United States General Accounting Office

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GAO

Report to Congressional Requesters

February 1986

CONTRACT AUDITS

DCAA Needs to Increase Its Management Oversight of Planning Operations

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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-220143

February 14, 1986

The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental
Affairs
United States Senate

The Honorable Jack Brooks
Chairman, Subcommittee on Legislative
and National Security
Committee on Government Operations
House of Representatives

This report summarizes the results of our examination of the Defense Contract Audit Agency operations. As you requested, we focused our work on (1) how effectively the Defense Contract Audit Agency plans and implements its audit work and (2) the usefulness of the Agency's reports.

As arranged with your Office, unless you publicly announce its contents earlier, we plan no further distribution of this report for 30 days. At that time, we will send copies to interested parties and make copies available to others upon request.

Frank C. Conahan
Director

Executive Summary

In fiscal year 1984, prime contract awards by the Department of Defense (DOD) totaled $136 billion, an increase of 84 percent from the fiscal year 1980 figure of $74 billion. The Defense Contract Audit Agency (DCAA) plays a key role in assuring fair and reasonable contract prices.

The Chairmen of the Senate Committee on Governmental Affairs and the Subcommittee on Legislation and National Security, House Committee on Government Operations, asked GAO to study DCAA's operations.

GAO focused its review on (1) how effectively DCAA plans and implements its audit work and manages its resources and (2) the usefulness of DCAA reports. GAO did not assess the quality of specific audit programs.

Background

DCAA is an audit agency in DOD responsible for auditing defense contracts. It provides accounting and financial advice on proposed and existing contracts and subcontracts to DOD procurement and contract administration personnel. The results of DCAA's audit work are used in negotiating contract prices and in the administration and settlement of defense contracts.

DCAA is a highly decentralized organization of about 4,000 people. Its headquarters is located in Alexandria, Virginia, with 6 regional offices located in major United States cities, and 130 field offices throughout the United States and overseas. Most DCAA field auditors are physically located at or near contractor plants.

Results in Brief

DCAA has a planning system which provides for identifying and prioritizing its work and for computing its resource requirements. However, because of inconsistent adherence to its planning system, the Agency cannot be sure that it is effectively identifying its resource needs and targeting resources to its most important work.

In a high percentage of audit reports GAO reviewed, the results of DCAA's work were used in establishing the government's negotiating position or in administering existing government contracts. Overall, DCAA's customers were satisfied with the results of its audit work. Report timeliness was their principal concern.

Principal Findings

GAO found differences in the way DCAA field audit offices implement its planning system. Specifically,

- vulnerability assessments designed to assess the government's potential exposure to fraud, waste, and error were not always performed;
- permanent files, which provide basic information on contractors' operations and internal controls, as well as potential auditable areas, were in some cases, incomplete and not up-to-date;
- an analytical procedure designed to identify auditable areas having the greatest potential for charging government contracts with significant amounts of unacceptable costs was not applied on a uniform basis; and
- the dollar value recorded as work backlog was not used to determine resource needs or the risk of not performing audits.

Some of these problems had been disclosed earlier by DCAA's own peer reviews, but remained uncorrected at the time of GAO's review.

In about 85 percent of the reports GAO reviewed, some part of DCAA's findings were used in establishing the government's negotiating position or administering existing government contracts.

In 43 percent of the reports, at least half of DCAA's findings were used. In cases where findings were not used, there often appeared to be valid reasons, such as the procurement being canceled or the audited proposal being significantly revised.

DCAA's customers were most satisfied with the accuracy, usefulness, and ease of understanding of its reports. Customers were least satisfied with the timeliness of DCAA's reports. Twenty-three percent of the customers GAO questioned were dissatisfied with report timeliness. GAO found that 47 percent of DCAA's reports it reviewed were received by the customer after the requested due date. However, only a few resulted in delayed negotiations and none had an identifiable effect on contract price.

DCAA could further improve on its performance by (1) providing more detail on why costs are questioned and (2) expanding the scope section of its reports to more fully explain the work steps taken during the audit.

Recommendations

GAO recommends that the Secretary of Defense instruct the Director, DCAA, to ensure that field audit offices adhere to the planning system so as to provide information which is reliable for approving work plans

and managing resources. As a minimum, GAO suggests that the Director, DCAA,

- reemphasize to all field offices the importance of adhering to the Agency's planning system;
- ensure that the results of the Agency's peer reviews are acted on; and
- as conditions permit, rely more heavily on the planning system for resource management.

