



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

JUL 9 1984

B-215639

Mr. Charles O. Starrett, Jr.
Director, Defense Contract Audit Agency

Dear Mr. Starrett:

Subject: Need for DCAA to Improve Both the Reporting
of Audit Results and the Management of the
Defective Pricing Program (GAO/NSIAD-84-131)

We have reviewed the adequacy of the Defense Contract Audit Agency's (DCAA's) postaward audits (known as defective pricing audits) of contracts and subcontracts for compliance with the Truth in Negotiations Act, Public Law 87-653.

Our findings are included in the enclosure. In summary, we found that defective pricing policies, procedures, and audit guidelines were generally adequate and that the DCAA regional offices reviewed (Philadelphia and San Francisco) were generally complying with them. Also, the two regional offices were doing a good job in recommending price adjustments. But the defective pricing reports did not comply with DCAA and GAO reporting standards in several respects. For example, DCAA needs to improve its reports to provide better and more accurate disclosure on the limitations of its audit work and, therefore, the conclusions. After we brought this matter to the attention of DCAA officials, they initiated action to insure reporting would comply with DCAA and GAO reporting standards. Therefore, we are not making any recommendation directed toward reporting at this time.

Also, many branch and resident offices we reviewed in DCAA's Philadelphia and San Francisco regions had found little or no defective pricing. These offices' results were well below regional averages. Therefore, we believe that management attention should be directed to identifying the reasons for this performance, so that corrective actions can be taken where warranted.

We recommend that you have regional directors evaluate the performance of branch/resident offices in the defective pricing area where defective pricing findings fall below the regional average to determine the reasons for this. In such cases,

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regional reviewers should concentrate on identifying action that should be taken in terms of such things as changes in individual audit steps, the selection of contracts, the adequacy of lead sheets, or the training of audit personnel.

We would appreciate being informed of any action taken on the matters discussed in this report.

Sincerely yours,

Robert M. Gilroy
Senior Associate Director

Enclosure

DCAA NEEDS TO IMPROVE
REPORTING OF RESULTS AND MANAGEMENT
OF DEFECTIVE PRICING PROGRAM

INTRODUCTION

The Truth in Negotiations Act, Public Law 87-653, enacted on September 10, 1962, requires contractors and subcontractors, for most negotiated contracts, to submit cost or pricing data which is accurate, current, and complete at the time parties reach an agreement on price. Noncompliance with the law is a basis for a price adjustment. Currently contractors and subcontractors are required to submit a Certificate of Current Cost or Pricing Data for negotiated contracts and subcontracts exceeding \$500,000, except when the price is based on adequate competition, when it is a catalog or a market price, or when it is set by law or regulation. Before December 24, 1981, the threshold amount was \$100,000.

In 1966, DOD directed DCAA to establish and conduct a program for auditing contracts and subcontracts negotiated under Public Law 87-653. These audits, known as defective pricing audits, are designed to (1) ascertain whether individual contractors provided cost or pricing data that was complete, accurate, and current, (2) propose contract price adjustments to contracting officers if the price negotiated was not based on complete, accurate and current data, (3) recommend changes to contractors' procedures to insure compliance with Public Law 87-653, and (4) provide audit coverage to non-DOD contracts not subject to the Public Law but covered under acquisition regulations of the civil agencies.

Between 1977 and 1982, the number of defective pricing audits DCAA performed increased from 720 to 1,313 annually. During this period, the ratio of findings resulting in recommended price adjustments, known as positive findings, had increased from one in every seven audits to one in every four audits. In the two regions (Philadelphia and San Francisco) we visited, defective pricing audits made up from 2 to 3 percent of their total direct audit effort in management year 1982, which ended June 30, 1982.

Guidance for programing annual defective pricing audits is contained in DCAA's Program Objective Document. The document does not contain specific program goals for defective pricing audits. Rather, it suggests that the number of such audits be forecast using dollar value criteria and information identifying contracts having potential for defective pricing. In selecting

contracts for review, DCAA uses a matrix system and other information to rate the probability of defective pricing for the particular procurement.

DCAA places a high priority on auditing larger dollar value contracts. The matrix system mandates the audit of all negotiated fixed-price contracts over \$10 million. The number of such contracts to be audited that are valued at between \$1 million and \$10 million can be as low as 1 of every 20. The number of contracts to be audited that are valued at under \$1 million is left to the discretion of the field office manager.

