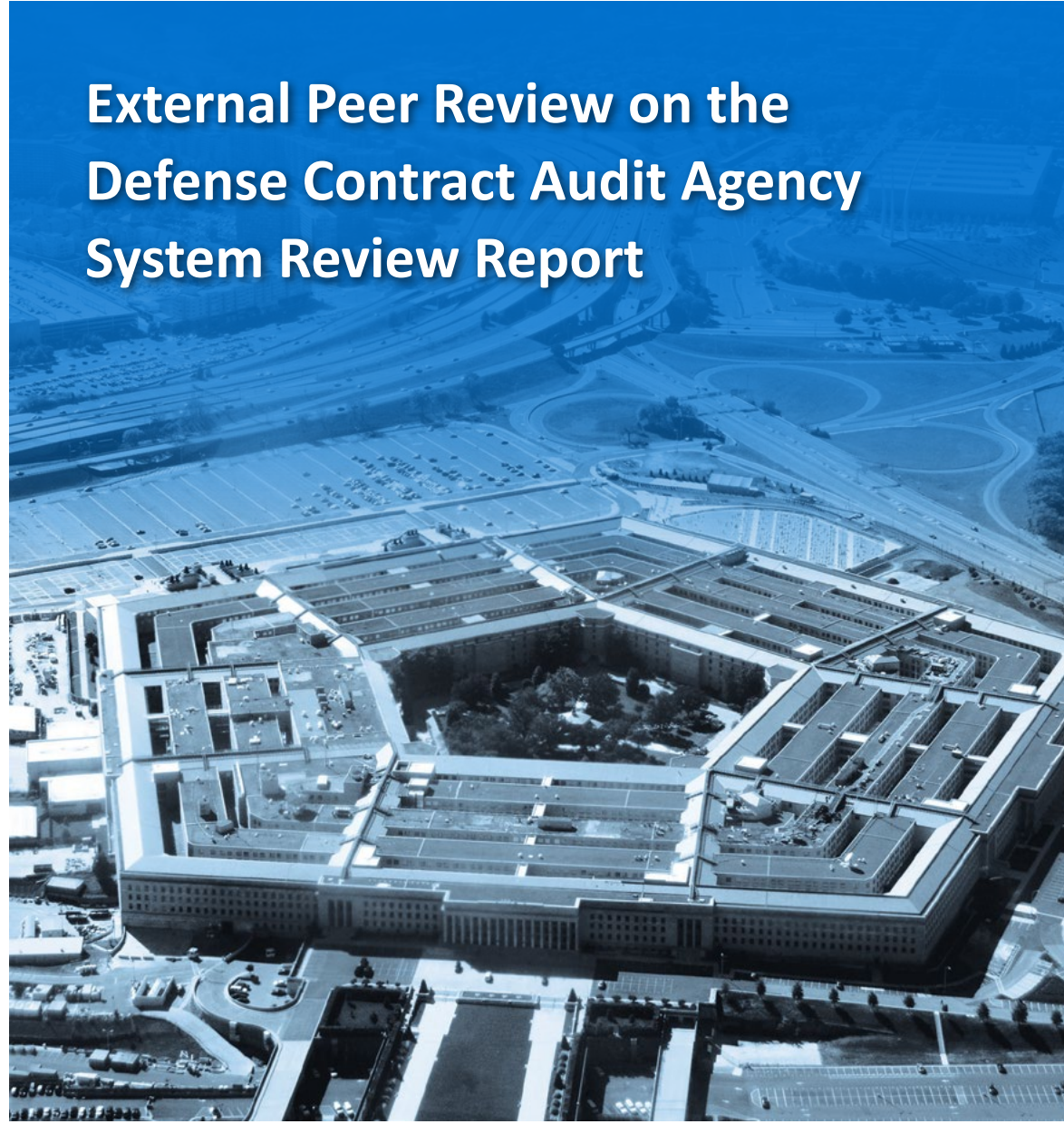




INSPECTOR GENERAL

U.S. Department of Defense

NOVEMBER 17, 2017



External Peer Review on the Defense Contract Audit Agency System Review Report

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**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

November 17 2017

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

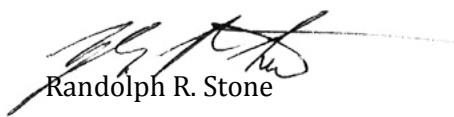
SUBJECT: External Peer Review on the Defense Contract Audit Agency
System Review Report (Report No. DODIG-2018-028)

Attached is the External Peer Review Report on the Defense Contract Audit Agency (DCAA). We conducted the review in accordance with Government Auditing Standards and the Council of the Inspectors General on Integrity and Efficiency *Guide for Conducting Peer Reviews of the Audit Organizations of Federal Offices of Inspector General*.

Enclosure 1 of the report identifies the scope and methodology for this review, including the DCAA offices we visited and assignments we reviewed. Enclosure 2 identifies the deficiencies we found for each assignment. Enclosure 3 contains a summary of specific DCAA management responses on seven of the assignments and our response to the comments. Finally, the complete DCAA response to a draft of the report is included as Enclosure 4.

As is customary, we issued a separate letter of comment that sets forth findings that were not of sufficient significance to affect our opinion expressed in this report.

We appreciate the cooperation and courtesies extended to our staff during the review.


Randolph R. Stone
Deputy Inspector General
Policy and Oversight

Enclosures:
As stated





**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

November 17, 2017

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: External Peer Review on the Defense Contract Audit Agency
System Review Report (Report No. DODIG-2018-028)

We reviewed the system of quality control for Defense Contract Audit Agency (DCAA) in effect for the year ended June 30, 2016. A system of quality control encompasses DCAA's organizational structure and policies adopted and procedures established to provide it with reasonable assurance of conforming to *Government Auditing Standards* (GAS). The elements of quality control are described in GAS. DCAA is responsible for establishing and maintaining a system of quality control that is designed to provide it with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements in all material respects. Our responsibility is to express an opinion on the design of the system of quality and DCAA's compliance with standards and requirements based on our review.

We conducted our review in accordance with GAS and the Council of the Inspectors General on Integrity and Efficiency *Guide for Conducting Peer Reviews of the Audit Organizations of Federal Offices of Inspector General*.¹ During our review, we interviewed DCAA personnel and obtained an understanding of the nature of DCAA's organization and the design of its system of quality control sufficient to assess the risks implicit in its organization. We selected audits and administrative files to test for conformity with professional standards and compliance with DCAA's system of quality control. The audits we selected represented a reasonable cross section of DCAA audits, with sufficient coverage of assignment types and DCAA regions. Enclosure 1 of this report identifies the scope and methodology for this review, including the 67 audits we selected for GAS compliance testing. We believe that the procedures we performed provide a reasonable basis for our opinion.

In performing our review, we obtained an understanding of the system of quality control for DCAA. In addition, we tested for compliance with DCAA's quality control policies and procedures to the extent that we considered appropriate. These tests covered the application of DCAA's policies and procedures on selected audits. Our review was based on selected tests; therefore, it would not necessarily detect all weaknesses in the system of quality control or all instances of noncompliance with it.

¹ The Council of the Inspectors General on Integrity and Efficiency *Guide for Conducting Peer Reviews of the Audit Organizations of Federal Offices of Inspector General* will hereafter be referred to as "CIGIE Guidance."

Inherent limitations exist in the effectiveness of any system of quality control. Therefore, noncompliance with the system of quality control may occur and not be detected. Projection of any evaluation of a system of quality control to future periods is subject to the risk that the system of quality control may become inadequate because of changes in conditions, or because the degree of compliance with the policies or procedures may deteriorate.

In our opinion, except for the evidence, reporting, documentation, supervision, and professional judgment deficiencies described after the Overall Management Comments and Our Response section, the system of quality control for DCAA in effect for the year ended June 30, 2016, has been suitably designed and complied with to provide DCAA with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Audit organizations can receive a rating of *pass*, *pass with deficiencies*, or *fail*. DCAA has received a rating of *pass with deficiencies*.

Enclosure 2 identifies the deficiencies by DCAA assignment number.

Overall Management Comments and Our Response

DCAA Director Comments

DCAA agrees with the *pass with deficiencies* opinion and overall conclusions on the documentation and evidence deficiencies. However, DCAA disagreed that the reporting, supervision, and professional judgment deficiencies rise to the level of a system-reportable deficiency as defined in the Council of the Inspectors General on Integrity and Efficiency (CIGIE) guidance. In addition, DCAA stated that the DoD Office of Inspector General (OIG) overstated the conclusions by citing the same finding under several deficiencies. For example, DCAA stated that the root cause of the problem with Assignment No. 6811-2008UI0100001 was a lack of evidence, yet the DoD OIG also cited the same assignment for supervision, reporting, and professional judgment deficiencies.

Our Response

Our reported deficiencies qualify as system-reportable deficiencies as defined in the CIGIE Guidance, which defines a deficiency as:

...one or more findings that the review team has concluded, due to the nature, causes, pattern, or pervasiveness, including the relative importance of the finding to the OIG audit organization's system of quality control taken as a whole, could create a situation in which the organization would not have reasonable assurance of performing and/or reporting in conformity with applicable professional standards in one or more important respects. For the External Peer Review, deficiencies that do not rise to the level of a significant deficiency are communicated in a report with a rating of pass with deficiencies.

For example, in 8 of 67 audits (12 percent), our review disclosed that DCAA did not comply with professional standards related to reporting, such as GAS 5.04 and Attestation Standard (AT) 101.73. After carefully considering the nature of the eight findings and their importance to DCAA's system of quality control taken as a whole, we concluded that the system did not provide reasonable assurance of reporting in conformity with applicable standards. The findings demonstrate a pattern and pervasiveness of issues that reflect the need for improving the reliability of DCAA's system of quality control and reporting in compliance with professional standards. Further, our sample of 67 audits was statistically based; therefore, our results are representative of the universe of the 4,251 audits that DCAA issued between July 2015 and June 2016. Accordingly, we made appropriate recommendations to help ensure that the system provides reasonable assurance of DCAA reporting in accordance with professional standards.

Furthermore, for Assignment No. 6811-2008U10100001, we recognize that evidence is critically important for ensuring the reliability of a reported opinion, but the other standards (such as planning, supervision, professional judgment, documentation, and reporting) also play a key role in ensuring the reliability of the resulting report. If the failure to plan or supervise an audit contributed to a lack of evidence, we have an obligation to point out the planning and supervision failures and recommend that DCAA take appropriate corrective actions to help prevent evidence deficiencies in the future.

Evidence

Deficiency 1. DCAA Did Not Obtain Sufficient Evidence

GAS 2.09a states that an audit consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter is based on the criteria in all material respects or the assertion is presented, in all material respects, based on the criteria. For 18 of 67 audits (27 percent) we selected for review, we found one or more instances in which DCAA auditors did not obtain sufficient, appropriate evidence to support an opinion expressed in the report. We found this deficiency in all six DCAA regions. Among the 18 audits, we found a total of 25 instances when the auditors did not obtain sufficient, appropriate evidence to support DCAA's opinion that contractor proposed costs were reasonable, allowable, or compliant with contract terms.

- In 13 instances, DCAA reported that the proposed costs were reasonable without performing tests to determine whether the costs were actually reasonable. For example, in DCAA Assignment No. 1271-2012G10100001, the audit report stated that DCAA examined the contractor's proposed costs to determine if they were allowable, allocable, and reasonable. Although the auditors took no exception to the reasonableness of salaries and software licensing costs, they did not perform tests

to establish the reasonableness of the costs. We noted that DCAA's standard audit programs² generally do not provide guidance to auditors on how to perform testing of costs for reasonableness.

- In seven instances, DCAA reported that the proposed costs were allowable without performing sufficient testing. For example, in DCAA Assignment No. 3231-2009M10100046, the auditor examined 13 transactions covering only 0.3 percent of proposed outside services costs. Yet, the proposed costs represented the largest account encompassing 25 percent of total proposed indirect costs. The auditor did not document how the limited amount of testing provided sufficient coverage to render an opinion on the allowability of outside services costs.
- In five instances, DCAA reported that the proposed costs complied with accounting or billing related contract terms even though the auditor did not design or perform tests to determine compliance with some of the contract terms (such as special contract provisions). For example, in DCAA Assignment No. 2161-2010P10100020, the auditor identified special contract provisions for overtime. However, the auditor did not design or perform the necessary tests to determine if the contractor complied with the terms. Although the auditor did not design or perform the necessary steps, the audit report stated that the contractor's proposed costs complied with contract terms.