If field offices realize that the system is being used in managing resources, it is likely that the system will be taken more seriously. Increased use of its peer reviews to guide top management in how much it can increase its reliance on the system appears worthy of serious consideration.

Agency Comments

DOD agreed with GAO's recommendations and stated that actions have been or are being taken to address the problem areas identified. Also, the Assistant Secretary of Defense's (Comptroller) office will monitor DCAA's progress in making the planned improvements and has a management review of DCAA's planning system underway.

Although DOD agreed with GAO's report, it said that DCAA's planning system applies to only about 20 percent of DCAA's work. Information is not available to precisely quantify the percent of DCAA's work that the planning system applies to, but based on our own review, we do not believe it is as low as 20 percent. Irrespective of the percentage, the audit requirement for the activities covered by DCAA's planning system is substantial and warrants DCAA management attention.

DOD stated that DCAA was studying the suggestions for audit report improvement and will take any action necessary.

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Abbreviations

CAS	Cost Accounting Standards
DCAA	Defense Contract Audit Agency
DOD	Department of Defense
GAO	General Accounting Office
MAAR	Mandatory Annual Audit Requirement
WRAP	Workpackage Risk Analysis Procedure

Introduction

In 1965 the Secretary of Defense consolidated military contract auditing into a single, independent Department of Defense (DOD) organization known as the Defense Contract Audit Agency (DCAA). DCAA is accountable to the Assistant Secretary of Defense (Comptroller), and is one of five professional DOD audit organizations.[1]

DCAA's mission is to perform contract audits and to provide accounting and financial advice on contracts and subcontracts to DOD procurement and contract administration personnel. Working with other members of the procurement team (contracting officers, price analysts, etc.), DCAA provides its services for use in the negotiation, administration, and settlement of government contracts and subcontracts. In addition, DCAA audits contracts for other government agencies at locations where DCAA auditors already audit DOD contracts.

The results presented in this report provide an assessment of the effectiveness of DCAA's audit planning process in terms of auditor resource utilization and usefulness of DCAA audit reports to its customers—defense contracting officers and price analysts. We did not assess the quality of specific audit programs. We are conducting ongoing reviews of defense contracting and pricing activities. The results of these reviews will provide assessments of pricing, contract administration, and procurement efforts which may include effectiveness of specific types of DCAA audit support. For example, we reported in October 1985, in testimony before the Subcommittee on Legislation and National Security, House Committee on Government Operations, that DCAA needed to reemphasize contractor cost estimating system evaluations. We found that pricing deficiencies in the subcontract portion of major prime contracts often were linked to deficient contractor cost estimating practices.

The DOD Office of the Inspector General, through its Audit Policy and Oversight group, has conducted a number of recent reviews of DCAA audit activity and audit support. These reviews have recommended improvements in the Agency's efforts to gain access to contractor records, and efforts in reporting fraud or illegal acts. This group also concluded a review in January 1985, of DCAA's audit operations at small contractor audit locations (mobile audit sites). They found similar conditions to those discussed in this report in terms of audit planning. For example, DCAA did not have adequate permanent files or vulnerability

[1]The others are the DOD Office of the Inspector General and Army, Navy, and Air Force Audit Agencies.

assessments necessary for effective audit planning or coverage for more than one half of the 185 auditable contractors examined.

Organization of DCAA

DCAA is a highly decentralized organization with its headquarters located in Alexandria, Virginia. Its field operations are done through six regional offices in Atlanta, Boston, Chicago, Los Angeles, Philadelphia, and San Francisco. (See app. I for DCAA organization chart and app. II for regional boundaries.) These regions, in turn, supervise over 130 field audit offices throughout the United States and overseas. The field audit offices are of two types, as follows:

- Resident office, generally responsible for DCAA's work at a major contractor location, and physically located at the contractor's plant. DCAA defines a major contractor as one that has an annual incurred cost volume of $40 million or more or where DCAA's annual audit effort is 5,000 hours or more.
- Branch office, responsible for DCAA's work at all contractor locations within a designated geographical area, except for contractors where DCAA has a resident office. Branches often have suboffices that perform on-site audits at contractor locations where the work load justifies a small prepositioned staff.

In addition to field audit offices, DCAA has liaison offices at major procuring agencies which coordinate contract audit matters with procurement offices.

