current, we would move those to audits that we aren't doing now that we need to be doing, more cost accounting standard disclosure audits, TINA [Truth in Negotiations] Act audits, those types of things, because we aren't doing all of the audits in other areas that we should.

One of the questions that had come up is, well, if you had hired more people earlier, could you have got the backlog down more quickly? We could have, but then it would be, do I want to staff up and have that temporary workforce or do I want to look at what we would need for a steady state?

In addition, it is how many contract and how many auditors can the contractor support at one time. Because we have had pushback even now as we go in to do the backlog is we can't support any more audit from the contractors.

Mrs. HARTZLER. Very good.

Mr. Moulton, do you have any more questions?

Mr. MOULTON. Thank you, Madam Chairwoman.

Just a couple things, and really points for clarification, because I have some numbers in front of me that I just don't fully understand.

The first question is just about the average time it takes for an incurred cost audit to be completed, because I see one number of

838 days, in some instances we have 124 days. Can you just speak briefly to that discrepancy?

Ms. BALES. So the 885 days shows how long they have been in inventory. It is not actually how long it takes to complete the audit once started. The 134-day average is once we have an entrance, let the contractor know we are starting to do that audit, how long it takes us to do and issue the report.

The 885, as I said, especially, since we have a backlog, is high, because that is when we first received the proposal, the incurred cost submission.

Mr. MOULTON. Great. That is very helpful.

And then we have heard this estimate that privatizing this business would cost the taxpayer about 30 percent more. Can you explain where that comes from and why—what you have to justify that estimate, Director?

Ms. BALES. Sure. So we looked at that. We did a very simple comparison of saying that—compare our hourly rate compared to the GSA [General Services Administration] schedules for companies that would be probable contenders in here. So looking at that, we did a conservative estimate. Our rate includes our, you know, all levels of our auditors, including up to our senior management, and we compared that to a senior auditor rate, which doesn't include the senior partners and everything. So that is how we came up with an estimate on that.

But I think that is one of the things when I said that it would give us some time to evaluate that, I think a business case on whether, you know, will it be cheaper, will it not, I think would be appropriate to do.

Mr. MOULTON. That was some of my experience serving in Iraq, is that a lot of times having private contractors made short-term costs go down but long-term costs go up, and that underlies some of my concerns.

Ms. BALES. Sir, like I said, we don't have a business case analysis. I do have some anecdotal stories, but they are anecdotes. We had some of our nondefense customers wanted to come back to us. We had one that, because we were in backlog and weren't getting the work done, went to an IPA to have their work done.

Then, in fiscal year 2016, they wanted to come back to us, but because of the other language they couldn't. But they wanted to come back to us. One of the reasons was because the contractor doubled their price in the second year.

So those, I think, are some of the concerns, that if we could do and have the opportunity to do a good business case analysis could be evaluated.

Mr. MOULTON. Okay. Thank you, Director.

And then just one other quick question. Mr. Scott brought up this issue with the testimony. Can you just describe in a little bit more detail what the holdup is with OMB? That is where it got held up? Is that right?

Ms. BALES. They passed it back for some language.

Mr. MOULTON. Are these political considerations, or what was going on?

Ms. BALES. They thought we were—because we talked about potential legislative—acquisition reform legislation—and because

we—they had not been aware of legislation, they were concerned that we had not went through them on legislation reform and proposals. So that could have been I said the word “legislation” instead of that we are here to talk about ideas for potential reform.

Mr. MOULTON. Okay. Well, I would hope in the future that we would be able to——

Ms. BALES. So I think that is what got us hung up.

Mr. MOULTON. We would certainly value your feedback on legislative proposals. After all, we are legislators, and we are here to hear your views and opinions. And so, hopefully, that will be not an issue in the future.

Director, thank you very much.

Madam Chairwoman, I yield back.

Mrs. HARTZLER. You bet.

Well, thank you, Ms. Bales. We appreciate you being here today. And so this will conclude the first panel. We appreciate that very much.

And I ask the second panel now to come to the witness table.

Thank you, gentlemen, for being here. We appreciate it very much.

We have Mr. David Berteau from Professional Services Council here, Mr. John Panetta from Financial Executives International, and Mr. James Thomas from the National Defense Industrial Association.

And the members have been provided with your biographies.

So, Mr. Berteau, we will start with you.

**STATEMENT OF HON. DAVID BERTEAU, PRESIDENT AND  
CHIEF EXECUTIVE OFFICER, PROFESSIONAL SERVICES  
COUNCIL**

Mr. BERTEAU. Thank you very much, Chairwoman Hartzler and Ranking Member Moulton and other members of the subcommittee who might come in while we are talking here. We really appreciate the opportunity to testify this morning on behalf of the 400 members of the Professional Services Council. These are all government contractors who fall into the category of both being audited and some of them being potential third-party independent providers for services being discussed here this morning.

Your invitation letter asked us to discuss evaluating the defense contract auditing process. And as part of that discussion, my written statement includes a number of specific recommendations as well as some criteria that we think are useful to you. And I would ask that my full written statement be incorporated into the record this morning. I would just highlight a couple of things.

Mrs. HARTZLER. So ordered.

Mr. BERTEAU. For efficiency and effectiveness, we certainly endorse the idea that the government needs good, timely auditing and proper accounting practices. They have actually got pretty good guidelines out there to do it.

I have brought with me this morning the last printed version of the DCAA contract audit manual. This roughly 4,000 pages gives very good guidance on how to do contract auditing. It also, I think, illustrates the complexity of the process and part of the reason why

it might take a while. So I just bring those along so you can get a sense.

These issues, though, have been with us for a long time. It is not just a result of increased defense spending in the aughts. And the questions are, clearly: How do we protect the government's interests in a timely and cost-effective manner? How do we do this without excessive burden on the system, both the contractors and the program offices that manage those contractors and the contracting officers? How do we focus on getting the best and most useful results? And how do we use contract auditing to support better contracting and better program management? Because auditing is not an end in itself. It is a means to support the execution of government missions and the achievement of government objectives.

The private sector has these same issues, those same questions. And they have made great progress over the years in applying innovative processes and automated tools. And there are some examples that I would be happy to go into during the questions.

Simply adding more people doesn't really change the dynamic of the problem. When you have got a backlog of 2½ years, even if you cut the time in half, it is still taking more than a year to audit a year's worth of costs. And at some point you can't dig your way out of that hole. So that, I think, is an important element to keep in mind.

Many of the functions performed by DCAA that we have talked about this morning should, in fact, only be performed by government employees. But auditing activities themselves as compared to the use of the results of those audits are not an inherently governmental function.

In fact, one of the things that we have seen over the last couple of years is a dramatic increase in the use by civilian Federal agencies of independent third-party contractors. You may be aware there is actually a schedule from the General Services Administration, a contract schedule, which has prequalified auditors on there, and at the time an agency wants to issue a potential task for bid by those prequalified auditors, they can be screened so you eliminate anybody who has a potential conflict of interest for the particular task to be contracted.

So it addresses some of the questions that came up here earlier today of how do you resolve those conflict of interest questions, how do you make sure you only deal with actually qualified entities who can do cost auditing and who have a demonstrated track record.

And, in fact, if you look at the agency costs for these audits, the costs they were paying to DCAA to do the audit before and the costs they are paying to the independent third-party auditors to do that now, you will see not a 30 percent increase, but in many cases a dramatic reduction in those costs.

And I would submit that it would behoove the committee to get some data on that, and we will be happy to try to provide some of that as well, what we have from the public record, but the agencies themselves have substantially more data.

So how would third-party auditors help? They might reduce the cost. They might reduce the backlog. They would certainly help address the question that Ms. Bales raised of, I want to increase, but I don't want to increase the permanent staff, I want to be able to

meet my surge requirements and then come back down to a steady state. This is exactly where you use contractors, is to increase that surge capacity and then draw it back down.

I really wanted to associate myself with Mr. Moulton's comments about what you saw in Iraq in terms of sometimes the short-term costs went down but the long-term costs went up.

I had the privilege in 2007 of being a member of the Gansler Commission that looked at contracting in Iraq and Afghanistan, and then later had the opportunity in DOD to be overseeing the policy associated with that.

And some of that was actually not the fault of anybody in theater, but of policies and procedures back here. The Army, for instance, releasing funds one week at a time so you can never actually buy the thing, you could only rent it for a week, with the cost built in at the end to haul it out of the country, right?

That is not a good way to—that only matters if you think you are only going to be there for another week. We won't go there this morning.

So in the end here, DCAA, I think, has a critical role to play. The numbers say they need some help, and they have admitted that, that is what they have asked for here. The question is, what is the best way to give them that help? And I would submit that there is an enormous opportunity, and it would be useful for them to test that opportunity in reality, not just do a business case assessment but actually try it out and see what the results are.

And rather than recommend to the committee that you repeal the language that you put in the fiscal year 2017 NDAA, actually test it out, and let's look at the results. And I think we will have a very fair comparison under those circumstances. And I would submit to you that would be a good way to go forward.

So I am over my time here, so I will shut up.

[The prepared statement of Mr. Berteau can be found in the Appendix on page 52.]

Mrs. HARTZLER. Well, what you said was very, very helpful. I appreciate that very much.

Mr. Panetta.

#### **STATEMENT OF JOHN PANETTA, NATIONAL SECRETARY, FINANCIAL EXECUTIVES INTERNATIONAL**

Mr. PANETTA. Good morning, Chairwoman Hartzler, Ranking Member Moulton, and committee members. I am John Panetta, the senior director of government accounting at Raytheon in Waltham, Massachusetts. I am here today on behalf of and representing the Financial Executives International Committee on Government Business.

Defense contract auditing has been a matter of discussion in both the private sector and the government for several years. The timeliness of audits, and in particular final incurred cost rate audits, are at the center of the conversation.

Let me start by talking about how we got here. The current state is due to a series of events starting in 2008 when reports surfaced critical of DCAA audit practices. DCAA's reaction was to stress audit quality and independence above all other considerations.

Quality standards over a period of years were in a state of flux. New, untrained auditors were added without sufficient supervision and audit schedules were not considered.

From 2006 to 2015, DCAA's staff grew by approximately 20 percent. Incurred cost audits that were issued over that period were generally incredibly long and packed with immaterial items. This resulted in the number of audits being issued per DCAA employee declining by approximately 90 percent.

In 2012, the Federal Acquisition Regulation Council, at DCAA's urging, expanded the requirements for certified incurred cost proposals in the regulations by adding 30 items for the submission of final indirect rates. Many of these items are not relative to final indirect rates.

DCAA used this FAR change to retroactively reject many previously accepted contractor proposals. This action further delayed the settlement of final rates as contractors needlessly created complicated informational schedules for DCAA that we view as having little, if any, value.

Recently, some progress has been made. DCAA has put a dent in the audit backlog through the use of multiyear audit techniques. Contractor resources have been strained supporting these multi-year audits, and that is not sustainable over the long run. We are not where we need to be. More needs to be done.

The backlog of audits is merely a symptom of underlying issues. Working off the backlog by applying resources will not prevent the condition from returning after the spotlight has moved on to other priorities.

In today's environment, risk management is a buzz word, and risk avoidance is the practice. Adopting an outlook of risk avoidance drives behavior. Perfection becomes the standard, and perfection is an expensive commodity.

There is no question, perfection is something that we should all strive to achieve. However, if the cost to implement a perfect system exceeds the risks that are being addressed, we are collectively wasting resources that could better be applied in other areas.

The CGB [Financial Executives International's Committee on Government Business] believes that getting back to basics, implementing efficient audit management practices, and changing how success is measured with respect to oversight will go a long way in addressing the root cause of the issues we are addressing.

Emphasizing audit practices such as establishing materiality thresholds, relying on the work of others, meeting schedules, and using documentation standards that are accepted by other audit groups, will all speed up the process without shifting significant risks to the government.

For example, a company that has received a passing grade from a CPA [certified public accountant] firm with respect to the requirements of the Sarbanes-Oxley Act has already run a gauntlet of audits. Why should DCAA retest underlying systems and transactions that have already been validated for financial reporting purposes?

The current measure of success at DCAA is the amount at annual findings. That is akin to paying a CPA firm upon the receipt of a clean opinion. That works against the requirements for inde-

pendence, and CPAs would certainly grab the attention of the SEC [Securities and Exchange Commission] for that.

This measure creates churn in the acquisition process. There are a number of examples where DCAA's implementation of the FAR to generate those findings resulted in legal disputes overturning their positions. This, again, wastes both the government and contractor resources. Success should be measured by the completion of a timely, quality audit that promotes and provides reasonable assurance of an effective acquisition process.

These actions, together with the introduction of independence CPA firms to conduct audits at DOD, as they do at other executive departments, will result in the fundamental change that is required for the acquisition process to function as envisioned in the guiding principles of the FAR.

Thank you very much. I would be happy to answer any questions that you have.

[The prepared statement of Mr. Panetta can be found in the Appendix on page 68.]

Mrs. HARTZLER. Very good. Only 12 seconds over 5 minutes. That is pretty amazing.

I have a lot of questions. I want to come back to you on a lot of good stuff there.

Mr. James Thomas, let's go to you, though, first.

**STATEMENT OF JAMES THOMAS, ASSISTANT VICE PRESIDENT  
OF POLICY, NATIONAL DEFENSE INDUSTRIAL ASSOCIATION**

Mr. THOMAS. Thank you. Chairwoman Hartzler, Ranking Member Moulton, and members of the subcommittee, thank you for the opportunity to appear before you this morning. I am here on behalf of the National Defense Industrial Association, the Nation's oldest and largest defense industry association, comprised nearly of 1,600 corporate and 80,000 individual members.

My testimony this morning will focus on the main theme and associated recommendations within my written statement, the change in DCAA's mission from its original purpose, and the effect of that change on industry and the operations of the defense acquisition system.

Industry recognizes that the audit responsibilities of DCAA play an essential role within DOD's acquisition oversight activities throughout the contracting life cycle. DCAA was stood up in 1965 to serve as an advisory function for contracting officer decision making, but has evolved to serve solely as an enforcer of their own process requirements, lacking a nexus with the contracting officer decision-making process.

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 oversight role.

DCAA is not a profit center, but their reports to Congress highlight that the measure of mission success is that their audit activities provide a large return on investment 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 while continuing to emphasize success based upon questioned costs and return on investment.

Auditing is process based, not outcome based. DCAA asserts that their return on investment to the taxpayer in fiscal year 2015 was \$4.80 per dollar spent. Unfortunately, that value computation does not accurately measure all costs to the acquisition system and contractors. These costs include but are not limited to delays in contract closeouts for the government, legal disputes, and records retention for industry.

Another cost driver for industry occurs through the misunderstanding of the concept of materiality as expressed in the work product and inconsistent judgment of DCAA auditors. As it pertains to business system, contractors incur high costs to achieve perfection and internal controls to avoid any allegations of deficiencies rather than achieve controls that provide reasonable assurance.

Striving for perfection is admirable; however, the costs incurred by industry to seek perfection of systems and controls in order to avoid allegations of deficiencies when a reasonable assurance standard would serve the agency mission objectives and not result in increased costs to the government runs contrary to the emphasis on risk management contained in the FAR.

This level of process perfection driven by a reluctance to employ judgment about materiality undermines the timeliness of business systems in post-award audits. Instead, DCAA should measure its success in quality audits that meet the expectations of contracting officers in a timely manner, which aligns more appropriately with DCAA's original purpose.

Contracting officers need audit reports with timely and actionable findings to help them make decisions. A review of aggregate data provided in the five publicly available reports to Congress from fiscal year 2011 to 2015 and the DOD inspectors general semiannual report shows decreasing productivity in the number of audits completed per auditor and that less than one-third of the questioned costs are sustained for fiscal year 2014 and 2015.

Moving forward, the following recommendations should be considered.

