

DEFENSE CONTRACT AUDIT AGENCY
Management Discussion and Analysis
FY 2015



A COMMITMENT TO EXCELLENCE

DEFENSE CONTRACT AUDIT AGENCY
FY 2015 MANAGEMENT DISCUSSION AND ANALYSIS

A message from the Director.....	2
I. Overview	
Mission.....	3
Organization and Structure.....	3
Management and Performance Challenges.....	5
II. Performance	
Strategic Plan.....	5
Goals, Objectives, and Results.....	5
III. Financial	
Appropriated Fund.....	6
Analysis of the Financial Statements.....	6
Limitation of the Financial Statements.....	12
IV. Systems, Controls, and Legal Compliance	
Management Assurance.....	13
Internal Control Assessment and Results.....	13



MESSAGE FROM THE DIRECTOR

I am pleased to present the Defense Contract Audit Agency's (DCAA) Management Discussion and Analysis for the fiscal year (FY) 2015. DCAA's mission is to provide audit and financial advisory services to Department of Defense (DoD) and other federal entities responsible for acquisition and contract administration. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

The Management Discussion and Analysis provides executive-level information on the Agency's mission and vision, organization and structure, performance results, financial highlights, system control and legal compliance. We accomplish these in an effective and efficient manner through continuous process improvement.

The DCAA team is committed to organizational excellence and sound financial management. I am pleased to report that DCAA received its 15th consecutive unqualified audit opinion on its financial statements. These audit results not only show that DCAA's financial statements are a reliable reflection of the Agency's financial position, but are also an integral component of the Agency's annual Statement of Assurance.

A handwritten signature in blue ink that reads "Anita F. Bales". The signature is fluid and cursive.

Anita F. Bales
Director

ABOUT DCAA

Prior to 1965, each branch of the military had separate contract audit functions and regulations. Contractor and government personnel recognized the need for consistency, and Secretary of Defense, Robert S. McNamara instituted “Project 60” in May 1962, to examine whether it was feasible to centrally manage contract administration and audit activities. An outcome of this study was the decision to establish a single contract audit capability – the “Defense Contract Audit Agency.” DCAA began providing audit and financial advisory services to government contract officials on July 1, 1965.

OVERVIEW

Mission

DCAA’s primary function is to conduct contract audits, accounting system audits, and to provide financial advisory services regarding contracts and subcontracts to all Department of Defense (DoD) components. We provide these services in connection with the negotiations, administration, and settlement of contracts and subcontracts to ensure fair and reasonable contract prices when the DoD spends taxpayer dollars. Contract audits are independent, professional reviews of financial representations made by defense contractors. DCAA audits only contractors; it has no internal audit responsibilities within DoD. DCAA provides contract audit services to other Federal agencies on a reimbursable basis when appropriate. The scope of DCAA’s influence is significant. DCAA provides definitive recommendations to contracting officers that directly influence negotiations with contractors. Because of these recommendations, contracting officers are better able to negotiate prices and settle contracts for major weapons systems, services, and supplies.

Organization and Structure

At the end of FY 2015, DCAA had 309 Field Audit Offices (FAOs) throughout the United States, Europe, the Middle East, Asia, and the Pacific. To manage the geographically dispersed and complex work, DCAA is comprised of seven major components: a Headquarters and six Regions—five with geographic boundaries plus a Field Detachment that handles classified work.

- **Headquarters** is located at the Andrew T. McNamara Headquarters Complex, Fort Belvoir, Virginia. Principal elements of Headquarters are the Director, Deputy Director, General Counsel, and the Assistant Directors for Operations, Policy and Plans, Integrity and Quality Assurance, and Human Capital and Resource Management.
- **Regional offices** are located in Lowell, Massachusetts; Philadelphia, Pennsylvania; Smyrna, Georgia; Irving, Texas; and La Palma, California. The Field Detachment is located in Falls Church, Virginia. Each regional office directs and administers the accomplishment of the DCAA audit mission for their assigned geographical area by managing personnel and resources assigned to their region and by directing the operation of Field Audit Offices (FAOs) within their region. Principal elements of regional offices are the Regional Director, Deputy Regional Director, Special Assistant to the Regional

Director, Regional Audit Managers, Regional Special Programs Manager, and Regional Resources Manager. DCAA identifies FAOs as either branch or resident.