Information identifying contracts having potential for defective pricing is obtained during audits of price proposals that contractors are to submit to the government preparatory to negotiating contracts. During these price proposal audits, the auditor notes significant data for possible future audit consideration on lead sheets. In preparing the lead sheets, the auditor evaluates factors such as (1) the time spent by the contractor in preparing the proposal; (2) the adequacy of the contractor's support for the proposed costs; (3) any changes in production methods, design, etc.; (4) the length of time between the date of the price proposal and date of price negotiations; (5) any unusual conditions noted during the pricing proposal audit; and (6) information presented in the memorandum record of negotiation. After contract award, the auditor reviews the memorandum record of negotiation and notes similar data on the lead sheets for possible future audit consideration. When the lead sheets are completed, the auditor rates the probability of defective pricing for the particular procurement action on a scale of 1 to 10 (highest probability).

The DCAA audit guidelines consist of two parts, the preliminary and expanded audit steps. The purpose of the preliminary steps is to determine the scope of work or expanded audit steps to be performed. In performing preliminary audit steps, the auditor determines whether the contractors submitted the Certificate of Current Cost or Pricing Data and obtains a copy of the memorandum record of negotiation. If actual incurred cost data is available, the auditor compares actual costs with negotiated costs. Where actual costs are significantly lower than negotiated costs, an underrun exists. Significant cost underruns are to be more thoroughly reviewed. If actual incurred costs are not available, the auditor identifies the significant cost elements from the proposal that would be more thoroughly reviewed. The expanded audit consists of procedures for detailed audit of such cost items as material, subcontract costs, direct labor, other direct costs, and indirect expenses.

Upon completion of the defective pricing audit, a report is issued to the contracting officer. A report without defective pricing findings is called a negative report and, if defective pricing findings are indicated, a report with positive findings is issued. Guidance for preparing defective pricing audit reports, including format, is contained in DCAA's Contract Audit Manual.

SCOPE AND METHODOLOGY

We reviewed the adequacy of DCAA defective pricing audits in two of DCAA's six regional offices; Philadelphia and San Francisco. In accordance with an informal agreement with DCAA headquarters personnel, the San Francisco regional office was selected because it had an above average number of positive findings whereas the Philadelphia regional office had a below average number of positive findings.

We reviewed DCAA policies, procedures, and audit guidelines on defective pricing audits. We evaluated a sample of assignments completed by both regional offices in DCAA management year 1982.

Within the Philadelphia region, we reviewed 31 of 208 assignments completed by 7 of its 18 area and resident offices. Within the San Francisco region, we reviewed 38 of 255 assignments completed by 6 of its 22 offices. In making our selection of offices and assignments for review, we considered the number of audits completed by each office, the ratio of positive findings, and the dollar value of the contracts audited.

For each assignment selected, we reviewed the audit work papers to determine whether the scope of work was adequate and whether the audit results were reported in accordance with policies, procedures, and guidelines. We reviewed audit reports to determine whether conclusions reached were supported by the work done and whether they provided full disclosure. We discussed the audit approach and results with the responsible auditors or supervisory auditors, branch/resident managers, and regional audit managers. In addition, we analyzed field office audit results for management years 1981 and 1982 and evaluated the process used by the regions in programming the annual defective pricing audit effort.

Our review was performed in accordance with generally accepted government auditing standards.

Our findings, which were discussed with the regional directors and DCAA headquarters officials, are set forth below.

REPORTING NEEDS IMPROVEMENT

DCAA defective pricing reports need to be improved to provide better and more accurate disclosure on the limitations of DCAA audit work and, therefore, the conclusions.

The format and contents of DCAA defective pricing audit reports are contained in the Agency's Contract Audit Manual. Generally, negative reports contain only a statement that a selective review of the contract disclosed no evidence of significant defective pricing. Reports with positive findings state that a selective review of documents and transactions was made to determine if the contract price, including fee or profit, was increased by a significant amount because the contractor furnished inaccurate, incomplete, or noncurrent cost or pricing data. Details of the positive findings are to be shown in a schedule showing the contractor's cost elements as certified, DCAA's price adjustment recommendation, and explanatory notes supporting DCAA's price adjustments.