First, reevaluate the DCAA mission, organization, and management and responsibilities and functions provided in DOD directive 5105.36. This could be achieved by establishing a working group of government and industry acquisition and auditing professionals to align mission objectives with the statutory audit record requirements.

Second, establish timely deadlines for the completion of incurred cost audits. The optimal timeline would be 90 days from submission of incurred cost proposals, which aligns more closely with SEC requirements for a company's annual filing. These filings incorporate an accounting firm's audit opinion regarding these statements.

Third, embrace the use of third-party auditors for incurred costs in business system audits. This is likely the only solution to eliminate the incurred cost audit backlog and should continue thereafter. However, it is not a complete solution. The efficacy of Sec-



tions 820 and 893 in reducing the backlog will be limited if DCAA still requests working papers and backup materials on work performed by public accounting firms, which we believe is not necessary or appropriate.

Fourth, publish an annual report card with assessment of DCAA's services from DOD entities responsible for procurement and contract administration. This feedback would be highly beneficial in understanding how well DCAA is performing in its customer service role. We are not aware of any existing attempts to do this.

And lastly, Congress should strongly consider the recommendations of the congressionally established 809 panel. The Section 809 panel will be examining the defense contract audit process as part of its larger review. Although their final report is not due for another 18 months, it should provide insight into the proper role and responsibilities of DCAA and other oversight actors through a broader systemic perspective.

Thank you for the opportunity to appear before you this morning, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Thomas can be found in the Appendix on page 87.]

Mrs. HARTZLER. Thank you very much. Some good information here.

I would like to ask all of you, I guess start with you, Mr. Panetta, because you mentioned multiyear audits in your testimony. And DCAA has indicated to us, and she just testified, that even after the backlog is eliminated, the agency would like to see more multiyear auditing done as the standard practice.

So how does that practice compare to private sector norms? And what do you think of that practice for both audits in the backlog and for new ones going forward?

Mr. PANETTA. Well, thank you, Madam Chairwoman.

In comparing that to private sector norms, in the private sector audits are done on a concurrent basis. And we don't see multiyear audits. DCAA audits are retrospective. And what we see when we look, say, at our financial statement audits, the auditors are auditing the year as we are going along such that when the year is complete, a couple months after the year is closed, we issue our financial statements and they issue their opinion.

So we don't really see multiyear audits. We see concurrent audits. And I see a problem with doing multiyear audits from a DCAA perspective, and it is because it is very difficult for contractors.

We like to staff at a level of activity. And, normally, audit activity will go along at a certain level. When you go to multiyear audits, you are going to have peaks and valleys and spikes. And to support that activity, it strains the organization, because you either have to be overstaffed for part of the year or you have to bring in excess resources otherwise that aren't familiar.

So we would rather see a regular cadence of an annual audit that is done quickly and concurrently.

Mrs. HARTZLER. Obviously, votes are occurring, but I would like to visit with you more about the concurrent. How would that

change if the DCAA would do concurrent rather than after? What changes would there be?

Mr. PANETTA. Years ago they used to do concurrent auditing as a practice. They would roll it out. And what would happen is, as the year would go along, they would test particular accounts that were as costs were incurred, and contractors would, say, make adjustments as they found things, such that when the year was over, the audit work was complete, the findings were known, and the contractors could actually make the adjustments before we made the submission.

I mean, that to me would be nirvana, in that when you make your submission 6 months after the year, it has already been audited in terms of the underlying information and adjustments have been made and you are done. I mean, that would be a great goal to try to achieve.

Mrs. HARTZLER. Yes, Mr. Berteau.

Mr. BERTEAU. Madam Chairwoman, if I could add one thing to that. The value of multiyear is only there if you have a substantial backlog that goes back a number of years. We have some examples of third-party independent auditors for civilian agencies that are current through fiscal year 2015 and soon current through fiscal year 2016. And so there is no need for a multiyear audit if you are up-to-date. And I think that should be the objective that we want to achieve. Even if we can't go nirvana, we can at least get partway to currency.

Mrs. HARTZLER. Yeah. That is good.

I will go ahead and shift to Mr. Moulton.

Mr. MOULTON. Thank you, Madam Chairwoman.

So just to hone in on that for a second. The director just testified that she would be completely open to moving to single-year audits if a cost-benefit analysis showed that they would be more effective. I mean, do you agree with that assessment?

Mr. BERTEAU. I think a level playing field assessment, particularly if you tested it with real world experience and try it out, would produce the kind of results that she would be comfortable with and we would be comfortable with.

Mr. MOULTON. And, Mr. Panetta, would you agree with that as well?

Mr. PANETTA. A single-year audit would certainly make more sense to me.

Mr. MOULTON. Well, that is not what I asked. I asked if you would be open to having a cost-benefit analysis determine whether a single-year audit or a multiyear audit is more effective.

Mr. PANETTA. Well, certainly. More information and understanding is always something good. So data-driven decisions always work out best.

Mr. MOULTON. Okay.

And, Mr. Thomas, what is your opinion on this?

Mr. THOMAS. I agree with the other two members. Having a multiyear process is really not ideal for a standard practice. Certainly, it is a benefit to address a backlog. Most of our members agree that that is okay for that purpose. But as a standard practice, having concurrent and timely audits is more ideal.

In answer to your question just now about having a business case analysis, I don't think that would hurt at all. But I think if there was an analysis done, it has to take into account all the costs associated with having all the liabilities on the books, the time and the costs associated with that, not just the efficiency of being able for the department to move through those audits.

Mr. MOULTON. Thank you.

And, Mr. Thomas, in your testimony you cited the fact that DCAA talks about the ROI [return on investment] for taxpayers, the dollars that it recovers. And I think the issue about risk avoidance versus risk mitigation is well taken, and this is something that we have heard from other folks as well. But it just seems to me that if the agency is recovering a significant amount of money here, then obviously there is a purpose to having these audits. I mean, there is clearly some waste, fraud, and abuse going on.

Do you disagree with that?

Mr. THOMAS. I don't disagree entirely. I think, though, we have to draw a distinction between waste, fraud, and abuse and finding certain unallowable costs or things that can be easily addressed. Most companies want to comply. They want to be able to be audit ready and have these done in a timely, efficient manner.

And when you look at the purpose of the DCAA, it is really for an advisory role to the contracting officer to make a final determination of price reasonableness and understand that risk assurance. That is really separate from the role of an IG [inspector general]. Certainly, you can identify where they blend together. Obviously, you are identifying issues within an audit.

But the purpose really shouldn't be to identify that. That is why you have a separate entity. It really should be to work with the contractor through the audit process, identify those issues, make the appropriate changes, and move on so that the contracting officer can make a determination in a reasonable amount of time.

Mr. MOULTON. So we have to wrap up, but just real quickly so I understand here, you agree that, clearly, there is a role for auditing in the Department of Defense? I mean, we have the Secretary of Defense now saying we should audit the entire Department, which is something I think we on the committee all agree with. And yet you say the mission—there has sort of been some mission creep here or whatever.

Look, I don't accept the premise that just because the mission in 1965 is different than the mission today that therefore it is wrong. I mean, the mission of the Marine Corps that I joined is not the same today as it was in 1775. So that can evolve.

But if there is this issue with auditing, we have acknowledged at length the backlog, and you think that this should be more taken up by the inspector general, then I must assume that there are not enough resources with the IG to do this. Would that be your conclusion as well?

Mr. THOMAS. Not necessarily. I don't know that the two roles are the same in audit. And first, I do agree, absolutely, that it is an essential part of the government, particularly DCAA, to be able to audit as part of the internal control process of the acquisition system. So there is no question, particularly from our members.

But I believe that the inspector general has a different purpose in identifying abuse, whereas the auditor's financial—going through the audit to find risk assessment with the rate sustainment is very different, and that is really, again, just more of an advisory function for the contracting officer.

Mr. MOULTON. Well, there is a certain way to look at it, which might be oversimplistic, which is that there is a difference between outright fraud and abuse versus just getting the best price so we don't have the sort of infamous \$30,000 toilet. But, nonetheless, taxpayers want both, and I think taxpayers probably deserve both. Is that right?

Mr. THOMAS. Absolutely.

Mr. MOULTON. Okay. Thank you, Madam Chairwoman. I yield back.

Mrs. HARTZLER. Well, we have had a very good discussion with a lot of information here today, and we want to continue this discussion. And we will look further into your testimony and these ideas moving forward.

But we really appreciate your insights. Thank you for being here today.

And this hearing is now adjourned.

[Whereupon, at 10:15 a.m., the subcommittee was adjourned.]

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# **A P P E N D I X**

APRIL 6, 2017

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**PREPARED STATEMENTS SUBMITTED FOR THE RECORD**

APRIL 6, 2017

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**Opening Remarks of Chairwoman Vicky Hartzler  
Subcommittee on Oversight & Investigation Hearing  
“Evaluating the Defense Contract Auditing Process”  
April 6, 2017**

Good morning. This hearing will come to order.

I welcome our subcommittee members and witnesses testifying before us today.

I welcome the members of the full committee who are not permanent members of the subcommittee who are or will be attending. I ask unanimous consent that these committee members be permitted to participate in this hearing with the understanding that all sitting subcommittee members will be recognized for questions prior to those not assigned to the subcommittee. Without objection, so ordered.

Over the last 15 years, the Department of Defense has become increasingly reliant on the use of government contractors. When used properly, this public and private partnership can both improve our national security and at the same time preserve limited government resources.

But, this work requires competent and timely oversight. To that end, financial audits of defense contracts can play a vital role in ensuring that expenditures paid by the government for goods and services are fair and reasonable. It also ensures that tax payers are getting the best bang for their buck.

Within the Department of Defense, the Defense Contract Audit Agency (or DCAA) is charged with this critical mission. Today’s hearing seeks to learn more about where the auditing process is working and identify any shortcomings with current accounting efforts.

I’m always looking for productive ways to improve government performance. I look forward to hearing from our witnesses about their feedback on the current auditing system.

At the outset, I have several overarching questions about how the audit process is working within DCAA. In particular, for years, DCAA has had a significant backlog of “Incurred Cost Audits.” These audits are meant to identify instances where the government might have overpaid.

However, as I understand, it has been taking on average more than 2 years from the time DCAA receives the information necessary to conduct an incurred cost audit to the date the audit report is issued. These delays can create problems for government contract managers. Their efforts to recover improper costs are slowed. It also means managers do not have important financial information available soon after an expenditure takes place, when the information is most important.

From a business perspective – this delay can also create economic burdens. I look forward to hearing from our panel of industry experts on how these delays impact the private sector.

I also have questions about how efficiently DCAA is performing these incurred cost audits. Although they account for the most significant portion of total costs audited each year, these audits only account for a relatively small amount of reported savings. I want to understand how much these audits are costing American tax payers compared to the return from that cost.

On a related note, I'm interested to hear from our witnesses about how DCAA audit practices compare to what is commercially acceptable in the private sector. Perhaps there are lessons to be learned outside of government that could improve defense contract audit performance.

The bottom line is simple: we all want a fair, efficient, and timely auditing process that works for all interested parties. I look forward to everyone's views this morning in addressing these important topics.

**Opening Remarks of Ranking Member Seth Moulton  
Subcommittee on Oversight & Investigation Hearing  
“Evaluating the Defense Contract Auditing Process”  
April 6, 2017**

Thank you, Madam Chairwoman. The topic of our hearing today should be important to anyone concerned about accountability, efficiency, and transparency in our multibillion-dollar defense sector.

The Defense Contract Audit Agency (DCAA) is the government organization charged with auditing the \$287 billion in defense contracts that the Pentagon and other agencies make with private businesses every year. That makes it one of the main organizations whose job it is to ensure that the taxpayers’ defense dollars are not stolen, wasted, or otherwise abused. DCAA also helps the government negotiate more competitive prices from the private sector.

These roles, in which DCAA holds a public trust, are important to keep in mind as we discuss the pace of DCAA’s auditing process. According to their annual report, DCAA currently has a backlog of incurred cost audits that it needs to reduce to ensure defense contracts are not unnecessarily delayed.

But, as we try to reduce this backlog, we should also be wary of proposals to fix it that could undermine the public trust. I understand Congress may be considering proposals to privatize the functions of DCAA and hand this important work over to private auditors. I am a strong believer in public-private partnerships, and I’ve personally advocated for private involvement in a number of projects including transportation projects. In this case, however, I caution that not only would privatization cost the taxpayer about 30 percent more; we would also be positioning a small number of auditing companies to oversee defense contractors with whom there would likely be conflicts of interest. The history of Enron and the financial crisis tell us that is not a good idea.

We should also keep in mind the origin and state of DCAA’s backlog, as we develop defense reform policies. DCAA first developed a backlog when the number of defense contracts and expenditures ballooned during the wars in Iraq and Afghanistan. DCAA has certainly made mistakes, but in 2010 it recognized this problem, hired 400 additional workers, and adopted new strategies to begin reducing the backlog. Those efforts in fact succeeded, and as you can see from a graph of the backlog, the backlog has been shrinking by about 4,000 contracts per year to the point where only about 4,677 are left in the queue. When the pace has slowed, it has been due to sequestration and now President Trump’s hiring freeze.

This evidence suggests we can make a lot of progress on this backlog by properly resourcing DCAA’s mission, mitigating the impact of sequestration and hiring freezes, and ensuring DCAA has enough capacity to

cope with an unexpected increase in defense spending. In fact we should be concerned that privatizing DCAA's auditing work might throw a wrench in the process and make it slower for contractors, as opposed to letting DCAA address their backlog in a strategic way. I look forward to your testimony.

Testimony  
of  
Anita F. Bales  
Director, Defense Contract Audit Agency  
before the  
House Armed Services Subcommittee  
On Oversight and Investigations  
on  
April 6, 2017

Chairwoman Hartzler, Representative Moulton, and members of the Subcommittee, thank you for the opportunity to appear before you today. I am pleased to provide you with an overview of DCAA's contract audit mission and responsibilities. I will discuss DCAA's current operations to include pace and schedule of audits and current ideas on acquisition reform.

**Background**

DCAA is a distinct agency of the Department of Defense (DoD) that reports to the Under Secretary of Defense (Comptroller). The DCAA mission is to perform the necessary audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting, thereby protecting the taxpayer's interest and supporting the warfighter. Our charter was intentionally developed to permit DCAA to provide these same contract audit services to other Federal agencies.

Government officials draw on DCAA audit findings throughout the acquisition process. With these recommendations, contracting officers are better able to negotiate prices and settle contracts for major weapons systems, services, and supplies. At the front end, DCAA's findings can directly impact the price that the government pays for contracted work. Even after a contract is underway, DCAA findings may address instances where the government overpaid contractors for work, uncover potential fraud or misuse of funds, and impact future contract prices by addressing inadequacies early on. Before officially closing out a flexibly price contract, DCAA assesses whether the contractor's claims for final annual incurred costs during contract performance are allowable and reasonable according to applicable acquisition regulations and contract provisions. This final task in the contract audit process ensures that no excess costs were charged to the Government.

**DCAA Contract Audit Effort**

To carry out its mission, DCAA has about 4,500 employees at 300 offices around the world. More than 85 percent of DCAA's personnel are auditors. In FY 2016, DCAA examined \$286.7 billion in contract costs, issued 4,269 audit reports, identified over \$9.9 billion in audit exceptions, reported \$3.6 billion in net savings, and produced a return on investment of about \$5.70 to \$1. These savings are actual dollar reductions in contract prices or payments to the Government based on contractor overpayments. In addition to making steady progress on the incurred cost backlog, the Agency also continued to conduct other audits to help contracting officers establish fair and reasonable prices and reduce the risk of contractor overpayments.

Today, I would like to highlight forward pricing and incurred cost, which represent the majority of our work and where we have made significant improvements resulting in better processes, higher performance, and increased value for our customers.