- **Branch Offices**, strategically situated within the regions, perform the majority of contract audit services within the assigned geographical area. Branch offices often have smaller sub-offices to ensure adequate oversight of contractors. Regional Directors establish sub-offices as extensions of FAOs when required to furnish contract audit service more economically. A sub-office is dependent on its parent FAO for release of audit reports and other administrative support.
- **Resident offices**, located at contractor sites, provide audit services when the workload of that contractor justifies the assignment of a permanent staff.
- **Liaison employees** provide assistance to acquisition, contract administration, and contract audit personnel for DoD and non-DoD procurement or contract administration offices. Some auditors provide financial advisory service at select procurement offices. This service improves the quality of audit information for decision-makers by providing confidence about the reliability and relevance of financial information.

DCAA assists acquisition personnel by:

- evaluating contractor submitted forward pricing proposals;
- providing contracting officers with accounting and financial advisory services useful to negotiations;
- verifying the propriety and acceptability of costs charged by contractors to flexibly priced government contracts; and
- deterring inefficient contractor practices through detection and correction, preventing excessive costs and contract prices.

The Defense Contract Audit Institute (DCAI) in Atlanta, Georgia, provides specialized contract audit training for DCAA's audit staff. In addition, DCAI's trained instructors provide leadership and interpersonal skills training to new supervisors and other Agency employees.

DCAA's Professional Workforce is comprised of nearly 4,800 highly qualified employees. Approximately 93 percent have a bachelor's degree and 39 percent have an advanced degree. In addition, about 25 percent are Certified Public Accountants and 89 percent of DCAA employees are auditors. The remaining 11 percent are professional support staff that work in a variety of occupational fields including administrative support, accounting, budget, human resources, security, information technology, and legal.

Management and Performance Challenge

To help ensure the quality and efficiency of audit operations, DCAA issued additional guidance on documenting significant judgments, disclaiming an opinion, independent reference reviews, and the audit review process, and revised its planning and performance system to require a Statement of Sufficiency of Evidence and the Basis of the Audit Opinion.

DCAA's aim is to continue to provide contracting officers with high quality and timely audit reports, advice, and negotiation support to establish fair and reasonable contract prices. During contract performance, DCAA auditors continue to verify that results and outputs of contractor business systems comply with applicable rules, regulations, and contract terms.

PERFORMANCE

Strategic Plan

DCAA's current strategic plan covers 2011-2015. It is anchored by core values—Teamwork, Excellence, Accountability, Mutual Respect, Integrity, Trust—and a vision statement: “Dedicated employees working together to deliver top-quality audit services to support the Department and the warfighter, and to protect the taxpayer's interest.” DCAA is effectively using the plan to focus on audit quality, workforce issues and to identify operational improvements. During FY 2015, the Agency established five Strategic Plan Action Teams to address Agency career paths; the review of analytic tools available to auditors; consider changes to the agency's audit planning and performance systems; increase the effectiveness of DCAA working relationships with external stakeholders; and to improve the agency's succession planning model.

Goals, Objective, and Results

During FY 2015, DCAA examined \$257.5 billion in contract costs, issued 4,546 audit reports, continued to focus on incurred cost work, identified \$3.1 billion in net savings, and produced a return on investment of about \$4.8 to 1. Although there are no specific goals for savings and return on investment, the results do provide indicators of the value of DCAA audit services to the U.S. taxpayer.

FINANCIAL

Appropriated Funding

DCAA has four sources of funding. Appropriated funds are comprised of an Operation and Maintenance (O&M) Fund, Procurement Fund, and Defense Acquisition Workforce Development Fund (DAWDF). Additionally, DCAA has reimbursable funding authority. Reimbursement revenue supplements the O&M Fund.

O&M funds pay for goods and services used during the normal course of business in the fiscal year appropriated. Examples of expenses include civilian salaries and benefits, travel, information technology, leased office space, training and education, recruiting, and business assets. The FY 2015 O&M funding of \$575.2 million was \$9.3 million or 1.6% below the prior year level.