All five instances involve DCAA's audit of a DoD contractor's annual claim for reimbursement of incurred costs (hereafter referred to as an incurred cost audit). The DCAA standard audit program for an incurred cost audit instructs the auditor to review the contractor's contracts for any terms or provisions that may impact reimbursement of the contractor's proposed incurred costs. However, if the auditor identifies any such terms or provisions, the audit program does not assist or guide the auditor in designing or performing appropriate tests for confirming that the contractor has complied with contract terms. DCAA should develop additional guidance to assist auditors in designing and performing tests which verify the contractor's compliance with contract terms, including special contract provisions.

DCAA Actions on a Previous DoD OIG Recommendation

In the previous peer review of DCAA conducted by the DoD OIG, "DCAA Peer Review: System Review Report," August 21, 2014, the DoD OIG reported on 11 instances in which DCAA did not document or obtain sufficient evidence to support the reported opinion. The DoD OIG recommended that DCAA take additional steps to improve quality before report issuance, such as requiring an independent reference review (IRR) on more audits.

² As part of its guidance provided to auditors, DCAA maintains standard audit programs for each major type of audit that DCAA auditors conduct. The programs outline the specific audit steps and techniques that auditors should complete as they conduct an audit.

An IRR consists of another auditor, having no prior involvement in the audit, reviewing the report and working papers to ensure the auditor obtained sufficient evidence to support the conclusions reached and the results reported. The auditor who conducts the IRR completes a checklist to document various observations, such as whether: (1) the factual matters in the draft report are consistent with the working papers, (2) the planned audit scope agrees with the testing performed, and (3) working papers include a detailed description of the work performed. DCAA policy requires an IRR only when certain thresholds are met based on audit type. For example, incurred cost audits require an IRR when the audited costs equal or exceed \$100 million.

In February 2016, DCAA revised its IRR procedures to request that field audit offices perform additional IRRs on a sample of audits that do not meet the thresholds. However, the revised procedures do not specify a minimum number of additional reviews that field audit offices must perform, or establish a monitoring program to ensure that the offices are actually performing the additional reviews. DCAA should consider requiring a minimum number of additional IRRs that field audit offices must perform, and implementing a monitoring program to verify that offices are complying with the requirements.

Based on the results of our current review, DCAA still needs to consider additional steps to ensure that auditors gather sufficient evidence to support reported opinions. Of the 18 audits that lacked sufficient evidence, only 2 were subject to an IRR. The IRRs conducted on the two audits did not detect a lack of evidence for supporting DCAA's opinion that the proposed costs were reasonable. As with any form of quality control, an IRR may not detect all deficiencies. However, if effectively implemented, a robust IRR program can prove to be a valuable tool for helping to ensure that auditors obtain adequate evidence in support of reported opinions.

Management Comments on the Deficiency and Our Response

DCAA Director Comments

DCAA disagreed that several of the 18 assignments lacked sufficient, appropriate evidence, stating that the evidence issues do not rise to the level of a finding and overall deficiency. Specifically, for 7 of the 18 assignments discussed in the DCAA comments, DCAA stated that the DoD OIG did not adequately consider materiality in making the determination. For example, DCAA stated that the DoD OIG cited Assignment No. 4901-2010C10100001 for not having sufficient evidence to express an opinion on the reasonableness of legal and miscellaneous costs. According to DCAA, the legal and miscellaneous costs of \$2.5 million accounted for only 2 percent of the total contractor claimed costs of \$133 million. DCAA also noted that the auditor had already questioned \$1.2 million of the \$2.5 million, because the auditor concluded that the costs were unallowable. Therefore, DCAA disagreed that not testing the legal and miscellaneous costs for one element of allowability (reasonableness) should result in an evidence finding.

Finally, for six additional assignments, DCAA stated that the DoD OIG did not appropriately consider materiality or other facts of the assignment, which do not support the DoD OIG findings. See Enclosure 3 for a summary of the DCAA management comments and the DoD OIG response for all seven assignments.

Our Response

We disagree with DCAA that we did not adequately consider materiality in making our determination. DCAA auditors use a risk-based approach to perform transaction testing because available DCAA audit resources normally do not allow for 100 percent testing. For various reasons, such as prior audit findings, cost accounts that make up a relatively small percentage of a total proposal can carry a higher degree of audit risk than accounts that make up a larger percentage of total costs. For each assignment we selected, we considered the DCAA auditor's assessment of total audit risk and how the auditor's assessment affected the auditor's planned testing of cost accounts. When auditors do not complete planned testing that they determine to be necessary based on the assessed audit risk, this situation can indicate that the auditor did not obtain sufficient evidence to support the audit opinion, particularly if the auditors do not adequately document why they deviated from the testing plan.

In the example cited in DCAA's management comments, Assignment No. 4901-2010C10100001, the auditor planned to perform testing of the legal and miscellaneous accounts for allowability, allocability, and reasonableness based on the auditor's assessment of audit risk. Although the accounts made up 2 percent of the total claimed costs of \$133 million, the auditor's decision to test the accounts was appropriately based in part on the auditor's establishment of a \$100,000 threshold of materiality, and the significance of questioned legal and miscellaneous costs in prior audits. We did not question the auditor's documented judgment to select the accounts based on these factors. However, we determined that the assignment lacked sufficient evidence because we found no indication in the audit file that the auditor had tested the two accounts for reasonableness. In addition, the audit file lacked any explanation for not testing the legal and miscellaneous accounts for reasonableness, as the auditor had planned.

Questioning \$1.2 million of the legal costs for allowability did not diminish the auditor's need to test the accounts for reasonableness because the auditor had planned tests of the accounts based on his assessment of audit risk. Because the DCAA report included an opinion on the reasonableness of the proposed costs, the auditor should have performed testing of reasonableness to support that opinion. In addition, if the auditor had performed appropriate testing for reasonableness, such testing could have disclosed that the costs were also unreasonable and further strengthened the Government's position to disallow the costs.

Recommendation, Management Comments, and Our Response

Recommendation 1

The Defense Contract Audit Agency Director should assess Defense Contract Audit Agency's quality control procedures for providing reasonable assurance that auditors obtain sufficient and appropriate evidence in support of reported conclusions. As part of the assessment, Defense Contract Audit Agency should:

- a. **Provide refresher training to auditors on the requirements and techniques for obtaining sufficient and appropriate evidence of reported conclusions.**

DCAA Director Comments

DCAA disagreed with the recommendation; however, DCAA proposed alternative corrective actions. DCAA stated that the recommendation was not specific enough and did not address the root cause of the deficiency. DCAA alternatively proposed to perform an assessment of DCAA's policy and, after completing the assessment, develop training to address the specific areas of reasonableness and contract terms.

Our Response

The DCAA comments adequately addressed the intent of the recommendation. Because most of the evidence issues relate to reasonableness and contract terms, we agree that focusing on the training needs of these specific areas is appropriate. Therefore, the recommendation is resolved but remains open. We will close the recommendation after DCAA provides us with the results of the assessment and the corrective actions taken to help ensure that DCAA auditors obtain sufficient evidence.

- b. **Develop standard audit steps that assist auditors in performing tests for examining the:**
 - (1) **Reasonableness of proposed costs.**
 - (2) **Contractor's compliance with contracts terms, including special contract provisions.**

DCAA Director Comments

DCAA disagreed with the recommendation; however, DCAA proposed alternative corrective actions. DCAA did not agree that standard audit steps should be included to address the evidence issues. Instead, DCAA will assess its policy to determine the most appropriate corrective action, which may include changes to DCAA standard audit steps. DCAA will complete the assessment by December 31, 2017.

Our Response

The DCAA comments adequately addressed the intent of the recommendation. DCAA's alternative plan to perform an assessment and determine the most appropriate corrective action, which could include establishing standard audit steps, should help ensure that auditors perform appropriate tests of reasonableness and compliance with contract terms. Therefore, the recommendation is resolved but remains open. We will close the recommendation after DCAA provides us with the results of the assessment and the corrective actions taken to address the deficiency.

- c. Assess and improve Defense Contract Audit Agency's procedures for performing independent reference reviews to ensure adequate coverage of completed audits. Consider requiring a minimum number of additional independent reference reviews that field audit offices must perform, and monitoring field audit offices to ensure compliance with the requirements.**

DCAA Director Comments

DCAA did not agree that there was a need to improve its independent reference reviews, because DCAA expanded the use of IRRs in 2016. In addition, DCAA stated that it would reemphasize the importance of the IRR program. Also, DCAA listed guidance and training that DCAA issued in the last 2 years to ensure that DCAA auditors gather sufficient and appropriate evidence in support of reported conclusions.

Our Response

The DCAA comments do not adequately address the recommendation; therefore, the recommendation is unresolved and remains open.

Although DCAA revised its IRR policy in 2016 to expand the use of IRRs, the revised policy does not provide any guidelines to DCAA field offices on the additional number or percentage of IRRs that the offices should perform. In addition, the revised IRR policy does not establish a mechanism to monitor compliance with the revised policy. Therefore, DCAA does not have a means of determining whether the DCAA field offices are complying with the new policy for performing additional IRRs.

Reemphasizing the current IRR policy and providing training to DCAA field audit offices are important, but these actions alone may not sufficiently improve the reliability of DCAA auditors obtaining sufficient evidence. The DoD OIG also cited evidence as a deficiency in the prior peer review of DCAA. To adequately address this repeated evidence deficiency, DCAA needs to further improve its IRR program, which should involve more specific requirements for conducting additional IRRs and monitoring the results of the IRRs. An IRR serves as a key control for ensuring that adequate evidence exists prior to report issuance; therefore, subjecting more audits to an IRR should measurably improve the sufficiency of evidence gathered by DCAA auditors and provide insight into areas where additional training or guidance is needed.

We request that DCAA provide additional comments in response to this recommendation by December 18, 2017, describing the actions that DCAA will take to assess and improve its IRR policy.

Reporting

Deficiency 2. DCAA Did Not Report on Pertinent Information or Scope Restrictions

GAS 5.04 requires auditors to communicate pertinent information to individuals requesting the audit. In addition, as discussed in AT 101.73 and .74, restrictions or limitations on the scope of an audit may prevent the auditor from issuing an unqualified opinion. When the reported opinion is qualified or disclaimed, the reasons for doing so should be described in the audit report.

For 8 of 67 audits (12 percent), DCAA did not appropriately communicate pertinent information or important limitations to the contracting officer. We found this deficiency in five of the six DCAA regions. For example, in DCAA Assignment No. 6711-2008K10100007, DCAA issued a disclaimer of opinion but did not appropriately communicate other pertinent information in the “Report on Other Matters” appendix of the report.

Specifically, the “Report on Other Matters” appendix described the work as an examination and presented material noncompliances in an unclear manner, including:

- an exhibit showing columns for “Proposed Costs” and “Non-Compliant” costs, implying that the auditor had audited and accepted the difference between the two columns. However, the auditor did not perform sufficient testing to render an opinion on the proposed costs as a whole. In accordance with DCAA Contract Audit Manual 10-208.7, the auditor should have presented only the non-compliant costs and avoided any comparison with the proposed costs;
- the inappropriate use of the term “examination” 20 times when the auditor did not perform an examination in accordance with GAS; and
- a statement that the auditor examined the proposed costs for allowability, allocability, and reasonableness, implying an opinion that all costs were allowable, allocable, and reasonable, except for the reported noncompliant costs. AT 101.73 prohibits auditors from providing assurance when they disclaim an opinion due to the auditor’s inability to obtain sufficient evidence in support of an opinion. The auditor’s statement in this report could be interpreted as an inconsistency with the standard.

Presented in such a manner, the report reader could construe the information as conveying a piecemeal opinion,³ which could overshadow or contradict the disclaimed opinion.

³ A piecemeal opinion involves the expression of an opinion on a portion of the auditee’s assertion (such as a DoD contractor’s incurred cost proposal or financial statements).

In another example (DCAA Assignment No. 9871-2008M10100029), DCAA failed to appropriately report two limitations on the scope of the audit involving costs for shared-service allocations and intercompany transfers that had not yet been reviewed. Also, DCAA did not appropriately present the costs as unresolved in the exhibits and schedules of the report because the auditor had not made a final determination on the allowability, allocability, and reasonableness of the costs. As a result of failing to report the limitations, contracting officers responsible for acting on this report could misinterpret the actual findings and take unintended actions, such as negotiating and accepting unresolved costs that have not been audited.

We reviewed DCAA's related policies and procedures for appropriately reporting pertinent information and scope limitations to the contracting officer and we found no inconsistencies with GAS. However, we found that the DCAA auditors did not comply with existing DCAA policy. For example, in Assignment No. 6711-2008K10100007, the auditor did not comply with DCAA policy to avoid the use of the term "examination" or "audit" in a disclaimer of opinion report. In Assignment No. 9871-2008M10100029, the auditor did not comply with DCAA policy requiring auditors to report all pertinent limitations. DCAA should reemphasize to its auditors the importance of appropriately communicating other matters in a disclaimed opinion and reporting all limitations that prevent the auditor from issuing an unqualified opinion.