**Forward Pricing**

We get the highest return on investment (ROI) from forward pricing audits, which have netted the government an average of \$3 billion per year. These savings represent actual reductions in negotiated contract prices for the goods and services the government is buying. We continually seek feedback on our forward pricing process to improve our value to our customers, and we have executed several initiatives that have increased efficiency and improved communication. As a result of these actions, we have cut our response time by 20 percent over the last five years and established a consistent practice of proactive, early engagement with contracting officers, which has demonstrably improved audit effectiveness. Customer feedback

from approximately 200 surveys a year consistently reflects high satisfaction ratings with audit timeliness, accuracy, communication, and overall satisfaction. In addition, our commitment to early and ongoing communication with contracting officials at all levels allows us to identify the highest risk contract actions and perform the right audit services to meet their needs.

We have put a particular emphasis on the highest risk forward pricing rates because they generally represent the major portion of the contract dollars. We have been highly proactive with the Defense Contract Management Agency (DCMA) to reinvigorate our audit processes to make recommended forward pricing rates available to the contracting officer. This collaboration has led to quicker settlements on fair and reasonable prices, which has sped up the overall acquisition process.

DCAA has also focused on delivering our product to the contracting officers as promised, which is essential to help the acquisition community keep the contract award process on track. We have seen our on-time rate improve by roughly 50 percent in the last five years.

We are consistently seeking out new ways to improve internal processes, communication, and timeliness of audits without compromising audit quality.

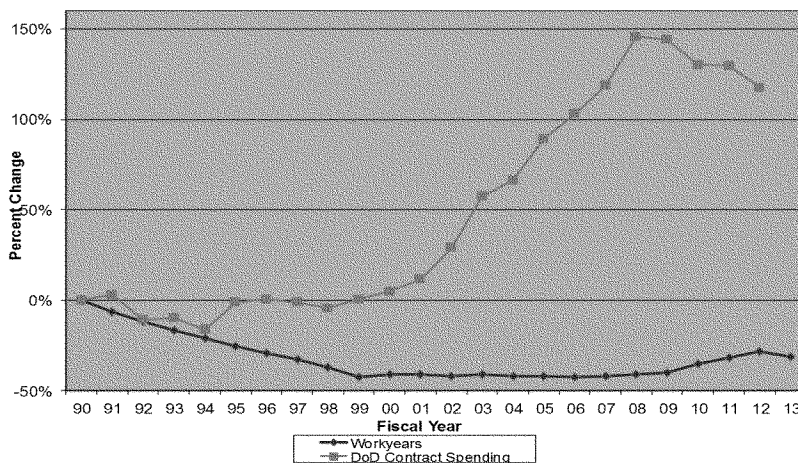
#### **Incurred Cost**

Incurred cost audits return less ROI than Forward Pricing, but they carry substantial intrinsic value across our entire portfolio of audits. Incurred cost audits are critically important in the acquisition process, and we audit the incurred cost proposal to ensure that all direct and indirect costs are compliant with contract terms and government acquisition regulations. Beyond ensuring compliance, however, incurred costs give us pertinent information that increases our efficiency on many other audits. For example, an incurred cost audit can reveal poor accounting practices including noncompliance with Business System requirements and Cost Accounting



standards. They also provide valuable historical information necessary to close out contracts and establish forward pricing rates that we rely to negotiate new fixed price contracts.

The incurred cost audits, particularly the incurred cost backlog, have received a lot of attention by several organizations concerned about us getting the backlog current. First, it is important to understand the root cause of the backlog. Specifically, during 2000-2009, defense contract spending increased in support of the Gulf war, but DCAA resources remained the same (Figure 1). Because we didn't have sufficient audit staff to perform all the new work, we dedicated our limited resources to high risk defense procurements and deferred incurred cost audits, the only audits that could be postponed without significant risk to the taxpayer or the warfighter.



**Figure 1.**  
DoD Contract Spending (2012 Constant Dollars) Vs. DCAA  
Staffing Percent Change from 1990

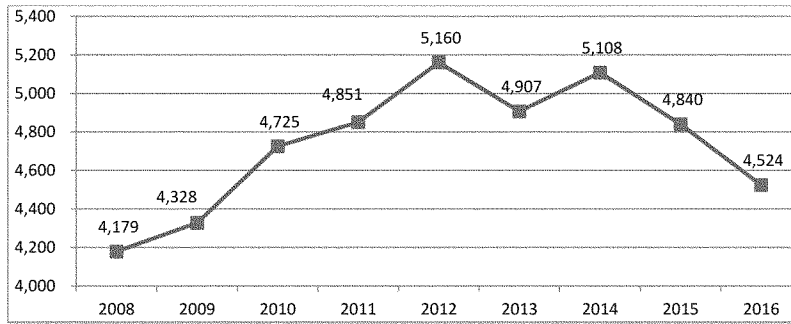
As a result, by the end of FY 2011, DCAA had an estimated backlog of about 21,000 contractor incurred cost submissions on hand with a total value of about \$333 billion. To address

this backlog, DCAA developed an action plan for more efficient audits, including executing a four-prong strategy to eliminate the backlog. The four-prong approach included the following:

1. A comprehensive low risk incurred cost sampling process. Contractors that have less than \$250 million in incurred costs on flexibly priced contracts and have been determined to be low risk are audited on a sampling basis, similar to the IRS process. Contractors that have been identified as high risk undergo an incurred cost audit every year.
2. Multi-year audits. Instead of auditing only one incurred cost year at a time, DCAA began auditing two or more years during the same audit. This process has been extremely efficient, reducing our labor costs by 40 percent over separate single-year audits for the subject years.
3. Dedicated audit staff. To maintain our momentum on reducing the backlog, we dedicated auditors to incurred cost work and ensured that they could not be shifted to other work.
4. Additional resources. We obtained additional resources to close the resource gap that occurred between 2000 and 2009.

This four-pronged approach was in full operation by the end of FY 2012. DCAA has made solid, consistent progress since 2011 towards eliminating the incurred cost backlog. However, our progress has been adversely affected by our inability to sustain the fourth prong of the strategy. DCAA's inability to maintain a steady level of staffing has presented a major barrier and hindered our ability to successfully accomplish our mission. To perform and sustain the full complement of contract audits that pose the greatest risk to the government, DCAA needs to

have a stable and well-qualified workforce that can deliver on its mission. Since reaching our target in 2012, DCAA has seen significant staffing fluctuations (Figure 2).

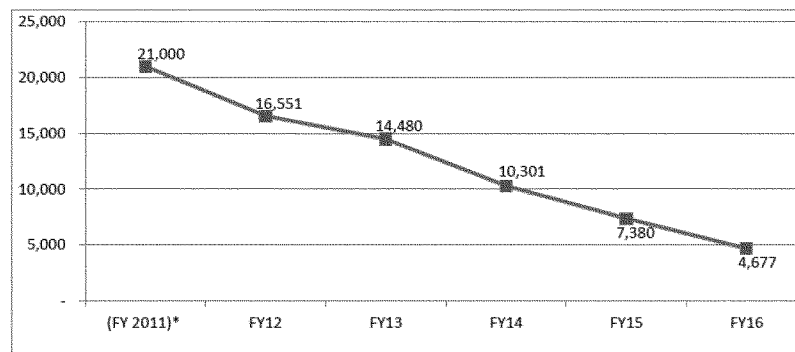


**Figure 2. DCAA staffing FY2008-FY2016**

Sequestration, furloughs, hiring freezes, and other funding limitations have prevented the Agency from hiring to its authorized staffing level for several years. These circumstances, in turn, continue to impact subsequent Agency budgets through Congressional marks that are largely based on DCAA's under execution of authorized funding levels. We repeatedly find that these staffing upheavals negatively affect workload projections, delay training plans, and disrupt the professional development pipeline critical for meeting the high risk needs of our customers. For example, based on our trajectory on eliminating the Incurred cost backlog (Figure 3), we were planning to be fully current by 2018. However, the passage of the 2016 NDAA (Section 893), which prohibited DCAA from receiving reimbursements from non-DoD agencies, necessitated a hiring freeze that interrupted our progress. Because of that hiring freeze, together with the additional hiring freeze for FY 2017, we are currently reassessing our projections to determine how these events will impact our target dates.

Finally, it is important to note that our timeliness also requires cooperation and information from contractors, which can sometimes be challenging on both sides.

Regardless of the challenges we have faced, our strategies have clearly been effective. We closed out FY 2016 with the backlog down to 4,677 incurred cost years, representing a 75 percent reduction of the backlog.



\* Baseline

**Figure 3. Incurred Cost Backlog Reduction FY2011-FY2016**

We request the help of Congress to ensure that we can hire and maintain a stable staffing level necessary to execute the audits vital for protecting the government's interests.

#### **Acquisition Reform**

We value the Committee's commitment to improving the acquisition process. DCAA also upholds that commitment, and we consider process analysis, optimization, and improvements as fundamental in executing our mission to serve the warfighter and protect the taxpayer. We

appreciate the opportunity we have had to review acquisition reform and to provide information about what DCAA is already doing, the progress we have made, and the ways we can best help achieve your objectives. I'd like address several areas with the Committee today, including our risk-based approach to audits, materiality thresholds, for the requirement for GS-14 managers to be CPAs, the potential role of Independent Public Accounting (IPA) firms, and mandated timelines for Incurred Cost.

#### **Risk-based Approach and Materiality**

One of the acquisition reform ideas call for providing detailed criteria for defining materiality and for DCAA to develop a risk-based approach to audits. DCAA has a comprehensive risk-based approach, and I'm happy to provide you more information on our processes.

DCAA assesses risk at two levels, which allows us to target our resources on the work that provides the most value. The first step is conducting a risk assessment to determine whether the audit engagement represents a significant risk to the Government. We worked with the acquisition community to establish dollar thresholds to identify the point at which an audit is necessary to protect the Government's interests. For pricing actions, the Department established the thresholds in Table 1.

**Table 1. Forward Pricing Proposal Audit Threshold**

<b>Contract Type</b>	<b>Audit Threshold</b>
Fixed-price Proposals	Greater than \$10 Million
Cost-type Proposals	Greater than \$100 Million

The difference in these thresholds represents the risk inherent in different types of proposals. For example, Cost-type proposals pose a lower risk because they are subject to

Incurred cost audits; therefore, the threshold is higher. Fixed-price proposals are not subject to Incurred Cost audits, so there is more risk to the Government if we do not identify unreasonable prices before the contract is awarded. Neither of these thresholds, however, are absolute. If a contract poses a higher risk based on other factors, DCAA will work with the contracting officer and perform the necessary audit services to address the risk.

Incurred cost proposals for flexibly-priced contracts are put into three categories based on dollar value and assessed risk to determine if the proposal will be audited to protect the Government's interest.

1. All proposals exceeding \$250 million in incurred costs in a fiscal year must be audited.
2. Proposals less than or equal to \$250 million in a fiscal year will be assessed for risk, and any high-risk proposals will be audited.
3. The remaining proposals less than or equal to \$250 million that are determined to be low risk and adequate will be randomly selected for audit.

Having determined which proposals will be audited, we move to the second step of our process. In this step, DCAA assesses risk of the different cost elements within the proposal to determine the degree to which that element needs to be audited to prevent the potential for overpayment on government contracts. To make their determinations, auditors assess various risk factors such as previous experience with the contractor, reliability of contractor systems, and type of contract. The assessment is also based on the how material each segment is to the overall proposal. Auditors consider materiality when evaluating elements of cost and then assess the findings for an overall material impact. The auditor only reports findings or noncompliances if they will have a significant material effect on contract costs.

We are consistently reviewing our risk-based processes to ensure our risk assessments are valid. For example, we confer annually with the Government Accountability Office to review our low risk sampling process and make adjustments where necessary. In general, however, we find few anomalies that challenge our confidence in our low-risk approach.

We don't believe there is a need to further define a risk-based approach nor materiality because as shown we already implement these concepts in our methodologies. We also believe that defining materiality to the specificity being considered will be too limiting and will not allow our auditors to exercise their professional judgment to adjust to unique circumstances as required by all auditors' professional standards.

#### **Introduction of Independent Public Accounting Firms**

We have also reviewed a reform idea to allow independent public auditors (IPAs) to do audit work historically performed by DCAA. DCAA is better positioned to perform these audits because of their expertise in auditing to the unique requirements of Government contracts, and I believe that allowing IPAs to conduct these could have a significant negative impact on DoD contract administration and audit processes.

First, I would like to provide a brief overview of the differences between the type of audits traditionally performed by Independent Public Auditors and DCAA, each of which requires a unique set of skills. An IPA's expertise is predominately in tax work and financial statement audits. For example, a financial statement auditor knows the necessary audit procedures to conclude that financial statements fairly present the financial position of the company in accordance with Generally Accepted Accounting Principles (GAAP). In contrast, DCAA auditors are skilled in cost accounting and have a thorough knowledge of the Federal

Acquisition Regulations (FAR) and Cost Accounting Standards (CAS). Knowledge of FAR and CAS is a fundamental to auditing Government contracts. Based on their expertise, DCAA is able to develop unique auditing procedures to ensure that costs incurred and paid by the Government are allowable and allocable in accordance with the FAR and CAS.

In addition to the contract audit expertise of the DCAA workforce, we bring efficiencies to the audit process by having purview over an entire portfolio of contract audits for each contractor and an entire population of incurred cost submissions. First, all audits for a single contractor are interrelated during the acquisition process, and we use the information from other audits to assess risk on incurred cost proposals, which greatly reduces our efforts on the audit. For example, a DCAA paid voucher audit informs the auditor on key cost considerations to use when assessing incurred costs. In addition, having an IPA perform the incurred cost audits will lead to inefficiencies in DCAA's performance of the other contract audits. During the audit of the incurred cost audit, DCAA is able to gain insights into business systems and historical trends that help inform the risk for other audits DCAA performs like forward pricing audits. Secondly, because we receive all contractors' incurred cost submissions, we have been able to implement sampling of low risk submissions across that population. DCAA's other audit work at these contractors allows DCAA to rely on its knowledge of the contractor and sample low risk contractors, which results in only a small percentage of low-risk submissions undergoing an audit. Without historical knowledge of the contractors and access to the population from which to pull a sample, an IPA will not be able to make these low risk determinations and implement sampling. Additionally, there will be inherent inefficiencies when the audits transition from one IPA to another IPA when the IPA audit work is re-competed over the years. Therefore, there



will be an increase in audit effort. Over the past 5 years, we closed over 14 thousand incurred cost years without an audit based on our alternative low risk procedures.

Another incurred cost audit process that would be significantly impacted and contribute to inefficiencies is the audits of subcontracts that have to be done to support the prime contractor's incurred costs. Currently, DCAA facilitates the audit completion of several hundred subcontract incurred cost audits that are deemed high risk. Let me explain. When performing an incurred cost audit at a prime contractor, we identify the significant and high risk flexibly price subcontracts that also require audit. We request assistance from our cognizant DCAA office for that subcontractor, and they perform the audit because the subcontractors will not allow the prime contractor access to their proprietary data. We incorporate those results into the audit of the prime and then provide the audit results to the contracting officer for resolution. Since DCAA is the only audit agency for the Department and located worldwide, this process is very efficient. If an IPA were to perform the prime contract incurred costs, a new process would have to be established where DCMA would have to facilitate the assist audit process and potentially contract with several different IPAs to perform the subcontract audits, thereby increasing costs to the taxpayer due to these increased efforts. Processes would have to be developed for establishing agreements for IPAs to work together while also ensuring all contractor proprietary data is kept secure.