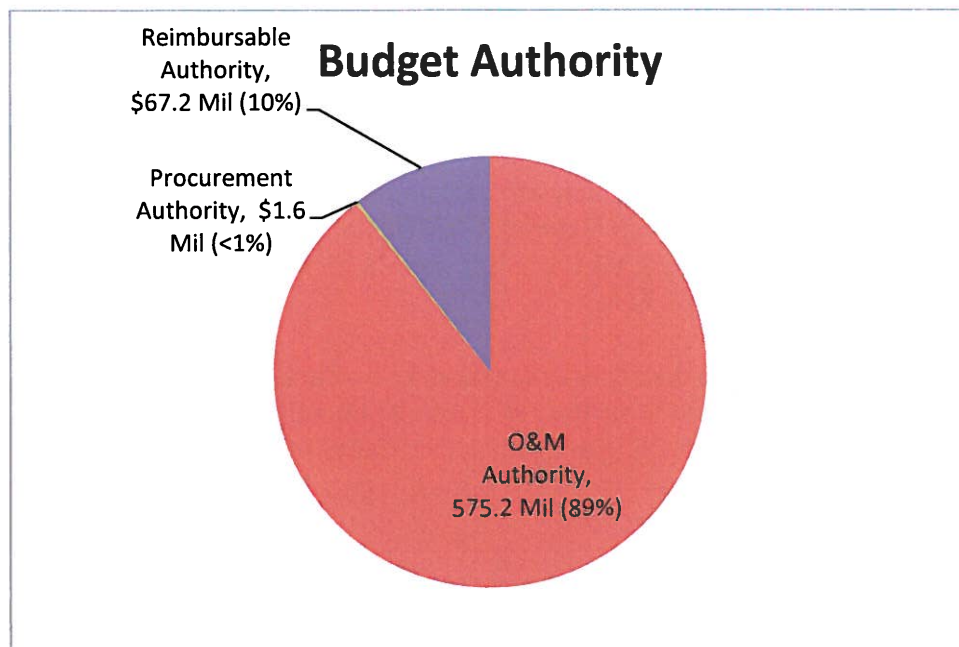
Reimbursable funds are paid by non-DoD agencies for DCAA audit services. The Office of Under Secretary of Defense, Comptroller [OUSD (C)] sets reimbursable authority annually. DCAA executed \$63.9 million in FY 2015 reimbursable authority.

Procurement funds pay for mission essential and automated data processing equipment. DCAA typically uses procurement funds for high-dollar network and information technology components. In FY 2015, DCAA used \$1.6 million to purchase Local-Area Network (LAN) equipment.

DAWDF funds are used to recruit and train acquisition personnel. The Office of the Under Secretary of Defense for Acquisition, Technology and Logistics [OUSD (AT&L)] provided DAWDF funding of \$15.9 million. These funds are part of OUSD (AT&L)'s financial reporting and not shown on DCAA's financial statements. The DAWDF funding has been a valuable program for DCAA, allowing us to grow, train, and sustain the audit workforce.