Management Comments on the Deficiency and Our Response

DCAA Director Comments

DCAA disagreed with seven of the eight assignments we cited for a reporting noncompliance. DCAA responded that our review of the seven assignments identified no systemic or pervasive conditions to warrant reporting them as a deficiency. DCAA provided specific comments on two of the seven assignments. For Assignment No. 6711-2008K10100007, DCAA disagreed that the assignment contained a piecemeal opinion, because the report stated that the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. DCAA stated that although the auditor inappropriately used audit terms and did not present noncompliances in accordance with DCAA policy, DCAA maintains that these issues do not overshadow the disclaimer of opinion language.

For Assignment No. 9871-2008M10100029, DCAA stated that the two scope limitations that the auditor failed to include in the report covered only \$600,000 of \$44 million in proposed costs. Therefore, DCAA stated the limitations were insignificant and did not need to be identified in the report.

For three additional assignments, DCAA stated the reported noncompliances address a variety of unrelated and nonrecurring issues, which do not constitute a reporting deficiency.

Our Response

We disagree with DCAA's position. Of the 67 assignments we statistically sampled, 8 assignments (12 percent) contained 14 reporting noncompliances that impacted the reliability of the reports. The findings demonstrate a pattern and pervasiveness of issues that reflect the need for improving the reliability of DCAA audit reports. After carefully considering the nature of the eight findings and their importance to DCAA's system of quality control taken as a whole, we concluded that the system did not provide reasonable assurance of reporting in conformity with applicable standards.

For Assignment No. 6711-2008K10100007, DCAA did not adequately communicate pertinent information in the report. Although DCAA used appropriate disclaimer of opinion language in 8 pages of the report, DCAA used inappropriate audit opinion language (such as the word "examination") throughout the "Report on Other Matters" section, which encompasses 68 pages of the 115-page report. In addition, in presenting the noncompliant costs, the report also implied that the auditor had accepted the significant difference between total proposed costs and the noncompliant costs. These examples represent significant deviations from DCAA policy for appropriately disclaiming an opinion. As a result, we maintain that our finding is supported.

For Assignment No. 9871-2008M10100029, we disagree with DCAA's statement that the two missing limitations were immaterial and not required to be included in the report. The DCAA auditor documented in the working papers the need to include the scope limitations in the audit report. Also, the two limitations missing from the audit report covered \$600,000 in proposed costs, which is a significantly larger amount than the \$32,000 in subcontract costs that the auditor questioned in the same audit report. The auditor appropriately decided to question the \$32,000 in the audit report because the decision resulted in saving \$32,000 for the DoD and the taxpayer that could be put to better use. An audit of the \$600,000 could have resulted in questioning significantly more than the \$32,000 that the auditor chose to question in the audit report. The DCAA auditor had an obligation to inform the report user that the \$600,000 in proposed costs had not been audited. By not appropriately including the two scope limitations in the report, DCAA did not protect the Government's interest because the report user could incorrectly conclude that the \$600,000 in proposed costs were audited and determined to be allowable.

We disagree with DCAA's conclusion that the remaining three assignments involve unrelated, nonrecurring issues. We found four reporting noncompliances within the three assignments, and all of them involve the incorrect reporting of important information. For example, the report for Assignment No. 1271-2012G10100001 did not provide the correct criteria by which the proposal was evaluated against. In this case, the report indicated that the DCAA auditor evaluated a contractor proposal for allowability, allocability, and reasonableness, but the auditor actually evaluated the proposal for compliance with contract terms. This report inaccuracy qualifies as a deficiency as defined in the CIGIE Guidance, because it could diminish the reliability of the reported opinion.

Recommendation, Management Comments, and Our Response

Recommendation 2

The Defense Contract Audit Agency Director should emphasize through training or other appropriate means, the importance of adhering to Government Auditing Standard 5.04, Attestation Standards 101.73 and 101.74, and Agency policy for appropriately:

- a. Communicating other pertinent information in a report that disclaims an opinion.
- b. Including all scope limitations in the report that prevent the auditor from issuing an unqualified opinion.

DCAA Director Comments

DCAA did not agree that corrective actions are needed because DCAA does not consider any of the noncompliances to be systemic. However, DCAA also stated that it had created a new E-learning course and updated its guidance on disclaimer of opinion reports in October 2016. In addition, DCAA updated its Contract Audit Manual to include updated guidance on disclaimers of opinion. Finally, DCAA will continue to emphasize its quality processes over audit reporting to ensure adherence with GAS and DCAA policy.

Our Response

We disagree with DCAA's position. Although the reporting deficiencies associated with the eight assignments did not always involve identical circumstances, they all involved a common theme of reporting incorrect or misleading information.

However, we determined that the corrective actions recently taken by DCAA adequately addressed the intent of the recommendation. We verified that DCAA created an E-learning course for new auditors and updated its guidance that adequately address the types of reporting deficiencies we found, such as those involving disclaimer of opinion reports and scope limitations. Therefore, we consider the recommendation closed.

Documentation

Deficiency 3. DCAA Did Not Adequately Document the Procedures Performed

GAS 5.16a requires that auditors prepare audit documentation in sufficient detail to enable an experienced auditor, having no previous connection to the examination engagement, to understand from the documentation the nature, timing, extent, and results of procedures performed. In 9 of the 67 audits (13 percent), the documentation taken as a whole was insufficient to understand the nature, timing, extent, or results of work performed by the DCAA auditor. We had to hold extensive discussions with the audit staff to understand the procedures performed and why those procedures accomplished the audit objective. We found this deficiency in three of the six DCAA regions. Each of the nine audits had four or more documentation inadequacies.

Some of the more common documentation inadequacies involved DCAA auditors failing to adequately document the:

- performance of audit program steps that were planned to satisfy the audit objective,
- basis for the judgmentally selected transactions for testing, or explain why the judgmentally selected transactions resulted in adequate coverage to satisfy the audit objectives, and
- criteria used by the auditor to evaluate the contractor's proposed costs and report the audit results. As stated in GAS 5.12, the audit criteria provides a critical context for evaluating the audit evidence and understanding the audit findings.

For example, in DCAA Assignment No. 6321-2010V10100027, the auditor did not adequately document the completion of several planned audit steps, such as performing a mathematical verification of the contractor's submission and considering fraud indicators that may impact audit planning. In addition, in the same assignment, the auditor did not adequately document the basis for judgmentally selecting transactions within the areas of subcontracts, labor, adjusting entries, and other direct cost accounts. Also, the auditor did not document the criteria that the auditor used to test labor costs, such as contract terms related to labor costs. Finally, the auditor did not adequately document the impact that a prior labor system audit had on planning steps for the assignment.

Our review did not disclose any inadequacies with DCAA policies and procedures related to documenting the work performed in accordance with GAS. However, the auditors did not comply with established DCAA procedures. Given the number and significance of documentation deficiencies we found (including additional, less significant documentation issues addressed in our Letter of Comment dated November 17, 2017), DCAA should assess the effectiveness of its controls for ensuring compliance with established Agency policies and procedures and take appropriate corrective action. As part of its corrective action, DCAA should consider the need to provide comprehensive refresher training on the GAS documentation requirements.

Recommendations, Management Comments, and Our Response

Recommendation 3.a

The Defense Contract Audit Agency Director should assess and improve the quality control procedures to help ensure that Defense Contract Audit Agency auditors adequately document the:

- 1. Performance of planned audit program steps.**
- 2. Basis for judgmentally selecting transactions for testing, and why the selection adequately addresses the audit objectives.**
- 3. Criteria used in the audit.**

DCAA Director Comments

DCAA agreed with the recommendation and will assess its training needs and will provide training to address the specific areas identified in the recommendation. DCAA anticipated completing the actions in response to the recommendations by December 31, 2017.

Our Response

The DCAA comments addressed the specifics of the recommendation; therefore, the recommendation is resolved but remains open. We will close the recommendation once DCAA provides the DoD OIG with the results of the assessment and evidence that training was provided to the audit staff covering the areas identified in the recommendation.

Recommendation 3.b

The Defense Contract Audit Agency Director should consider providing comprehensive refresher training on the documentation requirements in the Government Auditing Standards.

DCAA Director Comments

DCAA disagreed with the recommendation. DCAA did not agree that comprehensive training on documentation is necessary. However, DCAA will provide training in the areas specified in Recommendation 3.a. In addition, DCAA identified updates to guidance and training for documentation topics, including judgmental selection, statistical sampling, and briefing contracts.

Our Response

The DCAA comments addressed the intent of the recommendation; therefore, the recommendation is resolved but remains open.

Although DCAA disagreed with Recommendation 3.b, the additional training being provided in response to Recommendation 3.a, along with the additional guidance and training recently developed for judgmental selection, statistical sampling, and briefing contracts address the intent of the recommendation.

We verified that DCAA took the following recent actions.

- DCAA provided training workshops on judgmental selection and statistical sampling.
- DCAA updated its guidance and for documenting judgmental selections and for briefing contracts.
- DCAA updated its training courses for briefing contracts and for planning procedures to determine compliance with key contract terms.

These actions, along with the actions planned for Recommendation 3.a, effectively address the intent of providing comprehensive refresher training. Therefore, we will close Recommendation 3.b when DCAA provides the DoD OIG with the results of the assessment and evidence that training was provided to the audit staff covering the areas identified in Recommendation 3.a.

Supervision

Deficiency 4. DCAA Did Not Perform Adequate Supervisory Reviews

AT 101.43 states that proper supervision helps ensure that planned procedures are appropriately applied. AT 101.48 states that supervision involves directing the efforts of staff who participate in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing staff and reviewing the work performed. Additionally, the extent of supervision appropriate in a given instance depends on many factors, including the nature and complexity of the subject matter and the qualifications of the persons performing the work.

For 6 of 67 audits (9 percent), we found inadequate or ineffective supervision which impacted the accomplishment of audit objectives. The inadequate supervision contributed to the significant evidence, reporting, or documentation deficiencies we found with each assignment. The deficiencies were apparent, so a reasonable review of the work performed would have identified the deficiencies and prompted the supervisor to initiate corrective action. We found this deficiency in five of the six DCAA regions. The supervisors assigned to the six audits failed to prevent or detect and correct the GAS noncompliances we found. Examples include the following:

- In DCAA Assignment No. 2201-2016H28000001, the supervisor should have recognized that the auditor did not follow procedures agreed upon with the requestor when the auditor incorrectly included a manually-adjusted indirect rate in a draft of the report. The procedures agreed to with the requestor clearly stated that the rates should be based on those included in the contractor's accounting system, which would not include any manual adjustments made outside of the system. Additionally, the supervisor should have recognized that the auditor used language that could lead a reader to believe an examination was performed instead of an agreed-upon procedure. Finally, the supervisor should have noticed that the auditor did not list all procedures performed in a draft of the report in accordance with AT 201.31. As a result, DCAA issued the report without mentioning that one of the agreed-upon procedures included reporting on the contractor's material handling rate.

- In DCAA Assignment No. 1311-2016N21000001, the supervisor should have discovered that the auditor had not completed a critical step of documenting a plan for testing solicitation terms. Additionally, the supervisor should have noticed that the auditor used the contractor’s system-generated reports during transaction testing without verifying the reliability of the reports. Finally, the supervisor should have required that the auditor better explain why the limited testing of labor transactions was sufficient to satisfy the audit objective. As a result, the audit report could not be relied upon because the supervisor did not ensure that the auditor had obtained sufficient evidence in support of the reported opinion.

A supervisor performing an adequate review would have likely prevented or corrected the deficiencies identified in the six assignments.

DCAA Actions on a Previous DoD OIG Recommendation

In the previous review, “DCAA Peer Review: System Review Report,” August 21, 2014, the DoD OIG reported on 11 instances in which DCAA did not document or obtain sufficient evidence to support the reported opinion. To help ensure quality, the DoD OIG recommended that DCAA consider requiring supervisors to complete and certify a checklist that demonstrates they have reviewed the project for compliance with significant GAS requirements.

Rather than implement a checklist, DCAA decided to require that supervisors sign a form referred to as the “Statement on Sufficiency of Evidence,” which certifies that sufficient evidence exists to support the reported opinion. In all six cases, the supervisors signed the statement in accordance with DCAA policy. DCAA should still consider implementing a comprehensive checklist which reminds the supervisor of the several key GAS requirements that must be adhered to by the auditor before the report is issued. Instead of signing a statement, implementing a supervisor checklist may prove a more useful tool for ensuring adequate supervision and compliance with GAS.

