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Testimony

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DCAA AUDITS

Widespread Problems with Audit Quality Require Significant Reform

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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to discuss our recent audit of the Defense Contract Audit Agency's (DCAA) overall management environment and quality assurance structure. DCAA is charged with a critical role in Department of Defense (DOD) contractor oversight by providing auditing, accounting, and financial advisory services in connection with the negotiation, administration, and settlement of contracts and subcontracts.¹ DCAA's mission encompasses both audit and nonaudit services in support of DOD contracting and contract payment functions. DCAA audits of contractor internal controls in accounting, billing, estimating, and other key systems support decisions on pricing and contract awards. Internal control audits also impact the planning and reliability of other DCAA audits because DCAA uses the results of these audits to assess risk and plan the nature, extent, and timing of tests for other contractor audits and assignments.

Last year, we reported² the results of our investigation of allegations about certain DCAA audits at three locations in California, which substantiated claims that (1) audit documentation did not support the reported opinions; (2) DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes; and (3) sufficient work was not performed to support the audit opinions and conclusions. At that time we were conducting a broader audit of DCAA's overall organizational environment and quality control system. Given the evidence presented at the Committee's September 2008 hearing, you requested that we expand our ongoing assessment. Our current report,³ which the Committee is releasing today, presents the results of our DCAA-wide audit, including (1) an assessment of DCAA's management environment and quality assurance structure; (2) an analysis of DCAA's corrective actions in response to our July 2008 report and two DOD reviews,⁴ and (3) potential legislative and other actions that could improve DCAA's effectiveness and independence.

¹ DCAA also performs audit services for other federal agencies on a fee-for-service basis.

² GAO, *DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, [GAO-08-857](#) (Washington, D.C.: July 22, 2008).

³ GAO, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-468](#) (Washington, D.C.: Sept. 23, 2009).

⁴ DOD reviews included (1) an Under Secretary of Defense (Comptroller/Chief Financial Officer (CFO)) tiger team review and (2) a Defense Business Board Study.

To assess DCAA's overall management environment and quality assurance structure, we analyzed DCAA's mission statement and strategic plan, performance metrics, policies and audit guidance, and system of quality control. We also reviewed audit documentation for 69 selected audits and cost-related assignments at certain field audit offices (FAO) in each of DCAA's five regions for compliance with generally accepted government auditing standards (GAGAS)⁵ and other applicable standards. We selected 37 audits of contractor internal control systems performed by seven geographically dispersed DCAA field offices within the five DCAA regions during fiscal years 2004 through 2006.⁶ Our approach focused on DCAA offices that reported predominately adequate, or "clean," opinions on audits of contractor internal controls over cost accounting, billing, and cost estimating systems issued in fiscal years 2005 and 2006.⁷ We did this because contracting officers rely on these opinions for 3 or more years to make decisions on pricing and contract awards, and payment. For example, audits of estimating system controls support negotiation of fair and reasonable prices.⁸ Also, the FAR requires contractors to have an adequate accounting system prior to award of a cost-reimbursable or other flexibly priced contract.⁹ Billing system internal control audit results support decisions to authorize contractors to submit invoices directly to DOD and other federal agency disbursing offices for payment without

⁵ GAO, *Generally Accepted Government Auditing Standards*, [GAO-03-673G](#) (Washington, D.C.: June 2003) and [GAO-07-731G](#) (Washington, D.C.: July 2007).

⁶ Although our selection of the seven offices and 37 internal control audits was not statistical, it represented about 9 percent of the total 76 DCAA offices that issued audit reports on contractor internal controls and nearly 18 percent of the 40 offices that issued 8 or more reports on contractor internal controls during fiscal year 2006. Of the 37 internal control audits we reviewed, 32 reports were issued with adequate opinions and 5 reports were issued with inadequate-in-part opinions. In the case of follow-up audits, we also reviewed the documentation for the previous audit to gain an understanding of the scope of work and deficiencies identified in the prior audit. These were the most recently completed fiscal years at the time we initiated our audit.

⁷ In selecting the seven DCAA offices, we considered a 2-year history of internal control audit results. The seven DCAA offices we selected reported adequate opinions on 89 percent or more of the internal control reports they issued during fiscal year 2006. During fiscal year 2005, 4 of the 7 offices reported adequate opinions in 85 percent or more of the internal control reports they issued, and the other 3 offices issued adequate opinions in 50 to 69 percent of the internal control audit reports they issued.

⁸ DCAA *Contract Audit Manual (CAM)* 5-1202.1a and *Defense Federal Acquisition Regulation Supplement (DFARS)* 215.407-5.

⁹ FAR §§ 16.104(h) and 16.301-3(a)(1).

government review.¹⁰ Because DCAA uses the results of internal control audits to assess risk and plan the nature, extent, and timing of tests for other contractor audits and assignments, the conclusions and opinions in these audits impact hundreds of other DCAA audits. At the same seven DCAA field offices, we selected an additional 32 cost-related assignments for review, including 16 paid voucher reviews, 10 overpayment assignments, 2 requests for equitable adjustment audits, and 4 incurred cost audits that were completed during fiscal years 2004 through 2006. We reviewed supporting documentation for the cost-related assignments to determine whether DCAA auditors were identifying and reporting contractor overpayments and billing errors.¹¹

To assess DCAA corrective actions, we reviewed the status and analyzed several key actions that DCAA initiated as a result of our earlier investigation, including changes in performance metrics and policy and procedural guidance, as well as DCAA efforts in response to DOD Comptroller/Chief Financial Officer (CFO)¹² and Defense Business Board¹³ recommendations. To identify potential legislative and other actions that could improve DCAA's effectiveness and independence, we considered DCAA's current role and responsibilities; the framework of statutory authority for auditor independence in the Inspector General Act of 1978, as amended;¹⁴ best practices of leading organizations that have made cultural and organizational transformations; our past work on DCAA organizational alternatives; GAGAS criteria for auditor integrity,

¹⁰ FAR § 42.101 and DFARS § 242.803.

¹¹ Contractor overpayments can occur as a result of errors made by paying offices, such as duplicate payments and payments in excess of amounts billed, and contractor billing errors, such as using the wrong overhead rate, failing to withhold designated amounts on progress payments, duplicate billings, or billing for unallowable cost. Recoveries of overpayments can be accomplished through refunds, subsequent billing offsets, or other adjustments to correct billing errors.

¹² Under Secretary of Defense—Comptroller, *Memorandum for Director Defense Contract Audit Agency*, Subject: Implementation of Corrective Actions (Washington, D.C.: Aug. 20, 2008).

¹³ Defense Business Board, *Report to the Secretary of Defense: Independent Review Panel Report on the Defense Contract Audit Agency*, October 2008.

¹⁴ Codified in an appendix to Title 5 of the United States Code (hereafter 5 U.S.C. App.).

objectivity, and independence; and GAO's Standards for Internal Control in the Federal Government¹⁵ on managerial leadership and oversight.

Throughout our audit, we met with the DCAA Director and DCAA headquarters policy, quality assurance, and operations officials and DCAA region and FAO managers, supervisors, and auditors. We also met with DOD Office of Inspector General (OIG) auditors responsible for DCAA audit oversight and DOD OIG hotline office staff. In addition, we met with the former DOD Comptroller/CFO to discuss plans for the Office of Comptroller/CFO and Defense Business Board reviews, and we continued to meet with and obtain information from the new DOD Comptroller/CFO and his staff. We also met with the Comptroller's new DCAA Oversight Committee. We conducted our performance audit from August 2006 through December 2007, at which time we suspended this work to complete our investigation of hotline allegations regarding audits performed at three DCAA field offices. We resumed our work on the performance audit in October 2008 and performed additional work through mid-September 2009 to evaluate DCAA's quality assurance program during fiscal years 2007 and 2008, assess DCAA corrective actions on identified audit quality weaknesses, and consider legislative and organizational placement options for DCAA. We conducted our performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for findings and conclusions based on our audit objectives. We performed our investigative procedures in accordance with quality standards set forth by the Council of the Inspectors General on Integrity and Efficiency (formerly the President's Council on Integrity and Efficiency).

Today, I will summarize the results of our audit.

¹⁵ GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

Widespread Management Environment and Audit Quality Problems

We found audit quality problems at DCAA offices nationwide. Of the 69 audits and cost-related assignments we reviewed,¹⁶ 65 exhibited serious GAGAS or other deficiencies similar to those found in our investigation, including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision. Although not as serious, the remaining four audits also had GAGAS compliance problems. In addition, while DCAA did not consider 26 of the 32 cost-related assignments we reviewed to be GAGAS audits, DCAA did not perform sufficient testing to support reported conclusions on that work. According to DCAA officials, DCAA rescinded 80 audit reports related to our prior investigation as well as the audit leading to today's report because the audit evidence was outdated, insufficient, or inconsistent with reported conclusions and opinions and reliance on the reports for contracting decisions could pose a problem. About one third of the rescinded reports relate to unsupported opinions on contractor internal controls and were used as the basis for risk-assessments and planning on subsequent internal control and cost-related audits. Other rescinded reports relate to Cost Accounting Standards (CAS) compliance and contract pricing decisions. Because the conclusions and opinions in the rescinded reports were used to assess risk in planning subsequent audits, they impact the reliability of hundreds of other audits and contracting decisions covering billions of dollars in DOD expenditures.

