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DCAA—Is Anyone Home?

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This article follows up on my earlier article, “GAO vs. DCAA – And The Winner Is? ... Contractors!” 5 CP&A REP. ¶ 15. In that article, I explored the findings from two Government Accountability Office reports² that had a profound impact on the Defense Contract Audit Agency. Little did I know just how profound that impact would be to the contracting community and taxpayers.

Towards the end of the earlier article, I posed the question of whether DCAA’s initiatives for improved working paper documentation and improved sampling of low-risk transactions, as recommended by GAO, would result in improvements in DCAA audits. I ended with a comment that only time will tell whether the impact of the GAO reports on DCAA would result in greater audit findings. Now I am back two years later to answer that question—and the answer is a very sad no. In many practical ways, DCAA has, in essence, stopped performing audits.

400-Percent Reduction in Completed Audits Since 2008

GAO issued the first of the two reports in July 2008. At that time, some would argue that DCAA was at its peak in terms of the number of audits it was performing. In fiscal year 2008, DCAA issued 30,352 audit reports and covered about \$458 billion of proposed and claimed contractor costs.³ Going forward three years to the

end of FY 2011, DCAA has completed just 7,390 audits covering \$129 billion.⁴ This is a reduction of 22,962 reports or over 400 percent, and a reduction of about \$330 billion or over 350 percent in dollars audited. It is almost incomprehensible how DCAA could just stop performing so many audits, especially as contracting actions and dollars awarded have not decreased in any material way.

To put perspective on the issue, the decrease in audits is not due to a reduction in staffing. DCAA’s staffing has actually increased. In FY 2008, there were about 4,200 employees⁵ performing 30,352 audits. In FY 2011, DCAA had just over 4,777 employees,⁶ but completed many fewer audits. In reviewing the audit guidance issued in FY 2011 as posted on the DCAA public website, it is clear that DCAA auditors are instructed to spend considerably more time on working paper documentation and what some might characterize as the administrative aspects of an audit.

Keep in mind that prior to the GAO reports of 2008 and 2009, DCAA had received a clean opinion on peer reviews since inception of the requirement for peer reviews pursuant to direction from the President’s Council on Integrity and Efficiency.⁷ Did DCAA need such a drastic overhaul that it no longer has time to complete thousands of required audits, or did the agency respond to the GAO reviews by going overboard and spending an inordinate amount of time on working paper documentation to ensure that GAO and the Department of Defense inspector general would not find fault with any working papers, all the while letting billions of contract costs go unaudited? Where has DCAA placed its priorities for ensuring proper use of taxpayer dollars? Apparently, it is on the administrative side of performing audits. And accordingly, the productivity of DCAA auditors appears to be at an all time low. It is inconceivable how an audit agency can increase its staff and yet perform fewer audits covering billions of dollars less.

	Oct 2005– Mar 2006		Apr 2006– Sep 2006		Total	
	Reports	\$ (Mil)	Reports	\$ (Mil)	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	10,507	63,097	13,190	65,020	23,697	128,117
Forward Pricing Proposals	4,271	60,808	4,744	121,444	9,015	182,252
Cost Accounting Standards	1,002	82.8	1,411	138.7	2,413	222
Defective Pricing	174		311		485	-
Total	15,954	123,988	19,656	186,603	35,610	310,591

	Oct 2006– Mar 2007		Apr 2007– Sep 2007		Total	
	Reports	\$ (Mil)	Reports	\$ (Mil)	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	9,466	67,141.8	13,053	75,916.9	22,519	143,059
Forward Pricing Proposals	3,899	100,979.2	4,283	114,088.5	8,182	215,068
Cost Accounting Standards	1,270	194.6	1,378	30.6	2,648	225
Defective Pricing	125		327		452	-
Total	14,760	168,315.6	19,041	190,036	33,801	358,352