Management Comments on the Deficiency and Our Response

DCAA Director Comments

DCAA disagreed with the deficiency, stating that it is a duplication of previously identified findings in other deficiencies, including evidence, reporting, and documentation. Further, DCAA stated that four of the six assignments cited for inadequate supervision are also cited for inadequate professional judgment. DCAA also stated that the issues in these four assignments were not systemic and did not result in an overall supervision deficiency. In addition, DCAA disagreed with the evidence issues discussed in Assignment 2201-2016H28000001 and stated that the limited issues do not support a supervision deficiency.

Our Response

We disagree with DCAA's position. Each standard in GAS, including supervision, outlines separate and distinct requirements; they are not duplicative. The findings we identified in evidence, reporting, documentation, and professional judgment could have been prevented or corrected with adequate supervision. In accordance with AT 101.48, DCAA supervisors should have directed the auditors' efforts to ensure that the objectives of the audit were appropriately accomplished. Failure to appropriately supervise the audit staff in obtaining appropriate evidence, reporting all pertinent information, documenting procedures performed, and exercising professional judgment prevent the objectives of the audit from being accomplished.

Assignment No. 2201-2016H28000001 clearly lacked sufficient evidence to support the audit report, and a prudent supervisory review should have detected the evidence deficiency. In this agreed-upon procedures assignment, the requester asked the auditor to report on indirect rates from the contractor's accounting system. Instead, for one of the more important indirect rates that is applied to all contracts, the auditor reported an adjusted rate of 20-percent rather than the 12-percent rate reflected in the contractor's cost accounting system. The adjusted rate was based on a handwritten \$1.6 million adjustment made by the contractor, but the auditor did not make any inquiries with the contractor to determine the basis or need for the adjustment. Also, the auditor did not mention the adjustment in the report to the contracting officer. An adequate supervisory review would have detected and prevented this deficiency.

Recommendation, Management Comments, and Our Response

Recommendation 4

The Defense Contract Audit Agency Director should assess and improve the quality assurance procedures for assisting supervisors in their reviews of audits, to include ensuring that the auditor sufficiently documents the work, obtains sufficient evidence, and prepares reports that comply with Government Auditing Standards. The Director should consider requiring supervisors to complete a checklist addressing the key professional auditing standards.

DCAA Director Comments

DCAA disagreed with the recommendation because it does not agree that a supervision deficiency exists. In June 2014, DCAA added language to one of its standard working papers, instructing supervisors to assess whether sufficient, appropriate evidence exists to support the audit opinion. Additionally, in October 2015, DCAA added language to the standard working paper, requiring that supervisors sign a statement that they have reviewed the audit package for sufficient, appropriate evidence.

DCAA further responded that four of the six assignments identified by the DoD OIG did not include the required supervisory statement on the sufficiency of evidence. DCAA does not agree that the other two assignments have a supervision deficiency and they did include the supervisory statement. Accordingly, DCAA stated that the supervisory statement on sufficiency of evidence is effective to ensure adequate supervision, and there is no need for an additional checklist. By October 31, 2017, DCAA stated that it would reemphasize Agency policy to ensure that supervisors are completing the statement on sufficiency of evidence.

Our Response

The DCAA comments did not address the specifics of the recommendation; therefore, the recommendation is unresolved and remains open. We disagree with DCAA that four of the six assignments did not include a statement on the sufficiency of evidence. For five of the six assignments, although the exact language of each statement differed slightly, the supervisor signed a statement indicating that sufficient evidence existed to support the opinion. For the remaining assignment, the supervisor signed a statement with modified language to reflect that DCAA issued a disclaimer of opinion report because the contractor did not provide adequate supporting documentation. Therefore, in all six cases, the use of the statement was not effective in helping to ensure that auditors gather sufficient evidence or avoid other GAS noncompliances. Reemphasizing a procedure that has thus far been ineffective is not sufficient to address the DCAA noncompliances with supervision.

We maintain that DCAA should assess and improve the quality assurance procedures for assisting supervisors in their review of assignments for compliance with GAS. DCAA should reconsider requiring supervisors to complete a checklist that covers the key professional auditing standards. Because multiple deficiencies were identified in the areas of evidence, documentation, reporting, and professional judgment, we reiterate that improving supervisory review procedures could result in more DCAA audits that comply with professional standards.

Accordingly, we request that DCAA provide additional comments on response on this recommendation by December 18, 2017, describing the actions that DCAA will take to assess and improve the quality assurance procedures for assisting supervisors in their reviews of audits.

Professional Judgment

Deficiency 5. DCAA Audit Staff Did Not Exercise Professional Judgment in Some Instances

GAS requires that auditors use professional judgement in performing their duties. Some of the key requirements related to professional judgement include the following:

- GAS 3.60 states that auditors must use professional judgment in planning and performing audits and in reporting the results.

- GAS 3.61 indicates that professional judgment includes exercising reasonable care and professional skepticism. Reasonable care includes acting diligently in accordance with applicable professional standards and ethical principles.
- GAS 3.64 states that using professional judgment is important to auditors in carrying out all aspects of their professional responsibilities, including defining the scope of work; evaluating, documenting, and reporting the results of the work; and maintaining appropriate quality control over the audit process.

For 4 of 67 audits (6 percent), we determined that the audit staff did not use appropriate professional judgment. We found multiple evidence, reporting, documentation, or supervision deficiencies among the four audits, leading us to conclude that the audit staff, as a whole, did not exercise reasonable care when conducting the audits.

For example, in DCAA Assignment No. 9871-2008M10100029, the audit staff did not use appropriate professional judgment because they failed to:

- design tests or obtain evidence to determine if proposed costs complied with special contract provisions involving indirect rates, fees, funding, and overtime. The provisions affected approximately 99 percent of the proposed costs. Without performing sufficient steps, the audit staff inappropriately reported that the proposed costs complied with all contract terms, including special contract provisions.
- design tests or obtain evidence to assess the reasonableness of \$27 million in proposed labor and subcontract costs, even though they reported that the costs were reasonable. Although the audit staff had planned to perform reasonableness testing of labor and subcontract costs, no such testing was ultimately performed.
- include a scope limitation in the report explaining that \$600,000 in costs had not yet been audited. Also, the audit team did not refer to the costs as “unresolved,” in the report exhibits, as DCAA’s procedure requires. The scope limitation was omitted from the report even though the auditor and supervisor documented the need for it during the audit planning phase. Instead of including the scope limitation, the audit staff inappropriately reported to the audit requester that the \$600,000 in unaudited costs were allowable on Government contracts.
- distribute the audit report to the contracting officer charged with taking action on the audit findings, as DCAA policy requires. As a result, the contracting officer may have unknowingly reimbursed DCAA-questioned costs to the contractor that did not comply with the Federal Acquisition Regulation (FAR).

The number and significance of the deficiencies demonstrate that the audit staff did not exercise reasonable care in conducting the audit. As a result of the deficiencies, users of the resulting audit report could not rely on the reported conclusions.

We found a professional judgment deficiency in four of the six DCAA regions. DCAA needs to consider additional training to ensure that its audit staff understands the requirements and expectations for exercising reasonable care.

Management Comments on the Deficiency and Our Response

DCAA Director Comments

DCAA agreed that three of the four assignments lacked professional judgment. Other than a lack of documentation, DCAA indicated that, overall, Assignment No. 1311-2016N21000001 complied with the GAS standards.

Our Response

We disagree that Assignment No. 1311-2016N21000001 generally complied with the GAS standards. In addition to not adequately documenting the work performed, the audit staff for Assignment No. 1311-2016N21000001 did not exercise appropriate professional judgment because they failed to:

- perform procedures to ensure that historical labor data was in compliance with the FAR. Because these procedures were not performed, the data on which the proposed costs were estimated could have included costs that were not allowable, allocable, or reasonable.
- reconcile the contractor's production report to source documents in order to validate its reliability. The auditors relied on the production report for their analysis of proposed labor hours. Without reconciling the report to source documents, the auditors may have relied on inaccurate information.
- perform adequate testing of direct labor and indirect costs. Testing was limited, and the auditor did not document in the working papers why the testing was sufficient to satisfy the audit objective. For proposed direct labor, the auditor tested only \$3,950 worth of transactions out of the \$1.4 million in proposed direct labor (0.3 percent of proposed direct labor costs). For indirect costs, the auditor tested only \$727,000 of the \$47.1 million in indirect costs (1.5 percent of indirect costs).
- adequately test for compliance with the Government's solicitation terms, even though the reported opinion addressed whether contractor complied with solicitation terms. For example, the Government solicitation addressed special solicitation terms for vendor parts. However, the auditors did not plan or perform procedures to test compliance with solicitation terms related to vendor parts. As a result, the auditors did not adequately plan the audit to ensure costs complied with the Government solicitation terms.

Collectively, the failures associated with Assignment No. 1311-2016N21000001 demonstrate that the audit staff did not exercise reasonable care in conducting the assignment.

Therefore, we maintain that the audit staff associated with 4 of the 67 assignments we reviewed did not use appropriate professional judgement in accordance with GAS.

Recommendation, Management Comments, and Our Response

Recommendation 5

We recommend that the Defense Contract Audit Agency Director provide the audit staff with training on the requirement and expectation for exercising professional judgment and for adhering to other key Government Auditing Standards, including evidence, planning, reporting, and documentation.

DCAA Director Comments

DCAA agreed in principle with the recommendation. DCAA plans to provide training to the four DCAA field offices where the professional judgment noncompliances were found. Additionally, the four offices will coordinate with the audit requestor to determine if there is a benefit to the Government to supplement audit work in order to make the audits compliant with GAGAS. If the Government will not benefit, the audit office will issue a memorandum to the contracting officer stating that the audit was not performed in accordance with GAGAS and the report should not be relied upon.

Our Response

The DCAA comments did not address the specifics of the recommendation; therefore, the recommendation is unresolved and remains open. DCAA agreed to provide training to only the four offices where we found the deficiency. Our recommendation is to provide training to all DCAA audit staff.

As discussed in GAS 3.64, using professional judgment is important to auditors in carrying out all aspects of their professional responsibilities, such as defining the scope of work; evaluating, documenting, and reporting the results of the work; and maintaining appropriate quality control over the audit process.

We reviewed a statistical sample of 67 DCAA assignments from a universe of 4,251 DCAA audit reports issued between July 2015 and June 2016. We found a professional judgment noncompliance in 4 of the 67 assignments we reviewed, which equals a 6-percent noncompliance rate. After applying the statistically based 6-percent rate to the universe of 4,251 audits, the resulting estimate is that 255 audits within the universe may not have complied with the professional judgment standard. It should also be noted that we found the professional judgment deficiency in four of the six DCAA regions. The statistically based results demonstrate that the professional judgement deficiency is not isolated to the four DCAA field offices. Therefore, training only the four offices on the professional judgment issue would not comprehensively address the issue or help to ensure that DCAA auditors agency-wide take reasonable care in the performance of their duties. Accordingly, the entire DCAA audit staff would benefit from training on the requirement and expectation for exercising professional judgment.

We request that DCAA provide additional comments on Recommendation 5 by December 18, 2017, describing the training that DCAA will provide on the GAS professional judgment standard and other key GAS standards.

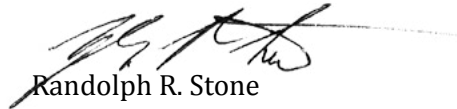
For the four assignments which lacked professional judgment, we agree with DCAA's plan to require that the four DCAA field offices:

- coordinate with the audit requester on the benefits of supplementing the audit work,
- perform additional audit work to make the assignments compliant with GAS (if the Government will benefit from the additional audit work), and
- issue memorandums to the audit requesters stating that the audits did not comply with GAS and the report should not be relied upon.

Once completed, we request that DCAA provide the DoD OIG with evidence that the four field offices have completed the three actions.

As is customary, we are issuing a letter of comment that will set forth findings that were not considered to be of sufficient significance to affect our opinion expressed in this report.

We appreciate the courtesies extended to the staff. For additional information on this report, please contact Ms. Carolyn R. Hantz at (703) 604-8877 (DSN 664-8877) or Carolyn.Hantz@dodig.mil.



