

GAO September 2009 Report: DCAA Audits - Widespread Problems with Audit Quality Require Significant Reform

Author: Tim Di Guiseppe

The General Accountability Office (GAO) final report on its evaluation of the DCAA audit management environment and control structure in performing audits of government contractors was released September 23, 2009. The cover page of this report, entitled “DCAA Audits—Widespread Problems with Audit Quality Require Significant Reform”, broadly summarizes the GAO findings.

GAO’s overall findings and basis for its recommendations can be found in the following statement contained in the report:

“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 [sic] 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.”

The problems GAO found in DCAA audits are summarized under the following three major functional weaknesses:

“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.”

“Insufficient testing. Thirty-three of 37 internal control audits did not include sufficient testing of internal controls to support auditor conclusions and opinions.”

“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.”

The purpose of this newsletter is to provide an analysis of the potential impact of GAO’s recommendation on contractors. We purposely did not provide a summary of the GAO findings because the heart of the report is the recommendations and the early efforts by Congress to reconstitute the DCAA based on those recommendations. For those of you that want to read the full report, go to the following link - <http://www.gao.gov/new.items/d091009t.pdf>

GAO Recommendations:

While the report contained 17 general recommendations, it is the recommendations under the section titled “Legislative and Other Actions Could Further Improve DCAA” that could fundamentally change DCAA as an organization and significantly increase its audit authority and independence within the DoD. The following section from GAO’s legislative recommendation makes clear the potential impact DoD and contractors.

“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 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.”

The good summary of the 17 general recommendations contained in the GAO report for correcting DCAA deficiencies was provided by Beason & Nalley:

- “The Secretary of Defense revise DCAA’s mission statement to reflect need for quality audits, establish milestones for completing DCAA corrective action, and monitor DCAA progress on a routine basis.
- The Secretary of Defense require DCAA to undertake the following actions:
 - Develop a strategic plan, consistent with a revised mission statement and measure progress in achieving goals through metrics that are tied to the mission statement.
 - Seek expert guidance to develop a risk-based contract audit approach.
 - Establish a senior executive position for audit quality assurance.
 - Establish a separate DCAA internal review organization.
- Review DCAA’s current “portfolio of audit and non-audit services” to determine if any such services should be moved to other DOD agencies, or simply terminated.
- Develop a staffing plan that identifies resource requirements using a risk-based analytical approach.
- Create a slot for an “expert on auditing standards”, or otherwise seek external consulting advice in revising contract audit policy, providing guidance on statistical sampling, and developing training on auditing standards.
- Amend DCAA audit policy to better identify what comprises sufficient audit testing in accordance with GAGAS.
- Develop agency wide training on government audit standards.
- Perform comprehensive and objective evaluations of the revised quality assurance function, and develop recommendations to “address annual quality assurance review findings of serious deficiencies and GAGAS noncompliance issues”.
- Establish policies & procedures to avoid independence issues among functions of auditors.
- Have the DOD IG reconsider its overall conclusions giving an adequate opinion on DCAA system of quality control (May 2007 DOD IG report), and determine if that report should be rescinded or modified.”

Commentary:

The GAO report, with its multiple issues and recommendations, makes it difficult to predict the future impact of this report on government contractors. An issue that should be of concern to contractors is the fact that DCAA rescinded over 80 audit reports based GAO findings. There is a significant likelihood that those companies whose audits were rescinded, will face new audits of the same internal controls and have to withstand a more rigid audit process which will likely cause a broad-based disapproval of many internal controls, and withholdings on payments of invoices. Evidence of this can be found in the fact that a few publicly-held government contractors have included qualifying verbiage with the submission of their latest SEC forms (10-Q or 10-K) identifying this potential threat to those companies' future financial posture.

In our opinion, the following are three potential consequences of this report:

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

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

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

We will continue to monitor the impact of this report and issue news alerts as appropriate.