Analysis of the Financial Statements

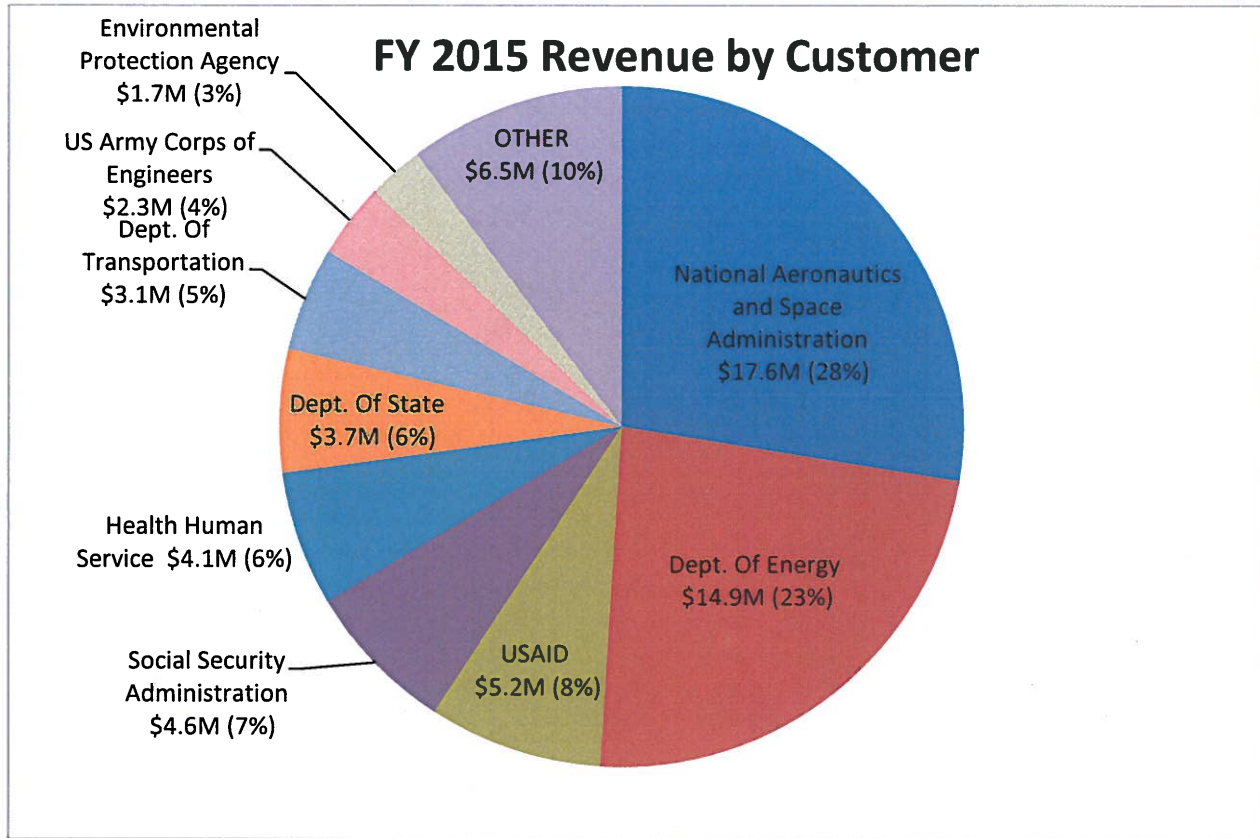
The following tables and graphs of key financial areas summarize information about the Agency's financial condition. The Consolidated Balance Sheet and Cumulative Results of Operations offer a snapshot of the Agency's financial position as of September 30, 2015 as compared to September 30, 2014. The Consolidated Statement of Net Cost summarized key expenditures, less reimbursable revenue earned, incurred for the year ended September 30, 2015 compared to the year ended September 30, 2014.



The **Consolidated Statement of Net Cost** presents the annual costs of operating programs. The net cost of each specific program operation equals the program’s gross costs less any earned revenue. The following table presents DCAA’s major cost categories for the fiscal years ended September 30, 2013 and September 30, 2014.

Consolidated Statement of Net Cost				
\$ in millions				
	FY 2015	FY 2014	Dollar Change	% Change
Gross Costs				
Personnel Payroll	\$414.8	\$409.8	\$ 5.0	1.2%
Personnel Benefits	\$138.7	\$132.8	\$ 5.9	4.4%
Purchased Goods & Services	\$ 93.0	\$ 66.9	\$26.1	39.0%
FECA Tax	\$ 28.7	\$ 28.0	\$ 0.7	2.5%
Total Gross Costs	\$675.2	\$637.5	\$37.7	5.9%
Less: Earned Revenue	(\$63.8)	(\$56.4)	(\$7.4)	13.1%
Net Cost of Operations	\$611.4	\$581.1	\$30.3	5.2%

The graph below shows DCAA's FY 2015 earnings by major customer.