Finally, I would like to discuss the inherently governmental nature of the audit process. The work DCAA does for approximately 65 percent of all incurred cost audits has been classified as inherently governmental. These are the submissions for which DCAA determines the annual indirect rates using auditor determined procedures pursuant to FAR 42.705 and 42.705-2. The determination of indirect rates involves "determining whether contract costs are

reasonable, allocable and allowable,” which FAR Subpart 7.503(c) (12) (vii) lists as an inherently governmental function. This determination cannot be performed by a private auditor pursuant to the Government auditor determination procedure at FAR 42.705-2. Thus, all audits conducted by an IPA will introduce inefficiencies and require the contracting officer to perform significantly more contract administration effort as the final indirect cost rates must be determined by a contracting officer pursuant to the contracting officer determination procedure at FAR 42.705-1. While the other 35 percent of DCAA’s incurred cost work isn’t defined as inherently governmental because the rates are determined by the contracting officer through negotiation, DCAA plays a significant role in assisting the contracting officer in determining the allowable costs paid to the contractor. Because of the degree of involvement with the contracting officer in making final rate determinations, including providing negotiation support, our work in these areas contains characteristics of inherently governmental work.

#### **CPA requirement for GS-14 managers**

Another acquisition reform would require DCAA GS-14 managers to be CPAs (Certified Public Accountant) and at least one year of experience working on audits of Government contracts with either a defense contractor or qualified private auditor. Although we consider these qualifications in selecting a candidate, in our experience, they have not necessarily been good predictors of successful hires for GS-14 manager positions. Having a CPA or experience in industry doesn’t call for the same technical skills required to conduct contract audits nor indicate the ability to be a leader, and should not override these qualifications needed in our manager positions. If we do enforce these requirements, we will undoubtedly see a dramatic decrease in our applicant pool of otherwise well-qualified applicants.

#### **Performance of Multi-year audits**

Another reform calls for the incurred cost audit to be completed within one year after receipt of a qualified submission. As discussed above, DCAA has initiated a process improvement to perform multi-year incurred costs audits for many contractors where two years of a contractor's incurred costs are audited in one audit. This method reduces audit labor costs by 40 percent over separate single-year audits for the subject years and benefits contractors because less time is required to support the audits. The proposed requirement for completing these audits in one year would no longer allow DCAA to save the Government these resources in the future.

These efficiencies do not just make the best use of its resources DCAA, contractors also benefit because they spend less time on audits. Given that this process has not been in place for more than a few years, we have and continue to seek contractor input about its efficacy and usefulness. That said, we have received significant positive support from many of the contractors who have experienced it. Additionally, since 74 percent of contractor submissions are due on June 30 of each calendar year, requiring a 12 month timeframe for audits is not practical, as it does not allow for a normal workflow. The current language in FAR 4.804-1 already contains a timeframe of 36 months for closing out these types of contracts. We believe the current FAR provisions support the acquisition process.

#### **SUMMARY**

I would like to conclude by asking the committee for sufficient time to work through the acquisition reform ideas and address the concerns I have raised. I am truly concerned about the inefficiencies associated with introducing IPAs into the contract administration process, and I

believe that the Committee should have a full understanding of how this change will impact the acquisition community.

In the coming year, I would like to thoroughly examine several issues. First, I want to work with the committee to better understand its objectives and how to best achieve them. Next, I propose that we reach out to industry, the Services, Defense Procurement and Acquisition Policy, DCMA and other stakeholders to ascertain the appropriate use of IPAs. Specifically, I want to better understand DCMA's perspective on how IPAs will impact their resources, and I want to better understand industry's perspective on the benefits they envision and any concerns they have about sharing proprietary data with several independent auditors as opposed to sharing it only with DCAA.

I would also like time to work with industry, the Services and DCMA on a cost benefit analysis of performing single-year audits vs. multi-year audits. As I stated in my testimony, we have seen clear benefits: multi-year audits reduce our audit labor costs by 40 percent and industry has responded favorably to the potential of reducing their resources as well. One of the key reasons offered for discontinuing multi-year audits is that two years of incurred cost inventory cannot be considered "current." I want to better understand any detrimental effects of a two-year inventory, and I will ask stakeholders to provide the costs and benefits of auditing one year at a time. At this point, however, I suggest that a 40 percent increase in efficiency makes a compelling case for gathering more information before discontinuing the multi-year process. Once we have obtained that information, I commit to you that if a data-driven, cost-benefit analysis demonstrates that single year audits are more beneficial than multi-year audits, then we will stop conducting multi-year audits.

I would like to thank the committee for allowing me to share our story. I am very proud of all our dedicated DCAA employees who continue to find more efficient and effective ways to execute our mission, support the warfighter, and protect taxpayer dollars. I know there have been concerns that we couldn't get the incurred cost backlog down fast enough. Our track record clearly indicates that, with the proper resources, we will get it down. The delays we have experienced directly correlate to fluctuations in staffing and inefficient processes that we have addressed and overcome. If investments are going to be made in additional resources, I'd like the opportunity to restore and stabilize DCAA staffing levels. I'd like the opportunity to finish what we are so close to achieving.

**Ms. Anita F. Bales**  
**Director, Defense Contract Audit Agency**

Ms. Anita Bales was appointed as the Director, Defense Contract Audit Agency on August 31, 2014, and is responsible for all matters related to the management of the Agency and its resources. In that position she is responsible for managing the worldwide operation of the DCAA and its resources.

DCAA performs contract audits for DoD and provides accounting and financial advisory services regarding contracts and subcontracts to all DoD Components in support of national defense. These services are provided in connection with negotiation, administration, and settlement of contracts and subcontracts. Ms. Bales, through an executive team, exercises executive direction for a staff of over 5,000 personnel, 85 percent of which are professional auditors, with a \$600 million annual operating budget. As the Director, Ms. Bales directs the planning, development, execution, and evaluation of comprehensive programs to implement public law and Secretary of Defense Directives in carrying out the contract audit mission assignment to the Agency.

Ms. Bales entered the Senior Executive Service in November 2006

**CAREER CHRONOLOGY:**

- April 2011-August 2014: Deputy Director, Defense Contract Audit Agency, Ft. Belvoir, VA
- Nov 2006-April 2011: Deputy Auditor General, Forces and Financial Audits, Army Audit Agency, Alexandria VA
- Oct 2001 – Nov 2006: Program Director, Financial Management Audits, Army Audit Agency, Alexandria, VA
- Sep 1998 – Sep 2001: Audit Manager, Force Management Audits, Army Audit Agency, Ft. Belvoir, VA
- Jun 1996 – Aug 1998: Student, Syracuse University
- Mar 1992 – Jun 1996: Audit Supervisor, Central Region, Army Audit Agency, St. Louis, MO
- Jan 1988 – Mar 1992: Auditor: European Region, Army Audit Agency, Frankfurt, Germany
- Aug 1983 – Dec 1987: Auditor: Midwest Region, Army Audit Agency, Rock Island, IL

**COLLEGE:**

- MBA, Syracuse University
- BS, Business Administration/Accounting, Drake University

**SIGNIFICANT TRAINING:**

- Federal Executive Institute, Leadership in a Democratic Society
- Syracuse University, Army Comptrollership Program

**CERTIFICATIONS:**

- Certified Public Accountant
- Certified Information Systems Auditor
- Certified Government Financial Manager

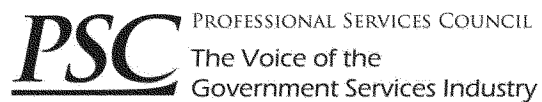
**AWARDS AND HONORS:**

- Neil Ginetti Award for Outstanding Performance in Financial Management, Professional Development, Career Management and Mentoring
- President's Council on Integrity and Efficiency Award for Auditing
- Leonard F. Keenan Award (Syracuse University)

- Resource Management Award from the Assistant Secretary of the Army (Financial Management and Comptroller)
- Commander's Award for Civilian Service
- Achievement Medal for Civilian Service

**PROFESSIONAL MEMBERSHIPS AND ASSOCIATIONS:**

- Association of Government Accountants
- American Society of Military Comptrollers
- Association of the U.S. Army
- Professional Advisory Board for Drake University's School of Accounting



**Statement of David Berteau  
President & CEO  
Professional Services Council**

**“Evaluating the Defense Contract Auditing  
Process”**

**Subcommittee on Oversight and Investigations  
House Committee on Armed Services  
U.S. House of Representatives  
April 6, 2017**



*Written testimony of David Berteau, President & CEO Professional Services Council  
before the House Armed Services Committee Oversight and Investigations  
Subcommittee on April 6, 2017.*

### **Introduction**

Chairwoman Hartzler, Ranking Member Moulton, and Members of the Subcommittee, thank you for the invitation to testify on behalf of the Professional Services Council's (PSC) over 400 member companies and their hundreds of thousands of employees across the nation.<sup>1</sup> PSC is the voice of the government technology and professional services industry, representing the full range and diversity of the government services sector. I appreciate the opportunity to discuss with you the defense contract auditing process, an issue of critical importance to our membership, to the defense contracting community, and to the success of Department of Defense (DoD) missions.

Today I will make several specific recommendations on the roles and responsibilities of the Defense Contracting Audit Agency (DCAA) below. I will also offer some priorities and criteria that PSC would urge you to keep in mind as your subcommittee focuses on evaluating the defense contract auditing process, both in this hearing and in your future efforts. They include:

- defining proper materiality and relevance standards for contract audits,
- sustaining a robust contractor base,
- ensuring vendors remain interested in bidding, and
- helping the government's acquisition processes provide better access to innovation.

I believe these attributes will help guide you toward practical and productive reforms.

### **Contractors Provide Significant Value to the Government**

The contractor community plays a vital role in assisting the government in providing services to the American people; in DoD, contractor work provides a wide range of goods and services to the warfighter, to the civilian employees of the Department, and to the National Command Authority. These contractor contributions are necessary and vital to maintaining government operations. Many of the capabilities that contractors provide do not exist within the government, and the government benefits from a strong,

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<sup>1</sup> For over 45 years, PSC has been the leading national trade association of the government technology and professional services industry. PSC's over 400 member companies represent small, medium, and large businesses that provide federal agencies with services of all kinds, including information technology, engineering, logistics, facilities management, operations and maintenance, consulting, international development, scientific, social, environmental services, and more. Together, the association's members employ hundreds of thousands of Americans in all 50 states. See [www.pscouncil.org](http://www.pscouncil.org).

diversified national interest business base to support its current and emerging requirements.

#### **PSC Recognizes the Government's Central Role in the Contract Auditing Process**

DoD is the largest single contracting department in the federal government, spending in Fiscal Year 2016 over \$296 billion on an incredible range of goods and services, with more than half of that (\$149 billion) on services. Overall, DoD spending on the purchase of goods and services decreased over 30 percent between fiscal years 2011 and 2015, but with much smaller rates of decline in services than in products.

Proper auditing and accounting practices are necessary for the government in its internal functions and for contractors in their contracting functions, to demonstrate that the government is spending taxpayer dollars in an efficient and effective manner. PSC recognizes the government's central role in the auditing process and as described below, believes many of the functions performed by DCAA should only be performed by federal employees. It matters a lot to know what the cost of performance is, whether by government or by contractors. Regrettably, while we have exquisite detail on the cost of contractors, neither the Congress nor the public has much hard data on the cost of government performance for most of its functions.

#### **Defining the Roles and Responsibilities of DCAA**

As you know, DCAA has the primary responsibility for auditing contractors doing business with DoD. Many DoD contractors also do work with the civilian agencies, and DCAA generally audits all of the work of those contractors, not just their DoD work. Up until the last fiscal year, when the Congress directed otherwise, DCAA also performed audits on contractors doing work only with certain civilian agencies, on a cost-reimbursable basis from those agencies.

DCAA needs a degree of independence in its work. But it should not, and cannot, function as an isolated activity. Its role has always been, and must clearly and solely remain, as an advisor to the decision-making responsibility of the contracting officer, who is warranted by the government to make decisions that are in the best interest of the government. DCAA also, where appropriate, serves as an advisor to the program officer, who is accountable for delivering the results to the warfighter or other DoD end-user.

Recently DCAA has assumed a primary and independent responsibility of "protecting the taxpayer interests." As a result, there is a concern among acquisition professionals within the government that can prevent them from reasonably questioning DCAA's methodology and data or justifying not following its advice.

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.

We see time and again cases where too many DoD contracting officers believe they have no real discretion to deviate from DCAA’s recommendations, even when there is a significant basis for disagreement with the data or the methodology. In cases like those, it may take the Armed Services Board of Contract Appeals, or a federal court, to make decisions when a contracting officer or a program manager can’t or won’t.

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.

#### **DCAA’s Acquisition Lifecycle Responsibilities**

Today’s hearing has a proper focus on incurred cost audits. To understand the issues around incurred cost audits and the impact of a backlog in completing those audits, it is useful to look at DCAA’s responsibilities through the entire acquisition cycle, not just at the end of a contract.

DCAA plays important roles throughout the contracting process and over the lifecycle of a contract. Contracting officers work with and consult auditors on the front end (before contract award), after a contract is awarded and while the work is being performed, and as the auditors review incurred costs. DCAA is engaged in reviewing contractors in all three major phases of the acquisition lifecycle.

First, under a set of six DoD regulations referred to as “business system requirements,” DCAA is responsible for reviewing certain DoD contractors’ compliance with three of those business systems: accounting, estimating, and earned value management. The Defense Contract Management Agency (DCMA), a sister DoD independent agency, has primary responsibility for assessing contractor compliance with the other three: purchasing systems, material management systems, and government property.

DCAA’s annual report states that 675 major contractors<sup>2</sup> require reoccurring audits of their business systems, typically every three years.

“To conduct business system audits at all of these companies on a cyclical basis, DCAA needs to do over 2,000 Business System audits over a three-year period.

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<sup>2</sup> A major contractor is generally defined as a single contractor (including its subsidiaries) that has at least \$250 million in cost reimbursement contracts with the Department of Defense.

DCAA's approach is to do one business system per year at each contractor— a total of 675 business system audits per year—covering all three business system audits in a three-year period. Over the past several years, due to resource constraints, DCAA has averaged only 22 business system audits per year.”

Given the importance of these business system reviews both to DoD and to contractors, and with an average of 22 out of 675 needed reviews, DCAA could clearly use some help! This backlog also has significant implications in major contracting activities in both DoD and the civilian agencies. In our view, third party reviews of these business systems, which are quite common in the general commercial world and which often cover the same business systems, would also be beneficial.

Second, DCAA provides proposal audit support on major program solicitation responses submitted by contractors during the **pre-award** phase of the acquisition lifecycle. Their work is critical in support of the Department's evaluation of price proposals during the competitive phase of the contracting process and can impact who wins a contract and on what basis. Here, timely and thorough recommendations are essential for the government's pricing evaluation team in support of their award decisions.

Finally, DCAA has a well-known role in the post-award phase, primarily in auditing a contractor's costs incurred during performance, leading to the closing out of a contractor's annual billing cycle. DCAA also has a role in assessing a contractor's rates that serve as the basis for future interim contract billings. These are known as “forward-pricing rates,” and they are evaluated based in part on looking back at the costs actually incurred by that contractor in previous billing cycles. For most contractors, the final determination of forward prices rates rests with the Defense Contract Management Agency, but this process depends on timely input from DCAA. Delays in that timely input harms the competitive situation for contractors, so it could also use some adjustment.

At the incurred cost stage, both the contractor and the government have an interest in moving rapidly. For the contractor, the government commonly withholds significant funds that should be reconciled and paid in a more timely manner. The government wants to be able to collect any money that might be determined to be due from the contractor, while there is still time and funds available to be collected. The government also wants to be sure that any money already invoiced by the contractor is correct and consistent with the terms and conditions of the awarded contracts. These are legitimate goals, but for the contractor, who paid their costs years earlier during the performance of the work under the contract in question, delays in making government payments results in additional costs to the contractor because they have to finance their own costs at their own expense, often for years until the incurred cost audits are completed.