	Oct 2007– Mar 2008		Apr 2008– Sep 2008		Total	
	Reports	\$ (Mil)	Reports	\$ (Mil)	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	8,689	73,161.5	11,267	71,911.3	19,956	145,073
Forward Pricing Proposals	4,049	189,125.7	4,064	123,989	8,113	313,115
Cost Accounting Standards	928	53.9	999	173.1	1,927	227
Defective Pricing	141		215		356	-
Total	13,807	262,341.1	16,545	196,073.4	30,352	458,415

	Oct 2008– Mar 2009		Apr 2009– Sep 2009		Total	
	Reports	\$ (Mil)	Reports	\$ (Mil)	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	5,758	36,415.4	7,068	45,955.3	12,826	82,371
Forward Pricing Proposals	3,168	131,745.4	3,836	87,473	7,004	219,218
Cost Accounting Standards	584	509.3	708	113	1,292	622
Defective Pricing	78		76		154	-
Total	9,588	168,670.1	11,688	133,541	21,276	302,211

	Oct 2009– Mar 2010		Apr 2010– Sep 2010		Total	
	Reports	\$ (Mil)	Reports	\$ (Mil)	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	2,671	13,973.7	2,495	28,350.3	5,166	42,324
Forward Pricing Proposals	2,694	119,025.3	2,896	66,035.6	5,590	185,061
Cost Accounting Standards	452	885.5	464	60.8	916	946
Defective Pricing	30		29		59	-
Total	5,847	133,884.5	5,884	94,447	11,731	228,331

	Oct 2010– Mar 2011		Apr 2011– Sep 2011		Total	
	Reports	\$ (Mil)	Reports	\$ (Mil)	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	1,974	12,900.2	1,912	12,314.9	3,886	25,215
Forward Pricing Proposals	1,456	52,202.3	1,143	50,977.1	2,599	103,179
Cost Accounting Standards	372	102.4	502	148.1	874	251
Defective Pricing	19		12		31	-
Total	3,821	65,204.9	3,569	63,440	7,390	128,645

FY 2008 vs. FY 2011		
Difference		
	Reports	\$ (Mil)
Incurring Cost, Ops Audits, Special Audits	16,070	119,858
Forward Pricing Proposals	5,514	209,935
Cost Accounting Standards	1,053	(24)
Defective Pricing	325	-
Total	22,962	329,770
	411%	356%

Over \$1 Trillion in Contract Costs Going Unchecked

The reduction of DCAA audits does not generally mean that the audits do not need to be completed. Rather, the majority of audits are simply deferred to future years, resulting in a massive backlog of audits awaiting completion. A significant portion of the audits that have not been completed are the annual audits of costs incurred on cost-type contracts. These audits represent a validation that contractors have only charged the Government for reasonable, allocable and allowable costs. Delaying the audits for years increases

the risk of overpayments going unchecked and significantly reduces the likelihood of future recoupment.

As reported by the Commission on Wartime Contracting in Iraq and Afghanistan, the unaudited backlog in August 2011 was \$558 billion.⁸ The CWC stated that DCAA has reported that the backlog will “continue to grow virtually unchecked” and will exceed \$1 trillion in 2016. This means that \$1 trillion in contractor costs are not being audited by DCAA. Without a significant course correction in the manner that DCAA conducts its audits, which seems unlikely given the 400-percent decrease in audits performed by DCAA since 2008, one does not have to be a statistician to conclude that DCAA will not reduce the backlog in any meaningful manner. It is very likely that for many of the contracts, the statute of limitations for recouping overpayments will run out before DCAA gets around to completing the audits, resulting in a significant loss of savings to the taxpayer.

Some non-defense organizations have already recognized the potential issue with DCAA’s backlog and have decided to use public accounting firms to complete the annual audits, but at a much higher price. In a hearing on improving federal contract auditing in February 2011, the witness from the Department of Education acknowledged DCAA’s reduction in completed audits and stated, “DCAA cannot always accommodate non-DOD requests for audit support. Obtaining audit support from a non-governmental firm can be costly and time-consuming.”⁹

Perhaps DCAA’s rapid decline has not gone unnoticed by some members of Congress. Section 805 of the FY 2012 National Defense Authorization Act requires DCAA to prepare an annual report of activities, including the total number of audit reports completed and pending, the length of time taken for each audit and an assessment of the audits pending longer than allowed pursuant to DCAA guidance. The report is due to Congress by March 3 each year, with public availability no later than 60 days after submission to Congress. DCAA’s growing backlog of audits should become even more apparent after the report is issued.

