

Supplemental Issue

GAO September 2009 Report: DCAA Audit Quality & Independence Issues



newsletter

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Synopsis of GAO Findings and Recommendations

The General Accountability Office (GAO) has made public its final report that outlines findings and recommendations resulting from an extensive evaluation of the DCAA audit management environment and control structure in performing audits of government contractors.

The GAO's cover page to its report, entitled "DCAA Audits—Widespread Problems with Audit Quality Require Significant Reform", broadly summarizes the GAO findings that are presented in the subsequent report narrative.

The September 2009 GAO report is actually an extension of an earlier GAO review of DCAA's management and quality audit systems, the results of which were reported in July 2008. The July 2008 report, which castigated DCAA for failing to meet audit professional standards, was based on observations at three DCAA field offices in California.

After the release of the July 2008 report, Congress requested GAO continue its evaluation with expanded assessment criteria focused on a nationwide review of DCAA audit quality.

Scope of GAO Evaluation:

GAO was requested to perform testing of DCAA field audit activities, controls, and specific audit work, as well as provide options for organizational changes, within the three following scope definitions:

- (1) Conduct a broad assessment of DCAA's management environment and audit quality assurance structure;
- (2) Evaluate DCAA actions to date to correct previously identified problems, and;
- (3) Identify potential legislative and other actions for improving DCAA effectiveness and independence.

Audit procedures and evaluation steps were conducted for each of the three above scope definitions as follows:

DCAA's Management Environment and Audit Quality

- (1) Analyzed DCAA's mission statement, strategic plan, performance metrics, policies, audit guidance and system of quality control.
- (2) Selected a total of 69 completed audits, performed by 76 DCAA field offices that were issued between fiscal years 2004 and 2006; those audits included:
 - o 37 audits of contractor internal controls systems, which contained "clean opinions" specific to internal controls for (a) cost accounting (b) billing, and (c) estimating functions.
 - o 32 audits of paid vouchers, overpayment, requests for equitable adjustments, and incurred cost proposals.

DCAA's Corrective Action to Date

GAO analyzed "key initiatives" undertaken by DCAA in response to the GAO's earlier recommendations, and DCAA's "efforts in response to DOD

Comptroller/CFO and Defense Business Board recommendations.”

Improving DCAA's Effectiveness and Independence

GAO evaluated DCAA's current role and chartered duties, and authoritative guidelines surrounding audit independence (Inspector General Act of 1978). GAO also compared DCAA's practices to those of “leading organizations that have made cultural and organizational transformations”, GAGAS criteria for auditor independence, and GAO's Standards for “Internal Control in the Federal Government”.

During the audit, GAO continuously interfaced with the DCAA Director and other officials, to include DCAA headquarters and field managers. Also included in discussions were the former and new DOD Comptroller, and the Comptroller's DCAA Oversight Committee. Comments regarding GAO findings and recommendations were also solicited from DOD and DOD IG officials.

The audit was conducted between August 2006 and December 2007, suspended until October 2008, and then resumed and completed in mid-September 2009.

GAO Findings and Rationale:

DCAA's Management Environment and Audit Quality

The GAO found broad-based “audit quality problems at DCAA offices nationwide...” summarized as:

- Compromise of auditor independence.
- Insufficient audit testing.
- Inadequate planning and supervision.

The summary “highlights” section of GAO's report addressing these issues states that the audit quality structure was “based on a production-oriented mission

that put DCAA in the role of facilitating DOD contracting without also protecting the public interest” and blames audit quality issues on a “poor management environment”. Moreover, DCAA audit quality problems disclosed by GAO are demonstrated by DCAA's rescission of 80 audit reports in response to the GAO report, as well as the detailed findings noted during the review of the 69 audits/cost related assignments selected for review.

More specific details that we find interesting in pages 14 through 41 of the GAO report which discuss the DCAA audit work products and causes of reported issues follow:

- GAO asserts that out of the total 69 DCAA audits or other assignments reviewed, 65 “exhibited serious GAGAS or other deficiencies...”
- DCAA internal controls audits reviewed by GAO disclosed that 33 of the 37 audits reviewed lacked sufficient testing of internal controls, and that lack of sufficient support “rendered them unreliable for decision making on contract awards, direct billing privileges, the reliability of cost estimates, and reported direct cost and indirect cost rates”. Further, none of the 20 DCAA audits of billing system internal controls contained sufficient testing of controls to support the audit opinions.
- DCAA supervisors “dropped auditor findings of significant deficiencies from the audit reports, or treated them as suggestions for improvement without adequate support.” While GAO criticizes the deletion of significant audit findings from reports, the GAO also critiques DCAA's new policy in which the “inadequate in part” opinion has been deleted--GAO notes that this policy “does not recognize different levels of severity and could unfairly penalize contractors whose systems have less severe deficiencies by giving them the same opinion (that is, “inadequate”)”.
- None of the 32 cost related assignments (paid vouchers, overpayment, incurred costs & equitable adjustments) contained adequate testing to support DCAA

results. GAO noted that in many instances only a few judgmentally selected transactions were reviewed, while suggesting that statistical sampling techniques should have been used. Moreover, testing that was performed was often superficial.

- Reports not requiring conformance under GAGAS, such as paid voucher reviews, sometimes mistakenly included verbiage that GAGAS standards were applicable.

The GAO report, in support of its belief that the poor management environment is the primary cause of audit quality issues, makes the following observations in its report:

- DCAA's mission statement and strategic plan are not focused on the public interest.
- DCAA objectives under its strategic plan require a focus on process improvements, but fail to stipulate a clear plan for achieving its goals, and do not contain adequate metrics for measuring its success. DCAA's metrics for assessing performance in meeting various goals are largely output based, such as dollars audited per hour or meeting demand audit deadlines within 30 days of request. As a result, DCAA managers were more focused on getting audits done quickly to demonstrate high productivity and return on investment for services provided to the government procurement offices; thus GAO believes a “risk-based audit planning approach” for evaluating success should be taken.
- DCAA's audit quality assurance program was not properly implemented. GAO asserts that DCAA's internal audit quality review process (peer reviews) allowed satisfactory ratings given to 13 of 14 field audit offices, but supporting information behind those peer reviews for 10 of these offices showed “2 or more instances of serious GAGAS noncompliance, including inadequate planning, lack of proper supervision, and insufficient support for reported conclusions and opinions.”
- The DOD IG peer review process of DCAA requires consistency between findings noted and the IG's opinion. GAO states that the FY 2006 IG report of the DCAA audit process

identified significant noncompliance with professional standards, but DCAA was nonetheless given a “clean” opinion.

- Auditors are not adequately supervised, nor is training for auditors sufficient to ensure competence in performing their tasks utilizing required GAGAS professional performance standards; within this section, GAO comments that some DCAA supervisors responsible for “deficient audits identified in GAO’s prior investigation were promoted”, suggesting that bad supervision is rewarded.

DCAA’s Corrective Action to Date

The GAO report acknowledges that DCAA has taken “several positive steps” in overcoming audit quality problems, but also underscores that DCAA’s “production-oriented culture”, decentralized management environment, and hiring and promoting from within DCAA employment ranks makes it difficult to change the DCAA culture and implement meaningful corrective actions.

GAO cites several corrective action initiatives that should be taken, but thus far, have not been addressed or completed. Comments discussed within pages 42 through 60 of the GAO report iterates corrective action that must be taken to issues which we discuss above (under our article’s subheading, “DCAA’s Management Environment and Audit Quality”).

A few corrective action items set forth in the report include:

- Amend the DCAA mission statement and strategic plan that develops “(1) an annual performance operating plan and a balanced scorecard tied to the strategic plan, and (2) a human capital strategic plan”.
- Avoid performance metrics that focus more on production output, rather than on achieving quality audits. GAO notes that some output metrics, such as efficiency goals (dollars per hour to complete an audit), are helpful in assessing in use of audit

funds. Nevertheless, the report raises concerns that using such measurements for achieving quality has historically stymied auditors in performing quality audits.

- Restructure DCAA’s audit quality assurance program which would include “report review findings; provide training and additional policy guidance, as appropriate; and perform follow-up reviews to assure corrective action was taken”.
- Implement a risk-based planning infrastructure that “expands DCAA self-initiated audits and increases the potential for identifying, fraud, waste, and abuse, and higher rates of return to the taxpayer...” DCAA has resisted this recommendation and correctly asserted that such a process is restricted by contract regulations which permit reviews of selected (and not all contracts), and the absence of a legal basis to obtain cost data from a contractor if the access-to-records contract provisions are missing from certain contracts.
- Improve DCAA management’s role in “key decisions”, and avoid independence problems.