Randolph R. Stone
Deputy Inspector General
Policy and Oversight

Enclosures:
As stated

Enclosure 1

Scope and Methodology

We reviewed DCAA's system of quality control in effect for the year ended June 30, 2016. We conducted our review from May 2016 to October 2017 in accordance with GAS and the Council of the Inspectors General on Integrity and Efficiency *Guide for Conducting Peer Reviews of the Audit Organizations of Federal Offices of Inspector General*. As part of the review, we:

- reviewed quality control procedures used by DCAA to help ensure compliance with GAS;
- selected a random sample of 69 DCAA employee training records to determine if the employees obtained the required number of continuing professional education hours;
- interviewed 69 employees to assess their knowledge of GAS;
- initiated a review of services that DCAA referred to as non-audit services.⁴ We discontinued the review after determining that the services do not meet the definition of non-audit services in GAS because DCAA performs the services on the behalf of a Government contracting officer, not the auditee (DoD contractor);
- reviewed a non-statistical sample of 16 internal quality reviews performed by the DCAA Quality Directorate to determine the adequacy and comprehensiveness of the reviews;
- evaluated a non-statistical sample of 50 cancelled audits to determine if DCAA complied with GAS requirements pertaining to cancelled audits; and
- reviewed a reasonable cross-section of 67 assignments to determine the extent to which the audits complied with GAS requirements for attestation engagements (see Table 1). We statistically selected the 67 audits among 4,251 audits that DCAA issued between July 1, 2015 and June 30, 2016.

Table 1. Selected DCAA Assignments

| | DCAA Region | Field Audit Office | Assignment Number | Assignment Type |
|---|-------------|--------------------|--------------------|----------------------|
| 1 | Central | Rocky Mountain | 3151-2010E10100597 | Incurred Cost |
| 2 | Central | Rocky Mountain | 3151-2015E19100009 | Disclosure Statement |
| 3 | Central | Wichita | 3161-2012J10100028 | Incurred Cost |
| 4 | Central | Wichita | 3161-2015F21000010 | Price Proposal |
| 5 | Central | Wichita | 3161-2015J19100001 | Disclosure Statement |
| 6 | Central | Wichita | 3161-2015J19100002 | Disclosure Statement |
| 7 | Central | St. Louis | 3201-2009R10100006 | Incurred Cost |
| 8 | Central | Salt Lake Valley | 3231-2009M10100046 | Incurred Cost |

⁴ GAS 2.12 defines nonaudit services as professional services other than audits or attestation engagements.

Table 1. Selected DCAA Assignments (cont'd)

| | DCAA Region | Field Audit Office | Assignment Number | Assignment Type |
|----|------------------|-------------------------|--------------------|-----------------------------------|
| 9 | Central | Salt Lake Valley | 3231-2014L23000005 | Forward Pricing Rates |
| 10 | Central | Salt Lake Valley | 3231-2016L21000002 | Price Proposal |
| 11 | Central | Houston | 3521-2016J27010003 | Cost Realism |
| 12 | Central | Houston | 3531-2011E10100006 | Incurred Cost |
| 13 | Central | Richardson | 3531-2014L19200001 | CAS Noncompliance |
| 14 | Eastern | Nashville | 1211-2009E10100009 | Incurred Cost |
| 15 | Eastern | Nashville | 1211-2015D17740002 | Preaward Accounting System Design |
| 16 | Eastern | New Orleans | 1241-2009S10100009 | Incurred Cost |
| 17 | Eastern | Alabama | 1261-2016A17740001 | Preaward Accounting System Design |
| 18 | Eastern | Tampa Bay | 1271-2012G10100001 | Incurred Cost |
| 19 | Eastern | Carolina | 1281-2015B17741003 | Post Award Accounting System |
| 20 | Eastern | Greenville | 1291-2015H23000001 | Forward Pricing Rates |
| 21 | Eastern | Space Coast | 1311-2015S11090004 | System Deficiency |
| 22 | Eastern | Space Coast | 1311-2016N21000001 | Price Proposal |
| 23 | Eastern | Lockheed Martin Orlando | 1461-2010H10100001 | Incurred Cost |
| 24 | Eastern | Lockheed Martin Orlando | 1461-2016B21000003 | Price Proposal |
| 25 | Eastern | Dayton | 1641-2016G21000001 | Price Proposal |
| 26 | Eastern | GE Cincinnati | 1731-2011G10100001 | Incurred Cost |
| 27 | Eastern | Gulf Coast | 1751-2015C17600001 | Financial Capability |
| 28 | Field Detachment | Shenandoah | 9711-2014E19100005 | Disclosure Statement |
| 29 | Field Detachment | Northeast | 9721-2015A23000001 | Forward Pricing Rates |
| 30 | Field Detachment | Northeast | 9721-2016A23300001 | Restructuring Proposal |
| 31 | Field Detachment | South Central | 9741-2011A19100002 | Disclosure Statement |
| 32 | Field Detachment | Great Western | 9761-2009E10100005 | Incurred Cost |
| 33 | Field Detachment | Great Western | 9761-2011E10100002 | Incurred Cost |
| 34 | Field Detachment | West Coast | 9841-2009G10100001 | Incurred Cost |
| 35 | Field Detachment | Bull Run | 9871-2008M10100029 | Incurred Cost |
| 36 | Field Detachment | Dulles | 9881-2014E19100006 | Disclosure Statement |
| 37 | Mid Atlantic | Herndon | 6161-2009G10100035 | Incurred Cost |

Table 1. Selected DCAA Assignments (cont'd)

| | DCAA Region | Field Audit Office | Assignment Number | Assignment Type |
|----|--------------|---|--------------------|----------------------------|
| 38 | Mid Atlantic | CSC | 6211-2015C23000002 | Forward Pricing Rates |
| 39 | Mid Atlantic | Lockheed Martin Rockville | 6271-2015B23000001 | Forward Pricing Rates |
| 40 | Mid Atlantic | Reston | 6321-2008V10100027 | Incurred Cost |
| 41 | Mid Atlantic | Reston | 6321-2010M10100035 | Incurred Cost |
| 42 | Mid Atlantic | Reston | 6321-2010V10100022 | Incurred Cost |
| 43 | Mid Atlantic | Springfield | 6331-2015M17740006 | Preaward Accounting System |
| 44 | Mid Atlantic | Southern New Jersey | 6341-2016C17500001 | Progress Payment |
| 45 | Mid Atlantic | Lockheed Martin Mr. Laurel | 6501-2010T10100001 | Incurred Cost |
| 46 | Mid Atlantic | Lockheed Martin Mr. Laurel | 6501-2016C21000002 | Price Proposal |
| 47 | Mid Atlantic | Virtual Incurred Cost Team 2 | 6701-2011N10100008 | Incurred Cost |
| 48 | Mid Atlantic | Northrop Grumman Electronic Sector | 6711-2008K10100007 | Incurred Cost |
| 49 | Mid Atlantic | Northrop Grumman Electronic Sector | 6711-2013B19200001 | CAS Noncompliance |
| 50 | Mid Atlantic | BAE York | 6811-2008U10100001 | Incurred Cost |
| 51 | Mid Atlantic | BAE York | 6811-2009U42000001 | Defective Pricing |
| 52 | Mid Atlantic | Northrop Grumman Electronic Business System | 6841-2014N17500001 | Progress Payment |
| 53 | Mid Atlantic | Valley Forge | 6851-2016M19100001 | Disclosure Statement |
| 54 | Mid Atlantic | NGAS Bethpage | 6871-2014D11090001 | System Deficiency |
| 55 | Northeastern | Northern New England | 2161-2010P10100020 | Incurred Cost |
| 56 | Northeastern | Boston | 2171-2010L10100003 | Incurred Cost |
| 57 | Northeastern | Boston | 2171-2010P10100001 | Incurred Cost |
| 58 | Northeastern | Long Island | 2201-2016H28000001 | Agreed Upon Procedure |
| 59 | Northeastern | Sikorsky Aircraft | 2641-2015A21000006 | Price Proposal |
| 60 | Western | San Diego | 4151-2015D17740004 | Preaward Accounting System |
| 61 | Western | Los Angeles/Orange County South IC | 4231-2010V10100023 | Incurred Cost |
| 62 | Western | Silicon Valley | 4281-2010U10100013 | Incurred Cost |

Table 1. Selected DCAA Assignments (cont'd)

| | DCAA Region | Field Audit Office | Assignment Number | Assignment Type |
|----|-------------|------------------------------------|--------------------|----------------------------|
| 63 | Western | Silicon Valley | 4281-2016U17740002 | Preaward Accounting System |
| 64 | Western | Miramar | 4531-2015V23000002 | Forward Pricing Rates |
| 65 | Western | Miramar | 4531-2016P21000003 | Price Proposal |
| 66 | Western | Los Angeles/Orange County North IC | 4901-2009C10100002 | Incurred Cost |
| 67 | Western | Los Angeles/Orange County North IC | 4901-2010C10100001 | Incurred Cost |

Enclosure 2

Table 2. Deficiencies by DCAA Assignment Number

| | DCAA Assignment Number | Type of Engagement | Finding | | | | |
|----|------------------------|-----------------------|----------|-----------|---------------|-------------|-----------------------|
| | | | Evidence | Reporting | Documentation | Supervision | Professional Judgment |
| 1 | 03151-2010E10100597 | Incurred Cost | | | X | | |
| 2 | 03161-2012J10100028 | Incurred Cost | | | X | | |
| 3 | 03201-2009R10100006 | Incurred Cost | X | | | | |
| 4 | 03231-2009M10100046 | Incurred Cost | X | X | X | X | X |
| 5 | 03231-2014L23000005 | Forward Pricing Rates | | | X | | |
| 6 | 03531-2011E10100006 | Incurred Cost | X | | | | |
| 7 | 01241-2009S10100009 | Incurred Cost | X | X | | | |
| 8 | 01271-2012G10100001 | Incurred Cost | X | X | X | | |
| 9 | 01311-2016N21000001 | Price Proposal | X | | X | X | X |
| 10 | 01461-2010H10100001 | Incurred Cost | X | | | | |
| 11 | 01461-2016B21000003 | Price Proposal | X | | | | |
| 12 | 09841-2009G10100001 | Incurred Cost | X | | | | |
| 13 | 09871-2008M10100029 | Incurred Cost | X | X | | X | X |
| 14 | 06161-2009G10100035 | Incurred Cost | X | | | X | |
| 15 | 06271-2015B23000001 | Forward Pricing Rates | | X | | | |
| 16 | 06321-2008V10100027 | Incurred Cost | | | X | | |
| 17 | 06321-2010M10100035 | Incurred Cost | X | | | | |
| 18 | 06321-2010V10100022 | Incurred Cost | X | | X | | |
| 19 | 06701-2011N10100008 | Incurred Cost | X | | | | |

Table 2. Deficiencies by DCAA Assignment Number (cont'd)

| | DCAA Assignment Number | Type of Engagement | Finding | | | | |
|--------------|------------------------|-----------------------|-----------|-----------|---------------|-------------|-----------------------|
| | | | Evidence | Reporting | Documentation | Supervision | Professional Judgment |
| 20 | 06711-2008K10100007 | Incurring Cost | | X | | | |
| 21 | 06811-2008U10100001 | Incurring Cost | X | X | X | X | X |
| 22 | 06851-2016M19100001 | Disclosure Statement | | X | | | |
| 23 | 02161-2010P10100020 | Incurring Cost | X | | | | |
| 24 | 02201-2016H28000001 | Agreed Upon Procedure | X | | | X | |
| 25 | 04901-2010C10100001 | Incurring Cost | X | | | | |
| Total | | | 18 | 8 | 9 | 6 | 4 |

Enclosure 3

Management Comments on Selected Assignments and Our Response

1. Assignment No. 1271-2012G10100001

DCAA Director Comments

DCAA Assignment No. 1271-2012G10100001 involved an audit of \$56 million over 3 fiscal years. DCAA disagreed that testing for reasonableness of \$22 million in proposed salaries was not performed. The audit report stated that another DCAA office was testing reasonableness of executive compensation. The testing performed was sufficient because the total impact to Government contracts was \$779,000.

DCAA also disagreed with our position that commercial maintenance-software license costs were not tested for reasonableness. DCAA stated that the auditors tested for reasonableness by ensuring the costs were ordinary and necessary. In addition, the auditors determined the costs were incurred within the appropriate period and paid appropriately. This testing was sufficient as the impact was \$82,000.

Our Response

We disagree with DCAA's position that there was sufficient reasonableness testing. The auditors selected the salaries, wages, and maintenance-software license accounts based on materiality. However, the auditors also identified risk factors that required them to design tests to address the risk. In the risk assessment, the auditors did not determine if the contractor had internal controls that would ensure the reasonableness of salaries and wages or maintenance-software license costs. Without this understanding, the auditors would be unable to adequately assess the risk of misstatement due to reasonableness. During their review of prior audits, the auditors also noted a prior finding in which the contractor did not identify and segregate unallowable costs. In addition, using a trend analysis, the auditors determined there was a significant increase in maintenance-software license costs incurred in one of the years under audit. Based on the risks identified, the auditors planned to perform reasonableness testing of the selected accounts.