The Deterrent Effect

Have you ever been late for work and the spotlight begins to turn yellow? Do you immediately stop, or do

you look around for any cars, and better yet, any police? If none are around, do you still stop, or do you chance it and run the light in the hope no one will catch you?

Well, contractors are faced with this same dilemma when it comes to the accounting for contract costs. If the auditors are not around, how are the grey areas of costs handled? Are losses on fixed-price contracts moved to the general and administrative (G&A) cost pool for allocation to other customers? Are greater liberties taken in the treatment of “like costs in similar circumstances?” Because the traffic cop in the contractor cost world, known as DCAA, is no longer looking at the costs and no longer performing very many audits, it becomes much more tempting for contractors to stretch the interpretation of the Cost Accounting Standards and the contract cost principles. Profit margins are shrinking with the reduction in Government funding. Contractors need to find more ingenious ways of cutting costs, and sometimes that means changes in accounting practices that may result in allocations to customers that have deep pockets, such as DOD cost-type contracts. The result is an increased risk of inappropriate costs charged to Government contracts. At a time when contractor costs need to be audited more closely than ever, the traffic cop is not out on the beat ensuring compliance with laws and regulations, but rather at the police precinct preparing working paper documentation that goes through layers of management review.

The “Clericalization” of DCAA

In a September 2009 report, GAO concluded that DCAA’s internal control audits did not comply with auditing standards. Although DCAA had previously passed peer reviews performed by the DOD IG, GAO appeared to have a more stringent interpretation of the auditing standards than the IG and DCAA. As a result of the GAO review, DCAA underwent a review of its approach to internal control audits. One of the first areas to be reviewed was billing-system audits. Two years later in October 2011, DCAA finally issued its program guidance on the audit of contractor billing systems,¹⁰ and if the program is any indication of the direction of DCAA, it is clearly one of “clericalizing” the audit function.

A billing system is one of the more important internal control systems for Government contractors.

It is the system that ensures costs charged to the Government comply with contract terms and regulation. Many of the overcharges on Government contracts result from weak internal controls over the billing process. One only needs to look to the findings of the CWC and the numerous overcharges on Government contracts to understand the need for adequate billing-system internal controls.

The revised DCAA audit program documentation is 27 pages. It is stated to be applicable to large and small contractors. However, the program applies only to the portion of the billing system involving provisional billing, and not the final billing at the completion of the contract. It seems odd that an audit program covering a billing system would not cover the internal controls governing the final billing, since it is the final billing that represents the final payment by the Government and, in essence, is the final “true-up” of the interim billings.

In reviewing the program, it is apparent that DCAA has become very prescriptive in its guidance to auditors, to the point of providing multiple steps for the initial team discussion and interim team discussions by prescribing the items that the auditors, the supervisor and the manager should discuss at the beginning of the audit and at points throughout the audit.

Because these discussions are part of the audit program, the auditing standards require that the discussions be documented and referenced in the working papers. After 10 pages of steps that involve documenting discussions with team members and contractor meetings, does DCAA get to any meaningful audit procedures?

Given the extensive directions to auditors for documenting nearly every discussion and every piece of paper obtained from the contractor, it is clear that DCAA's direction is one of form over substance and it is placing much greater emphasis on the completion of audit working papers than on the completion of an actual audit. In fact, the requirement for the auditor to “document” audit effort is stated over 50 times in the audit program.