Contractors must initiate the incurred cost audit process by submitting a timely and complete incurred cost proposal within the timeframes of the acquisition regulations – and the government is right to raise questions about any unexplained delay in

contractors meeting that obligation. However, contractors also have a reasonable expectation that the DCAA process will move along expeditiously and fairly.

### **The Incurred Cost Backlog**

"Incurred costs" are the expenditures made by the contractor after the award of the contract and in support of that contract performance. Some costs are characterized as "direct" costs because they are specifically incurred in the performance of only the instant contract.

Other costs are characterized as "indirect" costs because the contractor incurs them in the performance of multiple contracts or in support of the contractor's general and administrative business functions.

There are extensive regulations governing how contractors are required to account for and allocate those costs (called the "Cost Accounting Standards") and how to treat the allowability of specific elements of cost (called the "cost principles"). The government only reimburses contractors for costs that are "allowable" under the cost principles and the terms of the contract.

The regulations require most DoD contractors to develop and follow this unique set of government cost accounting and cost allowable rules in the performance of cost-reimbursement contracts.<sup>3</sup>

DCAA's FY15 Report to Congress showed an average completion time of 883 days from the time DCAA received an adequate annual incurred cost submission from a contractor to the date of its closeout. This is nearly two and a half years. That's a long time to wait for payment on a contract.

DCAA sought to redefine the time for an audit by beginning their measurement from the date of the entrance conference until completion, which they note as averaging 124 days. That is still too long and misleading, as PSC's members and others are adversely burdened by the more than two years of time that passes on average between their submission and DCAA's completion.

PSC agrees with DCAA's FY15 Report to Congress that states: "Getting current on incurred cost means that we can conduct audits closer to the year the costs were actually incurred, which will improve our ability to retrieve relevant records, ease

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<sup>3</sup> There are certain exemptions from the requirements to comply with the single, government-wide established Cost Accounting Standards. As the Congress, along with PSC and many other commentators have noted, the requirement for most contractors to comply with these government-unique cost accounting standards and specific allowable cost rules in performing cost-reimbursement contracts is typically cited as the number one barrier to companies' willingness to do business with the federal government. This is particularly true for smaller businesses, those who largely sell commercial items, or those for whom the federal government is only a small share of their total business. But the time and cost burdens are also significant on those firms that are currently covered by such requirements.

contractor burden, encourage better compliance and identify issue[s] that may impact future audits.”

What the report does not say is that “getting current” will also make it more efficient and effective for the government in awarding new contracts for essential mission support work. It’s not just future audits that may be impacted, it’s future defense missions.

To “get current,” DoD and DCAA must address the incurred cost backlog in a broader framework and must better delineate and distribute the “roles and responsibilities” of DCMA, DCAA, and DoD program offices.

#### **Negative Impact of the Backlog**

The timeliness of completing contract incurred cost audits and contract closeout remains a top priority for PSC and our member companies. The negative implications of the backlog on contractors are wide-ranging and consequential:

- There is an impact on company cash flow because of government withholding of contractor funds;
- Contractors must pay administrative and carrying costs that are unallowable and therefore not recoverable from the government;
- There are significant and costly records retention requirements to maintain documents, well beyond general accepted accounting principles; and
- There is an impact on companies’ future business, through delays in establishing forward pricing rates and in the decrements that may be imposed after the fact on those future billing rates.

An example of costly record-keeping requirements, the FAR sets out the government’s record retention policy for various types of records for different oversight purposes. The insistence of audit staff that contractors keep and provide access to original documents long after the regulatory retention period has expired is inconsistent with the rules and does not align with the accepted modern commercial practice of digital record retention.

The government is also negatively impacted by the backlog. Lengthy delays in resolving incurred cost audits cause several problems, including:

- Making administrative contracting officers and program officers unsure of the financial condition of their programs;
- Risking government funds that may have been paid out in excess of or not in compliance with the terms and conditions of the contract;
- Delaying achieving the closeout of contracts.

None of those impacts help the government if they are years too late.

### **DCAA Multiple Year Auditing**

One of the techniques DCAA has been using to help reduce incurred cost audit backlogs is to audit several years simultaneously. This holds out the hope that the audit work will be conducted once and yield results that will cover several “open” years of review. For most defense contractors who do not have DCAA auditors resident in their facility, they would prefer to address as many open issues as possible when their cycle arrives.

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.

### **Some DCAA Functions Are “Inherently Governmental,” And Some Are Not**

Many of the functions performed by DCAA at each of these acquisition lifecycle steps are properly characterized as “inherently governmental,” and those functions and activities should be performed by federal employees. This includes providing the organizational structure for audits, governance and guidance on the application of the auditing standards, and setting performance standards and evaluating performance. Decisions on the final recommendations relating to the audit are also inherently governmental.

But it is important to note that the auditing activities themselves are not an inherently governmental function. As noted elsewhere in this testimony, third party auditors are already used extensively and quite successfully by other government agencies to perform identical work as DCAA performs for DoD.

### **No DCAA Auditors Need To Be Terminated**

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.

### **Expanding the Use of Third-Party Audits Will Improve Acquisition Outcomes**

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. While each phase has its own, unique elements, there is an interdependence among them, and later phases of the acquisition process benefit from the on-time completion of earlier phases.

As we noted earlier, DCAA's advice can be the most impactful during the government's proposal evaluation phase of large, cost-reimbursement contracts, particularly when requirements and a limited vendor base mean those contracts must be solicited on a limited or sole-source basis. When the government understands how an offeror's pricing is derived, it can better negotiate final pricing and structure the contract award and expected performance based on that knowledge.

Stated another way, when the contract terms and conditions are clear and the contractor's basis for award is clear, there is a greater likelihood that the contractor's costs incurred in performance will align with the contract objectives. Each of these actions contributes to the government being a smarter buyer and increases the likelihood of improving acquisition outcomes. Everyone benefits from that: the government, the contractors, and the taxpayers.

### **Using Third-Party Audits Will Reduce the Incurred Cost Backlog**

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. The President's hiring freeze and the residue from and fears of sequestration have compounded existing resource and staffing problems. It is timely to consider the use of alternative solutions, including the use of independent third-party auditors.

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.

The federal government already has and uses models to provide a seamless transition to making better use of independent auditors. For example:



- The General Services Administration (GSA) already has an existing Schedules program to quickly engage private sector auditors employed by firms on the Schedules to assist federal agencies. Many federal agencies have used these auditors to supplement or serve as their in-house resources. Their past performance record is superior and quite visible to the government.
- Organizations that receive federal grants (and that are subject to the audit requirements under the Office of Management and Budget's Circular A-133 for universities and other non-profit organizations) already rely on third-party accounting firms for their annual and closeout audits. Many of the requirements applicable to grants are similar (or identical) to the contracting regulations and make for an easy transfer of capability from one type of audit to the other.
- Publicly traded companies are required by the Securities and Exchange Commission, and the Sarbanes-Oxley law, to have independent accounting firms review their books and records and make recommendations relating to internal controls and proper accounting activity. For those publicly traded companies that are also covered government contractors, their outside auditors are already reviewing government transactions, including compliance with regulatory requirements.
- DCAA could additionally, should it be necessary or useful, qualify firms in advance (similar to DoD's Qualified Suppliers List for Manufacturers (QSLM) and Qualified Suppliers List for Distributors (QSLD)). In both these examples, the Department pre-qualifies manufacturers and/or distributors to supply certain items. PSC has recommended that DCAA could adopt a similar pre-qualification system to ensure that the third-party audit firms selected have the qualifications they believe are necessary to perform the work.
- DCAA could contract directly with qualified firms and assign those firms to work as they see fit, complementing and augmenting DCAA capability and dramatically reducing backlogs.

Over the long term, it is in the government's interest to align more closely the government-unique cost accounting standards with Generally Accepted Accounting Principles (GAAP). This is one of the specific requirements of Section 820 of the FY17 National Defense Authorization Act (NDAA). If this can be accomplished, it will significantly reduce the burden on government agencies to be familiar with unique government requirements and reduce the burden on contractors to create and follow accounting systems solely for the purpose of doing business with the government. It will significantly reduce the cost of compliance for government and existing contractors, open opportunities for non-traditional companies to enter the marketplace, and encourage more small business participation. It will also increase the pool of qualified auditing firms that can fulfill the government's auditing needs.

Additionally, DCAA could maximize the opportunity to utilize third-party auditors. Their approach does not have to be all or nothing – or forever or never. DCAA could choose which functions or types of audits to focus on and when, and for how long, it makes sense to focus on them. Rather than reduce their workforce, DCAA could retain

employees and reassign their best and brightest for higher priority activities, such as proposal audits or fraud investigations.

Allowing independent auditors to conduct incurred cost audits will establish a balanced policy to reduce the incurred cost and business systems backlogs and improve the timeliness of forward pricing rate determination in ways that improve effective government management of the government's total workforce and of its contractors.

#### **The Defense CAS Board**

Finally, I would like to call your attention to one issue included in the FY17 NDAA that PSC believes will be confusing and harmful to the contracting community and its government customers.

The government's Cost Accounting Standards Board was re-constituted in 1998 and has "exclusive authority" over establishing government-unique cost accounting standards. Its purpose is to achieve "uniformity and consistency in the cost accounting practices governing measurement, assignment, and allocation of costs to contracts." It is chaired by the administrator of the Office of Federal Procurement Policy and includes government representatives from the Defense Department (the DCAA director by designation), GSA, and the private sector.

For the past 34 years, there has been only one set of cost accounting standards to which the entire government contracting community has had to adhere. The Board must also follow a detailed statutory process when considering and proposing government-wide cost accounting standards. The CAS Board is not perfect; there have been gaps when there was no action (or even no functioning Board) and sometimes long delays in promulgating standards.

Section 820 of the FY17 NDAA sought to address some of these issues by directing the CAS Board to meet at least quarterly and take other actions. But the Act also created a new Defense-only CAS Board, with separate (but similar) membership and specific responsibilities. It requires DoD to establish an independent, specialized Defense Cost Accounting Standards Board with "exclusive authority" to establish cost accounting standards for DoD contracts. The provision does not take effect until October 1, 2018.

PSC expressed last year and remains concerned today about Section 820(b). It imposes a costly compliance burden on contractors with limited, if any, added value to the government. It could have the effect of subjecting contractors that do work at both DoD and at other federal agencies to two potentially divergent sets of accounting standards.

Currently, many outside, innovative companies do not have the systems in place to accommodate one – let alone two – separate and distinct government-unique cost accounting standards over and above their existing commercial accounting practices. To comply with the actions of this new Board, some companies will be required to

create and maintain at least one new system for government contracts. This will have a particularly burdensome impact on smaller firms and on those who only engage in limited contracting with DoD and the civilian agencies. It will hurt DoD access to innovation at a time when we need more of it, not less.

PSC expressed our concern to the Senate as it considered its version of this provision last year and shared our view again with the conferees on the bill. PSC believes there is simply too much risk associated with developing and implementing separate and distinct standards that will be confusing and contradictory in their implementation by government and in their application by contractors.

We continue to believe that the provision will do more harm than good. In response to the requests from the staffs from several committees, we will be making specific recommendations on ways to improve this provision. While we would prefer a repeal of the provision to create the new Defense CAS Board, our recommendations will include raising the dollar threshold for full CAS coverage at DoD and adding additional exemptions for coverage. That could reduce but will not eliminate the negative impacts.

#### **Conclusion**

On behalf of PSC and our members, I thank you for your time and consideration of these matters. As always, PSC is available at your convenience to address any questions or concerns the subcommittee has, now and in the future. I will try to answer any questions you may have.

The Honorable David J. Berteau  
President and Chief Executive Officer, Professional Services Council

Mr. Berteau became the President and Chief Executive Officer of the Professional Services Council (PSC) on March 28, 2016. With more than 400 members, PSC is the premier advocate of and resource for the federal services industry. As CEO, Mr. Berteau focuses on legislative and regulatory issues related to government acquisition, budgets, and requirements by helping to shape public policy, leading strategic coalitions, and working to improve communications between government and industry.

Prior to PSC, Mr. Berteau was confirmed in December 2014 as the Assistant Secretary of Defense for Logistics and Materiel Readiness. He oversaw the management of the \$170 billion in Department of Defense logistics.

Previously, Mr. Berteau served as Senior Vice President and Director of the National Security Program on Industry and Resources at the Center for Strategic and International Studies (CSIS). His research and analysis covered national security, management, contracting, logistics, acquisition, and industrial base issues.

Mr. Berteau is a Fellow of the National Academy of Public Administration and has also served as an adjunct professor at Georgetown University and at the Lyndon B. Johnson School of Public Affairs, a Director of the Procurement Round Table, and an Associate at the Robert S. Strauss Center at the University of Texas.

Prior to CSIS, Mr. Berteau was director of national defense and homeland security for Clark & Weinstock, director of Syracuse University's National Security Studies Program and a professor of practice at the Maxwell School of Citizenship and Public Affairs, and senior vice president at Science Applications International Corporation. Before SAIC, he held a variety of positions in the Department of Defense. Throughout his career, he served a total of 14 years at senior levels in the U.S. Defense Department under six defense secretaries.

Mr. Berteau graduated with a B.A. from Tulane University in 1971 and received his master's degree in 1981 from the LBJ School of Public Affairs at the University of Texas.

**DISCLOSURE FORM FOR WITNESSES  
COMMITTEE ON ARMED SERVICES  
U.S. HOUSE OF REPRESENTATIVES**

**INSTRUCTION TO WITNESSES:** Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 115<sup>th</sup> Congress requires nongovernmental witnesses appearing before House committees to include in their written statements a curriculum vitae and a disclosure of the amount and source of any federal contracts or grants (including subcontracts and subgrants), or contracts or payments originating with a foreign government, received during the current and two previous calendar years either by the witness or by an entity represented by the witness and related to the subject matter of the hearing. This form is intended to assist witnesses appearing before the House Committee on Armed Services in complying with the House rule. Please note that a copy of these statements, with appropriate redactions to protect the witness's personal privacy (including home address and phone number) will be made publicly available in electronic form not later than one day after the witness's appearance before the committee. Witnesses may list additional grants, contracts, or payments on additional sheets, if necessary.

Witness name: DAVID J. BERTEAU

Capacity in which appearing: (check one)

☐ Individual

☒ Representative

If appearing in a representative capacity, name of the company, association or other entity being represented: PROFESSIONAL SERVICES COUNCIL

**Federal Contract or Grant Information:** If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) or grants (including subgrants) with the federal government, please provide the following information:

2017

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
<b>NONE</b>			

2016

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
<i>NONE</i>			

2015

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
<i>NONE</i>			

**Foreign Government Contract or Payment Information:** If you or the entity you represent before the Committee on Armed Services has contracts or payments originating from a foreign government, please provide the following information:

2017

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
<i>NONE</i>			

2016

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
<i>NONE</i>			

2015

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
<i>NONE</i>			

Good morning, Chairwoman Hartzler, Ranking Member Moulton, and committee members. I am John Panetta and have worked in Government contracting in various roles for 37 years. I have provided a copy of my bio in the attachments to this testimony to further elaborate on my experience. I currently work as the Senior Director of Government Accounting at Raytheon Company in Waltham, Massachusetts, but am here today on behalf of Financial Executives International's Committee on Government Business (FEI-CGB).

The CGB appreciates the invitation and opportunity to speak today on the topics of defense contract auditing, including the pace and schedule of audits, costs, and Defense Contract Audit Agency (DCAA) standards and processes.

FEI is a professional association representing the interests of approximately 10,000 individual chief financial officers, treasurers, controllers, tax directors, and other senior financial executives from over 5,700 major companies throughout the United States and Canada. FEI represents both the providers and users of financial information. CGB formulates policy opinions on government contracting issues for FEI in line with the views of the membership. I am here today representing the views of the CGB.