A management environment and agency culture that focused on facilitating the award of contracts and an ineffective audit quality assurance structure are at the root of the agencywide audit failures we identified. DCAA's focus on a production-oriented mission led DCAA management to establish policies, procedures, and training that emphasized performing a large quantity of audits to support contracting decisions and gave inadequate attention to performing quality audits. An ineffective quality assurance structure, whereby DCAA gave passing scores to deficient audits compounded this problem.

Although the reports for all 37 audits of contractor internal controls that we reviewed stated that the audits were performed in accordance with GAGAS, we found GAGAS compliance issues with all of these audits. The issues or themes are consistent with those identified in our prior investigation.

¹⁶ Of the 69 DCAA assignments we reviewed, 37 were audits of contractor systems and related internal controls and 32 were cost related audits and assignments.

Lack of independence. In seven audits, independence was compromised because auditors provided material nonaudit services to a contractor they later audited; experienced access to records problems that were not fully resolved; and significantly delayed report issuance, which allowed the contractors to resolve cited deficiencies so that they were not cited in the audit reports. GAGAS state that auditors should be free from influences that restrict access to records or that improperly modify audit scope.¹⁷

Insufficient testing. Thirty-three of 37 internal control audits did not include sufficient testing of internal controls to support auditor conclusions and opinions. GAGAS for examination-level attestation engagements require that sufficient evidence be obtained to provide a reasonable basis for the conclusion that is expressed in the report.¹⁸ For internal control audits, which are relied on for 2 to 4 years and sometimes longer, the auditors would be expected to test a representative selection of transactions across the year and not transactions for just one day, one month, or a couple of months.¹⁹ However, we found that for many controls, the procedures performed consisted of documenting the auditors' understanding of controls, and the auditors did not test the effectiveness of the implementation and operation of controls.

Unsupported opinions. The lack of sufficient support for the audit opinions on 33 of the 37 internal control audits we reviewed 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. For example, we found that:

- For many controls, DCAA did not perform any testing at all. For example, audits of contractor accounting systems do not include any transaction testing. Instead, these audits focus on a review of the adequacy of contractor policies and procedures. At least six of the nine accounting audits we reviewed did not include procedures for confirming contractor segregation of allowable and unallowable cost.

¹⁷ See [GAO-03-673G](#), § 3.19, and [GAO-07-731G](#), § 3.10.

¹⁸ [GAO-03-673G](#), § 6.04b.

¹⁹ AICPA *Statements on Auditing Standards*, AU 350 and *Audit and Accounting Guide: Audit Sampling*, §§ 3.14, 3.29-3.34, 3.58, and 3.61.

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- DCAA issued an adequate opinion on the accounting system for a major DOD contractor after performing a walkthrough of the accounting process and interviewing two employees.
 - In billing system audits we reviewed, DCAA auditors often tested only two, three, or sometimes five transactions to support audit conclusions on contractor systems and related internal controls. Further, the auditors performed limited procedures such as determining whether the vouchers were mathematically correct and included current and cumulative billed amounts. Twenty of the 22 billing system audits we reviewed did not include tests to identify duplicate invoices.
 - DCAA auditors reported on the adequacy of a contractor's billing system based on tests of four vouchers, all issued on the same day.
 - In an audit of controls over indirect and other direct cost for a business segment of one of the top five DOD contractors, DCAA auditors tested 12 out of about 22,000 transactions processed from May through July 2005.

We also found that reports did not adequately disclose the criteria used in performing individual audits. According to GAGAS, audit reports should, among other matters, identify the subject matter being reported and the criteria used to evaluate the subject matter. Criteria identify the required or desired state or expectation with respect to the program or operation and provide a context for evaluating evidence and understanding the findings.²⁰ None of the 37 internal control audit reports we reviewed cited specific criteria used in individual audits. Instead, the reports uniformly used boilerplate language to state that DCAA audited for compliance with the "FAR, CAS, DFARS, and contract terms." As a result the user of the report does not know the specific Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS), or contract terms used as criteria to test contractor controls. This makes it difficult for users of the reports to determine whether the reports provide the level of assurance needed to make contracting decisions.

Similarly, the 32 cost-related assignments we reviewed did not contain sufficient testing to provide reasonable assurance that overpayments and billing errors that might have occurred were identified. As a result, there is little assurance that any such errors, if they occurred, were corrected and that related improper contract payments, if any, were refunded or credited

²⁰ [GAO-07-731G](#), § 4.15.

to the government. Contractors are responsible for ensuring that their billings reflect fair and reasonable prices and contain only allowable costs, and taxpayers expect DCAA to review these billings to provide reasonable assurance that the government is not paying more than it should for goods and services. We identified the following problems with these assignments.

Paid voucher reviews. DCAA performs annual testing of paid vouchers (invoices) to determine if contractor voucher preparation procedures are adequate for continued contractor participation in the direct-bill program.²¹ Under the direct-bill program, contractors may submit their invoices directly to the DOD disbursing officer for payment without further review. Although DCAA does not consider its reviews of contractor paid vouchers to be GAGAS engagements, it has not determined what standards, if any, apply to these assignments. In addition, for the 16 paid voucher assignments we reviewed, we found that DCAA auditors failed to comply with DCAA Contract Audit Manual (CAM) guidance.²² Rather than documenting the population of vouchers, preparing sampling plans, and testing a random (statistical) sample, auditors generally did not identify the population of vouchers, did not create sampling plans, and made a small, nonrepresentative selection of as few as one or two invoices for testing to support conclusions on their work. The auditors performed limited procedures such as determining whether the vouchers were mathematically correct and included current and cumulative billed amounts. Based on this limited work, the auditors concluded that controls over invoice preparation were sufficient to support approval of the contractors' direct billing privileges. This is of particular concern because we determined that Defense Finance and Accounting Service (DFAS) certifying officers rely on DCAA voucher reviews, and they do not repeat review procedures they believe to be performed by DCAA.

Overpayment assignments. DCAA performs overpayment assignments to verify that contractors have billing procedures and internal controls in place to identify and resolve contractor billing errors and overpayments in a timely manner. DCAA guidance states that these engagements should be conducted in accordance with GAGAS to the extent applicable under the

²¹ DCAA does not perform paid voucher reviews during the year that it performs an audit of the contractor's billing system internal controls.

²² CAM 6-1007.

circumstances.²³ However, none of the 10 overpayment assignments we reviewed were performed or reported as GAGAS engagements. We found that auditor judgments about the population and selection of transactions for these assignments did not provide a representative universe for testing and concluding on contractor controls over billings and payments received. For example, for the 10 assignments we assessed, the auditors selectively reviewed an accounts receivable aging report to identify overpayments and determine if they had been resolved. As a result, this work does not provide reasonable assurance that contractors have adequate controls in place to identify and correct overpayments and billing errors and make appropriate, timely refunds and adjustments.

Incurred cost audits. The purpose of incurred cost audits is to examine contractors' cost representations and opine on whether the costs are allowable, allocable to government contracts, and reasonable in accordance with the contract and applicable government acquisition regulations.²⁴ DCAA performs these audits as GAGAS attestation engagements. For the four incurred cost audits we reviewed, we found that the auditors did not adequately document their judgments about control risk or the sampling and test methodologies used. In addition, we found that the auditors traced claimed pool and base costs (indirect costs) to the contractors' accounting books and records to determine their accuracy and allowability. However, the auditors did not perform sufficient, detailed testing of claimed indirect and direct costs. For example, the auditors traced and reconciled indirect costs to contractor accounting system data, but did not test a representative selection of direct costs. As a result, the scope of work performed was not sufficient to identify claimed costs, if any, that were not adequately supported or unallowable costs, if any, that should have been questioned.

Production environment and audit quality issues. DCAA's mission statement, strategic plan, and metrics all focused on producing a large number of audit reports and provided little focus on assuring quality audits. For example, DCAA's current approach of performing 30,000 to 35,000 audits and issuing over 22,000 audit reports with 3,600 auditors substantially contributed to the widespread audit quality problems we identified. Within this environment, DCAA's audit quality assurance

²³ DCAA, "Audit Program: Audit of Contractor Overpayments," (Activity Code 17310), April 2004, September 2007, and May 2008.

²⁴ CAM 6-102.

program was not properly implemented, resulting in an ineffective quality control process that accepted audits with significant deficiencies and noncompliance with GAGAS and DCAA policy. Moreover, even when DCAA's quality assurance documentation showed evidence of serious deficiencies within individual offices, those offices were given satisfactory ratings. Considering the large number of DCAA audit reports issued annually and the reliance the contracting and finance communities have placed on DCAA audit conclusions and opinions, an effective quality assurance program is key to protecting the public interest. Such a program would report review findings along with recommendations for any needed corrective actions; provide training and additional policy guidance, as appropriate; and perform follow-up reviews to assure that corrective actions were taken. GAGAS require that each audit organization performing audits and attestation engagements in accordance with GAGAS should have a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and have an external peer review at least once every 3 years.²⁵

DCAA officials advised us that going forward, DCAA will no longer rate an FAO's overall compliance with GAGAS and DOD policy. The officials told us that instead, DCAA headquarters plans to (1) report the detailed results of the audit quality reviews, (2) make recommendations to FAOs for any needed corrective actions, (3) conduct follow-up reviews for all FAOs with identified audit deficiencies to ensure that corrective actions are taken, and (4) provide training and policy guidance, as appropriate. If properly implemented, these procedures would help to assure an effective audit quality assurance program.