For the salaries and wages account, the auditors stated they would perform reasonableness testing in addition to the testing performed for executive compensation. Executive compensation represented the compensation of one employee. The contractor was required to identify its five highest compensated executives. In this audit, the contractor indicated there was only one executive which met the requirement. Therefore, we agreed with the

auditors' decision to test salaries and wages in addition to executive compensation because this would allow the auditors to get better coverage of the account. However, based on the working paper documentation and subsequent discussions with the auditors, we determined that reasonableness testing of nonexecutive compensation was not performed.

For the maintenance-software license account, the auditors planned to test the account for reasonableness. The auditors did verify that the maintenance-software license costs were incurred and paid. However, the auditors did not test the costs for reasonableness. Reasonableness cannot be established solely by reviewing invoices and payment documentation. In addition, the auditors did not perform testing to address the significant increase in costs noted by the auditors.

Although materiality should be considered when determining the extent of testing, the testing performed should also address other risk factors identified by the auditor during the risk assessment.

2. Assignment No. 3201-2009R10100006

DCAA Director Comments

DCAA stated the evidence issue cited for this assignment does not rise to the level of an evidence deficiency. The auditor limited testing of the Recruitment & Relocation and Miscellaneous accounts (representing approximately \$410,000) to a reconciliation and verified that no mark-ups or profit was applied to the claimed costs. There is no documentation identifying why the testing performed was considered sufficient to address the reasonableness and allowability of the costs in these accounts. However, when considering the impact on Government flexibly priced contracts, these costs represented a risk of only \$64,000.

Our Response

We disagree with DCAA. The audit report concluded that the costs in Recruitment & Relocation and Miscellaneous accounts were reasonable and allowable under applicable FAR Part 31 provisions. However, the auditor did not obtain documentation that supports this conclusion.

The auditor established a materiality threshold of \$25,000 in net savings during the planning stage of the audit. If the auditor appropriately tested the accounts worth \$410,000 for reasonableness and allowability, the auditor could have questioned all or part of the costs and saved the Government significantly more than the \$25,000 savings threshold established by the auditor.

In addition, the auditor documented that he had selected the accounts for testing based on additional risk factors. Regarding the Recruitment & Relocation account, the auditor selected the account for testing because he documented that the prior audit had reported significant questioned costs in the account. Regarding the Miscellaneous account, the auditor documented that the costs booked to the account had increased significantly over the previous year. The auditor did not perform any testing to appropriately address these documented risk factors.

3. Assignment No. 4901-2010C10100001

DCAA Director Comments

DCAA stated that the legal and miscellaneous costs of \$2.5 million are immaterial, and failing to test these costs for reasonableness should not result in an evidence deficiency. The auditor questioned \$1.2 million of the combined \$2.5 million claimed in these accounts and the remaining amount, after factoring the impact on Government flexibly-priced contracts, is only \$227,000. The auditor did not clearly document why the testing performed was sufficient.

Our Response

We disagree with DCAA's opinion that the legal and miscellaneous costs were immaterial. The DCAA auditor determined a \$100,000 materiality threshold for testing. The legal account and miscellaneous account exceeded the auditor's threshold, and the auditor noted prior audits questioned a significant amount of legal and miscellaneous costs.

The auditor concluded that the costs were reasonable without obtaining any evidence to reach this conclusion.

4. Assignment No. 2201-2016H28000001

DCAA Director Comments

DCAA stated that an evidence issue involving 1 of 27 proposed rates should not result in an overall determination that the audit lacked sufficient evidence. However, DCAA acknowledges that the auditor should have contacted the requestor to clarify the agreed upon procedure to report the actual rates from the contractor's accounting system.

Our Response

We maintain that the auditor did not obtain sufficient evidence. The auditor did not report the correct general and administrative rate in accordance with the procedures agreed to with the requestor. Rather than report a 12-percent rate from the contractor's accounting system, the auditor reported a 20-percent rate (a 67-percent higher rate). The higher 20-percent rate resulted from the contractor making a hand-written addition of \$1.6 million to the costs

booked in the contractor's accounting system. Because the \$1.6 million addition was not entered in the contractor's accounting system, it effectively bypassed the internal controls built into the accounting system. However, the auditor failed to ask the contractor to explain the \$1.6 addition or request support for it.

Although the general and administrative rate encompassed 1 of 27 proposed rates, the application of the general and administrative rate resulted in significant additional costs for each of the contractor's Government contracts. Therefore, the Government impact of reporting a 67-percent higher general and administrative rate was significant.

5. Assignment No. 1241-2009S10100009

DCAA Director Comments

DCAA disagreed that the failure to test the reasonableness of direct material costs warranted an evidence finding and stated that the significance is minimal due to immateriality of the cost element. DCAA further indicated that the testing is adequate because the materials purchased were commercial in nature, which indicates that the prices paid were reasonable. Additionally, the auditor performed testing on the proposed costs by tracing them to vendor invoices and verifying payment of the materials.

Our Response

We disagree with DCAA's position that failure to test reasonableness of direct material costs is insignificant. The auditor documented during planning that the audit risk associated with direct material costs was increased because no audit of material costs was performed during the fiscal year under review. The auditor further stated that transaction testing would be necessary to address this risk. Additionally, purchasing commercial items does not automatically equate to price reasonableness. According to FAR 15.403(c)(1), "the fact that a price is included in a catalog does not, in and of itself, make it fair and reasonable." Therefore, reasonableness cannot be established solely by reviewing invoices and payment records. There is no evidence in the audit package to support that the auditor tested the direct material costs for reasonableness, even though the audit opinion states that all costs are allowable, allocable, and reasonable.

6. Assignment No. 6161-2009G10100035

DCAA Director Comments

DCAA stated that the evidence issue cited for this assignment is immaterial and the lack of a determination of noncompliance on a cost does not imply that the costs are compliant because the overall disclaimer of opinion is explained in the report. Further, DCAA stated that the two accounts with the cited evidence issue are immaterial as the discrepancy relates to only \$120,000.

Our Response

The auditor is required by AT 101.51 and DCAA policy to have adequate evidence to support the reported conclusions. Although the auditor issued a disclaimer of opinion report, the auditor chose to present conclusions in the report based on audit procedures they were able to perform. The auditor presented the conclusions in a table which included columns for requested costs, unsupported costs, and inadequately supported costs. The following table reflects an excerpt of the table included in the DCAA report covering the conclusions on proposed indirect costs.

Table 3. Excerpt of Table in DCAA Audit Report Number 6161-2009G10100035

| Indirect Account Description | Requested Costs | Unsupported Costs | Inadequately Supported Costs |
|------------------------------|------------------|-------------------|------------------------------|
| General & Administrative | \$ 57,690 | \$50,190 | \$0 |
| Service Center Labor | 114,342 | 1,370 | 0 |
| Total | \$172,032 | \$51,560 | \$0 |

The requested costs reflect the costs that DCAA selected for testing within the two indirect accounts. DCAA requested the contractor to provide supporting documentation for the requested costs. The table could mislead the user to conclude that the contractor had adequately supported the total difference between the requested costs and the unsupported costs (\$120,472). However, the DCAA audit file does not reflect that the auditor received adequate support for the difference. Therefore, DCAA did not gather sufficient evidence to determine that the \$120,472 was supported.

We disagree with DCAA that \$120,472 is not material to the reported opinion. The \$120,472 represents approximately 7 percent of the indirect costs that DCAA selected for testing, and this amount is significant in relation to the \$50,190 and \$1,370 amounts that DCAA reported as unsupported.

7. Assignment No. 1311-2016N21000001

DCAA Director Comments

DCAA disagreed that Assignment No. 1311-2016N21000001 lacked professional judgment and sufficient evidence and stated that an adverse opinion was issued for this assignment, which adequately protected the Government's interests. DCAA further stated that numerous noncompliances and scope limitations were identified in the audit report. Overall, DCAA stated that the audit staff planned, performed, and supervised the audit in accordance with professional standards.

Our Response

We maintain that the auditor failed to obtain sufficient evidence to support the audit conclusions and the audit staff did not exercise appropriate professional judgment. We noted deficiencies in evidence, documentation, and planning which supports our position that Assignment No. 1311-2016N21000001 lacked professional judgment. The issuance of an adverse opinion alone does not automatically protect the Government's interests or eliminate the obligation of the auditor to perform appropriate audit procedures and report all significant noncompliances and limitations associated with those procedures. Based on the deficiencies we found, DCAA should have performed additional procedures and reported on additional noncompliances that may have resulted from the procedures. Additionally, the scope limitations identified in the audit report were not sufficient to accurately inform the report user of the work that was not performed. Therefore, the Government's interests were not fully protected because the auditor did not gather sufficient evidence to provide an opinion on all significant areas of proposed costs or inform the report user of all significant limitations on the scope of the audit.

We found four significant deficiencies associated with Assignment No. 1311-2016N21000001 that led us to conclude the audit staff did not exercise appropriate professional judgment. First, the auditors did not obtain sufficient evidence to determine that historical labor data were allowable, allocable, and reasonable in compliance with the FAR. The auditors accepted the historical direct labor rates based solely on reconciling the historical costs to the contractor's records. This reconciliation is not sufficient to determine that the costs were allowable, allocable, and reasonable in compliance with the FAR.

Second, the auditors relied on a production report provided by the contractor to determine if the proposed labor hours were allowable, allocable, and reasonable. The auditors failed to verify the accuracy of the contractor's production report to source documents in order to validate the report's reliability. Without verifying the report to source documents, the auditors could have relied on inaccurate information. Additionally, the auditors did not establish that the hours in the production report were allowable, allocable, and reasonable in accordance with the FAR.

Third, the DCAA auditors did not gather sufficient evidence to support the conclusions for proposed direct labor and indirect costs. For direct labor, the auditors tested only \$3,950 of \$1.4 million in proposed direct labor costs (0.3 percent of proposed direct labor was tested). For indirect costs, the auditors tested only \$726,767 of \$47.1 million of proposed costs (1.5 percent of indirect costs were tested). Testing was limited, and the auditors did not document in the working papers why the testing was sufficient to satisfy the audit objective of determining if the costs were allowable, allocable, and reasonable in accordance with the FAR.

Fourth, the auditors did not adequately plan for testing compliance with Government solicitation terms, even though the reported opinion addressed whether the contractor proposal complied with solicitation terms. For example, the Government solicitation addressed the special solicitation terms for vendor parts. However, the auditors did not plan procedures to test the solicitation terms for vendor parts. As a result, the auditors did not adequately plan the audit to ensure that the proposed costs complied with the Government's solicitation terms.

Collectively, the four deficiencies associated with Assignment No. 1311-2016N21000001 demonstrate that the audit staff did not take reasonable care to comply with GAS.

Enclosure 4

DCAA Director Comments



DEFENSE CONTRACT AUDIT AGENCY
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

September 5, 2017

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL, POLICY AND OVERSIGHT,
OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF
DEFENSE

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System
Review Draft Report (Project No. D2016-DAPOCF-0122.000)

We appreciate the opportunity to respond to the subject draft report, dated August 1, 2017 and the time you spent discussing the issues with the DCAA staff.

We have performed a detailed review of the findings and concur with the pass with deficiencies rating. We agree with DoDIG's overall conclusion on the Documentation and Evidence deficiencies, but we don't agree the other three deficiencies rise to the level of a deficiency reportable in the report on the system quality controls as they are not pervasive as defined in the Guide for Conducting Peer Reviews of Audit Organizations of Federal Offices of the Inspector General, Reporting the External Peer Review Results, dated September 2014. In addition, we believe that the DoDIG overstated its conclusions by citing the same finding under several deficiencies. For example, for assignment 6811-2008U10100001, we concur that the audit lacked sufficient evidence; however, the DoDIG cited the same assignment for supervision, reporting, and professional judgment even though the root cause of the problem was lack of evidence.

We also disagree that several of the findings reported under the Evidence and Reporting Deficiencies meet the definition of deficiency as defined by the "Guide" which states, "The significance of disclosed findings in the selected audits reviewed should be determined by the *extent the reports could not be relied upon due to the failure of the reports and underlying work*, including documentation, to adhere to GAGAS" [*emphasis added*]. For those we question we do not believe the users' ability to rely on the report was significantly impacted and therefore did not rise to the level of a system deficiency.

We disagree with several of the recommendations because we don't believe they will address the root cause of the issues. For those recommendations we do agree with, we have already implemented several actions that we believe will correct many of the issues. In addition to actions we have already taken, we propose that we identify the root causes of the findings and develop corrective actions that more directly address the cited deficiencies. We appreciate your consideration of these proposed alternative corrective actions.

Identified below are our comments relative to deficiencies and associated recommendations included in the draft report.