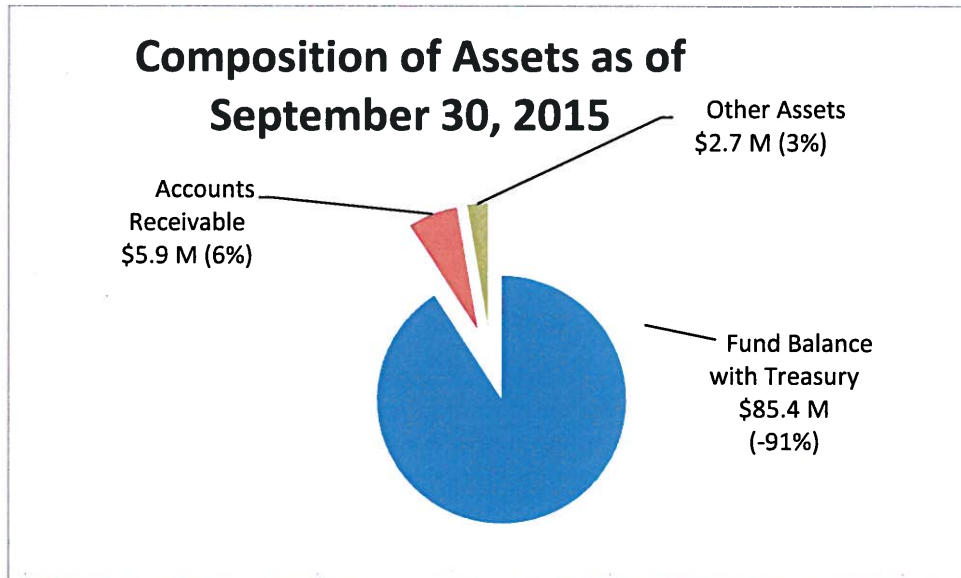
The Consolidated Balance Sheet provides a snapshot in time, descriptions of Agency “assets,” “liabilities,” and the difference, which is known as “net position.” Below is a list of DCAA’s major balance sheet categories as of September 30, 2015, September 30, 2014, and a comparison between the two.

Consolidated Balance Sheet as of September 30, 2015
\$ in millions

	FY 2015	FY 2014	\$ Change	% Change
Assets				
Fund Balance with Treasury	\$85.4	\$98.3	(\$12.9)	(13.1%)
Accounts Receivable	5.9	7.0	(1.1)	(15.7%)
Other Assets	<u>2.7</u>	<u>0.4</u>	<u>2.3</u>	<u>575.0%</u>
Total Assets	\$94.0	\$105.7	(\$11.7)	(11.1%)
Liabilities				
Employment Benefits	\$18.4	\$19.2	(\$0.8)	(4.1%)
Accrued Payroll & Leave	13.4	12.0	1.4	11.6%
Payroll Tax Payable	2.6	2.2	0.4	18.1%
Accounts Payable	9.6	10.5	(0.9)	(8.2%)
Unfunded FECA Liability	4.2	4.3	(0.1)	(2.3%)
Unfunded Leave	<u>39.5</u>	<u>38.7</u>	<u>0.8</u>	<u>2.1%</u>
Total Liabilities	\$87.7	\$86.9	\$0.8	0.9%
Net Position				
Unexpended Appropriations	\$68.5	\$80.8	(\$12.3)	(15.2%)
Cumulative Results of Operations	<u>(62.3)</u>	<u>(62.1)</u>	<u>(0.2)</u>	<u>0.3%</u>
Total Net Position	\$6.2	\$18.7	(\$12.5)	(66.7%)