In addition, the DOD IG reported an adequate ("clean") opinion on DCAA's most recent peer review results although the reported evidence indicated that numerous audits had serious deficiencies in audit quality.²⁶ In conducting DOD's audit oversight review of DCAA audits, DOD IG audit oversight reviewers considered the same results of DCAA's internal audit quality assurance reviews that we analyzed and reviewed numerous additional audits, which also identified significant GAGAS noncompliance

²⁵ GAO-07-731G, §§ 3.50-3.52.

²⁶ All 10 categories of recommendations in the DOD IG's report related to GAGAS compliance problems.

as evidenced by DOD IG peer review findings and recommendations. Although the DOD IG report contained evidence of significant, systemic noncompliance with professional standards throughout DCAA audits that OIG staff reviewed and the IG report included numerous findings and recommendations related to those issues, the DOD IG gave DCAA a “clean” peer review opinion,²⁷ concluding that for audits and attestation engagements performed during fiscal year 2006, “...the internal quality control system was operating effectively to provide reasonable assurance that DCAA personnel were following established policies, procedures, and applicable auditing standards....”

The overall report conclusion in the DOD IG report is inconsistent with the detailed observations in the report, which indicate numerous significant deficiencies in DCAA’s system of quality control. Furthermore, of the 80 audit reports that DCAA rescinded, 39 of the rescinded reports were issued during fiscal year 2006—the period covered by the last DOD IG peer review. Therefore, we have concluded that DCAA’s quality control system for the period covered by the last DOD IG peer review was not effectively designed and implemented to provide assurance that DCAA and its personnel comply with professional standards.

DCAA Is Making Progress, but Sustained Leadership and Oversight Is Needed

Although DCAA has taken several positive steps, much more needs to be done to address widespread audit quality problems. DCAA’s production-oriented culture is deeply imbedded and will likely take several years to change. Under DCAA’s decentralized management environment, there had been little headquarters oversight of DCAA regions, as demonstrated by the nationwide audit quality problems. DCAA’s mission focused primarily on producing reports to support procurement and contracting community decisions with no mention of quality audits that serve taxpayer interest. Further, DCAA’s culture has focused on hiring at the entry level and promoting from within the agency and most training has been conducted by agency staff, which has led to an insular culture where there are limited perspectives on how to make effective organizational changes.

DCAA corrective actions. DCAA initiated a number of actions to address findings in our July 2008 report, the DOD Comptroller/CFO August 2008 “tiger team” review, and the Defense Business Board study, which was

²⁷ DOD Inspector General, *Oversight Review: Review of the Defense Contract Audit Agency Quality Control System*, Report No. D-2007-6-006 (Arlington, VA: May 1, 2007).

officially released in January 2009. Examples of key DCAA actions to date include the following.

- Eliminating production metrics and implementing new metrics intended to focus on achieving quality audits.
- Establishing an anonymous Web site to address management and hotline issues. DCAA's Assistant Director for Operations has been proactive in handling internal DCAA Web site hotline complaints.
- Revising policy guidance to address auditor independence, assure management involvement in key decisions, and address audit quality issues. DCAA also took action to halt auditor participation in nonaudit services that posed independence concerns.

Further, DCAA has enlisted assistance from other agencies to develop a human capital strategic plan, assist in cultural transformation, and conduct a staffing study. In March 2009, the new DCAA Comptroller/CFO established a DCAA Oversight Committee to monitor and advise on DCAA corrective actions.

While these are positive actions, other DCAA actions have focused on process improvements, and DCAA has not yet addressed the fundamental weaknesses in its mission, strategic plan, audit approach, and human capital practices.

Although DCAA is making progress, we are concerned that DCAA actions to date evidence some of the past cultural problems that could limit their success. For example, DCAA identified the following six new performance metrics as focusing on the intended outcome-related goal of achieving quality audits that comply with GAGAS.²⁸

1. Obtaining an unqualified DOD IG peer review opinion.
2. DCAA's internal quality assurance program results show that 100 percent of the audits reviewed reflected professional judgment.
3. Checklist confirmation that issued reports did not include serious deficiencies.
4. A goal that 45 percent of audit reports will have findings as an indication of the tangible value of the audit work performed.

²⁸ DCAA also established contracting officer sustention rates related to questioned cost and net savings as an informational goal to show return to the taxpayer.

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5. A goal that 15 percent of the audits will use quantitative methods to measure the extent to which advanced level audit techniques are used.
 6. A goal that auditors will meet 100 percent of their continuing professional education requirements on time.

Given the problems with DOD IG peer review results and DCAA's ineffective quality assurance program, for these metrics to achieve the intended audit quality goal, significant changes will be needed. DCAA also retained three performance metrics that address issuing reports within specified times to support contract awards and closeouts, for example:

1. A forward-pricing audit timeliness goal of 95 percent based on agreement with requesters.
2. Incurred cost audit timeliness goals of 90 percent of corporate audits completed within 12 months, 90 percent of major contractor audits completed in 15 months, and 95 percent of non-major contractor audits completed in 24 months.
3. An efficiency goal of cost per direct audit hour of less than \$113.45 to be monitored at the agency level only.

It is critical that agreements with the contracting community on timeliness goals for forward-pricing and incurred cost audits allow performance of sufficient audit procedures to help contracting officers ensure that prices paid by the government are fair and reasonable, and that contract costs comply with applicable laws, regulations, cost accounting standards, and contract terms.

Risk-based audit approach. DCAA did not agree to develop a risk-based audit approach, as recommended by the Defense Business Board. DCAA lacks a risk-based audit approach to address how it will perform required audits with available audit resources, reassess the need to perform 30,000 or more audits annually and the appropriate level of audit resources, and establish priorities for performing quality audits that meet GAGAS within available resources. While resources are a key element of a risk-based planning approach, DCAA is performing the Defense Business Board recommended staffing study as a stand-alone effort rather than performing this study in concert with an effort to establish a risk-based planning process.

DCAA policy guidance. DCAA's new policy guidance on adequate audit documentation and testing does not contain sufficient instruction to assure that auditors (1) adequately document significant decisions affecting the audit objectives, scope and methodology, findings,

conclusions, and recommendations and (2) perform sufficient work to support decisions to approve contractors for direct-bill status. For example,

- DCAA’s new policy on “Workpaper Documentation of Judgmental Selections”—requires a description of the universe (population) from which items are selected for testing, identification of items and attributes to be tested, and an explanation to support that the judgmental selection will result in adequate audit coverage.

Emphasizing the requirement that audit documentation include a description of the population used for sampling and identification of items and attributes to be tested is appropriate. However, the requirement for an explanation in the audit documentation that the judgmental selection will result in adequate audit coverage needs to be sufficiently justified. GAGAS and AICPA standards require that auditors document significant decisions affecting the audit objectives, scope and methodology, findings, conclusions, and recommendations resulting from professional judgment.²⁹

- DCAA’s new policy on “Audit Guidance for Annual Testing of Contractor Eligibility for Direct Bill” is intended to determine whether continued reliance can be placed on the contractor’s procedures for preparation of interim vouchers. This policy change clarified and consolidated audit steps related to the contractor’s compliance with contract provisions, added audit steps for reviewing vouchers under time-and-material and labor-hour contracts, and removed the requirement to verify that the contractor’s Central Contractor Registration is current. The policy memorandum states that this scope of work performed does not constitute an audit or attestation engagement under GAGAS.

While it is within DCAA’s purview to determine whether these procedures constitute an audit, because direct-bill decisions present a risk of undetected improper contract payments, prudent decisions to continue a contractor’s direct-bill authorization would necessarily be

²⁹ GAO-07-731G, § 3.38 and AU § 339.12.

based on testing a statistical sample of invoices³⁰ and include a review of supporting documentation, including documentation to confirm the government received goods and services noted on the billing invoice. We confirmed that Defense Finance and Accounting Service certifying officers rely on DCAA reviews and that they do not repeat review procedures they believe to be performed by DCAA.

In addition, DCAA's policy to eliminate the "inadequate-in-part" opinion for contractor internal control systems audits does not recognize different levels of severity of control deficiencies and weaknesses and could unfairly penalize contractors whose systems have less severe deficiencies by giving them the same opinion—"inadequate"—as contractors having material weaknesses or significant deficiencies that in combination would constitute a material weakness. DCAA would benefit from outside expertise to develop effective audit policy guidance and training on auditing standards.