DCAA Director Comments (cont'd)

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System Review Draft Report (Project No. D2016-DAPOCF-0122.000)

Deficiency 1 – DCAA Did Not Obtain Sufficient Evidence: For 18 of 67 (27 percent) audits we selected for review, we found one or more instances in which DCAA auditors did not obtain sufficient, appropriate evidence to support an opinion expressed in the report.

DCAA Comments on Deficiency: Of the 18 assignments identified as lacking sufficient, appropriate evidence, we disagree with the findings on several of the assignments because many of the identified issues do not rise to the level of a finding or overall deficiency. We do not believe that the DoDIG considered materiality in reporting the findings, many of which are not material enough to impair the reliability of the audit report. For example, in Assignment No. 4901-2010C10100001, the DoDIG cited the audit of a \$133 million corporate office cost submission as not obtaining sufficient evidence to express an opinion on the reasonableness of legal cost and miscellaneous costs. Legal costs and miscellaneous costs (\$2.5 million) together equate to only two percent of the claimed costs and we questioned \$1.2 million of the \$2.5 million. Given the total amount of the legal and miscellaneous costs compared to the overall cost submission and the significant number of audit steps performed (over 100 detailed audit steps), we disagree with the DoDIG conclusion that not testing these immaterial costs for one element of allowability results in an overall evidence finding. This example along with six other examples where we believe either materiality was not appropriately considered or the facts do not support the findings are described in more detail in the Enclosure to this response.

DoDIG Recommendation #1: The Director, Defense Contract Audit Agency, should assess the Defense Contract Audit Agency quality control procedures for providing reasonable assurance that auditors obtain sufficient and appropriate evidence in support of reported conclusions. As part of the assessment, the Director should:

- a. Provide refresher training to auditors on the requirements and techniques for obtaining sufficient and appropriate evidence of reported conclusions;
- b. Develop standard audit steps that assist auditors in developing and performing tests for examining the:
 - (1) Reasonableness of proposed costs.
 - (2) Contractor's compliance with contracts terms, including special contract provisions.
- c. Assess and improve Defense Contract Audit Agency procedures for performing independent reference reviews to ensure adequate coverage of completed audits. Consider requiring a minimum number of additional independent reference reviews that field audit offices must perform, and monitoring field audit offices to ensure compliance with the requirements.

DCAA Comments on Recommendations: Nonconcur because we don't believe the recommendations address the root cause and therefore, won't be effective in resolving the issue. We propose alternative corrective actions. Based on our review, we concur that some of the assignments lacked sufficient evidence in two prime areas (1) reasonableness of claimed costs,

DCAA Director Comments (cont'd)

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System Review Draft Report (Project No. D2016-DAPOCF-0122.000)

and (2) compliance with special contract terms. However, we disagree with Recommendation 1.a., because it is not specific to the identified areas of concern (i.e., testing for reasonableness and contract terms). Merely providing broad-based training to the workforce on obtaining sufficient and appropriate evidence would not be efficient and would not effectively address the root causes. However, we will provide training as deemed necessary to address the specific areas of reasonableness and contract terms once we complete the assessment discussed below.

We also disagree that standard audit steps should be included in the audit programs to address the areas of concern. However, we will assess current Agency policy to address the testing for reasonableness of proposed costs and compliance with contract terms to determine the most appropriate action that will correct these conditions (Recommendation 1.b.) to include any changes to standard audit programs. We will complete this assessment by December 31, 2017.

As to Recommendation 1.c., we disagree with the recommendation that we need to assess and improve the independent reference review (IRR) process. We do not believe this will address the root cause of the evidence issues. As identified by the DoDIG, DCAA expanded the use of IRRs in 2016 and we believe this improved the process. We will reemphasize the importance of the updated IRR policy to ensure the staff understands the importance of the program and uses it as envisioned.

DCAA has issued guidance and enhanced its training in the past two years related to ensuring sufficient appropriate evidence is gathered in support of reported conclusions that we believe will assist in addressing many of the deficiencies cited by the DoDIG. For example:

- In February 2015, the Selected Areas of Cost Guidebook: FAR 31.205 Cost Principles was posted and many chapters include specific information pertaining to testing for reasonableness;
- In the summer of 2015, the live Incurred Cost course (1145-AUD210) was updated and includes guidance on planning procedures to determine whether the claimed amounts comply with the key contract terms; and
- In February 2017, DCAA updated the E-learning Briefing Contracts course (1121-AUD126E) and provides guidance on the importance of identifying special contract provisions when briefing contracts.

Deficiency 2 – DCAA Did Not Report on Pertinent Information or Scope Restrictions: For 8 of 67 (12 percent) audits, DCAA did not appropriately communicate pertinent information or important limitations to the contracting officer.

DCAA Comments on Deficiency: We disagree with the DoDIG conclusions that support this deficiency. The DoDIG identified eight reporting noncompliances where DCAA did not appropriately communicate pertinent information or important limitations to the contracting officer. In our opinion, no systemic or pervasive conditions were found supporting Audit

DCAA Director Comments (cont'd)

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System Review Draft Report (Project No. D2016-DAPOCF-0122.000)

Reporting as a deficiency. The resulting DoDIG recommendations address two areas of concern, specifically, (1) disclaimers of opinion, and (2) scope limitations. Of the eight assignments identified by the DoDIG, two relate to disclaimers of opinion and three relate to scope limitations. The remaining issues either do not rise to a level of a deficiency or do not represent a systemic condition. Our comments on some of the individual assignments identified by the DoDIG are detailed below:

The DoDIG stated that Assignment No. 6711-2008K10100007 (Disclaimer of Opinion) contained a piecemeal opinion in the "Report on Other Matters" appendix. We disagree. Under the "Auditor's Responsibility" section of the report, it clearly states:

"Our responsibility is to express an opinion on [contractor name] compliance based on conducting the examination in accordance with Generally Accepted Government Auditing Standards (GAGAS). However, because of the matters described in the Basis for Disclaimer of Opinion paragraph, *we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion*" [emphasis added].

Further, under the "Basis for Disclaimer of Opinion" section of the report, it stated:

"*We were unable to carry out all of the appropriate audit procedures necessary to complete audits of the [contractor name] FY 2008 and FY 2009 proposed local costs. Due to contractor internal control deficiencies, denials of access to required information, inadequate incurred cost submissions, and imposed time constraints we have been unable to obtain sufficient appropriate audit evidence on which to base an opinion on the proposed local costs*" [emphasis added].

The verbiage above clearly indicates that a disclaimer of opinion is being rendered on the assertion. When issuing a disclaimer of opinion, the audit team, in accordance with GAGAS, must report any material noncompliances (i.e., FAR, DFARS, contract terms, etc.) found during the performance of the limited audit procedures. Before reporting on any noncompliances, the audit team must support the noncompliances with sufficient appropriate audit evidence, and it is Agency policy that the team present the noncompliance(s) in an appendix to the report labeled "Other Matters to be Reported." The DCAA guidance states that in this appendix, the audit team should describe the nature of each noncompliance and its actual or potential effect on the subject matter of the audit. However, the guidance also states that the description should avoid summary exhibits that show a difference column and the term "questioned" costs to avoid the appearance of an audit report with a qualified opinion. We recognize the auditor used these terms, however we do not believe it overshadowed the clear language in disclaimer of opinion from the body of the report, nor that it affected the reliance of the report; consequently, we do not believe that this issue rises to the level of a reporting deficiency.

DCAA Director Comments (cont'd)

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System Review Draft Report (Project No. D2016-DAPOCF-0122.000)

As to the scope limitation issues identified, two of the three issues cited do not rise to the level of a finding (Assignments Nos. 6811-2008U10100001 and 9871-2008M10100029). For example, the DoDIG highlighted that Assignment No. 9871-2008M10100029 was deficient because of two missing scope limitations involving unresolved costs for two accounts. The DoDIG also included this issue in the reporting findings as not identifying the associated unresolved costs in the audit report. We disagree. The total costs audited were over \$44 million and the claimed costs for these two accounts totaled less than \$600 thousand. As such, these two accounts represent only 1.4 percent of costs on the contracts audited. Attestation Standard 101.71 specifically states:

“The third standard of reporting is—The practitioner must state all of the practitioner’s significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report” (emphasis added).

The immaterial nature of these costs does not represent a significant reservation. As such, they do not rise to the level of identifying these costs as unresolved, and, accordingly, does not require a scope limitation.

The remaining three assignments identified as supporting the Reporting deficiency address a variety of unrelated non-recurring issues. As such, of the eight issues the DoDIG identified as contributing to the overall Reporting deficiency, we believe that only one scope limitation issue rises to the level of a finding in the 67 assignments reviewed; specifically, the omission of the scope limitation for the lack of a real-time review of direct labor and direct material (Assignment No. 1241-2009S10100009).

DoDIG Recommendation #2: The Director, Defense Contract Audit Agency, should emphasize through training or other appropriate means, the importance of adhering to Government Auditing Standards 5.04, Attestation Standard AT 101.73, 101.74, and Agency policy for appropriately:

- a. Communicating other pertinent information in a report that disclaims an opinion; and
- b. Including all scope limitations in the report that prevent the auditor from issuing an unqualified opinion.

DCAA Comments on Recommendation: Non-Concur. The DoDIG identified eight reporting noncompliances where DCAA did not appropriately communicate pertinent information or important limitations to the contracting officer. Based on our review of the DoDIG findings, there were no systemic conditions found and, therefore, specific corrective action is not deemed necessary as our training already includes material on disclaimers and scope limitations. As part of our standard practice of continually updating classes DCAA created a new E-learning course (6116) entitled “Developing an Effective Audit Report” which includes detailed information in this training on disclaimers of opinion. This course is required to be

DCAA Director Comments (cont'd)

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taken by all new DCAA employees. Additionally, in October 2016, DCAA updated its Contract Audit Manual (CAM) Sections 10-208.6 and 7 to include updated guidance on disclaimers of opinion. DCAA will continue to emphasize its quality processes over audit reporting to ensure adherence with GAGAS and Agency policy.

Deficiency 3 – DCAA Did Not Adequately Document the Procedures Performed: In 9 of the 67 audits we reviewed (13 percent), the documentation taken as a whole was insufficient to understand the nature, timing, extent, and results of work performed by the DCAA auditor.

DCAA Comments on Deficiency: We concur with the overall DoDIG conclusion on this deficiency.

DoDIG Recommendation #3:

- a. The Director, Defense Contract Audit Agency, should assess and improve the quality control procedures to help ensure that Defense Contract Audit Agency auditors adequately document the:
 - (1) Performance of planned audit program steps.
 - (2) Basis for judgmentally selecting transactions for testing, and why the selection adequately addresses the audit objectives.
 - (3) Criteria used in the audit.
- b. The Director, Defense Contract Audit Agency, should consider providing comprehensive refresher training on the documentation requirements in the *Government Auditing Standards*.

DCAA Comments Recommendations: **Partially Concur.** We concur with Recommendations 3.a.(1) through (3); however, we disagree with Recommendation 3.b. because we do not believe that comprehensive training on documentation requirements is necessary as a result of the DoDIG findings. However, we will provide training to address the specific areas identified in 3.a.(1) through (3) above as soon as the assessment is complete and guidance has been updated, if necessary. We expect to complete this action by December 31, 2017. In addition, DCAA has already taken the following actions relating to documentation:

- In March 2017 at the FAQ Workshops, DCAA provided training on Judgmental Selection and Statistical Sampling. The judgmental selection portion of the training included the importance of appropriate documentation;
- In February 2016, CAM 4-403g(4) was updated to include a more detailed example of the working paper documentation required when judgmental selection is used;
- In February 2017, DCAA updated the E-learning course entitled Briefing Contracts. This course provides guidance on the importance of identifying special contract provisions when briefing contracts;

DCAA Director Comments (cont'd)

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- In the summer of 2015, the live Incurred Cost course was updated and includes guidance on planning procedures to determine the claimed amounts comply with the key terms of selected significant auditable contracts.

Deficiency 4 – DCAA Did Not Perform Adequate Supervisory Reviews: For 6 of 67 audits (9 percent), we found inadequate or ineffective supervision which impacted the accomplishment of audit objectives. The inadequate supervision contributed to the significant evidence, reporting, or documentation deficiencies we found with each assignment.

DCAA Comments on Deficiency: We disagree with the cited deficiency as it represents a duplication of previously identified findings in the other deficiencies (i.e., evidence, reporting, documentation, and professional judgment). Of the six reported supervisory findings, four are associated with assignments also cited as lacking professional judgement (see Deficiency #5), leaving only two assignments not addressed. Of the two assignments, DCAA disagrees with the DoDIG finding on Assignment 2201-2016H28000001, as identified in the Enclosure addressing the Evidence issues. The limited issues identified in this assignment clearly do not rise to a finding supporting a Supervision deficiency. Further, the nature of the findings within the assignments cited as lacking professional judgement do not represent systemic issues that would rise to a level citing supervision as a separate deficiency.