*Numbers may not be exact due to rounding

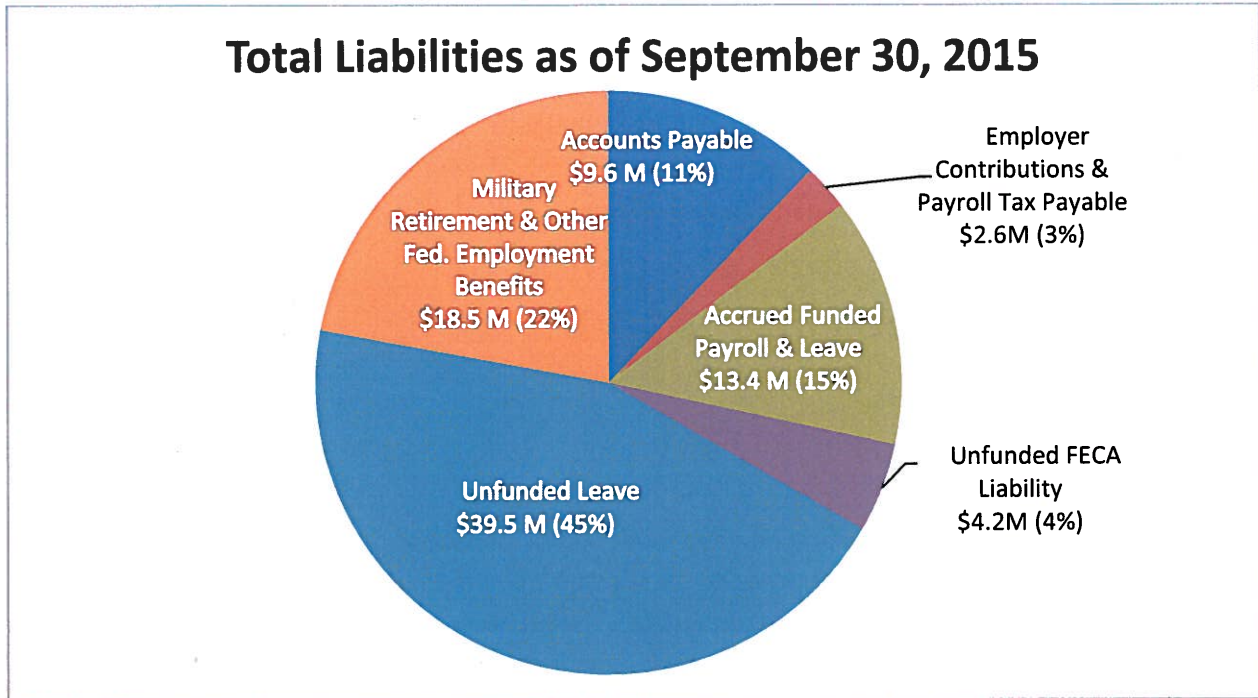
DCAA's Assets of \$94.0 million are comprised of the Fund Balance with Treasury (FBWT), Accounts Receivable (AR), and "Other" Assets. This amount represents a decrease of \$11.7 million or 11 percent less than last year's balance. The decrease is attributed to a \$9.0 million decrease in appropriations received; a \$5.7 million change in cancelling appropriations; and a \$2.5 million increase in advance payment for the purchase of assets.



*Numbers may not be exact due to rounding

FBWT is comprised of appropriations and collections received, less expenses paid. DCAA continuously reviews reimbursable accounts receivable balances and promptly takes appropriate collection actions for aged accounts.

DCAA's Liabilities of \$87.7 million are classified as either funded (covered by current budgetary resources) or unfunded (covered by future budgetary resources). Funded liabilities include employer contributions to employee benefits, accounts payable, payroll taxes payable, and current accrued payroll. Unfunded liabilities consist primarily of employment benefits, estimated future Federal Employment Compensation Act (FECA) liabilities, and accrued leave. DCAA's total liabilities increased by \$0.8 million.



Net Position represents the difference between assets and liabilities. Changes in the net position result from changes that occur within the Cumulative Results of Operations and Unexpended Appropriations. Unexpended appropriations represent the amount of undelivered orders and unobligated balances of budgetary authority. Our net position decreased by \$12.5 million, from \$18.7 million in FY 2014 to \$6.2 million in FY 2015. The decrease is attributed to a \$36 million increase in beginning balances and a negative of \$48.3 million in budgetary financing sources when compared to September 30, 2014. The negative of \$48.3 million includes a negative of \$17.4 million in Appropriations received, a negative of \$5.7 million in cancel year of appropriations, and a negative of \$25.2 million in appropriations used.

