

Testimony

of

Patrick J. Fitzgerald
Director, Defense Contract Audit Agency

before the

Subcommittee on Contracting Oversight

Senate Committee on Homeland Security and Governmental Affairs

on

Improving Federal Contract Auditing

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Chairman McCaskill, Senator Brown, 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 also discuss the role DCAA plays in performing contract audits for agencies other than the Department of Defense.

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. Our charter was intentionally developed to permit DCAA to provide these same contract audit services to other Federal agencies.

To carry out its mission, DCAA has about 4,725 employees and 114 field audit offices around the world. More than 85 percent of DCAA's personnel are auditors. And of those auditors, 29 percent hold advanced degrees and 28 percent are Certified Public Accountants (CPAs). In FY 2010, DCAA performed over 11,700 audits covering \$228 billion in proposed or claimed contractor costs. These reviews recommended reductions in proposed or billed costs of \$13.7 billion (referred to as questioned costs); and \$20.2 billion in estimated costs for which the contractor did not provide sufficient information to explain the basis of the estimated amounts (referred to as unsupported costs). In any one year, DCAA audits between 8,000 and 9,000 different contractors.

DCAA Contract Audit Effort

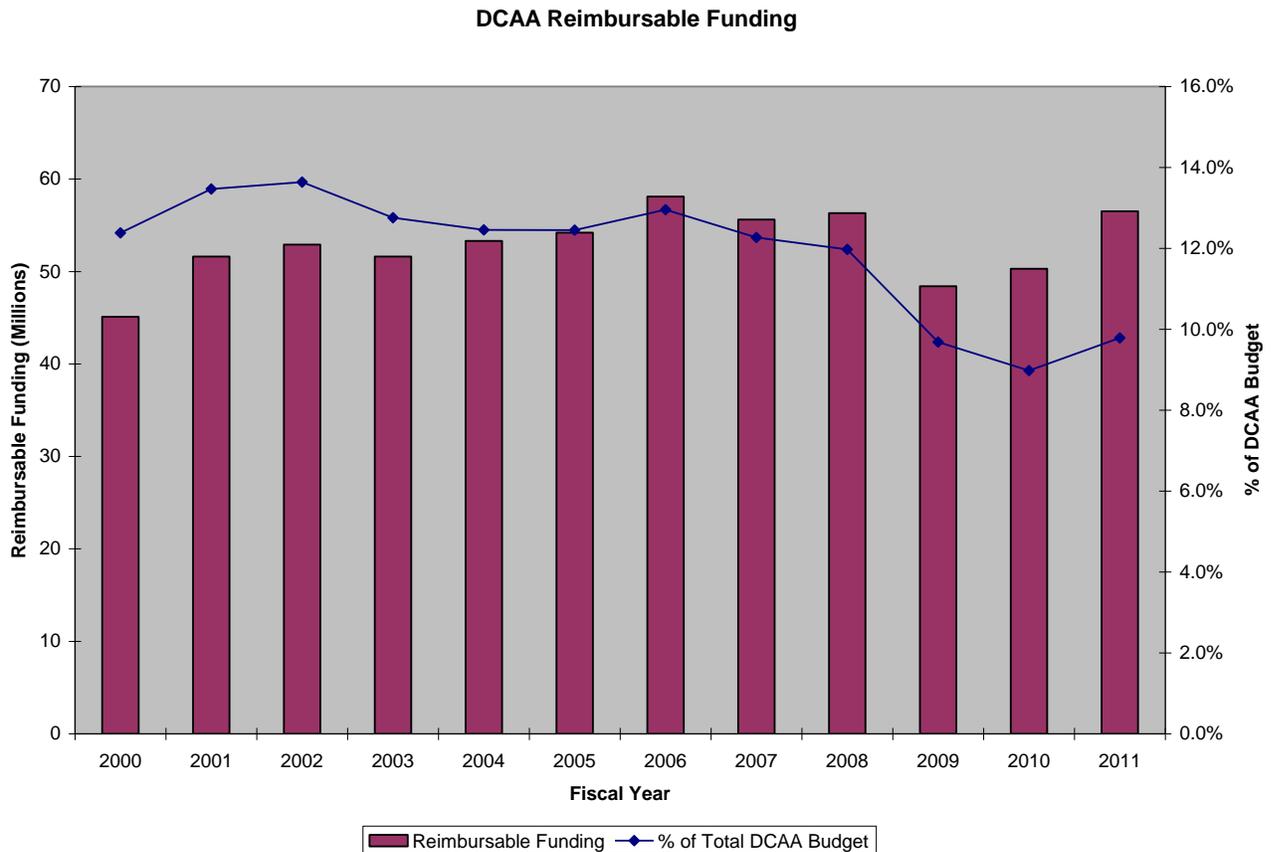
To support the Secretary of Defense's initiatives to obtain maximum value for the dollars spent in defense contracting, DCAA plays an integral part in the oversight and management instituted by DoD to ensure integrity and regulatory compliance by contractors performing on DoD contracts. Decision-making authority on DCAA recommendations resides with contracting officers within the procurement and contract management organizations; they work closely with DCAA throughout the contracting process.