Legislative and Other Actions Could Further Improve DCAA

In addition to correcting the fundamental weaknesses in DCAA's mission and overall management environment, we believe certain legislative measures as well as other actions could enhance DCAA's effectiveness and independence. For example, granting DCAA certain authorities and protections—similar to those offered to presidentially appointed inspectors general (IG) under the IG Act³¹—could enhance DCAA's independence. The IG Act contains provisions that enhance the independence of presidentially appointed IGs, including protections from removal without congressional notification, access to independent legal counsel, public reporting of audit results, rights to take statements from

³⁰ Disbursing officers are authorized to make payments on the authority of a voucher certified by an authorized certifying officer, who is responsible for the legality, accuracy, and propriety of the payment. 31 U.S.C. §§ 3325, 3527(c). DOD 7000.14-R, Department of Defense *Financial Management Regulation* (DFMR), Vol. 5, Ch. 11 (March 2009), paras. 110102, 110203. In general, certifying officers designated in writing by the agency are financially liable for any improper, illegal, or incorrect payment made, and each payment made must be audited (or "examined"). 31 U.S.C. §§ 3521(a), 3528(a). DFMR, Vol. 5, Ch. 33 (April 2005), para. 330303. However, 31 U.S.C. § 3521(b) authorizes heads of agencies to carry out a statistical sampling procedure, within certain parameters, to audit vouchers when the head of the agency determines that economies will result. Further, 31 U.S.C. § 3521(c) provides that certifying and disbursing officials are not liable for payments that are not audited if they were made in good faith under a statistical sampling procedure. See 68 Comp. Gen. 618 (1989); also see generally, GAO, *Policy and Procedures Manual for Guidance of Federal Agencies*, title 7, §§ 6.5, 7.4, and 7.5 (Washington, D.C.: May 18, 1993).

³¹ Codified in an appendix to Title 5 of the United States Code.

contractor and other personnel, and budget visibility. These provisions would enhance the important DCAA initiatives currently under way. In the longer term, Congress could consider changes in organizational placement after DCAA has had sufficient opportunity to effectively implement current reform efforts. However, moving DCAA as an organization would require careful analysis and planning before implementation. Continued monitoring and oversight will be essential to assuring the successful implementation of DCAA's management initiatives.

Our Recommendations and DOD's Response

Our report contains several recommendations to DOD as well as matters for congressional consideration intended to strengthen DCAA in fulfilling its contract audit responsibilities. Our report also discusses matters for congressional consideration that could enhance DCAA's effectiveness and independence. These recommendations and matters are discussed below.

We made 17 recommendations to improve DCAA's management environment, audit quality, and oversight, including 15 recommendations to DOD and 2 recommendations to the DOD IG regarding DCAA's last peer review. DOD fully agreed with 13 of the 15 recommendations, partially concurred on one recommendation and did not concur with one other recommendation. We view DOD comments as being generally responsive to the intent of our recommendations.

DOD partially concurred with our recommendation that DCAA consult with DOD stakeholders and engage outside experts to develop a risk-based contract audit approach that identifies resource requirements and focuses on performing quality audits that meet GAGAS. DOD stated that DCAA already has a risk-based contract audit approach that identifies resource requirements and focuses on performing quality audits that meet GAGAS. However, DOD stated that DCAA will coordinate with the Under Secretary of Defense for Acquisition, Technology, and Logistics (USD (AT&L)) to assess DCAA audit requirements.³² DOD expects to complete its assessment of stakeholder needs based on regulatory and statutory requirements by December 2010.

³² The USD (AT&L) is responsible under 10 U.S.C. § 133 for establishing DOD policies related to the negotiation, award, and administration of contracts, such as those related to the use of contract audit services, and for coordinating contract audit activities within DOD.

We appreciate these steps; however, we remain concerned that DCAA's current approach of performing 30,000 to 35,000 audits and issuing over 22,000 audit reports with 3,600 auditors substantially contributed to the widespread audit quality problems we identified. Generating that many reports and doing that many audits with 3,600 auditors leaves very little time to perform in-depth, complex audits of contractors.

DOD did not concur on our recommendation to develop policies and procedures related to direct-billing decisions, stating that (1) the department believes that a review of the contractor's interim public vouchers is an integral function of DCAA's continued assessment of a contractor's billing system, (2) DCAA is in the best position to review and approve contract interim billings based on its thorough understanding of the contractor's system, (3) DOD believes that our concerns are mitigated based on comprehensive supervisory and audit manager reviews, and (4) DCAA does not believe that the approval of interim vouchers along with the approval for contractors to be on direct billing results in a lack of auditor objectivity.

We continue to believe that DCAA's management (nonaudit) responsibility to perform prepayment reviews of contractor vouchers for DOD and the auditor's decision-making role of approving contractors for direct-billing privileges based on its audit conclusions about the strength of the contractor's system of internal controls, create audit objectivity issues. Under normal circumstances, DCAA auditors must review contractor vouchers prior to payment—a management support function for DOD. By obtaining direct-billing privileges, however, contractors can receive payment for goods and services without a voucher review by DCAA prior to payment. Because we found that this situation created an incentive for DCAA to reduce its workload by recommending that contractors are placed on direct billing, we recommended that DCAA develop new policies and procedures to ensure a separation between staff reviewing vouchers and staff making direct-bill decisions. DCAA did not explain the basis for its belief that DCAA administrative staff have a thorough understanding of the contractors' systems. Further, we disagree with DOD's statement that our concerns are mitigated based on the comprehensive supervisory and audit manager reviews because this is not supported by our findings. The fact that DCAA approvals of contractor direct-bill privileges were not based on sufficient audit procedures as demonstrated by our work and DCAA's removal of over 200 contractors from the direct-bill program since

our July 2008 report³³ support our concern that the existence of such an incentive presents an objectivity impairment.

With regard to our two recommendations to the DOD IG, the IG concurred on our recommendation to reconsider the overall conclusions in its May 2007 peer review report on its audit of DCAA's system of quality control. However, the IG did not agree with our recommendation to determine whether the report should be rescinded or modified and did not take action to do so. The IG comments stated that the IG took alternative action that conformed to the intent of our recommendation, including notification of DCAA on August 24, 2009, that the May 2007 "adequate" opinion on DCAA's system of quality control would expire on August 26, 2009. In addition, the IG stated, "We have determined that it is not prudent to allow the adequate opinion from our May 2007 report to carry forward." However, peer review opinions neither "expire" nor "carry forward" beyond the period covered by the peer review. Based on the significant audit quality deficiencies identified in the IG peer review report, DCAA's decision to rescind 80 audit reports—39 of which relate to the period of the IG's peer review—and the findings in our audit, we concluded that DCAA's quality control system for the period covered by the DOD IG peer review was not effectively designed and implemented to provide assurance that DCAA and its personnel comply with professional standards.

DOD also provided comments on our matters for congressional consideration. Although DOD disagreed with the matters we discussed, we continue to believe these are valid matters for congressional consideration. The IG Act provides many important authorities and protections for IG's that could enhance DCAA's independence and effectiveness. Further, if DCAA is unsuccessful in addressing our recommendations for resolving fundamental weaknesses in its mission and the overall management environment under the current organizational placement, additional options would need to be considered.

Mr. Chairman and Members of the Committee, this concludes my statement. We would be pleased to answer any questions that you may have at this time.

³³ [GAO-08-857](#).

Contacts and Acknowledgments

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Testimony

of

April G. Stephenson
Director, Defense Contract Audit Agency

before the

Senate Committee on Homeland Security and Governmental Affairs

September 23, 2009

Mr. Chairman, members of the Committee, thank you for the opportunity to appear before you today; I am pleased to be here.

As requested, I will describe the actions taken by the Defense Contract Audit Agency (DCAA), as a result of two reports issued by the Government Accountability Office (GAO): (1) the July 2008 GAO Report regarding allegations that certain DCAA audits did not meet professional standards (*DCAA Audits: Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*) and (2) the report issued most recently covering audits of contractor internal controls and related audits.

Please be assured that we have taken the GAO's findings very seriously. We have worked diligently since late 2008 to accomplish a number of actions to improve the quality of the audit services and to improve the working environment for our employees. As shown in the Appendix of the submitted testimony and as discussed with Committee staff members throughout the year, we have completed over 50 specific improvement actions. We are not done yet and have various long-term actions in place that we will accomplish in FY 2010 and several years thereafter.

Background on DCAA

Mr. Chairman, the 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 all necessary contract audits for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. In total, the DCAA has about 4,200 employees and 104 field audit offices.

In FY 2008, the DCAA performed 30,352 audits covering \$501 billion in proposed or claimed contractor costs. These audits recommended reductions in proposed or billed costs of \$17.9 billion (referred to as questioned costs), and \$7.2 billion in estimated costs where the contractor did not provide sufficient information to explain the basis of the estimated amounts (referred to as unsupported costs).

In total, the DCAA has about 4,200 employees and 104 field audit offices.

As you may know, the DoD Inspector General (IG) is responsible for the oversight of DCAA's quality control system, and the IG has previously determined both that DCAA's system of quality control is designed in accordance with Government Auditing Standards, and that the quality control system being used on audits is adequate. In August 2009, the IG notified DCAA that the prior "peer review" had expired and as a result, the expired "peer review" is mentioned in all audit reports issued after the notification, as well as a posting on the DCAA public web site.

GAO Report Findings and Root Causes

For purposes of my testimony today, Mr. Chairman, we have categorized the GAO's findings from both the July 2008 investigation and the most recent audit into four general areas: Insufficient Testing of Contractor Internal Controls; Ineffective Quality Assurance Program; Lack of Independence; and Management Abuses of Employees and Impediments to the 2008 GAO Investigation.

Insufficient Testing of Contractor Internal Controls

In its recent review, the GAO identified noncompliances with the auditing standards for nearly all the assignments it reviewed. The assignments covered 2004 to 2006, several years prior to the implementation of the many improvements we accomplished over the last year. One of the primary deficiencies involves the amount of transaction testing that is performed in audits that provide an opinion on contractors' internal control systems. The GAO has concluded that DCAA has not performed sufficient transaction testing to provide an opinion of "adequate."