The increased emphasis on documentation is also evident in the guidance DCAA has issued over the last year. In July 2011, DCAA issued a 15-page

guidance memorandum on independent reference reviews,¹¹ in which an individual not involved with the engagement completes an extensive review of the working papers, including verifying and cross-referencing working papers. The review is completed after the assignment has been reviewed by management. It is becoming clearer why DCAA has had a 400-percent reduction in completed assignments: an inordinate amount of time is being spent on administrative aspects of the audit rather than on conducting the audit.

Lack of Use of Contractor Internal Reviews

Noticeably absent from the 27-page billing-system audit program are procedures to obtain results of contractor internal control reviews. A fundamental aspect of any system of internal controls is the monitoring effort performed by contractors, and a critical aspect of monitoring is the contractor's internal review program. GAO recently criticized DCAA for not being more aggressive in obtaining the results of contractor internal reviews.¹² GAO noted that “[b]y not routinely obtaining access to relevant company internal audits, DCAA auditors are hindered in their ability to effectively plan work and meet auditing standards for evaluating internal controls.”

The importance of DCAA obtaining the results of contractor internal audits cannot be understated. Consequently, it is puzzling that when preparing its revised approach to auditing billing-system internal controls, DCAA did not include a step to obtain the results of contractor internal audits. Such a basic, but critical step seems to have been overlooked. Perhaps DCAA was obsessed with ensuring that auditors document their work and that the assignment has multiple oversight reviews, rather than ensuring that the audit procedures provide reasonable assurance that the contractor's policies and practices comply with contractual requirements and asset safeguards.

GAGAS

At the heart of the sparring between GAO and DCAA in 2008 and 2009 was the interpretation

of Generally Accepted Government Auditing Standards,¹³ the standards that provide the rules for an audit engagement. Anyone who has read GAGAS gets the sense that there can be a variety of interpretations. Clearly this was the case with respect to GAO and the DOD IG, given that DCAA had passed the DOD IG peer reviews since inception of the peer review requirement.

In light of DCAA's significant increase in requirements for documentation and internal reviews of working papers, it seems apparent that DCAA may be going overboard on complying with GAGAS. Compliance with GAGAS is important. But how much is enough? Should DCAA design its audit programs and procedures to comply with the minimum standards, or should it go beyond the minimum requirements and spend time and effort far exceeding the requirements of GAGAS? (Remember that the new billing-system audit program mentions the need to document audit work over 50 times.)

Given the growing backlog of audits anticipated to exceed \$1 trillion dollars, it is time that DCAA, GAO and the IG get together to resolve the GAGAS compliance issues. Taxpayers, Government agencies and contractors cannot afford the luxury of having DCAA perform audits that far exceed GAGAS requirements, but do not yield any tangible benefit. A reduction of 400 percent in audits using procedures that were once deemed compliant by the DOD IG would seem to indicate that DCAA has lost its perspective on its mission of contract auditing.

DCAA has not had a peer review completed in over five years.¹⁴ It seems evident that DCAA is attempting to have perfect working papers before engaging the IG to complete the next peer review. It begs the question of how DCAA is permitted to continue performing audits without a timely peer review. CPA firms would not be permitted to engage in audit work without a timely peer review.

The question for policy makers and those who profess to support taxpayer interests is whether it would be a better use of resources having DCAA contract auditors spending a majority of their audit time examining and analyzing contractor accounting records, rather than documenting discussions

with supervisors and managers on the risk assessment, audit steps and independent review results. It was the former type of auditors that completed over 30,000 audits for \$458 billion in FY 2008. It was those types of auditors that found millions of dollars in overpayments. Sadly, given the direction of DCAA, it does not appear that it is training its auditors in the art of auditing and sifting through records to find overcharges. Rather, DCAA is developing a generation of auditors that understand the art of working paper documentation and having team discussions.

Who Benefits?

So in the end who benefits? Not taxpayers, as over a trillion dollars potentially go unaudited and unchecked. Not the contracting officers, who rely on DCAA to timely complete audits for pricing and reimbursement purposes. And even some contractors, who initially welcomed the reduction in DCAA audits, are discovering that it is becoming increasingly difficult to close out enormous unaudited contract backlogs.