Improving DCAA’s Effectiveness and Independence

GAO provided several options for changes in DCAA’s “organizational placement” and culture toward overcoming independence and audit quality issues. These suggested actions in most cases require Congressional and/or DOD legislative action, and cannot be undertaken by DCAA without higher authority approval. Examples of those recommendations are:

- Elevating the DCAA Director position to one requiring presidential appointment, and Senate confirmation.
- Increasing DCAA’s audit authority by “providing the same level of access to records and personnel available to the IG.” GAO cites discussions with DCAA auditors and reviews of audit documentation as support that increased access to contractor employees and records would “be an important provision to improve the effectiveness of DCAA audit staff.”

- Mandating an external reporting requirement of DCAA via Congressional legislation (similar to the IG Act).

On a longer term basis, GAO suggested some stunning options regarding organizational placement, ones that would more likely turn the agency’s current charter and operational methods upside down—ideas such as:

- “Elevating DCAA within DOD as a separate component reporting to the Deputy Secretary of Defense”.
- Establishing a single independent Government-wide “Contract Audit Agency” and redefining responsibilities, governance and parameters in audit authority.

GAO Recommendations:

The GAO provided 17 general recommendations for undertaking corrective action to deficiencies found. Those recommendations are summarized in brief as follows--GAO recommends:

- Secretary of Defense revise DCAA’s mission statement to reflect need for quality audits, establish milestones for completing DCAA corrective action, and monitor DCAA progress on a routine basis.
- Secretary of Defense require DCAA to undertake the following actions:
 - Develop a strategic plan, consistent with a revised mission statement and measure progress in achieving goals through metrics that are tied to the mission statement.
 - Seek expert guidance to develop a risk-based contract audit approach.
 - Establish a senior executive position for audit quality assurance.
 - Establish a separate DCAA internal review organization.
- Review DCAA’s current “portfolio of audit and non-audit services” to determine if any such services should be moved to other DOD agencies, or simply terminated.
- Develop a staffing plan that identifies resource requirements using a risk-based analytical approach.

- Create a slot for an “expert on auditing standards”, or otherwise seek external consulting advice in revising contract audit policy, providing guidance on statistical sampling, and developing training on auditing standards.
- Amend DCAA audit policy to better identify what comprises sufficient audit testing in accordance with GAGAS.
- Develop agency wide training on government audit standards.
- Perform comprehensive and objective evaluations of the revised quality assurance function, and develop recommendations to “address annual quality assurance review findings of serious deficiencies and GAGAS noncompliance issues”.
- Establish policies & procedures to avoid independence issues among functions of auditors.
- Have the DOD IG reconsider its overall conclusions giving an adequate opinion on DCAA system of quality control (May 2007 DOD IG report), and determine if that report should be rescinded or modified.

Our Commentary & Analysis:

Because of the comprehensive dialogue within the GAO report, with multiple issues and recommendations, it is difficult to determine the short or long-term impact on government contractors. One issue likely to draw contractor concern and action is the fact that DCAA has rescinded over 80 audit reports as a result of the GAO findings. The DCAA rescission of those audits precipitates the notion that contractors, (those companies audited for which such audit reports were withdrawn), will face new audits of the same internal controls and have to withstand a more rigid audit process which will likely cause a broad-based disapproval of many internal controls, and withholdings on payments of invoices. We are aware that a few publicly-held government contractors have included qualifying verbiage with the submission of their latest SEC forms (10-Q or 10-K) identifying this potential threat to those companies' future financial posture.

Additionally, the following three consequences of this latest report (which are obvious when one reads the report) may occur:

- More audits of all government contractors — with particular emphasis on those audits examined by the GAO—internal controls, billed costs and invoice payments.
- Higher likelihood that most internal controls audits will result in “inadequate” systems, and be deemed subject to withholdings of payments until corrective action is taken.
- Lengthier audits, with more requests for evidential data, to justify audit conclusions; a companion fall-out of this will be more audit focus on access-to-records issues, should contractors, for any legitimate reason, choose not to divulge certain data.

The Senate is already sounding off in response to the latest GAO findings. Many legislators, such as Senator Tom Coburn, are indicating a need to “start over”, referring to a possible overhaul of the DCAA mission and structure.

Some legislators have indicated that Congress take a look at creating a single, more empowered government contract auditing agency; Senator Joe Lieberman recently stated, “The larger question ... is whether, as [GAO] suggested, we ought to take a look at creating a totally independent auditing agency for the federal government overall and go back to the idea of an auditor general.”

We will continue to analyze the content of this report and prepare future newsletter articles that target more specific issues contained within this report with more commentary as to the impact on government contractors.

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