#### **Background**

The issues surrounding defense contract auditing have been a matter of concern and discussion both in the private sector and the Government for several years. We have been pleased to see a number of recent initiatives implemented to address issues with respect to the timeliness of DCAA's incurred cost audits and the increasing backlog of contracts awaiting close out. Specifically, the CGB believes that the language in Section 836 of the Fiscal Year (FY) 2017 National Defense Authorization Act (NDAA) that permits close out of contracts awarded prior to FY 2000 without completion of a reconciliation audit as well as the instruction in Section 820 section f for DoD to accept the results of independent outside auditors without performing additional audit procedures were steps in the right direction. However, to achieve any meaningful reduction in the backlog of contracts awaiting close out not affected by that



legislation, significant improvements must be made to the acquisition audit and contract administration process. For example, 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).

In many cases, congressionally appropriated funds assigned to specific contracts expire waiting for final rate settlements. As such, the service branch then is required to request the use of current year funds appropriated for ongoing missions to pay prior period costs. If DCAA continues to lag behind this is something that will need to be addressed.

Audit validated incurred costs and indirect rates play an important part in establishing agreed to bidding rates used in negotiating follow-on and new contracts. The absence of recent years’ finalized rates causes the Government and contractors to expend more resources (administrative and bid and proposal support costs) in executing contracts. This in turn slows down the delivery of goods and services to the warfighter.

The CGB believes reducing the audit backlog of incurred cost rates and contracts awaiting close out will require implementation of efficient audit management practices focused on risk mitigation and materiality. At the same time, the acquisition community requires a cultural change in how the success of an audit and oversight is measured to effect real and beneficial change.

#### **How Did We Get Here?**

Due to a series of reports from the Government Accountability Office (GAO) and DoD Inspector General (DODIG), critical of DCAA's audit practices and adherence to professional standards, it resulted in negative repercussions for the acquisition community.

As a result, we observed DCAA changing its focus almost exclusively to performance of "quality" audits by "independent" auditors. There were additional internal DCAA management reviews of audits prior to their publication. DCAA also stood up an enhanced internal quality organization to review audits and practices, among other things. 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<sup>1</sup>. Any reports that were issued were generally incredibly long and packed with minutia.

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<sup>2</sup>. Even though many of the schedules were not relevant to the review of the indirect rates, DCAA used the FAR change as

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<sup>1</sup> Reference DCAA's most recent report to Congress page 7- [http://www.dcaa.mil/DCAA\\_FY2015\\_Report\\_to\\_Congress.pdf](http://www.dcaa.mil/DCAA_FY2015_Report_to_Congress.pdf)

<sup>2</sup> See Attachment listing 30 items added to regulation.

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.

The use of multi-year audit techniques has helped, however we are not where we need to be. Not only does more work need to be done in this area, contractor resources have been strained supporting these multi-year audits and that is not a sustainable model over the long run.

#### **Implementing Efficient Audit Management Practices**

Understanding how the incurred cost proposal backlog grew to the level it is today isn't merely interesting historical information; it's the key to understanding how DCAA must change its approach to auditing and its philosophy of risk avoidance to one of risk management in order to succeed. Risk management is the foundation for implementation of an efficient audit or any oversight management process. Simply stated, risk management is the identification, assessment, and prioritization of risks, followed by the coordinated and economical application of resources to minimize the impact of those risks. A perfectly documented audit that validates every dollar claimed but takes years to complete has no value to the acquisition community. For audit advice to be useable, to have value and meaning, it must be available at the time decisions are being made.

Risk management is not a new concept. In fact, under the regulations outlining Performance Standards in the FAR (FAR 1.102-2(c)(2)) it states:

*"To achieve efficient operations, the System must shift its focus from 'risk avoidance' to one of 'risk management'. The cost to the taxpayer of attempting to eliminate all risk is prohibitive. The Executive Branch will accept and manage the risk associated with empowering local procurement officials to take independent action based on their professional judgment."*

For assistance in implementing this process, DCAA only needs to look as far as the established practices of public accounting firms, in accordance with the American Institute of CPAs (AICPA)

rules and oversight by the PCAOB (Public Company Accounting Oversight Board of the SEC) and incorporate the critical considerations of:

*Materiality Thresholds* – Establishment of quantitative levels of what will vs. will not affect the decisions of the users of the information. In this case, the Defense Contract Management Agency (DCMA) COs are tasked with the individual responsibility of settling final indirect rates.

*Mitigation* – Consider the specific measures designed to reduce the extent of exposure to a risk by reducing the severity of consequences or reducing the probability of the risk's occurrence. Today's integrated financial systems are designed with key controls that are tested/validated to meet the company's audits of Sarbanes-Oxley Act (SOX) requirements and for Securities Exchange Commission (SEC) financial reporting audits for annual financial statements. Given these evaluations, the Government must consider the probability of certain types of irregularities occurring (e.g. phantom employees generating phantom costs or the depreciation of fictitious assets) and limit audit scope accordingly.

*Work of Others* – The Public Company Accounting Oversight Board (PCAOB) has recommended that external auditors "*rely on the work of others*" to reduce the costs of compliance with Section 404 of the Sarbanes-Oxley Act. The concept of reliance on the work of others is relevant within Government auditing. The GAO's Government Auditing Standards (i.e., Yellow Book) state that determinations should be made whether other auditors have conducted, or are conducting, audits that could be "relevant" to the current audit objectives. It also includes guidance on procedures that may be performed to use the work, thereby avoiding duplication of efforts (and expense).

Unfortunately, DCAA's practices and guidance within its Contract Audit Manual<sup>3</sup> restrict the parameters for reliance. It is only when the other party performed exactly the same audit steps planned by the individual DCAA auditor can the results of the other audit work be accepted or relied upon. DCAA's guidance further mandates that before reliance is placed on the other audit work, the DCAA must review the other organizations' audit programs, working papers, tests of

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<sup>3</sup> Link to DCAA's Contract Audit Manual (CAM) <http://www.dcaa.mil/cam.html>

compliance and conclusions reached, including performing its own tests of the documentary evidence contained in the other parties' working papers.

These practices and guidance actually prevent the synergies that generally accepted government auditing standards envision. 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.

Even when the audit steps performed by the external auditors are different than those planned by DCAA, they relate to the same type of risk within the same accounting system under review by DCAA and, thus, clearly serve to mitigate risk exposure. Audit steps such as validation of employee existence, proof of payment, and systemic testing are all re-performed by the DCAA.

*Firmly Established Due Dates* – Efficient audit management is particularly consequential for DCAA. Today, performing and supporting DCAA contract audits requires significant investment of both Government and contractor resources.

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.

Implementation of efficient audit management practices cannot be solely focused on timely completion of the old incurred cost proposals. It should be based on DCAA performing audit activities on a concurrent basis throughout the year.

DCAA's Mandatory Annual Audit Requirements (MAARs) recognize that certain basic core audit steps must be accomplished on a real-time basis to be efficient and effective. Unfortunately, in recent years DCAA has moved away from these fundamentals. A good example is DCAA's annual labor floor checks or interviews to test the reliability of employee time reporting records. Think how difficult it is years later to attempt to speak to an employee who is now no longer with the company. Even when an employee is still with the company, DCAA auditor interviews address work activities performed five years earlier are not very effective. The same is true for the evaluation of purchased materials to determine if they were properly ordered, received, and used in the delivered product. How do you demonstrate to an auditor that the consumable items received several years ago existed in the long since delivered and deployed products that have perhaps already been used by our warfighters? When DCAA fails to perform these types of routine evaluations on a real-time basis, considerable resources are wasted during the subsequent incurred cost audits.

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.

Another frustrating situation for contractors is DCAA's interpretation of the regulatory records retention requirements (FAR 4.703). The FAR outlines the time periods that contractors must retain books and records (e.g., financial and cost accounting records, documents, accounting procedures, and other supporting data) to satisfy contract negotiation, administration and audit

requirements. Different types of records have different retention periods. However, FAR 4.703(c) clearly states that:

*“Nothing in this section shall be construed to preclude a contractor from duplicating or storing original records in electronic form unless they contain significant information not shown on the record copy. Original records need not be maintained or produced in an audit if the contractor or subcontractor provides photographic or electronic images of the original records...”*

That section of FAR includes the requirement that the contractor/subcontractor have established procedures to ensure the imaging process preserves accurate images of the original records and that an effective indexing system is maintained to permit timely access to the imaged records. FAR further instructs that contractors/subcontractors must retain the original records for one year after imaging to permit periodic validation of the imaging systems.

In today’s environment, not only are records such as receipts and invoices routinely imaged, they often only exist in an electronic format (e.g., e-receipts and e-invoices). DCAA’s guidance instructs auditors to perform necessary tests of the records imaging process in the current year covering the prior 12-month period so that reliance may be placed on the electronic records.

Given the nature of today’s business environment and e-commerce, CGB doesn’t understand why this is even considered a risk or something that should be subject to an audit.

Nevertheless, 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. While the rest of the economy is moving to “the Cloud”, DCAA is asking for the paper.

If a contractor has preserved some or all of the originals, regardless of whether these documents are past the FAR prescribed retention periods, DCAA insists that the documents be provided so that it may test to the scanned images as part of the current audit. If a contractor refuses to

provide the originals, DCAA deems such refusal “a denial of access to records” with the potential undesirable consequences (DODIG subpoenas) that may follow.

If the contractor did not preserve the original documents past the one year period required by FAR, DCAA auditors are instructed to review the DCAA permanent files for risk factors and if no obvious risk is identified, then complete the audit with the scanned images and, at a minimum, qualify the report.

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.

Considering the amount of effort DCAA and Contractors invest in performing image audits, from a risk and common sense perspective, CGB believes the Government should consider not performing scanned image audits at Contractors that are subject to the Sarbanes-Oxley Act or similar oversight rules (i.e. U.K. fraud laws).

#### **Measurement of a Successful Audit**

For the contract auditing process to truly improve, Government Audit and Contract Administration functions will need to reassess and change what constitutes a successful audit. If DCAA’s annual report to Congress is the guide, the measure of success is the dollar value of costs questioned in relation to the costs to perform the audits. This is a misleading metric because it does not reflect the reality that only a small percentage of DCAA questioned costs are determined by COs as legitimate findings during negotiations with contractors. This can be seen by examining DCMA negotiation results at individual contractors. It also works against a fundamental rule of auditor independence which is audit fees cannot be based on the outcome of an audit engagement. Measuring the success of an audit engagement by the dollar value of findings motivates auditors to “find” or manufacture problems.



There are numerous instances, some of which have been the subject of recent court decisions that serve as clear examples of audit reports with significant “findings” that the courts have soundly rejected. For example, the Armed Services Board of Contract Appeals (ASBCA Cases #59508 & 59509, dated December 20, 2016) overturned a CO final decisions that the contractor owed the government \$116,789,631. In that case, the Board ruled that the CO had gone forward with a claim of over \$100 million against a contractor based on “*a plainly invalid legal theory*” “*originated by an auditor*” (DCAA).

In another recent example, a contractor was driven to seek relief in court for a \$53 million Government demand for payment that stemmed from a DCAA auditor’s creative application of statute and regulations (ASBCA #56701, dated March 31, 2011). In that decision the Judge “*found no merit*” in the DCAA arguments and went on to state “*...the Government (DCAA) arguments appear to be addressed to the wisdom and policy of the statute and regulation. Our role, however, is to apply the statute and regulations and not determine whether some other approach would be better.*” These examples support the CGB’s concern that the current measure of the success of an audit by the dollar value of its findings is incentivizing DCAA to maximize questioned costs, instead of performing an impartial evaluation of compliance with regulations that reflect current policy requirements established through statute.

There are a series of ASBCA cases addressing DCAA audits of employer compensation practices that present further examples where DCAA persists in reporting questioned costs even after the court determined that “*the methodology used by DCAA was fatally flawed statistically and therefore unreasonable*” (ASBCA 56105 & 56322, dated January 18, 2012) and that the analyses performed to support its conclusions were “*misleading,*” “*unproven,*” and “*highly questionable,*” (ASBCA Nos. 56624, 56751 & 56752, dated June 4, 2012).

There are many more examples outside of the published court and Board decisions where audit findings worth millions of dollars are resolved after protracted legal intercession that could have been avoided if the DCAA audits had been performed as part of a properly executed, unbiased, risk management framework.

CGB understands that contractors will make errors that will be discovered during audits and valid differences of opinion on FAR and Cost Accounting Standards (CAS) requirements will need to be addressed as part of the process. However, more and more, the routine “findings” that appear in DCAA’s audit reports are identified as “unsupported” costs or a “noncompliance” with FAR documentation requirements. DCAA views costs as “unsupported” when contractors cannot locate exactly the precise type or volume of corroborating evidence the auditor wants. The alleged “noncompliance” with FAR cost principles evolves from DCAA’s expansive and unwarranted interpretation of the documentation required for a given type of expense. In CGB’s experience, there is little motivation or effort by DCAA to objectively assess if the documentation or evidence that has been provided is sufficient or appropriate to provide reasonable assurance supporting the claimed cost. Instead, sweeping judgments are made and entire categories of expense are questioned, which ultimately shifts the burden on evaluating the allowability and reasonableness of the expense to the responsible CO or to the Courts for resolution.

The success of an audit is more appropriately judged by whether the audit is provided in a timely manner, in conformance with professional standards, and meets the needs of the requestor, namely the CO.

FAR Part 42, Contract Administration and Audit Services, Subpart 42.1 Contract Audit Services, makes it clear that the auditor is responsible for: *“Submitting information and advice to the requesting activity, based on the auditor's analysis of the contractor's financial and accounting records or other related data as to the acceptability of the contractor's incurred and estimated costs”*. This is an important role within the acquisition process, but not one that usurps the vested authority of the warranted COCOs, nor one that can be allowed to hinder the requirement of finalizing rates and closing out contracts.

CGB members have had experience with representatives from DCAA inhibiting CO attempts to reach fair settlements on cost issues and indirect rates, including escalation by multiple appeals through the DCMA chain of command and unwarranted referrals to the DODIG Hotline. Unfortunately, as the examples above demonstrate, this can lead to situations where resolution is protracted for many years and finally wind up in court. It is unclear whether these situations

result from DCAA's overly conservative interpretations, a policy of risk avoidance, or an ill-founded attempt to fulfill its mission statement of performing as "*dedicated stewards of taxpayer dollars.*"

What is very clear is that to fulfill its role as a key member of the Government acquisition team, ensuring that warfighters get what they need at fair and reasonable prices, DCAA has to embrace efficient time-bounded audit management practices in line with those of other oversight organizations (i.e. CPA firms) and reevaluate its measurement of success.

#### **Conclusion**

For the reasons outlined above, CGB recommends that direction and training be provided to DCAA to adopt the materiality and risk management practices common to the public accounting profession.

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.

These approaches, in concert with other recent legislative policies designed to streamline and increase the efficiency and effectiveness of the acquisition process, should serve to increase

understanding, reduce administrative operating costs and remove barriers and the unfavorable perceptions with respect to entry into US Government contracting markets.

Thank you for the opportunity to speak with you today and I look forward to answering any questions you may have.

The text below was added to the Federal Acquisition Regulation contract clause (52.216-7) for the submission of final indirect rates by contractors by the DCAA in May of 2011.

“(iii) An adequate indirect cost rate proposal shall include the following data unless otherwise specified by the cognizant Federal agency official:

(A) Summary of all claimed indirect expense rates, including pool, base, and calculated indirect rate.

(B) General and Administrative expenses (final indirect cost pool). Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts).

(C) Overhead expenses (final indirect cost pool). Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts) for each final indirect cost pool.

(D) Occupancy expenses (intermediate indirect cost pool). Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts) and expense reallocation to final indirect cost pools.

(E) Claimed allocation bases, by element of cost, used to distribute indirect costs.

(F) Facilities capital cost of money factors computation.

(G) Reconciliation of books of account (i.e., General Ledger) and claimed direct costs by major cost element.