Contractor internal control systems involve hundreds of "control points." Auditors assessed the risk of the control points on Government contracts and established the level of testing based on that risk. When the auditors determined that the risk was low, fewer control points were tested. When the risk was higher, more control points were tested and at a greater depth. The GAO did not agree with our policy on transaction testing and consequently concluded the audit work was deficient. In some instances, auditors permitted prior metrics and internal due dates to inappropriately reduce the level of testing performed in audits.

We recognize the GAO's concerns and initiated a project in 2009 to reassess the manner in which DCAA tests contractor business systems. Although the auditing standards do not require that DCAA express an opinion on the adequacy of the contractors' internal control systems, we did so to provide contracting officials meaningful information to approve or disapprove a contractor's system as stipulated under the Federal Acquisition Regulations. We are currently assessing the type of systems DCAA will need to audit and the type of opinion to be provided. We will continue to seek advice from the GAO and the DOD Inspector General. We anticipate our revised processes will be tested in early FY 2010 starting with the contractor's system for

preparing interim and final billings to the Government. We envision the revised processes will consolidate testing of contractor billings currently performed in three different types of audits into a single audit.

As stated at the hearing last year, after the GAO issued the investigation in July 2008, we initiated an assessment of the performance metrics. At the end of September 2008, we completely revamped our performance measures and the process for applying the measures. We eliminated 18 metrics that focused on productivity and hours per audit and implemented 8 new measures. The new measures emphasize audit quality and timeliness in terms of requestors' due dates and not a standard DCAA cycle time. The measures apply at the Agency level rather than at the field audit office or auditor level as had been done in prior years at some locations. Feedback from focus groups from across the Agency have been favorable on the new measures.

Ineffective Quality Assurance Program

The GAO concluded that DCAA's Quality Assurance program was deficient and as a result the risk of assignments that did not comply with the auditing standards is increased. After the GAO's issuance of the investigative report in July 2008, we recognized that improvements were required not only with the structure of the quality assurance organization, but the manner that we conducted the quality assurance reviews. In August 2008, we centralized the quality assurance function by moving it to Headquarters and reassigned all quality assurance employees to the new Headquarters directorate. However, centralizing the functions was not enough. We also changed the manner in which we performed the quality assurance reviews.

We more than doubled the number of assignments reviewed for each office. We no longer provide a rating of pass or fail that was dependent on the number of deficient assignments.

Rather, any field audit offices that are determined to have at least one assignment not in compliance with the auditing standards would be required to provide a meaningful corrective action plan. Corrective actions are monitored at the Headquarters level and not the regional level as in prior years. Moreover, all offices are reviewed on a three-year cycle, and all types of assignments are included in the sample universe. Performing quality assurance reviews is a full-time commitment of the quality assurance organization, and no other projects are undertaken, as had been done in prior years when the quality assurance function was at the regional level.

Lack of Independence

In its most recent review, the GAO concluded that DCAA lacked independence in seven assignments. The reason for the lack of independence in the recent review is somewhat different than the root cause discussed in the July 2008 investigative report. The root cause that led to the GAO's conclusion in July 2008 was DCAA's participation in Integrated Product Teams (IPTs). IPTs were established by DoD in the mid-1990s as a means of expediting the assessment of contractor bid proposals and the resolution of outstanding issues. DCAA discontinued participation in IPTs in August 2008.

In its recent review, the GAO concluded that DCAA's independence was impaired primarily due to auditors providing input on draft corrections to internal control policies and procedures and then auditing the final policies and procedures. In several instances, the auditors issued a no-exception audit report when the contractor corrected the deficiencies during the audit. It is not uncommon for contractors with system deficiencies to seek input from the auditors while they are developing corrections to the systems. In many instances, providing feedback throughout the processes expedites the correction of the deficiencies. However, the

GAO has concluded that this “feedback” impairs the auditors’ objectivity as they will audit information that they have provided feedback on prior to implementation. We have corrected both of these issues. Auditors no longer provide feedback to contractors on draft corrections to systems and no longer remove deficiencies from audit reports when the deficiencies are corrected during the audit.

Management Abuses and Impediments to the GAO’s 2008 Investigation

In the July 2008 investigation, the GAO concluded that DCAA had an abusive work environment and that there existed a pattern of frequent management actions that served to intimidate some of the auditors and create an abusive environment at two of the three locations covered by its investigation. The GAO stated that its conclusions were based on confidential interviews and e-mail documentation. In its recent review, the GAO did not report any specific instances of abusive behaviors by DCAA management.

Since the GAO did not provide specific information upon which any personnel action could be taken In July 2008, we requested the services of the DoD Inspector General to investigate the matter. The Inspector General completed its review in August 2009 and although the IG did not go so far as to state that DCAA had an abusive work environment, it concluded that two offices it reviewed did not have a work environment conducive to producing quality audits.

The DOD Inspector General reported that in one office, employees felt pressure to work uncompensated overtime (an average of about 7 hours per pay period). In a second office, the IG reported several employees had yelled or raised their voices in the office. We believe both of these issues have been adequately addressed, and the DoD IG concurs.

On the issue of impediments to the GAO's investigation, the DoD IG did not identify any attempts by DCAA to impede the investigation other than a letter written in August 2007 to one of the senior auditors. As was discussed in the hearing last September, the letter was prepared by one of the Defense Legal Services attorneys assigned to DCAA. The letter was rescinded the day after the hearing last year. Aside from the August 2007 letter, the DOD IG did not identify any other impediments to the GAO's investigation.

To provide employees an opportunity to report instances of perceived management abuse without fear of retaliation, we launched an anonymous web site in September 2008. The web site is treated as a hotline, and allegations are either investigated by a DCAA internal ombudsman team established in late 2008 or referred to the DoD IG hotline for investigation. For example, allegations involving a member of the Senior Executive Service are automatically referred to the DoD IG for investigation per DoD policy.

The ombudsman program is very active and prioritizes the investigations and reporting depending on the severity of the allegation. Issues of abusive management are top priorities for the team.

DCAA Actions

Mr. Chairman, as a result of the 2008 GAO investigation and the most recent review, we have taken a number of actions. The Appendix to my submitted testimony contains a list of actions completed to date, as well as actions that are in process as of today. In addition, I would like to discuss some of the more significant actions at this time.

Structure

1. With regard to the organizational structure of DCAA, we completed a bottoms-up staffing assessment, including an assessment of staffing for the quality assurance function, to determine whether we have the appropriate staffing at all levels of the organization. Staffing shortfalls were provided to the DoD Comptroller in September 2008 and discussed throughout FY 2009.

We submitted a proposal to DoD under the Defense Acquisition Workforce Development Fund in December 2008 and received funding in March, April, and August 2009. We were approved to hire 300 new auditor trainees in FY 2009, and 200 in FY 2010. We have tentative approval for 200 in 2011 depending on budget priorities, for a total of 700 new trainees by the end of FY 2011. We have met our hiring goal in FY 2009 and anticipate easily meeting the hiring goals in FY 2010 and 2011.

Although the increase in trainees is a good start toward improving our staffing situation, we will continue to work with the Department on how best to address future staffing needs.

2. We added 25 new field audit offices increasing from 79 offices in August 2008 to 104 offices in August 2009. This equates to an additional 25 field office managers and a number of new supervisory positions. We reduced the span of control for managers and supervisors to provide greater training to the new employees as well as to ensure appropriate oversight of audit quality.

3. As stated earlier, we completely revamped the quality assurance organization. We changed the manner in which the reviews are performed and greatly expanded the number of reviews conducted at each office every year.

Culture

1. With regard to the culture of DCAA , we completely revised the performance measure process. As stated earlier, we eliminated 18 measures and implemented 8 new measures to focus on audit quality. We held focus groups in FY 2009, and feedback was favorable as most employees reported that they did not feel pressure to meet the performance measures on individual assignments.

However, although budget hours on individual assignments is not considered a performance measure, many auditors felt pressure to meet initial budget hours and did not feel they could request an extension. As a result, we removed the requirement to meet budget hours from the performance standards and inserted new language on the requirement to complete audits in accordance with the auditing standards. We also conducted a review within each of the regions to ensure that performance actions were not being taken based solely on not meeting initial budget hours.

2. We hired the Center for Defense Management Reform at the Naval Postgraduate School, to assist with cultural transformation across the Agency. This is a long-term action that will be completed over three to five years and may continue thereafter. With the Center's assistance, we identified four major projects to address in FY 2010. These projects will answer the following questions:

- a. How can DCAA put people first to guide its decisions, actions and values? For example, an increased emphasis on "soft skills" such as building morale and developing employees (in terms of broad understanding as well as technical proficiency).

- b. How can DCAA develop leaders to serve the employees and the organization?

- c. How can DCAA structure the organization to facilitate compliance with Generally Accepted Government Auditing Standards; maximize audit results; and better align agency workload and resources?

- d. How can DCAA identify and resolve differing expectations between contracting officers; contractors; the public (Congress); and external review organizations?