The type and extent of DCAA audit work varies based on the type of contracts awarded. DCAA typically performs audits of contractors' bid proposals when cost data is provided and contracting officials determine the need for audit services. These audits are performed prior to contract award in accordance with the Federal Acquisition Regulation for both fixed-price and cost-reimbursable contracts to assist the contracting officer in negotiating a fair and reasonable price. DCAA audit services are generally limited to those procurements under Federal Acquisition Regulation Part 15 (Contracting by Negotiation). During FY 2010, DCAA conducted 4,380 audits of contractor proposals covering \$182 billion and reported cost questioned of about \$12.2 billion. Of the 4,380 proposal audits, 390 were conducted for civilian agencies and these reviews resulted in exceptions of more than \$870 million. After contract award, audit effort is concentrated on cost-reimbursable and time-and-material contracts. These types of contracts pose an increased risk of overspending, often with little incentive for the contractor to control costs. As a result, there is continual audit effort on these contract types from award to final closeout and payment. This effort is concentrated on audits of contractor business systems, provisional payments, and annual testing of contract costs for compliance with contract terms.

DCAA audits of fixed-price contracts after contract award are very limited and are generally focused on audits for compliance with the Truth in Negotiations Act and auditing contractor interim payment requests when determined necessary by contracting officials.

DCAA Effort at Civilian Agencies

DCAA has performed contract audits for civilian agencies since its inception in 1965. The type and scope of DCAA's efforts at civilian agencies are very similar to the audits we perform for the Department of Defense. Over the last several years, the percent of DCAA's total budget devoted to reimbursable work has ranged from 9 to 13 percent and the total reimbursable funding has ranged from \$45 to \$58 million.



In an average year, DCAA provides audit services to more than 30 civilian agencies. However, DCAA’s reimbursable effort is heavily weighted toward just a few civilian agencies. A breakdown of DCAA’s FY 2010 reimbursable effort is shown below:

Reimbursable Organization	Percent of Total DCAA Reimbursable Effort
NASA	33.0%
Department of Energy	19.1%
Foreign Military Sales	14.4%
Department of Health and Human Services	8.2%
Department of Homeland Security	5.0%
Department of State	4.6%
Remaining Civilian Agencies	15.7%

When performing contract audits, DCAA provides the same professional services to civilian agencies as it does to the DoD acquisition community. The current reimbursable rate DCAA charges civilian agencies is \$113.84 per hour.

DCAA audit services for civilian agencies can be grouped into two general categories. The first are requests pertaining to contractors where DCAA has a continuing presence. The second are audit requests for contractors not currently being audited by DCAA.

Audits at Contractors with a Continuing DCAA Presence. DCAA normally performs all contract audit services at contractors where DCAA maintains an active presence. This usually means the contractor has an active DoD contract. In FY 2010 nearly 90 percent of the contractors we audited were engaged in some type of DoD work. Using DCAA for contract audit services at these locations is a cost effective use of Government resources and provides assurance that a comprehensive audit is accomplished.

Audits at Contractors without a Continuing DCAA Presence. Audit requests at contractors without a continuing DCAA presence are handled on a case-by-case basis. The following criteria are used in determining whether to accommodate or decline the audit request:

- Is the requested service compatible with DCAA's contract audit services?
- Would the acceptance or refusal to perform the work result in duplicative audit activity?
- Can the work be performed within Agency resources?

During the past year, DCAA has developed a risk-based approach to performing contract audits. This approach has allowed DCAA to focus on the highest-risk areas with the biggest payback to the U.S. taxpayer. DCAA uses this risk-based approach when performing reimbursable audit effort. In general, this has meant DCAA has expended more resources in the forward pricing area (audits of contractor proposals) at the expense of resources devoted to the incurred cost area.

In addition, recent changes to the way DCAA performs audits means we are performing more comprehensive, high-quality audits, which include additional transaction testing and ensuring our audits comply with Generally Accepted Government Auditing Standards (GAGAS). While these changes have resulted in audits that take longer to complete, we believe the changes have resulted in an increase in audit quality. The additional audit procedures ensure the acquisition community is getting the best possible product. DCAA has applied these same changes to the way we perform reimbursable audits.

Recommendations to Strengthen Civilian Contract Audits

Over the past several months, the Department of Defense has taken steps to implement several initiatives that have improved contracting processes and related contract oversight. It is my opinion that the implementation of similar initiatives on a broader Federal level would provide similar benefits as discussed further below.