(H) Schedule of direct costs by contract and subcontract and indirect expense applied at claimed rates, as well as a subsidiary schedule of Government participation percentages in each of the allocation base amounts.

(I) Schedule of cumulative direct and indirect costs claimed and billed by contract and subcontract.

(J) Subcontract information. Listing of subcontracts awarded to companies for which the contractor is the prime or upper-tier contractor (include prime and subcontract numbers; subcontract value and award type; amount claimed during the fiscal year; and the subcontractor name, address, and point of contact information).

(K) Summary of each time-and-materials and labor-hour contract information, including labor categories, labor rates, hours, and amounts; direct materials; other direct costs; and, indirect expense applied at claimed rates.

(L) Reconciliation of total payroll per IRS form 941 to total labor costs distribution.

(M) Listing of decisions/agreements/approvals and description of accounting/organizational changes.

(N) Certificate of final indirect costs (see 52.242-4, Certification of Final Indirect Costs).

(O) Contract closing information for contracts physically completed in this fiscal year (include contract number, period of performance, contract ceiling amounts, contract fee computations, level of effort, and indicate if the contract is ready to close).

(iv) The following supplemental information is not required to determine if a proposal is adequate, but may be required during the audit process:

- (A) Comparative analysis of indirect expense pools detailed by account to prior fiscal year and budgetary data.
- (B) General organizational information and limitation on allowability of compensation for certain contractor personnel. See 31.205-6(p). Additional salary reference information is available at [http://www.whitehouse.gov/omb/procurement\\_index\\_exec\\_comp/](http://www.whitehouse.gov/omb/procurement_index_exec_comp/).
- (C) Identification of prime contracts under which the contractor performs as a subcontractor.
- (D) Description of accounting system (excludes contractors required to submit a CAS Disclosure Statement or contractors where the description of the accounting system has not changed from the previous year's submission).
- (E) Procedures for identifying and excluding unallowable costs from the costs claimed and billed (excludes contractors where the procedures have not changes from the previous year's submission).
- (F) Certified financial statements and other financial data (e.g., trial balance, compilation, review, etc).
- (G) Management letter from outside CPAs concerning any internal control weaknesses.
- (H) Actions that have been and/or will be implemented to correct the weaknesses described in the management letter from subparagraph (G) of this section.
- (I) List of all internal audit reports issued since the last disclosure of internal audit reports to the Government.
- (J) Annual internal audit plan of scheduled audits to be performed in the fiscal year when the final indirect cost rate submission is made.
- (K) Federal and State income tax returns.
- (L) Securities and Exchange Commission 10-K annual report.
- (M) Minutes from board of directors meetings.
- (N) Listing of delay claims and termination claims submitted which contain costs relating to the subject fiscal year.
- (O) Contract briefings, which generally include a synopsis of all pertinent contract provisions, such as: Contract type, contract amount, product or service(s) to be provided, contract performance period, rate ceilings, advance approval requirements, pre-contract cost allowability limitations, and billing limitations."

**John G. Panetta Sr.**  
**Senior Director of Government Accounting**  
**Raytheon Company**

John Panetta is the Senior Director of Government Accounting for Raytheon Company. In this role he is responsible for company interactions with the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) on matters of financial compliance with the Cost Accounting Standards (CAS) and the Federal Acquisition Regulations (FAR Parts 30 & 31).

Raytheon Company (NYSE: RTN), with 2016 sales of \$24 billion, is a technology and innovation leader specializing in defense, homeland security and other government markets throughout the world. With headquarters in Waltham, Mass., Raytheon employs approximately 63,000 people worldwide.

John started with Raytheon Company in 1980 as part of the Financial Management Development Program (FMDP). Over the ensuing years he has held a variety of positions with increasing responsibility as part of the Raytheon Company finance organization.

Previous positions held by John at Raytheon Company include; Deputy Director of Raytheon Company Government Accounting 2005-2008, Manager of Business Governance Raytheon Integrated Defense Systems 2000-2005, Manager of Financial Planning & Analysis at Raytheon Engineers & Constructors (RE&C) 1999, Manager of Budgets & Government Accounting at RE&C 1994-1999, Budgets and Planning at Raytheon Missile Systems Laboratories 1986-1993, Raytheon Internal Audit 1982-1986, FMDP 1980-1982.

John is a member of the Aerospace Industries Association Cost Principles Committee (AIA-CPC Chair 2010, Vice Chair 2009). Additionally he sits on the Financial Executives International Committee on Government Business (FEI-CGB Chairman 2013, Vice Chair 2011) and is currently serving on the National board of directors as Secretary for the Financial Executives International (FEI).

John has a bachelor's degree from Babson College (Wellesley, Massachusetts) where he graduated in 1980 as an accounting major with honors.

March 2017

**DISCLOSURE FORM FOR WITNESSES  
COMMITTEE ON ARMED SERVICES  
U.S. HOUSE OF REPRESENTATIVES**

**INSTRUCTION TO WITNESSES:** Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 115<sup>th</sup> Congress requires nongovernmental witnesses appearing before House committees to include in their written statements a curriculum vitae and a disclosure of the amount and source of any federal contracts or grants (including subcontracts and subgrants), or contracts or payments originating with a foreign government, received during the current and two previous calendar years either by the witness or by an entity represented by the witness and related to the subject matter of the hearing. This form is intended to assist witnesses appearing before the House Committee on Armed Services in complying with the House rule. Please note that a copy of these statements, with appropriate redactions to protect the witness's personal privacy (including home address and phone number) will be made publicly available in electronic form not later than one day after the witness's appearance before the committee. Witnesses may list additional grants, contracts, or payments on additional sheets, if necessary.

Witness name: JOHN G. PANETTA SR.

Capacity in which appearing: (check one)

☐ Individual

☒ Representative

If appearing in a representative capacity, name of the company, association or other entity being represented: THE FINANCIAL EXECUTIVES INTERNATIONAL - COMMITTEE ON GOVERNMENT BUSINESS.

**Federal Contract or Grant Information:** If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) or grants (including subgrants) with the federal government, please provide the following information:

2017

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
N/A			



2016

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
N/A			

2015

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
N/A			

**Foreign Government Contract or Payment Information:** If you or the entity you represent before the Committee on Armed Services has contracts or payments originating from a foreign government, please provide the following information:

2017

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
N/A			

2016

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
N/A			

2015

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
N/A			



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**Evaluating the Defense Contract Auditing Process  
 Testimony before the Committee on Armed Services  
 United States House of Representatives  
 Subcommittee on Oversight and Investigations  
 115<sup>th</sup> Congress**

**Mr. James Thomas  
 Assistant Vice President for Policy  
 National Defense Industrial Association**

**9:00 AM  
 Thursday, April 6, 2017  
 Rayburn House Office Building, Room 2212**

Chairman Hartzler, Ranking Member Moulton, and Members of the Subcommittee, thank you for the opportunity to appear before you this morning. I am here on behalf of the National Defense Industrial Association (NDIA), the nation's oldest and largest defense industry association, comprised of nearly 1,600 corporate and 80,000 individual members.

Industry recognizes that the audit responsibilities of the Defense Contract Audit Agency (DCAA) play an essential role within the Department of Defense's (DoD) acquisition oversight structure and that it operates within a broader set of controls to manage DoD's activities throughout the contracting lifecycle. 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.

NDIA, like many other industry associations, has called for a repeal of the Budget Control Act of 2011 and increases in defense spending proportional to the security threats facing our nation. Industry, taxpayers, DCAA, Congress, and most importantly our armed forces, thus all have a common interest in a properly configured and efficient oversight framework focused on risk based processes and procedures that allow the DCAA to perform their primary role of assisting COs to make decisions.

**NDIA has identified the following five key elements that have significant effect on the defense contract auditing process.**

## 1. DCAA Mission

Per their website, DCAA provides audit and financial advisory services to 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. DCAA's purpose and mission is thus to act as a subject matter financial advisor to COs on matters related to the transactional as well as contract oversight and closeout processes.

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 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.

DCAA asserts that their ROI to the taxpayer in Fiscal Year (FY) 2015 was \$4.80 per dollar spent. While such a figure may seem to be a favorable side effect of performing their central advisory mission, that value computation does not accurately measure all "costs" to the acquisition system for functions that go unfulfilled or delayed, or the costs for companies to maintain and achieve nearly perfect internal controls associated with business systems in order to avoid a DCAA allegation of a significant deficiency (see item 2 below) because of the Agency's perceived very low threshold for materiality. Nevertheless, ROI, appears to be held out to federal stakeholders as the reason for DCAA's existence. The pronounced shift in the agency's focus has crept well beyond its statutory mission over time and, accordingly, DCAA's mission should be reoriented away from a strict process compliance framework fixated on ROI to one directed at helping decision-makers determine fair and reasonable prices for products and services provided to the warfighter.

## 2. Implications of DCAA Audit Behavior for Industry

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.

The materiality issue also affects Cost Accounting Standards (CAS) noncompliance assessments as often allegations of CAS noncompliance issues are asserted by the agency without appropriate consideration of whether the assessments are in fact material. This can create extensive administration in resolution of the issue for the contractor, the Defense Contract Management Agency (DCMA), and DCAA years after the fact. Many of these issues consume valuable resources in the contract disputes process. Using clear and objective criteria would reduce the backlog of non-compliance allegations and assist in lowering the large backlog of contracts currently requiring closeout across industry.

Relative to business systems, there are also major implications for small businesses. Ensuring small businesses have sufficient opportunity to compete for prime contracts is a major public policy goal in federal procurement. Having a DCAA-approved accounting system has increasingly been used as an evaluation criterion for major small business government-wide contracting vehicles, such as One Acquisition Solution for Integrated Services (OASIS) and Alliant II. Small businesses are less likely to have had an audit of their accounting system, which undermines competition and stunts the growth of new entrants to the federal marketplace. Furthermore, the costs of DCAA compliance, as well as the business disruptions from audits, particularly when there are multiple audits, is much more significant on small businesses as a percentage of revenue and resources.

Another major burden from DCAA's approach to audit practices is in records retention. Federal Acquisition Regulation (FAR) 4.7 sets forth the government's record retention policy for various types of records for different oversight purposes, but the insistence of audit staff for contractors to provide access to original documents long after the retention period has expired is inconsistent with the rules and does not align with the practice of moving more records into the "cloud". Where such demands are not met, DCAA has been identifying contractors as having elevated risk, even where contractor imaging processes have been tested and approved by DCAA for compliance.

### **3. How to Measure "Success" in the Defense Contract Audit Process**

A core issue for DCAA is how to measure success. Based on a review of DCAA's annual report to Congress, it appears that the amount of costs it questions, and its ROI are its

most valuable measures of success. While on its face, that may make sense, overemphasis on those numbers runs counter to DCAA's role in the acquisition system and provides perverse incentives for the workforce. Audit quality is based solely on the process used to plan, perform, and report an audit. It is process based, rather than outcome based. Success should be measured in quality audits that meet the expectations of COs in a timely manner. NDIA understands that an overemphasis on the speed of audits was partially to blame for poor audit quality identified in Government Accountability Office reports from 2008 and 2009, a caveat for designing and implementing proper performance metrics. However, absent any goals for timely audits and reporting requirements that do not completely encapsulate DCAA's performance, there is a concerning erosion of accountability.

NDIA is concerned by the metrics included in DCAA's Annual Reports to Congress and the DoD Inspectors General (IG) Semiannual Reports. Review of this data makes clear that the number of audits completed per auditor continues to decrease. Further, while DCAA reported an 18% reduction in incurred cost proposals (ICP) pending audits or awaiting adequacy determinations on hand in its FY 2015 report to Congress, it failed to include the dollar value of those submissions. This was included in each of the previous four reports and showed a continual increase in value since FY 2011, despite the number of ICPs pending audit or awaiting adequacy determinations decreasing by over 50% in that time frame.

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." It appears that a weighted average of ICPs based upon their dollar value would have been a more effective metric as to whether this 18 month backlog goal had been achieved, as this should have a more direct impact on reducing the dollar volume of contracts across industry that still require closeout (due to awaiting final indirect rate year settlements).

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. DCAA achieved "major success" in fulfilling its initiatives in FY 2011 and described FYs 2012 and 2013 as "very successful" according to reports from those years. Since FY 2013, however, DCAA's return on investment fell from \$7.30 per dollar spent to \$4.80 per dollar spent. 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.”<sup>1</sup> Fast-forwarding to the FY 2015 version of the report, that metric was no longer highlighted, and was only 4.5%.

#### 4. DCAA Management

According to GAGAS, “leadership of the audit organization is ultimately responsible for the system of quality control.”<sup>2</sup> Within DCAA this is undermined by greater autonomy granted individual auditors in recent years. Historically, DCAA operated with a chain-of-command structure that more effectively directed, supervised, and managed its audit objectives, but that is no longer the case. A 2009 Audit Guidance Memorandum from DCAA that instructed individual auditors to take significant and sensitive issues directly to the DoD IG<sup>3</sup> is of particular concern. This increased autonomy likely aids DCAA’s high remarks in the Federal Employee Viewpoint Survey, but may also explain its high turnover amongst early careers employees reflected in Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics Human Capital Initiatives data, in comparison to the overall defense acquisition workforce.

DCAA’s regional structure has also frustrated contractors through inconsistent audit practices. The recent reductions in the number of DCAA regions and establishment of more Centralized Audit Responsibilities for the largest DoD contractors is a good start and should continue to help build more consistent positions. However, this will not be effective without greater two-way, face-to-face communication between DCAA and contractors including audit planning, performance, and reporting.

#### 5. DCAA Workforce

As previously mentioned, auditing is a process function. GAGAS standards on professionalism stress objectivity, and do not imply unlimited responsibility, nor infallibility for the individual auditor. Moreover, GAGAS states, “Professional judgment does not mean eliminating all possible limitations or weaknesses associated with a specific audit, but rather identifying, assessing, mitigating, and explaining them.”<sup>4</sup> Industry experience often does not reflect this. Rather, often we experience individual auditors lacking professional judgment trying to “find something” no matter

<sup>1</sup> “Report to Congress on FY 2013 Activities at the Defense Contract Audit Agency.” Accessible at: [http://www.dcaa.mil/DCAA\\_FY2013\\_Report\\_to\\_Congress.pdf](http://www.dcaa.mil/DCAA_FY2013_Report_to_Congress.pdf)

<sup>2</sup> Generally Accepted Government Accounting Standards (GAGAS) 3.86, Accessible at: <http://www.gao.gov/products/GAO-12-331G>

<sup>3</sup> DCAA Memorandum for Regional Directors (MRD) entitled, “Audit Guidance on Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials,” dated March 13, 2009. Accessible at: [https://www.crowell.com/pdf/09-PAS-004\(R\)-MRD\\_Unsatisfactory-Conditions-Govt-Officials.pdf](https://www.crowell.com/pdf/09-PAS-004(R)-MRD_Unsatisfactory-Conditions-Govt-Officials.pdf)

<sup>4</sup> GAGAS 3.68

how immaterial. This is likely driven by DCAA's focus on dollars questioned and ROI at the highest levels. While this seems admirable on the surface, we contend that an auditor's success should be based on their adherence to GAGAS and the utility of their findings. Audits timelines, auditor productivity, and a sustention rate of 31.6% for post-award audits do not reflect this.

Emphasis on "finding something" regardless of whether it is sustained or not, which often times can be the case because it is simply cheaper for industry to settle, is a major perverse incentive eroding the professionalism of the workforce. For instance, at one public accounting firm, early career auditors are assessed for year-end bonuses and promotion potential based on their audit quality from supervisor assessments and peer review. Based on results, managers within the firm collectively make decisions. DCAA should be structured such that the professionalism and output of individual auditors can be evaluated to ensure auditors are accountable and properly supervised in accordance with GAGAS requirements.

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.