But the real danger in DCAA's current approach to contract auditing and the obsession over working paper documentation is that it simply results in an enormous and unwise reduction in oversight of high-dollar contracts.

During the peak of the 1990s acquisition reform movement, some contractors and others sought to diminish, if not altogether eliminate, DCAA audits. Contractors no longer need to lobby for these reductions in audit oversight. DCAA has now done it to itself. It is unfathomable how anyone would think that potentially building a backlog of audits of over \$1 trillion is acceptable. It is unfathomable how anyone would think that a reduction of over 20,000 audits performed per year during the last three years is acceptable. Spending valuable taxpayer dollars documenting audit results far in excess of GAGAS requirements should be unacceptable to everyone.

With the billions of taxpayer dollars that are awarded annually in Government contracts, there is a need for a DCAA that conducts both qualitatively and quantitatively outstanding audits. The current DCAA approach satisfies neither consideration. It is time for

DCAA to balance these factors appropriately, rather than merely making sure that all “the appropriate boxes are checked.”

It is time for DCAA to concentrate on its core mission, and conduct contract audits.

❖ Endnotes

- 1 Richard C. Loeb is Adjunct Professor of Government contract law at the University of Baltimore School of Law. From 1991–2005, Loeb served as executive secretary and counsel to the Cost Accounting Standards Board, and from 2001–2003, as acting deputy administrator of the Office of Federal Procurement Policy. The views expressed herein are his own and do not necessarily reflect the views of any agency of the Government.
- 2 GAO report, *DCAA Audits: Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated* (GAO-08-857); and GAO report, *DCAA Audits: Widespread Problems with Audit Quality Require Substantial Reform* (GAO-09-468).
- 3 The number of audit reports and dollars examined come from the Department of Defense inspector general semiannual report to Congress, Appendix D, Contract Audit Reports Issued. The FY 2008 data comes from the semiannual reports for Oct. 1, 2007–March 31, 2008 and April 1, 2008–Sept. 30, 2008. The FY 2011 data comes from the semiannual reports for Oct. 1, 2010–March 31, 2011 and April 1, 2011–Sept. 30, 2011.
- 4 Ibid.
- 5 Testimony of DCAA Director to Senate Committee on Homeland Security and Government Affairs hearing titled *Defense Contract Audit Agency: Who is Responsible for Reform?*, Sept. 23, 2009, p. 1.
- 6 DCAA web page on staffing www.dcaa.mil/staff.
- 7 The President’s Council on Integrity and Efficiency has changed its name to Council of Inspectors General on Integrity and Efficiency.
- 8 CWC, *Final Report to Congress: Transforming Wartime Contracting, Controlling Costs, Reducing Risks*, August 2011, p. 162.
- 9 Testimony of Tom Skelly, Director of the Budget Service, Department of Education, to Senate Committee on Homeland Security and Governmental Affairs Subcommittee on Contracting Oversight, Hearing titled *Improving Federal Contract Auditing*, Feb. 1, 2011, p. 3.
- 10 DCAA audit program for activity code 11010, Billing Audit, Version 1.1, dated October 2011, available at www.dcaa.mil.
- 11 DCAA Memorandum for Regional Directors MRD 11-PPS-012(R), *Audit Guidance on Independent Reference Reviews*, July 26, 2011.
- 12 GAO report, *Defense Contract Audits: Actions Needed to Improve DCAA’s Access to and Use of Defense Company Internal Audit Reports* (GAO-12-88).
- 13 *Government Auditing Standards (Yellow Book)*, published by GAO.
- 14 The last peer review was issued May 2007 and covered the fiscal year ended Sept. 30, 2006, *DOD Inspector General Review of the Defense Contract Audit Agency Quality Control System* (Report No. D-2007-6-006). The review expired on Aug. 27, 2009, as stated on DCAA’s public website at www.dcaa.mil, under the tab for “External Quality Control Review.”