3. As mentioned earlier, we ceased participation in IPTs to avoid the appearance of a lack of independence. We also ceased participation in Source Selection Evaluation Boards. We no longer provide feedback to contractors during audits and will report deficiencies discovered during an audit even when the deficiencies are corrected prior to report issuance.

4. We established an anonymous web site and ombudsman program for employees to report inappropriate actions by management or other employees. We have assigned a dedicated team to the ombudsman function in the Agency.

5. I established a Senior Advisory Council for Improvement which I chair, to oversee the implementation of improvements as a result of recommendations from various external reviews.

Processes

Finally, to address the improvements in processes:

1. We instituted a revised process for determining the audit requirements for FY 2010. Based on the audits required under laws and regulations and an estimate of the audits required to meet contracting officials' demand requests, the field audit offices developed the hours necessary to accomplish the workload, taking into consideration the risk of the various contractors, the skill level of the audit staff and an estimate of the additional hours required to comply with the auditing standards. Based on the hours, we developed Agency-wide priorities. Since our funding provides for only about 65% of the audits that are required to be completed, we based the FY 2010 priorities on the audits of highest risk. This process is consistent with the GAO's recommendation of performing a risk based approach to auditing rather than "production line" auditing.

For example, all war-related effort in-theatre; requests for audits of contractor bid proposals prior to awarding of a contract; and billing and accounting system audits at the largest contractors.

We engaged the Army Force Management Support Agency to evaluate DCAA's process for planning FY 2010 audit needs as well as our staffing requirements. This effort is expected to be completed in October 2009.

2. We are in the process of improving the development and delivery of what is referred to as "life-cycle" training. The goal is to provide necessary training throughout the career of the staff, including auditors, management, and support staff.

3. We provided training to all DCAA employees on quality audits and the DCAA work environment in August during quality stand-down days. The discussion focused on barriers, actual or perceived, to performing quality audits and processes needed to remove the barriers.

4. We revised guidance on reporting unsatisfactory conduct of government officials when there has been a flagrant disregard for acquisition rules and regulations. The prior processes involved elevating the issue to the official's chain of command. The new process involves reporting the issue to the DoD IG for investigation when the chain of command has not resolved the issue to DCAA's satisfaction.
5. The Administration is considering whether it would make sense legislatively to expand the DCAA subpoena authority to be similar to the subpoena authority provided to the DoD IG. Under the proposal, DCAA would be provided access to the contractor accounting records and other information necessary to accomplish the contract audit function.
6. We continue to work with the Under Secretary Comptroller and Under Secretary for Acquisition, Technology, and Logistics, on an improved process for resolution of DCAA audit findings.

Closing

In closing, Mr. Chairman, I want to underscore the seriousness with which DCAA is taking this matter. Inadequate work is unacceptable, and disciplinary and personnel actions will be taken as appropriate. As I have indicated, a number of steps to resolve these issues have already been taken and completed. Others are in process, but DCAA is committed to ensuring that the agency is above reproach, that all of its audits are performed in accordance with auditing standards, and that its culture promotes the kind of vigilance and quality that protects the interests of the American taxpayers.

Mr. Chairman, thank you again for the opportunity to address the committee. I am happy to answer your questions.

**Appendix to Written Statement of Ms. April G. Stephenson
Senate Committee on Homeland Security and Governmental Affairs
Specific DCAA Actions in Response To The GAO Reports**

Structure

- Approved agency-wide reduction in supervisory span of control (June 2008).
- Approved 25 new field audit offices and 5 new Regional Audit Managers lowering the span of control (May – February 2009).
- Completed Agency-wide staffing assessment and requested staffing increase to Comptroller on September 10, 2008. Updates on staffing shortfalls were provided to the Comptroller at regular intervals throughout FY 2009.
- Realigned Quality Assurance to report directly to the Deputy Director (August 2008)
 - Submitted request to OSD for SES level position for the Integrity and Quality Assurance (QA) function (September 2008). Request was initially denied by DoD in January 2009 and the position was filled at the GS-15 level. However, after another attempt by the Director for a SES position, DCAA received approval in July 2009 and a job announcement was issued shortly thereafter.
 - Expanded the next round of QA reviews.
 - Revised process for tracking and following-up on QA findings.
 - Revised process for next 3-year cycle to ensure all audit offices are covered, after consultation with the DoD IG .
 - Completed assessment on level of QA staffing.
 - Issued revised comprehensive instruction on DCAA's QA program (December 2008).
- Submitted request for funds under Section 852 acquisition workforce fund in December 2008. Under the Defense Acquisition Workforce Development Fund, DCAA has received \$17.2 million to date (allotments in March, April, and August).
 - DCAA brought on-board 245 new interns by the end of July and have many offers with on-board dates in late FY 2009. As a result, DCAA will easily meet the goal of 300 by the end of September and will probably exceed it.
- Realigned all Financial Liaison Advisors from the Field Detachment region (region that handles all Top Secret audits) to Headquarters to avoid the appearance of a lack of independence. As of November 2008, all Financial Liaison Advisors report directly to Headquarters.
- At the request of the Director, the DCAA point of contact for the Office of Special Counsel investigation was moved from the DCAA General Counsel to the DoD General Counsel's office due to the investigation being expanded.

Culture

- Revised policy for resolving difference in audit results and opinions – elevate within management structure from two to four levels (July 2008).
- Ceased participation as members of Integrated Product Teams (IPTs) to avoid the appearance of a lack of independence (August 2008).
- Revised performance measures – eliminated 18 measures and added 8 measures (September 2008).
- Established web site for employees to anonymously voice concerns about the inappropriate use of performance measures and other inappropriate actions (September 2008).
- Engaged OPM to conduct an organizational assessment survey and are assessing results of the survey conducted by OPM – the working group is evaluating results and developing actions.
- Ceased participation as members of Source Selection Evaluation Boards to avoid the appearance of a lack of independence – requested audits will still be provided (November 2008).
- Director/Deputy Director staff presentations emphasize the need to perform quality audits and discuss performance measures (various presentations through 2008 and 2009).
- Established a Senior Advisory Council for Improvement chaired by the Director to oversee the implementation of improvements as a result of the Defense Business Board recommendations (report issued January 22, 2009).
- Issued several memorandums reiterating the importance of cooperating with GAO, IG and other reviewers/investigators.
- Held stand down day for audit quality at all DCAA locations (August /September 2008 and again in August 2009).
- Completed annual independence training (September 2008 and September 2009).
- Held focus groups to obtain feedback on implementation of performance measures issued in September 2008 which revealed minimal problems with implementation of new measures (February/March 2009).
- The Director required all regions to assess whether exceeding budget hours on individual assignments was inappropriately used to lower performance ratings. The regions completed the assessments and implemented corrective actions (December 2008).
- Established new process to obtain input regarding the new hire employment experience and to identify reasons why employees leave DCAA (November 2008).
- Revised job objectives/performance plans for the 0511 (auditor) positions to eliminate the language on meeting audit budget hours and productivity measures and added language strengthening the need to execute audits in accordance with the auditing standards and Agency policy (February 2009).
- Revised supervisory development curriculum based on feedback from focus groups and other feedback mechanisms to emphasize leadership skills and the more common day-to-day activities which supervisors perform (April 2009).

Processes

- Issued memorandum on adequate working paper documentation (July 2008).
- Completed Agency-wide assessment to determine whether GAO's findings are systemic across DCAA. Six of the forty assignments reviewed contained noncompliances. Actions being taken to address issues (September 2008).
- Raised the field audit office signature authority for all audit reports to the level of the manager or higher (August 2008).
- Revised policy for the monthly quality review of issued audit reports from regions to the Headquarters Quality Assurance division (October 2008).
- Revised DCAA Quality Checklist for Review of Audit Working Papers (checklist is used by auditors and supervisors prior to report issuance) (December 2008).
- Issued guidance clarifying DCAA's process for pursuing access to contractor records and initiating a subpoena (December 2008).
- Issued clarifying guidance on what constitutes a significant deficiency in contractor internal control systems (December 2008).
- Revised policy on reporting results of the review of contractor systems and related internal controls to eliminate the inadequate in-part opinion so that the overall opinion on the system is either adequate or inadequate (December 2008)
- Issued guidance on performing and reporting on limited scope internal control audits (December 2008)
- Issued guidance reminding auditors to report suspected contractor fraud and other irregularities encountered during the audit and emphasized that managers do not approve the Form 2000, but rather review it for clarity (February 2009).
- Issued guidance on documentation of judgmental sampling (February 2009).
- Revised guidance for reporting unsatisfactory conditions related to actions of Government officials wherein certain unsatisfactory conditions will be reported directly to the DODIG in lieu of reporting the conditions to a higher level of management (March 2009).
- Issued guidance clarifying requirements for contractor eligibility to participate in the Direct Bill Program (April 2009).
- Issued guidance to remove major contractors from direct billing where contractor has implemented a new billing system or accounting system that significantly impacts Government billings and the new system has not been examined (April 2009).
- Revised a self study training course (CMTL 1326) to include new guidance on identifying key elements of an effective internal control audit report and the requirements for issuing a real-time (flash) report (May 2009).
- Issued an audit alert emphasizing existing guidance which requires that a separate Cost Accounting Standards noncompliance audit report will be issued when a noncompliance is found during any audit (June 2009)
- Issued an audit alert to clarify that forward pricing due dates should be based on the realistic assessment of risk factors for each specific contractor and proposal under review (June 2009).
- Issued guidance on contract audit closing statement reviews in July (after receipt of DOD IG comments). This completes the last action item from the peer review.