Day-to-day management of DCAA operations is done at the field audit office level. DCAA's 130 field office managers are audit managers and the management link between the field office and the regional director. They are charged with being sufficiently involved in field office operations so that they can effectively review, evaluate, and supervise field office work plans and the performance of these plans.

DCAA Headquarter's role is primarily one of issuing audit policy and guidance, approving work plans and allocating resources, and assuring that policies and plans are carried out. Since headquarters has little direct involvement in day-to-day operations, management information systems become critical to its ability to oversee operations and manage resources.

In management year[2] 1984, DCAA employed a staff of about 4,000 in over 400 locations throughout the continental United States and overseas, distributed as follows:

Table 1.1: DCAA Staff Distribution

Organization level	Staffing level as of June 30, 1984
Headquarters	113
Region	416
Field audit office	3,440
Total	**3,969**[a]

[a]Total includes 775 administrative personnel.

DCAA's Role in the Acquisition Process

The purpose of contract auditing is to help procurement and contract administration personnel achieve prudent contracting actions by providing financial information and advice on proposed or existing contracts and contractors. DCAA's audit services are used in negotiating contract prices that are based on cost, both incurred and estimated, or on cost analysis, and in the administration and settlement of contract payments.

Although DCAA is organizationally independent of procurement and contract administration organizations, it works with them as a member of the procurement team. Over half of DCAA's audit work is in direct response to requests by procurement and contract administration personnel.

Audit Work Load

DCAA's audit work load can be generally characterized as either demand or discretionary. Demand audits, which are given higher priority, are customer directed with specific due dates. Nondemand audits, referred to in this report as "discretionary," are those for which DCAA has discretion in planning, scheduling, and performing.

The principal types of audits DCAA performs are as follows:

- Forward pricing audits—evaluations of individual contractor pricing proposals and other related efforts to assess the reasonableness of prospective contract costs.

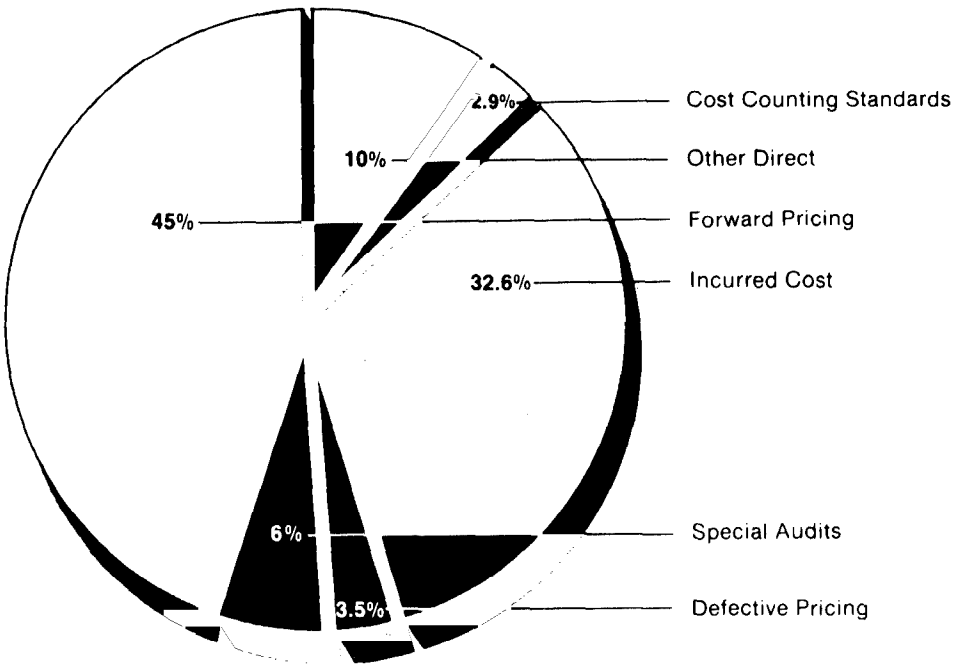
[2]DCAA has established the period July 1 through June 30 as its management year for preparing audit plans and measuring performance.