The Cumulative Results of Operations are presented in the Consolidated Statements of Changes in Net Position. DCAA had Financing Sources of \$611.2 million and Net Cost of Operations of \$611.4 million. The Net Cost of Operations includes accrued expenses for annual leave liability, personnel benefits liability, and actuarial liability. Future appropriations will fund these liabilities. The Net change of Cumulative Results of Operations were a negative of \$0.2 million, which is the difference between the Financing Sources and the Net Cost of Operations.

The following table presents comparative data for the Net Position and Results of Operations as of September 30, 2015 and September 30, 2014.

Change in Net Position and Cumulative Results of Operations
\$ in millions

	FY 2015	FY 2014	% Change
Unexpended Appropriations	\$68.5	\$ 80.8	(15.2%)
Cumulative Results of Operations	<u>(62.3)</u>	<u>(62.1)</u>	<u>0.3%</u>
Net Position:	\$ 6.2	\$ 18.7	(66.7%)
Financing Sources	\$611.2	\$582.8	4.8%
Net Cost of Operations	611.4	581.1	5.2%
Net Change	(0.2)	1.7	(112.2%)
Operations Beginning Balances	<u>(62.1)</u>	<u>(63.8)</u>	<u>(2.6%)</u>
Cumulative Results of Operations:	(\$62.3)	(\$ 62.1)	0.3%

Limitations of the Financial Statements

The Defense Finance and Accounting Service (DFAS), in collaboration with DCAA, prepares DCAA's financial statements. The principal financial statements report the Agency's financial position and results of operations, pursuant to the requirements of 31 U.S.C. 3515 (b). DFAS prepares the statements from the Agency's books and records in accordance with OMB Circular No. A-136, and to the extent possible, generally accepted accounting principles for Federal entities. The statements also are used to monitor and control budgetary resources, which are part of the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government.

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

DFAS prepares DCAA's financial statements based on data entered into the Defense Business Management System (DBMS), a legacy accounting system. The DoD legacy accounting systems track budget execution; they are not designed to capture the information necessary to create financial statements. Departments and agencies under the Executive Office did not produce annual financial statements until required by the Chief Financial Officers (CFO) Act of 1990.

The Federal Financial Management Improvement Act (FMFIA) of 1996 requires, among other things, that audit reports state if Agency financial management systems comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. Federal agencies must fully disclose financial data, including the costs of Federal programs and activities. DoD and DFAS have developed long-term strategies to replace the many legacy accounting systems such as DBMS. DCAA is converting to a new enterprise resource planning system, Defense Agencies Initiative (DAI). We anticipate the migration to be completed by FY 2018. DCAA is committed to implementing processes that support the accuracy and auditability of its financial statements.

DCAA's accounting system is adequate to ensure transactions are executed in accordance with budgetary and financial laws. Reasonable assurance is provided to ensure that assets are properly acquired, used, and safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud.

Management Assurance

In its Annual Statement of Assurance (SOA) for FY 2015, DCAA reported an unqualified statement of reasonable assurance to the Secretary of Defense; internal controls met the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 (Public Law 104-208).

The Agency has a rigorous system of internal financial and administrative controls to ensure effective management of the Agency's resources. This system provides the reasonable assurance required to certify that the objectives of the FMFIA are achieved. The FMFIA requires federal agencies to assess the effectiveness of internal controls for program, operational, and administrative areas, as well as accounting and financial management.

As an audit organization, DCAA is particularly aware of the importance of management internal controls. As part of its quality control process audit, DCAA made specific reviews and field visits during the past year to evaluate adequacy and consistency in the implementation of audit and procedural guidance. Other objectives of these reviews include identifying areas requiring additional policy coverage and determining the adequacy of existing coverage.

DCAA's Chief of Staff (CoS) champions the Agency's Managers' Internal Control Program (MICP). Individual assurance statements from each Regional Director and Headquarters Assistant Director serve as the primary basis for the Agency's assurance that management controls are adequate. The statements are based on information from various sources such as the managers' knowledge of day-to-day operations and controls, program reviews, management initiated evaluations, and audits, reviews, and investigations performed by the DoDIG and the GAO.