Although DCAA's reports follow the defective pricing report format, they do not conform in all respects with the reporting standards as set forth in GAO's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions and DCAA's own reporting requirements contained in its Contract Audit Manual. Some of the reporting standards follow.

- The scope and objectives should be described in the report.
- The scope statement should disclose what the auditors did or did not do.
- The objectives should give the reader a background against which the report and findings may be considered.
- All factual data, findings, and conclusions should be supported by sufficient objective evidence to demonstrate or prove the basis for the matters reported and their accuracy or reasonableness.
- Opinions and conclusions should be clearly identified as such and be based on enough work to warrant them.
- Where acceptable auditing procedures cannot be followed or have been limited, the auditor should comment on the scope of the audit and qualify the report as necessary.

--The reports should also state that the audit was performed in accordance with generally accepted government auditing standards.

Our review of audit reports in both regions showed that in many instances, DCAA had not completely followed these standards. The scope of work statements did not disclose the work done or not done, such as when DCAA had relied on the results of other reviews. Qualified opinions were not made when the scope of work was limited, nor did the reports state that the audits were performed in accordance with generally accepted government auditing standards. After we brought this matter to the attention of DCAA officials, action was initiated to revise the defective pricing reporting requirements in the DCAA Contract Audit Manual. The action under way is directed toward achieving compliance with GAO and DCAA reporting standards and should result in fuller disclosure to contracting officers.

DCAA NEEDS TO REVIEW AUDIT RESULTS

Many field offices in the two regions have found little or no defective pricing in management years 1981 and 1982. The regions did not have a specific program to evaluate performance in offices which find little or no defective pricing.

In 1982, the two regions issued 463 defective pricing reports. Our review of field office defective pricing audit results disclosed that in management year 1981, 14 of 42 offices had no positive findings and 8 offices had very few positive findings. In 1982, 12 of 40 offices had no positive findings and another 14 offices reported few positive findings. Some of these offices had no positive findings in either year. The defective pricing workload for these offices were comparable in terms of the ratio of the defective pricing work to other audit work performed.

Some offices performed numerous audits of the same contractor with minimal results. For example, one resident office programmed a total of 25 audits of the same contractor in 1981 and 1982 and reported 1 positive finding. Another office programmed 22 audits of the same contractor in 1981 and 1982 and reported 1 positive finding.

Also, some field offices may not have been placing as much emphasis on defective pricing audits as others. While we did not try to make comparisons on a field office basis of the factors which cause some field offices to achieve better results than others, we discussed defective pricing audits with the branch manager of one office that had above average results in 1981 and 1982. The branch manager stated that a high degree

of management emphasis was placed on defective pricing audits. He indicated, for example, that experienced supervisors were assigned to the audits and examples of defective pricing were discussed extensively in staff meetings.

Some offices improved their performance in 1982. For example, in one branch office, the manager placed a high emphasis on defective pricing audits. In 1981, this branch office performed 10 audits and had no positive findings. However in 1982, the branch office performed 20 audits and reported 17 positive findings. The branch office manager attributed his 1982 performance to (1) assigning higher graded auditors to the defective pricing audits, and (2) placing more emphasis on preparing better audit lead sheets for use in identifying contracts with the most potential for defective pricing.

We believe that the regions should periodically evaluate field office audit results to find out why some offices find very little defective pricing and to determine whether any action would be appropriate. We believe they should also identify the techniques used by offices that regularly find defective pricing and apply such techniques, if practical, to offices finding little defective pricing.

DCAA officials informed us that the regional audit managers are responsible for evaluating the performance of the regions' resident and branch offices in carrying out defective pricing reviews. They stated also that resident and branch office performance is reviewed during headquarters program manager reviews and peer group reviews. DCAA officials stated further that a lack of positive findings from many of the offices may have indicated that there was no defective pricing under the contracts reviewed and that they did a good job. For example, the auditors may have been successful in insuring the contractors had good accounting systems and estimating systems.

We found that while the regional audit managers were required to review performance and that reviews were performed by the program managers and peer groups, there was no evidence of a specific program by these groups to look at performance in offices which find little or no defective pricing to determine the reasons for the lack of defective pricing findings. As indicated earlier, there was evidence in one branch office that the lack of defective pricing findings was not attributable to good contractor accounting and estimating systems.

Accordingly, we believe that DCAA should have regional directors evaluate the performance of branch/resident offices where defective pricing findings fall below the regional average.