- Instituted a revised process of determining audit requirements for FY 2010. Developed Agency-wide audit priorities. Current budget for FY 2010 only covers about 65% of requirements – audits planned for FY 2010 based on higher risk assignments with lower risk assignments deferred to FY 2011 (backlog of audits growing each year since war effort) (September 2009).
- Submitted a legislative proposal expanding DCAA access to contractor information similar to the authority provided the DOD IG (September 2009).

Long-Term Planned Actions

- Obtained the services of the Naval Postgraduate School, Center for Defense Management Reform to assist with the Agency-wide cultural transformation. The initial effort started June 2nd with the DCAA executive team. As a result, four major initiatives were adopted for incorporation in the DCAA Strategic Plan. Teams of executives were assigned to each initiative to further develop the milestone plan for executing the objective. The four items are:

1. How can DCAA put people first to guide its decisions, actions and values? For example, an increased emphasis on “soft skills” such as building morale and developing employees (in terms of broad understanding as well as technical proficiency).

2. How can DCAA develop leaders to serve the employees and the organization?

3. How can DCAA structure the organization to facilitate compliance with GAGAS; maximize audit results/ROI; and better align agency workload/resources?

4. How can DCAA identify and resolve different expectations of contracting officers, contractors, the public (Congress), and external review organizations?

These items will be worked for about the next three years. Once the milestone plan for each of the four initiatives is developed, it is envisioned that each objective will have various completed actions throughout the next three years. Once the milestone plans are developed, the objectives will be communicated to the workforce.

- Performing a comprehensive assessment and revision to DCAA training by instituting a life-cycle training process. Effort started in FY 2008 and will conclude in about three years.
- Conducting a comprehensive organizational assessment (based on Baldrige). Estimated completion in FY 2010.
- Performing a comprehensive review of DCAA’s approach for performing internal control audits. Estimated completion of baseline audit opinions in FY 2010.
 - Briefed DOD IG on September 3rd – favorable feedback. Proceeding with developing plan for pilot testing.
 - Reassessing the “direct billing” program which permits contractor submission of interim payment invoices directly to the payment office without DCAA approval.

- Engaged the Army Force Management Support Agency to evaluate DCAA's process for planning FY 2010 audit needs as well as staffing requirements. The effort is expected to be completed by the end of September.
- Revamping the Strategic Plan and Human Capital Plan (planned December 2009).
- Reassessing performance plans to better align standards to work expectations. Effort started in FY 2009 and will continue in FY 2010.
- Submitting legislative proposal to DoD to expand DCAA's subpoena authority and greater access to contractor records similar to IG authorities.

Based on advice from GAO, on September 4th, we requested extension to peer review to assignments completed in FY 2011. FY 2010 will be a rebuilding year for audits of contractor business systems.

**Statement of The Honorable Robert F. Hale
Under Secretary of Defense (Comptroller)
Committee on Homeland Security and Governmental Affairs
United States Senate
September 23, 2009**

Mr. Chairman, thank you for the opportunity to share a few observations concerning the Defense Contract Audit Agency (DCAA). I will focus on the concerns raised by the recent Government Accountability Office (GAO) report regarding DCAA.

As Members of this Committee are aware, the Department of Defense has submitted a lengthy response to GAO's recommendations. We acknowledge the seriousness of GAO's findings and concur with their recommendations with very few exceptions, some of which I will explain below. Based on my review of DCAA and the GAO recommendations, I believe that DCAA, with assistance from DoD, needs to focus on three major issues:

- Improving the quality of audits, especially the approach to auditing contractor business systems.
- Assessing the number and types of audits performed by DCAA and whether all audits currently required by acquisition laws and regulations are appropriate.
- Assessing improvements in the process for resolving DCAA audit results to ensure the audit findings are fully considered during contracting officer deliberations.

DCAA has already begun to focus on these major issues and others. It is important to note that the audit assignments covered by GAO's review were completed three to five years ago and that a series of corrective actions was undertaken beginning in late 2008. In her testimony, the DCAA Director will describe the actions that have already been completed and those that are even now being implemented. The Committee should understand that it may take several years for the full benefit of these actions to be realized.

In addition, I would like the Members to know that the Office of the Under Secretary (Comptroller) has taken steps to improve oversight of DCAA operations, and we continue to monitor DCAA to ensure timely implementation of GAO's recommendations.

To assist with this monitoring, I established a DCAA Oversight Committee last March that provides my office with advice and recommendations concerning oversight of DCAA. The committee is made up of the Auditors General of the Army, Navy, and Air Force; the Director of Defense Procurement and Acquisition Policy (DPAP); and the DoD Deputy General Counsel for Acquisition and Technology. This senior group will assess DCAA's activities and the actions taken to correct problems identified by GAO and others. The oversight committee meets regularly, and I have met with them several times. I have also assigned a member of my senior staff to assist in these oversight efforts.

We have also taken steps to increase the resources available to DCAA:

- Between Fiscal Years 2001 and 2010, the budget for DCAA has increased from \$331.6 million to \$458.3 million, growth of 38.2 percent.
- DCAA's total staff will increase by 131 (or 3.2 percent) over this same period.
- DCAA is considering whether increasing DCAA staff by 700 auditor positions by the end of FY 2011 is a high budgetary priority, to be paid by the Defense Acquisition Workforce Development Fund.

We believe that -- by taking aggressive action, improving oversight, and increasing resources -- we can resolve the significant issues posed by the GAO report. We will monitor progress to determine if further actions need to be taken.

In two areas, however, we take issue with GAO's conclusions. These are considerations that GAO offered to Congress.

First, GAO suggested that Congress consider providing DCAA with independence similar to that of the Department's Inspector General (IG). We respectfully disagree. We do not believe that the DCAA Director should be a Senate-confirmed position unless DCAA is independent of DoD. Presidential appointment with Senate confirmation will inject an inappropriate political element into DCAA, and it will inevitably create lengthy periods when there would be no Director.

Likewise, we oppose fixed terms for the DCAA Director. If DCAA remains part of DoD, the Secretary of Defense must have the ability to choose an appropriate Director. We also question the wisdom of an independent

budget, which would prevent or limit our ability to move money into DCAA, as is occurring now with funding from the Defense Acquisition Workforce Development Fund. Nor do we support mandatory public reporting, an additional burden on an agency that is already working hard to meet its many mission demands.

While we do not support IG-like independence, we are taking steps to strengthen DCAA's independence internally by assessing improvements to the process used by contracting officials to resolve DCAA audit findings. Under this process, for highly significant issues, DCAA may appeal to the Director of DPAP. If DCAA disagrees with the DPAP decision, further appeal could be made to the Under Secretary (Acquisition, Technology, and Logistics) and to the Under Secretary of Defense (Comptroller), who would act together as a team. We expect that appeals to the Under Secretary level would involve only the most important issues.

Secondly, GAO suggested that Congress require DCAA to report to the Deputy Secretary of Defense. DoD strongly disagrees with this recommendation. The Deputy Secretary is the Chief Management Officer of one of the world's largest organizations and backs up the Secretary in the wartime chain of command. Adding direct oversight of an individual Defense agency would add unreasonably to his current responsibilities. Accordingly, at least until the issues related to GAO are resolved, we recommend that DCAA continue to report to the USD(C).

In sum, Mr. Chairman, we acknowledge that GAO has raised some serious issues. We believe that we have begun taking the appropriate steps to resolve those issues and will monitor the situation to determine if additional steps are needed.

Lastly, as we go forward it is also essential that we keep in mind the value of the services DCAA provides to DoD and other organizations. I have spoken personally to the Director of DPAP – one of DCAA's key customers – and he informed me that DCAA products are necessary and critical to the acquisition process. The Wartime Commission on Contracting has made similar comments. As we strive to resolve issues raised by GAO, we must be careful not to undermine the unique value of DCAA.

Mr. Chairman, thank you again for providing this opportunity for me to comment on the GAO findings. I am convinced that working together we

can ensure that the work of DCAA will continue to support the Department of Defense and the security of the United States.

September 23, 2009



Expected Release
10:00 a.m.

The Honorable Gordon S. Heddell
Inspector General
Department of Defense

before the
Senate Homeland Security and
Governmental Affairs Committee

on

"Defense Contract Audit Agency:
Who is Responsible for Reform"

Chairman Lieberman, Ranking Member Collins, and distinguished members of this committee— thank you for the opportunity to appear today before the committee to discuss continuing actions by my office to enhance the Defense Contract Audit Agency’s (DCAA) key role as a Department of Defense (DoD) watchdog over the billions of dollars spent by the Department in contracts. DCAA is critical to the Department’s ability to effectively execute its diverse mission.

It is an objective of the Department of Defense Inspector General, (DoD IG), to verify that DCAA audits and the audits of all DoD audit agencies comply with stringent standards. The DoD IG is engaged and continues its commitment to monitoring and evaluating the effectiveness of DCAA, DoD’s largest audit agency, in performing contract audits and providing accounting and financial advisory services to all DoD components as well as other federal organizations.