- Special audits—unscheduled post-contract award efforts generally performed as a result of a specific written audit request. They include, for example, reviews of contractors' books and records to validate the costs presented to the government for payment in connection with contract claims, termination settlements, price adjustments, and progress payments.
- Defective pricing audits—audits of awarded contracts to ensure that the contractor submitted accurate, complete, and current cost and pricing data as the basis for negotiation.
- Incurred cost audits—audits of costs which have been incurred, or the appraisal of the contractor's operations and procedures which affect the costs charged to auditable government contracts. They are designed to ensure procurement officials that labor, material, and overhead costs incurred under or charged to specific government contracts are allowable, allocable, and reasonable. By examining a contractor's accounting, operational, and internal control systems, the auditor judges the acceptability of the systems which generate contract costs.
- Cost Accounting Standards (CAS) audits—include audit work designed to determine that CAS Board rules and regulations (and related procurement regulations) are properly implemented.

Prior to February 1984, DCAA directive did not set forth a definition as to which specific audits were considered as demand work. We found some differences among field offices as to which audits were classified as demand versus discretionary. Forward pricing and special audits are generally considered demand audits, the major portion of the remaining being discretionary. Classified this way, as much as 50 percent of DCAA's annual direct work load could be considered discretionary, although in actual practice the total may be somewhat less. The work load distribution for a typical operating year is shown in figure 1.1.

This distribution of work has changed little over the last few years.

Figure 1.1: Direct Audit Effort by Type (Management Year 1985)



DCAA Also Supports Non-DOD Agencies

In addition to providing contracting support services to DOD procurement and contract administration personnel, DCAA provides similar services to other government agencies at locations where DCAA auditors already perform work. About 16 percent of its audit effort is performed for non-DOD agencies, such as the Department of Energy and the National Aeronautics and Space Administration.

Reported Savings From DCAA Audits

For the 12-month period ending June 30, 1984, DCAA reported[3] that its audit work resulted in $10.4 billion in recommended audit adjustments, distributed as shown in table 1.2.

[3]In November 1984, the DOD Inspector General reported that DCAA's reported savings (1) were not prepared in accordance with existing DCAA guidelines, (2) did not have sufficient documentation, (3) were claimed before they were realized through contracting actions, and (4) contained mathematical and clerical errors. DCAA disagreed and the report is currently undergoing resolution proceedings within DOD.

Table 1.2: Reported Savings From DCAA Audits 12-Months Ending June 30, 1984

Dollars in millions

Type of audit	Number of audit reports	Dollars examined	Exceptions sustained[a]
Forward pricing	28,326	$243,894.5	$ 9,655.0
Incurred cost	27,229	46,143.7	659.6
CAS	2,289	188.9	19.9
Defective pricing	1,163	(b)	52.3
Total			**$10,386.8**

[a]Exceptions sustained represent costs questioned by the auditor and either agreed to by the contractor and/or sustained by the contracting officer in negotiations with the contractor.

[b]Dollars examined are not normally reported in the defective pricing category.

Objectives, Scope, and Methodology

Between fiscal years 1980 and 1984, DOD's budget authority increased by 80 percent from $143 billion to $258 billion. Over the same period, DOD's prime contract awards increased by 84 percent, from $74 billion to $136 billion. In addition to the significant rise in DOD procurement costs, concern has increased in the Congress over the prices DOD pays for goods and services. Because of these factors and the key role that DCAA plays in the contracting process, we decided to evaluate the effectiveness of DCAA.

After initiating this effort, the Chairmen of the Senate Committee on Governmental Affairs and the Subcommittee on Legislation and National Security, House Committee on Government Operations, asked us to study DCAA's operations. Based on discussions with Committee and Subcommittee staffs, we agreed to focus our review on (1) how effectively DCAA plans and implements its audit work and manages its resources and (2) the usefulness of DCAA reports.

To accomplish the first objective, we addressed the following questions.

1. Does DCAA have a planning system which provides for identifying and prioritizing its work and for computing the personnel resources needed to do it?

2. Is the planning system being implemented in a manner which ensures DCAA's top management that its resources are being used for its most important work?

To evaluate the overall structure of the planning system (question 1), we obtained and reviewed DCAA's policies and procedures for identifying and prioritizing its audit work, and for allocating its resources. We also discussed how the system works with DCAA personnel at headquarters, regional, and field levels.

To evaluate the implementation of the planning system (question 2), we ascertained the extent to which each of 20 selected field audit offices (10 resident offices and 10 branch offices) adhered to those major components of the planning system which affect how DCAA determines and prioritizes its work load and computes its resource requirements. We reviewed supporting documents at each location and held discussions with DCAA officials.