Internal Control Assessment and Results

DCAA continued to evaluate its system of internal accounting and administrative controls in effect during the fiscal year ending September 30, 2015, in accordance with the guidance in OMB Circular No. A-123, Management's Responsibility for Internal Control. The objectives of the system of internal accounting and administrative controls of DCAA are to provide reasonable assurances for:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting,

- Compliance with applicable laws and regulations; and
- Financial information systems are compliant with FFMIA

DCAA and DFAS assessed internal control effectiveness over financial reporting according to the OMB Circular No. A-123, Appendix A, Internal Control over Financial Reporting (ICOFR), for the following:

- Fund Balance With Treasury
- Accounts Receivable
- Accounts Payable
- Financial Statement Compilation
- Federal Employees' Compensation Act Liabilities
- Other Liabilities
- Appropriations Received
- Payroll

Financial reporting is not limited to financial statement reporting. Circular No. A-123, Appendix A, included within the definition of "financial reporting" other significant internal and external financial reports that could materially affect spending, budgetary, or other financial decisions. Appendix A prescribed a process for assessing internal controls over financial reporting. The process included:

- Evaluating internal controls by understanding management's attitude, awareness, and actions to include:
 - Integrity and ethical standards,
 - Commitment to competence,
 - Management philosophy,
 - Organizational structure, and
 - Assignment of authority and responsibility.
- Evaluating internal controls at the process, transaction, and application levels and obtaining knowledge of the organization's key processes by:
 - Performing process risk assessments with regard to financial assertions of completeness, obligations and rights, valuation, existence and occurrence, reporting and presentation, compliance with laws and regulations, and safeguarding of assets from fraud, waste, and abuse.
 - Identifying existing key controls intended to mitigate identified risk.
- Assessing and testing the design and operation of internal controls over financial reporting.
- Issuing an Annual Statement of Assurance on Internal Control over Financial Reporting (ICOFR) as a subset of the Annual Federal Managers' Financial Integrity Act Statement of Assurance.

The CoS provides oversight, accountability, and an assessment as to whether there is reasonable assurance that DCAA's internal controls are in place, operating effectively, and being used for financial reporting. The CoS is also responsible for coordinating senior leadership-level representatives to review the Agency's top down commitment, assessment documentation to explain significant decisions made in identifying material business processes, the results of the assessments and internal control test plans are maintained, and in determining if material weaknesses continue to exist.

We conducted separate tests to assess the effectiveness of internal controls. No material weaknesses surfaced in the design or operation of the internal controls. DCAA reported an unqualified statement of assurance on ICOFR in its annual FMFIA SOA.

The concept of reasonable assurance recognizes that (1) the cost of management controls should not exceed the benefits expected to be derived and (2) the benefits consist of reductions in the risks of failing to achieve the stated objectives. The expected benefits and related costs of control procedures should be addressed using estimates and managerial judgment. Moreover, errors or irregularities may occur but remain undetected because of inherent limitations in any system of internal accounting and administrative control, including those limitations resulting from resource constraints, Congressional restrictions, and other factors.

DCAA has implemented internal controls that provide reasonable assurance that performance data and metrics are reliable and relevant. Procedures are in place that control access to DCAA's Management Information System (DMIS). Access to DMIS is through the Common Access Card (CAC). The DMIS login works hand-in-hand with the CAC network login. DMIS checks the user's network profile setting to determine how the user will log in to DMIS. These login procedures control the level of access to the information system. Point-of-data entry edit checks, numerous data accuracy queries run throughout the year, and specific quarterly reviews performed by Headquarters, the Regions, and FAOs assure performance data and metrics are not significantly misstated for the period.

In addition to the point-of-data entry edit checks to reduce risk of data input errors, DCAA executes other rigorous data accuracy queries after entering the data to ensure performance data and metrics are accurate and reliable. These queries focus on data relationships to highlight significant amounts that, if erroneous, could materially affect reported statistics for the period. The Agency maintains consistent oversight of DMIS, from data entry through transaction processing and reporting. The annual review of the Federal Information Security Management Act found DCAA within the compliance standards for all reportable areas.