DoDIG Recommendation #4: The Director, Defense Contract Audit Agency, should assess and improve the quality assurance procedures for assisting supervisors in their reviews of audits, to include ensuring that the auditor sufficiently documents the work, obtains sufficient evidence, and prepares reports that comply with *Government Auditing Standards*. The Director should consider requiring supervisors to complete a checklist addressing the key professional auditing standards.

DCAA Comments on Recommendation: Non-Concur. As stated above, we do not agree the findings identified by the DoDIG support reporting this as a deficiency and, therefore, we do not agree on the need for an added checklist and the additional resources that would be required. Additionally, in response to the prior DoDIG peer review, in June 2014, DCAA added language to the working paper A, Summary of Audit Conclusions section, as follows:

“Assess the completed audit plan and determine if sufficient appropriate evidence exists to support the audit opinion you plan to express; state below your professional judgment in arriving at this conclusion.”

In October 2015, DCAA revised the language on working paper A and clearly labeled the section as the “Supervisory Statement on Sufficiency of Evidence”. The following language was added right before the supervisor signature and date.

“Based on my review of this assignment, the signature below indicates that in my professional judgment, there is sufficient appropriate audit

DCAA Director Comments (cont'd)

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System Review Draft Report (Project No. D2016-DAPOCF-0122.000)

evidence that supports the significant judgments and the conclusion reported.”

Of the six assignments identified by the DoDIG as lacking adequate supervisory review, four did not include the latest Supervisory Statement on Sufficiency of Evidence. For the two assignments that did include this updated Statement, DCAA does not agree that the assignments lacked appropriate supervisory review (Assignment Nos. 1311-2016N21000001 and 2201-2016H28000001). Therefore, we believe the revised Supervisory Statement is effective, and there is no need for an additional checklist. Whereas we disagree with the identified deficiency and recommendation, we will reemphasize Agency policy to ensure the supervisors are appropriately completing the “Statement on Sufficiency of Evidence.” We will complete this action by October 31, 2017. We believe this is the appropriate tool to demonstrate the supervisor’s understanding of the responsibility to ensure sufficient evidence is included in the working paper package to support the audit findings.

Deficiency 5 – DCAA Audit Staff Did Not Exercise Professional Judgment in Some

Instances: For 4 of 67 audits (6 percent), we determined that the audit staff did not use appropriate professional judgment. We found multiple evidence, reporting, documentation, or supervision deficiencies among the four audits, leading us to conclude that the audit staff, as a whole, did not exercise sufficient professional judgment when conducting the audits.

DCAA Comments on Deficiency: We concur with three of the four assignments identified by the DoDIG as lacking professional judgment. However, for Assignment No. 1311-2016N21000001, we believe that, overall, the audit steps were sufficient and that the audit was appropriately planned, performed, and supervised in accordance with GAGAS. (See Enclosure for specific details.) We do concur with the deficiencies found related to documentation.

DoDIG Recommendation #5: We recommend that the Director, Defense Contract Audit Agency, provide the audit staff with training on the requirement and expectation for exercising professional judgment and for adhering to other key *Government Auditing Standards*, including evidence, planning, reporting, and documentation.

DCAA Comments on Recommendation: **Concur in principle.** Although we do not agree with the pervasiveness of these findings, we agree to provide the necessary training to the audit offices performing the assignments where the professional judgment noncompliances were found. Additionally, we have provided guidance and training subsequent to the performance of these audits that we believe will satisfactorily correct the noncompliance. In addition, to address potential issues on assignments cited as lacking professional judgment, the cognizant FAO will coordinate with the requestor to determine if there is a benefit to the Government to supplement the audit work and make the engagements compliant with the applicable GAGAS criteria. If there is a benefit to the Government, the FAO will perform the necessary additional audit procedures in accordance with GAGAS and supplement the audit report, as needed, as soon as possible. The FAO manager will determine the extent of additional procedures required to meet the standards. If there is no identified benefit to the Government, the FAO will issue a

DCAA Director Comments (cont'd)

SUBJECT: Response to External Peer Review on the Defense Contract Audit Agency System Review Draft Report (Project No. D2016-DAPOCF-0122.000)

memorandum to the contracting officer and add it to the audit file as documentation that the audit was not performed in accordance with GAGAS and should not be relied upon.

Concluding Remarks

In addition to the actions we have identified above to address the cited deficiencies, our Agency Executives are considering further processes, training, and other actions to address the areas you note above and ensure quality across the Agency. By January 31, 2018, we will evaluate these additional actions and processes to strengthen our audit quality. We will also ensure all auditors are aware of the peer review findings and, in line with our goal of continuous improvement, highlight areas the DoDIG identified as needing improvement. Additionally, in FY 2018, DCAA will be employing new audit software that will possess new audit tools and working paper processes that will facilitate better audit execution. As a result of these actions and ongoing assessments of our efficiency and effectiveness, we believe the quality and usefulness of our reports and reviews will continue to improve.



Anita F. Bales
Director

Enclosure: a/s

DCAA Director Comments (cont'd)

DCAA DISAGREEMENTS WITH INDIVIDUAL FINDINGS

The below seven examples describe where we believe the facts do not support the finding or materiality was not appropriately considered and did not rise to the level of a deficiency as defined by the Guide for Conducting Peer Reviews of Audit Organizations of Federal Offices of the Inspector General, Reporting the External Peer Review Results, dated September 2014: "The significance of disclosed findings in the selected audits reviewed should be determined by the *extent the reports could not be relied upon due to the failure of the reports and underlying work*, including documentation, to adhere to GAGAS" [emphasis added].

1. Assignment No. 1271-2012G10100001 was an audit of \$56 million of intermediate home office (IHO) costs over three fiscal years. The DoDIG identified that testing for reasonableness of \$22 million in claimed salaries was not performed. We disagree. First, the total impact to Government flexibly priced contracts of the \$22 million equates to \$779 thousand; therefore, minimal testing should be performed based on risk. The audit documented that executive compensation in excess of the mandated cap was voluntarily deleted by the contractor. Additionally, the audit report stated that the executive compensation portion was being tested by the DCAA corporate office for reasonableness. This represents more than sufficient audit coverage when considering that the total impact to Government contracts was only \$779 thousand. Any additional audit effort expended would not be warranted based on the risk. The DoDIG further identified software license maintenance costs, which were commercial items, as not being tested for reasonableness; however, the costs were tested to ensure they were ordinary and necessary (testing for reasonableness), incurred within the appropriate accounting period, and paid appropriately. This testing was commensurate with the risk associated with these costs. The impact on flexibly priced contracts for these software license maintenance costs was only \$82 thousand. Any impact of determining these costs as unreasonable would have virtually no impact on the flexibly priced contracts. These were the only evidence issues identified for this assignment. We concur that the audit file did not clearly document the decision that the above testing was sufficient based on the risk.
2. Assignment No. 3201-2009R10100006 was an audit of \$24 million of a contractor's segment incurred costs. The DoDIG cited the audit as not testing the Recruitment and Relocation account and the Miscellaneous Overhead account (representing approximately \$410 thousand of the \$5.8 million in the overhead pool) for reasonableness and allowability and instead limiting the testing to reconciling the costs to a journal entry. The auditor did limit the audit to a reconciliation and also verified that no mark-ups or profit on the claimed costs were applied. There is no documentation in the working papers identifying why the testing performed was considered sufficient to address reasonableness and allowability. However, when considering the impact on Government flexibly priced contracts, these costs represented a risk to the Government of only \$64 thousand. This single evidence issue in the audit does not rise to the level of concluding that the evidence gathered

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DCAA Director Comments (cont'd)

was insufficient to support the audit opinion. This was the only evidence issue cited for this audit.

3. In Assignment No. 4901-2010C10100001, the DoDIG cited the audit of a \$133 million corporate office cost submission as not obtaining sufficient evidence to express an opinion on the reasonableness of legal cost and miscellaneous costs. Legal costs (\$1.8 million) and miscellaneous costs (\$726 thousand) together equate to only two percent of the claimed costs. Of the \$1.8 million claimed in legal costs, \$1.5 million was judgmentally selected for audit (85 percent), resulting in \$1.2 million being questioned under various FAR provisions, leaving approximately \$600 thousand that was not questioned. When considering the impact on only the Government flexibly priced contracts, the \$600 thousand factors down to only \$104 thousand. For the miscellaneous overhead costs, the impact on flexibly priced contracts was only \$123 thousand, with appropriate testing being performed on those costs based on the risk (i.e., verified claimed costs to invoices and cancelled checks). Given the magnitude of the costs audited under this assignment (\$30.9 million applicable to Government flexibly priced contracts), and the significant number of audit steps performed (over 100 detailed audit steps), we disagree with the DoDIG conclusion that not testing these immaterial costs for one element of allowability (i.e., reasonableness) results in an overall evidence finding. These were the only evidence findings identified by the DoDIG in this assignment. Again, we concur that the auditor did not clearly document in the working papers why the testing performed was sufficient based on the risk.
4. The DoDIG identified Assignment No. 2201-2016H28000001 as lacking sufficient evidence. This Agreed-Upon Procedure (AUP) assignment addressed 27 separate rates, including labor, overhead, and General & Administrative Expense, over a four-year period. The DoDIG took exception to the reporting of one rate for one period and, as a result, concluded a lack of sufficient testing for the overall assignment. We disagree with the significance this one rate has on the overall results provided in the report. In this case, the auditor performed additional effort to provide relevant useful information to the requestor. As such, while we agree that the auditor should have contacted the requestor to clarify the AUP, we disagree with the DoDIG conclusion that insufficient testing was performed and the subsequent conclusion that the overall audit lacked sufficient testing. This was the only evidence issue cited by the DoDIG.
5. The DoDIG identified Assignment No. 01241-2009S10100009 as lacking sufficient evidence because reasonableness of direct material costs was not tested. Direct material costs for this submission was only approximately 7 percent (\$1.7 million direct material cost of \$25.1 million audited dollar value). The significance of this finding is minimal because the report could be relied upon by the requestor since potential misstatements would be very immaterial in relation to the overall assertion. In addition, we believe that the testing was adequate. Due to the commercial nature

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of the material being purchased (e.g. generators and power supplies), we believe the prices paid were reasonable. The audit traced the costs to vendor invoices and verified payment through the accounting system. There is sufficient documentation, including item descriptions, to support the commercial nature of these costs. The audit concluded that the nature of the costs is commercial and therefore subject to low risk of unreasonable pricing.

6. In Assignment No. 06161-2009G10100035, the DoDIG cited that a note in the Other Matters to be Reported Appendix shows costs that appear to be compliant, but not supported by evidence. We disagree. In accordance with GAGAS, when issuing a disclaimer report, the auditor should report any noncompliances found during the audit. In accordance with Agency policy, the report contained an Other Matters to be Reported Appendix that identified \$3.4 million of direct costs and \$1.2 million of indirect costs as noncompliant. However, the lack of a specific determination of noncompliance on any other cost does not imply compliance since the overall disclaimer of opinion is clearly explained in the report. Further, the issue raised by DoDIG only relates to two accounts: (1) one that cites a possible discrepancy with \$7.5 thousand of the \$7.2 million G & A expense pool (approximately 1 tenth of 1 percent) and (2) the other relates to \$112 thousand of indirect labor costs (only 1.1 percent of the total labor incurred by the contractor in the subject fiscal year). Therefore, the significance of this issue is minimal to the overall disclaimer of opinion.
7. The DoDIG identified Assignment No. 1311-2016N21000001 as lacking sufficient evidence and professional judgment. We disagree with the DoDIG. Based on the identified risk for the assignment, appropriate analytical procedures and detailed testing was performed to support the opinion rendered. The audit resulted in an adverse opinion, supported by the statement that the proposed amounts did not materially comply with the solicitation terms related to pricing. Rendering an adverse opinion supports the position that the assertion was not acceptable as a basis for negotiations. As such, the government's interests were protected. There were numerous material noncompliances and scope limitations identified in the audit report, resulting in over \$6.8 million in questioned or unsupported costs from the \$39.3 million examined. Direct material comprised over 60 percent (\$24.4 million) of the proposed costs, and the DoDIG took no exception to the audit procedures performed nor the documentation provided for these material costs. The DoDIG findings were related to other cost elements in the proposal. We believe that, overall, the audit steps were sufficient and that the audit was appropriately planned, performed, and supervised in accordance with GAGAS.

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