Contractor Business Systems. Business systems and related internal controls are an essential part of any organization and are vital to protecting the Government's interest and preventing contractor overpayments. DCAA generally provides the contract audit oversight of contractor business systems to assist the contracting officers as they negotiate and administer contracts. The Department has committed to improve DoD's oversight of contractor business systems and published proposed business system rules on January 15, 2010, and again on December 3, 2010, in the Defense Federal Acquisition Regulations Supplement (DFARS). The proposed rules define and establish criteria for each contractor business system and implement compliance mechanisms (specifically percentage withholds) when deficiencies are discovered. We are encouraged that the proposed rules will increase transparency by providing Defense contractors a clear understanding of what is required of them, while also improving the audit and administrative oversight activities. We believe that similar rules, if implemented to apply to all reimbursable Government contracts, would provide similar improvements beyond DoD.

Process for Adjudicating Audit Findings. Recognizing the importance of the DCAA's mission and the audit services provided for the benefit of the taxpayer, I believe that audit findings should receive full consideration during the contract negotiation process. One of my first actions as Director of DCAA was to engage with the Director, Defense Procurement and Acquisition Policy, to formulate a DoD process that ensures the taxpayer receives the full benefit of DCAA's audit services. On December 4, 2009, DoD issued a detailed adjudication policy. This provides a process for DCAA to elevate differences of opinion on contract audit matters when the contracting officer responsible for dispositioning DCAA audit findings and recommendations does not agree with the audit findings and/or recommendations. In addition, subsequent to the issuance of the DoD adjudication policy, Mr. Charlie Williams, Director,

Defense Contract Management Agency (DCMA), and I have committed our Agencies to aggressively target contractual opportunities to recover millions of taxpayer dollars by dispositioning outstanding audit findings. I believe that if a formalized adjudication policy existed for all Government contract audits, similar taxpayer benefits could be achieved.

Risk-Based Audit Requirement Approach. Another way to strengthen audit coverage across the Federal Government is to have a risk-based audit approach identifying the high-risk contract actions requiring audit resources. During the past several months, my staff has been working with Defense Procurement and Acquisition Policy to revisit the Department's reliance on DCAA audits to ensure that those audits are focused on the areas of the greatest risk to the Department, the warfighter and the taxpayer. DCAA audit requirements have grown significantly over the past several years. This has created a need to reassess the DCAA audit workload and priorities with the Department to ensure that the level of risk justifies the need for an audit as opposed to a lesser service (for example, cost/price analysis). One such example relates to the thresholds for seeking DCAA audits of contractor forward pricing proposals to provide goods and/or services to the Department. The Department's analysis revealed that the DoD threshold for requiring a DCAA audit was significantly lower than necessary, resulting in the ineffective use of DoD and DCAA audit resources. As a result, Sub-section 215.404-2(c) of the Defense Federal Acquisition Regulation's Procedures, Guidance, and Information was revised on September 17, 2010. It increased the audit thresholds for negotiated contracts to \$10 million for fixed-price contracts and \$100 million for cost-reimbursable contracts, commensurate with the associated risk. For the proposals under the revised thresholds, DCMA will provide cost- and price-analysis services to assist the contracting officer achieve fair and reasonable contract pricing. These revisions help the Department to ensure that DCAA focuses

its scarce audit resources on those areas of greatest risk. Again, I believe that these same initiatives should be considered by other Departments. Appropriate thresholds for audits should be established based on risks, to ensure that scarce audit resources are applied to those areas which pose the greatest risk to the taxpayer.

Finally, I know that the hearing today will examine the issue of creating a new Federal Contract Audit Agency. I do believe that DCAA, as it is currently positioned in the Department of Defense, does have sufficient organizational independence to perform high quality audits to accomplish its mission. In addition, the Department has taken steps to ensure DCAA's audit findings are given full consideration during negotiations through a formal adjudication process. And I would be remiss if I did not acknowledge the enormous support provided by the Comptroller's office over the last year. This support included a significant increase in DCAA resources (about 500 additional auditors over the past 2 years) and Department support for the many quality initiatives undertaken by DCAA.

Closing

In closing, I would like to say that civilian agencies are an important part of DCAA's contract audit effort. Let me assure you that we are committed to providing civilian agencies with high-quality audits that protect the interests of the American taxpayer. Over the past year, DCAA has implemented many initiatives to improve the quality of our audits and improve the work environment for our talented workforce. In response to the several external reviews, DCAA has made significant cultural changes such as issuing a new strategic plan and improving strategic communications both within the agency and with our external stakeholders. To assist in developing our workforce, we are overhauling our training programs as well as making changes to our hiring and promotion policies. In addition, DCAA has also issued several audit policy

changes to facilitate the performance of high quality audits. In summary, we have changed the way DCAA does audits by using a more collaborative and comprehensive approach to contract auditing. As we go forward, we intend to work towards achieving a proper balance between DCAA resources and the workload to enable us to address the growing incurred cost backlog, while continuing to improve the performance of quality audits.

I appreciate the opportunity to testify before you today and I will be glad to respond to your questions.