#### **NDIA Suggestions for Future Action**

*Reevaluate the DCAA Mission, Organization and Management, and Responsibilities and Functions provided in DoD Directive 5105.36.* Establish a working group of government and industry acquisition and auditing professionals to align mission objectives with the statutory audit-records requirements. Task the working group with 1) determining necessary contract audit, accounting, and financial advisory services needed by the Department, 2) establishing definable and measurable auditing criteria, materiality, and acceptable time frames by audit type, and 3) Identifying which agencies, organizations, or companies are best suited to provide the necessary and timely accounting and financial advisory services for the Department. For example, the effect of competing for the providing of advisory services may inherently improve the service (in all aspects) provided to the respective COs as companies and agencies must demonstrate superior performance in order to continue to perform this role for the Department.

*Establish timely deadlines for the completion of incurred cost audits.* DCAA needs to return to their historical practice (pre-2008) of completing timely audits. The optimal timeline would be 90 days from submission of incurred cost proposals. DCAA would have 30



days to reject the proposal as inadequate (if necessary) prior to beginning the audit, which would then be conducted and completed within 90 days. Once the audit is complete, COs could have 60-90 days to negotiate final incurred costs and indirect rate settlements. For reference, the Securities and Exchange Commission (SEC) requires a company's annual filing, Form 10-K, within 90 days (which incorporates an accounting firm's audit opinion regarding these statements). DCAA should focus objectives, audit programs, and audit techniques for compatibility with the timely completion of the work. Holding incurred cost audits to this timeline, which is proven effective for financial statement audits, would have the effect of significantly reducing costs at contractors (ultimately passed on to the government on their contracts) as personnel and records would be readily available thereby streamlining the audit process of these very current records.

*Embrace the use of third party auditors for incurred cost and business systems audits.* This is likely the only solution to eliminate the incurred cost audit backlog; however, it is not a complete solution. Once implementing regulations are finalized for Sections 820 and 893 of the FY 2017 National Defense Authorization Act, there will likely be more clarity in how interested public accounting firms will be in performing this work. Regardless, DCAA may still likely request working papers and backup materials on work performed by public accounting firms, which we believe is not necessary or appropriate. If each of these sections was expanded to include all contractors, especially those performing work on cost-reimbursable contracts, it would have greater effect. This would allow DCAA funds to be prioritized for forward pricing proposals, which notably, the America Institute of Certified Public Accountants would not allow public accounting firms to perform, as they are not permitted to opine on forward looking statements.

The Department of Transportation has accepted public accounting firm audits and opinions of indirect rate audits for years under American Association of State Highway and Transportation Officials (AASHTO) guidelines and audit requirements. From experience, these audits are efficient and cost effective, taking about 60 to 90 days start to finish. Other agencies have used public accounting firms for years to conduct audits.

*Publish annual report card with assessment of DCAA services from DoD functions responsible for procurement and contract administration.* Develop criteria attributes and a feedback mechanism for procurement and contract administration functions to provide DCAA with assessments on the quality, timeliness, relevance, and satisfaction with the services provided. This feedback would be highly beneficial in understanding how well DCAA is performing in its customer service role. We are not aware of any existing attempts to do this.

*Enhance government-industry dialogue.* Our members reported positive engagement with DCAA in the past, but note there has been little government-industry dialogue in the

last couple of years. Reinstating participation in “Integrated Product Teams” or a comparable dialogue of inquiry to facilitate the audit process and increase communication with auditees would help. It seems that independence has been used as the reason for not communicating with contractors. This is frustrating given that contractors want to comply and to be responsive to valid audit findings, but find themselves unclear in what actions would remediate a finding. Without open communication in the process, effective remediation is frequently delayed by lack of understanding on either or both parties. With open communication contractors can discuss effective remediation and feel comfortable their actions will resolve the audit finding. Dialogue would also be beneficial in training, particularly to teach auditors about standard business and accounting systems (e.g. SAP, Oracle, or Deltek) used by contractors, and how they work.

*Employ dedicated oversight, not necessary legislation, to encourage improvements at DCAA.* Industry would like to see greater use of commercial auditing practices in conducting and performing audits, including the incorporation of materiality in DCAA’s decision making, and recognition of timely completion of audit work. Industry is concerned that some of DCAA’s current annual reporting metrics have perverse incentives, but if they remain, metrics on auditor productivity, especially in comparison to the private sector, and cost borne on industry to achieve DCAA’s ROI should be incorporated. Unfortunately materiality is difficult to legislate, and relies primarily on the professionalism of the workforce; however, such materiality determinations are regularly applied in commercial auditing practices when examining and opining on company financial statements associated with SEC reporting. Similarly, designing metrics that adequately capture DCAA’s role in the Defense Acquisition System is difficult as well. Continued dedicated oversight and hearings such as these provide great benefit, however the views of other stakeholders, namely DCMA, should also be heard.

*Strongly consider the recommendations of the Congressionally-established Section 809 Panel.* The Section 809 panel will likely provide meaningful recommendations covering the defense contract audit process. Since their report is not likely to be released for nearly two years, although there is a possibility for interim recommendations, we recommend that Congress keep this in mind before taking any legislative action.

## **Conclusion**

In summation, a combination of factors has led to the reorientation of DCAA’s mission over the last several years to the detriment of the operations of the Defense Acquisition System. Moving forward, 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 ask

that each of the “Suggestions for Future Actions” above be strongly considered as a viable path forward in achieving these objectives.

**James Thomas**  
**Assistant Vice President of Policy**  
**National Defense Industrial Association**

James Thomas is the Assistant Vice President of Policy at the National Defense Industrial Association. He is the NDIA lead for congressional engagement and the primary point of contact for Members of Congress and their staff within the Association, with a particular focus on the House of Representatives.

Before joining NDIA, James served as the Legislative Director and National Security Policy Advisor to Congressman Duncan Hunter of California, a member of the House Armed Services Committee and Chairman of the Transportation and Infrastructure Subcommittee on Coast Guard and Maritime Transportation. In that capacity, James was responsible for all policy matters related to national security, foreign affairs, and veterans issues. He offered Congressman Hunter key advice and recommendations on matters relating to Iraq and Afghanistan, intelligence gathering and dissemination, industrial base policy, and military readiness and training, among many other policy matters.

Previously, James worked in the Administration of President George W. Bush as a Legislative Specialist in the Office of the Under Secretary for International Trade at the Department of Commerce. James managed all legislative activity for the International Trade Administration, assisted in drafting testimony for Congressional hearings, and provided strategic legislative advice to senior ITA principals.

From 2002 to 2010, James served in the United States Marine Corps Reserve with combat deployments to Iraq where he led Marines on search and recovery operations in the Al Anbar Province in western Iraq. He received numerous medals and awards, including the Marine Non-Commissioned Officer of the Quarter Award.

James is a graduate of the University of Dayton.

**DISCLOSURE FORM FOR WITNESSES  
COMMITTEE ON ARMED SERVICES  
U.S. HOUSE OF REPRESENTATIVES**

**INSTRUCTION TO WITNESSES:** Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 115<sup>th</sup> Congress requires nongovernmental witnesses appearing before House committees to include in their written statements a curriculum vitae and a disclosure of the amount and source of any federal contracts or grants (including subcontracts and subgrants), or contracts or payments originating with a foreign government, received during the current and two previous calendar years either by the witness or by an entity represented by the witness and related to the subject matter of the hearing. This form is intended to assist witnesses appearing before the House Committee on Armed Services in complying with the House rule. Please note that a copy of these statements, with appropriate redactions to protect the witness's personal privacy (including home address and phone number) will be made publicly available in electronic form not later than one day after the witness's appearance before the committee. Witnesses may list additional grants, contracts, or payments on additional sheets, if necessary.

Witness name: JAMES THOMAS

Capacity in which appearing: (check one)

☐

Individual

☒

Representative

If appearing in a representative capacity, name of the company, association or other entity being represented: NATIONAL DEFENSE INDUSTRIAL ASSOCIATION

**Federal Contract or Grant Information:** If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) or grants (including subgrants) with the federal government, please provide the following information:

2017

Federal grant/ contract	Federal agency	Dollar value	Subject of contract or grant
N/A			

2016

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
N/A			

2015

Foreign contract/ payment	Foreign government	Dollar value	Subject of contract or payment
N/A			

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**WITNESS RESPONSES TO QUESTIONS ASKED DURING  
THE HEARING**

APRIL 6, 2017

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**RESPONSE TO QUESTION SUBMITTED BY MRS. HARTZLER**

Ms. BALES. DCAA has issued over 34,000 audit reports between FY 2011–2016. However, the number of audit reports issued is only part of our workload. Incurred cost audits continue to be a top priority for DCAA and we have increased the number of audits covering multiyear incurred cost submissions although a multiyear audit only counts as one report. We believe multiyear audits help increase audit coverage and reduce our audit time over single-year audits. Furthermore, we perform other work that results in memorandums that are fed into other audits but does not count as a report issued. For example, we perform annual real-time labor verifications (also known as floor checks) and interview a sample of contractor employees to ensure they are correctly charging their time to the appropriate cost objectives. The results of these verifications are summarized in a memorandum rather than an audit report, and later incorporated into a future incurred cost report. We do notify contracting officials on a real-time basis if we find internal control issues and we notify the appropriate investigative agency if we identify evidence of mischarging. [See page 7.]



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**QUESTIONS SUBMITTED BY MEMBERS POST HEARING**

APRIL 6, 2017

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### QUESTIONS SUBMITTED BY MRS. HARTZLER

Mrs. HARTZLER. In reference to DCAA's response to HASC (March 31, 2017) question #4 ("Return on Investment") from FY 16 to FY 12, provide the mathematical justification (nominator/denominator) for each ROI reported. Please ensure the answer provides the amount of money, and percent of budget, DCAA allocated to incurred cost audits, forward pricing audits, and other audits in comparison to the respective net savings of each audit type.

Ms. BALES. DCAA does not calculate its ROI in the nature requested as DCAA does not collect the cost for each type of audit. DCAA calculates ROI as the ratio of savings to total Agency funding each year. Net savings are supported through a Contracting Officer's documented actions based on DCAA's recommendations. As a result, in the table below, we show a ROI breakdown by audit type for FY 2016 to FY 2012 by taking reported savings based on when we receive the contracting officer's negotiation memorandum over the total operating costs for the fiscal year we reported the savings.

	<u>FY 2016</u>	<u>FY 2015</u>	<u>FY 2014</u>	<u>FY 2013</u>	<u>FY 2012</u>
<b>Numerator (Savings) (\$000)</b>					
Incurred Cost	\$ 477,071	\$ 443,563	\$ 461,311	\$ 190,416	\$ 194,816
Proposals (w>\$500QC)	2,872,051	2,246,554	3,707,233	3,884,950	3,132,787
Other	<u>294,688</u>	<u>411,579</u>	<u>302,238</u>	<u>336,785</u>	<u>832,871</u>
Total Net Savings	<u>\$ 3,643,810</u>	<u>\$ 3,101,696</u>	<u>\$ 4,470,782</u>	<u>\$ 4,412,151</u>	<u>\$ 4,160,474</u>
<b>Denominator (Funding) (\$000)</b>					
Total Funding	<u>\$ 633,808.8</u>	<u>\$ 650,987.9</u>	<u>\$ 648,670.1</u>	<u>\$ 608,431.1</u>	<u>\$ 621,408.3</u>
<b>Return on Investment (ROI)</b>					
Incurred Cost	\$ 0.8	\$ 0.7	\$ 0.7	\$ 0.3	\$ 0.3
Proposals (w>\$500QC)	4.5	3.5	5.7	6.4	5.0
Other	<u>0.5</u>	<u>0.6</u>	<u>0.5</u>	<u>0.6</u>	<u>1.3</u>
Total ROI	<u>\$ 5.7</u>	<u>\$ 4.8</u>	<u>\$ 6.9</u>	<u>\$ 7.3</u>	<u>\$ 6.7</u>

Mrs. HARTZLER. What specific findings from forward pricing reviews are typically driving net savings? For forward pricing audits, how does DCAA define when a cost is "sustained" and when a cost generates a "net savings"?

Ms. BALES. In responding to this question, we looked at some of the audit reports issued in FY 2016 with large amounts of questioned costs where negotiations have taken place and we have visibility into the net savings. The majority of questioned costs related to labor and material costs proposed. We have provided a summary of some of the common findings related to labor and material below:

For labor, significant questioned costs have resulted from the following:

- The contractor overstated their labor hours when compared to historical hours and taking into account improvement curves and trends;
- The contractor proposed hours to account for a contingency with no basis to support the costs proposed;
- The application of the indirect rates to the questioned labor costs.

For material, significant questioned costs have resulted from the following:

- The inaccuracy of the prime/higher-tier contractor cost or price analyses resulted in overstated costs on a subcontract;
- The contractor did not update their proposal with current purchase orders, quotes, and/or agreements with vendors resulting in overstated costs;
- The contractor did not incorporate cost reduction initiatives in their estimates;
- The contractor overstated quantities when compared to historical actual quantities taking into account improvement curves and trends;
- The contractor did not include quantity discounts;
- Exchange rates were overstated;
- Escalation rates were overstated;

- The contractor did not account for lower prices that were available.

DCAA considers a questioned cost “sustained” when there is a negotiated cost reduction in the contract price directly attributable to audit exceptions and recognizes “net savings” as the amount of cost and profit the Government saves through sustention of our recommended audit exceptions. Because many factors affect the timing of contract negotiations, we report audit exceptions in the year the report is issued as a performance measure and document sustention and net savings in the year the contract is negotiated.

Mrs. HARTZLER. In Ms. Bales’ oral testimony on April 6, 2017, she indicated that DCAA had not implemented Section 820 of the NDAA FY 2017, in part, because DCAA “can’t just accept work from another auditor or auditing company without doing certain things to know that we can rely on their work.” Explain in greater detail why DCAA has not implemented Section 820 with respect to the mandate requiring acceptance of commercial audit findings of indirect costs.

Ms. BALES. The amendments made by Section 820 are not effective until October 1, 2018. In the interim, DCAA is taking the following actions.

DCAA has met with HASC and SASC staff members to discuss some of unintended consequences of Section 820 that do not appear to align with Congress’ intent. The results of these discussions are informing DCAA as they begin working the proposed rule with Defense Procurement and Acquisition Policy (DPAP). For example, while this provision was intended to remove barriers to non-traditional small businesses, this provision will apply to some of the largest Defense contractors resulting in them not being subject to government audits of their indirect costs. For example, some of the top defense contractors (e.g., Raytheon Missile Systems, Lockheed Martin Aeronautics, Boeing Military Aircraft) performing contracts on major defense programs (e.g., F-35, Chinook, AMRAAM) would be permitted under this provision to have their indirect costs audited by a private sector auditor.

DCAA plans to work with the Government Accountability Office (GAO) on the provision that requires DCAA to accept, without performing additional audits, the audit findings prepared by a private sector auditor. The law, as written, would have DCAA violate the auditing standards as published by the GAO. DCAA is not allowed to accept the work of another auditor without performing procedures for determining reliance. (Generally Accepted Government Auditing Standards (GAGAS) Section 2.09.) DCAA is committed to working with industry and Government stakeholders on the appropriate use of private auditors; however, they plan to seek the advice of the GAO to ensure they do not violate their professional standards.

DCAA is currently working with DPAP on developing a proposed rule for Section 893, Contractor Business System, which also includes the use of private auditors. DCAA intends to use the knowledge gained in implementing this rule in developing the proposed rule for implementing Section 820.

Lastly, DCAA has been asked to comment on draft FY 2018 legislation prepared by the HASC. The proposed language will directly impact the Section 820 language. DCAA plans to have additional discussions with the HASC and SASC staff members on the effects of the draft legislation on Section 820. These discussions will help inform DCAA as they begin working with DPAP on a proposed rule.