We recognize, based on our efforts and those of the Government Accountability Office, that significant vulnerabilities continue to exist in DCAA’s implementation of auditing standards in terms of guidance and execution. DCAA auditors must be properly trained, developed, and managed so that they can conduct audits within required standards. We are pleased to note that senior DoD leadership is now actively engaged in addressing DCAA’s deficiencies and

management challenges. This focus is necessary to ensure that DCAA audits and financial advisory services are accurate, timely, and responsive, so as to prevent and detect fraud, waste, and abuse and ensure the proper use of public funds.

DCAA MANAGEMENT ISSUES

Compliance with Audit Standards

The hearing held by this committee last year highlighted several issues within DCAA that were identified by my office and the GAO.

On May 1, 2007, we concluded the “Review of the Defense Contract Audit Agency Quality Control System” (the “peer review”) and issued a report (D-2007-6-006). We determined that DCAA warranted an “adequate” opinion, because the 10 deficiencies identified were not cumulatively significant enough to have a material impact on the overall system of quality control. In that report, we made 20 recommendations for improvement to DCAA audits and its quality assurance program. DCAA has taken action on 16 of these recommendations.

On July 22, 2008, GAO issued a report titled, “Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated,” GAO-08-0857. GAO reported on 13 cases involving 76 audits that did not comply with generally accepted government auditing standards (GAGAS).

DCAA Workplace Environment

In the July 2008 report, GAO also found that an abusive work environment existed at two field audit offices (FAOs). Problems identified included involuntary reassignment, threats of disciplinary action against auditors because they would not drop audit findings or draft favorable reports, and fear of retaliation among auditors for speaking with GAO representatives.

ONGOING IG DOD OVERSIGHT

IG DoD Followup Review, August 31, 2009

We have monitored DCAA's efforts to correct the deficiencies noted in our May 2007 peer review, and we conducted a significant review in response to the July 22, 2008, GAO report. Our audit report entitled "Follow-up Review on Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office Report" (D-2009-6-009) was issued on August 31, 2009, to address findings in the GAO report.

We reviewed DCAA audit documentation for 13 cases and interviewed auditors for 12 cases. When available, we also reviewed the current audits DCAA performed to correct the deficient audits identified by GAO. We visited two DCAA Western Region field audit offices and interviewed 68 audit employees, including supervisors and managers, to assess whether an abusive work environment existed.

Some of our more significant findings included:

1. Employee concerns with time pressures, uncompensated overtime, changes to audit results and opinions, and unprofessional behavior created a work environment not conducive to performing quality audits at two DCAA offices in the Western Region.
2. A flawed audit could have allowed a contractor to recover \$271 million in unallowable costs on the Evolved Expendable Launch Vehicle (EELV) program. Of the \$271 million, \$101 million has been paid to date. In our October 20, 2008, Memorandum to Commander, Air Force Space and Missile Systems Center, and Director, DCMA, we recommended SMC take immediate action to withhold any further payments from the EELV joint venture for unabsorbed Program Management and Support costs, immediately cease negotiations on a \$114 million proposal containing these same unallowable costs, and reassess the propriety of existing advance agreements between SMC, DCMA and the contractor.
3. DCAA provided ineffective audit advice and services to a contracting officer and DCAA had insufficient evidence to support a contractor's participation in the direct bill program.
4. Seventeen of 18 forward pricing audits performed by trainee auditors at a third Western Region office did not comply with standards.
5. DCAA did not adequately qualify the audit results of a compensation system report and had insufficient evidence to support a purchasing system audit opinion.
6. DCAA did not have sufficient basis for dropping four findings, and did not report a contractor's uncompensated overtime practice which increased the risk of cost mischarging.

On the basis of these findings, we recommended that:

1. DCAA rescind five audit reports and notify contracting officials not to place reliance on the reports' conclusions.
2. DCAA address management actions and behaviors that have a negative impact on the work environment.
3. DCAA create a mechanism for reporting external impairments to auditor independence in the DCAA Contract Audit Manual.

4. The Commander, Air Force Space and Missiles Systems Center, withhold future payments for certain unallowable costs on the affected contract
5. The Executive Director, Contracts, Defense Contract Management Agency, reassess the identified advance agreements pending receipt of newly initiated DCAA audits.

Our report also recommended that DCAA take “appropriate corrective action” regarding the performance of the two supervisors associated with nine of the thirteen cases of the non-compliant audits reviewed. DCAA has reported that the two supervisors will re-take supervisory courses at the Defense Contract Audit Institute, and their managers will identify other appropriate training activities. Legal review by DCAA determined that adjustments to prior performance ratings would not be appropriate.

DCAA concurred with 23 of our 24 recommendations and reserved comment on one other recommendation. We requested that the DCAA reconsider its position on the recommendation to rescind DCAA Audit Report No. 4461-2006A210000001, and comment on it in response to our final report. We also requested that DCAA reconsider its responses to three recommendations which did not meet the intent of the recommendations, and to provide comment on one recommendation we added.

The Air Force Space and Missile Systems Center concurred with our recommendations as did the Defense Contract Management Agency.

We will continue to monitor DCAA actions regarding our recommendations.

Senior Official Investigations

My office conducted a senior official investigation and concluded that the former Regional Audit Manager with responsibility for DCAA's Resident Office at Boeing, Huntington Beach, California, was not free from external impairments to independence as required by GAGAS and DCAA audit policy. Her direction resulted in a flawed audit that could have allowed Boeing to recover \$271 million in unallowable costs. Additionally, we received allegations that she created an abusive working environment.

Because this Regional Audit Manager was promoted to Deputy Director, Western Region, DCAA, the allegations were addressed in a senior official investigation that resulted in a report issued September 11, 2009. The investigation concluded that the individual failed to meet GAGAS standards for independence and objectivity by improperly directing changes to the audit report and that she engaged in conduct that was inconsistent with established leadership standards for senior officials. The report was provided to the Director, DCAA, for review and appropriate action.

We also conducted separate investigations into allegations that two other DCAA senior officials abused their authority by improperly directing changes to audit opinions. Those allegations were not substantiated.

Expiration of 2007 Peer Review Opinion

Based on the recent review of DCAA by GAO together with deficiencies identified in our May 2007 peer review, I took the extraordinary action of notifying DCAA that our May 2007 “adequate” opinion on DCAA’s system of quality control would expire as of August 26, 2009. On the basis of our action, I recommended that DCAA immediately begin to qualify its audits with a statement noting an exception to compliance with the Quality Control and Assurance Standard. Additionally, I recommended that DCAA publicly disclose the concerns of the GAO, including the questioning of the reliability of audit reports issued during the period ending September 30, 2006.

2009 Peer Review

The peer review of DCAA for the period ending September 30, 2009, was announced on August 5, 2009, and will be performed in three or four projects. We will assess whether DCAA’s quality control system provides reasonable assurance of compliance with standards in design and effective operation and compliance in practice. The review will follow up on various DCAA corrective actions in response to GAO and DoD IG findings and will also consider repeated non-compliances with government auditing standards identified in our May 2007 and December 2003 opinion reports on the DCAA quality control system. Additionally, when planning our review, we will take into consideration

deficiencies found by GAO in its July 2008 report and the report it is releasing today.

On September 1, 2009, DCAA sent a request to GAO to delay the announced peer review by at least two years to be able to continue its internal improvements to address previously noted deficiencies. I am not convinced that this is the right strategy at this time. Whether or not the peer review is delayed, the DoD IG continues to have a statutory responsibility to provide audit oversight. In the event the peer review is postponed, we would undertake a number of targeted reviews of DCAA high risk areas.

Hotline Complaints - Whistleblower Protection

Since the hearing last September, the Defense Hotline has continued to receive allegations of misconduct at DCAA. At this time we have 36 open Hotline complaints involving DCAA. Of those, 14 complaints concern potentially inappropriate contractor practices and have been referred to either DCAA or to the Defense Criminal Investigative Service. The 22 remaining cases include allegations such as changing findings and scope of audits, noncompliance with standards, lack of audit independence, and management abuses.¹ We are diligently pursuing these allegations and will take into consideration relevant

¹ Two cases involve allegations of inappropriate action by DCAA personnel. The allegations do not relate to audit quality or overall management issues and have been referred to DCAA for review.

Hotline complaints as part of our risk assessment of DCAA for the peer review, or for other high risk assessment projects.

A concern raised at the hearing last September was how the DoD IG protects the identity of whistleblowers who wish to remain confidential. Whistleblowers are critical sources of information to Inspectors General and it is vital that we protect their identities to the greatest extent possible. We have conducted a comprehensive review of the Defense Hotline and as a result have issued new Hotline operating procedures that implement several steps to improve our processes. One such step was to revise the warning statement that accompanies all Hotline documents to emphasize that access to Hotline information is limited to those responsible for responding to the DoD IG. This is intended to ensure information that may include the identity of a complainant is not provided to those without a need to know. Additionally, we have implemented additional checks to ensure that we identify if a complainant has consented to the release of his or her identity. We are also reviewing cases more closely to determine if referral to another agency could place a complainant at greater risk of reprisal, or should instead be retained by the DoD IG for investigation.

Conclusion

In closing, I emphasize the importance of the mission of DCAA and its impact on the Department of Defense. I am dedicated to helping improve DCAA

operations. Our oversight role is essential to helping DCAA identify weaknesses and where problem areas exist.

I welcome your questions.