To determine the usefulness of DCAA reports (objective 2), we selected a sample of 388 audit reports issued by DCAA between July 1, 1981, and December 31, 1982. Two hundred sixty-eight of these reports covered contractor proposals (forward pricing audits). These proposals ranged in costs from $117,000 to $7.8 billion. The remaining 120 covered other subjects, such as financial systems, contract progress payments, and defective pricing. Hence, most but not all of the reports were customer requested.

For each report, we compared the report results with available records, such as the field pricing report, the government's prenegotiation position, and the final price negotiation position to determine if and how the audit report was used. We also discussed these reports with the contracting officer and/or the price analyst or negotiator who received them to obtain more specifics on their use.

To complement our review of specific reports, we issued a questionnaire to each contracting officer and price analyst we interviewed to obtain their views about the quality of DCAA reports in general. We received 404 responses.

We did not assess the reliability of the computer system used to generate management information system data. Because our findings are not based on this information, not performing a reliability assessment does not adversely affect the results of our audit work. A list of locations we visited is shown in appendixes III and IV.

In selecting the DCAA field offices to visit, the reports to be reviewed, and the information to be obtained through questionnaires, interviews, or

otherwise, we attempted to obtain a representative cross-section of DCAA's operations. The information was not statistically selected; however, DCAA Headquarters officials agreed that the locations we selected should provide a typical profile of the audits and reports of the Agency.

Our field work was performed from May 1983 through June 1984. Our review was performed in accordance with generally accepted government auditing standards.

DCAA's Planning System: More Consistent Implementation Could Improve Resource Management

As discussed in chapter 1, DCAA operates under a highly decentralized management system. It has a small headquarters staff responsible for developing planning guidance, reviewing audit work plans and resource requirements prepared by field activities, and approving work plans and allocating resources. In turn, field activities are responsible for implementing the planning guidance, developing audit work plans and resource requirements, and using resources as approved by headquarters.

The central challenge facing DCAA is to manage its personnel resources in a way which ensures that the most important work of the Agency gets done. Because of the decentralized nature of DCAA's operations and the magnitude of its work load, if it is to meet this challenge, it must have:

- A sound planning system which identifies and prioritizes the work that needs to be done, and the resources needed to do the work.
- A planning system that is consistently implemented among field activities so that management is assured that resources are being programmed and used for the most important work. This means that the work and resource requirements information reaching headquarters must be reliable enough to serve this purpose.

DCAA's planning system does provide a systematic basis for identifying and prioritizing its work, and for computing the resources needed. If properly implemented, it can provide top management with a sound basis for managing its resources and assuring that the most important work of the Agency can be accomplished. However, inconsistencies in implementing the system among DCAA field offices detract from the value of the planning system and reduce assurances that the Agency is effectively using its resources.

This is not to say that DCAA is not doing important work or that its work is not adequately done. Rather, because of inconsistencies in the way the planning system is implemented, which is ultimately reflected in the information submitted to headquarters, top management cannot be assured that this data is a reliable representation of the most important work of the Agency or the resources needed to do it.

DCAA's peer review function also identified problems with inconsistent implementation of the planning system. Yet, because effective follow-up was not done on its findings, problems remained and were again disclosed by our review. (See pp. 24 and 25.)

We recognize that as a practical matter, the flexibility of DCAA top management to make short-run resource reallocation decisions to respond to shifting work load or priorities is limited because of the inherent difficulty of geographically moving people, particularly where personal sacrifices, such as uprooting families, selling houses, and so forth, are involved. Reallocation of resources is much more feasible within a limited geographical area where physical moves are not required. However, even if the short-run ability of DCAA to reallocate resources or move people is limited, DCAA management needs to assure itself that within the field audit offices, work is being prioritized and resources are being targeted to the most important work. A soundly designed and effectively implemented planning system can provide management with the assurances that field offices are going through the disciplined process of defining their work load, establishing priorities, and computing their resource requirements.

Finally, as conditions permit, implementing a planning system consistently allows management to better identify staffing imbalances and to plan for shifting resources over the long run.

Planning System Identifies and Prioritizes Work and Computes Staff Needs

DCAA's planning system is basically a "bottom-up" system because it is the field audit offices that identify the specific discretionary incurred cost work that needs to be done, prioritize the work, and identify the resources needed to do it. This system recognizes the decentralized nature of the work and the fact that DCAA personnel located at or near contractor plants are normally in the best position to identify the work and the potential risks to the government from not doing the work.

At the same time, field audit office personnel, because they are focused on one or a few contractors, normally have a limited perspective of DCAA's total operations. As such, they are not in a position to judge the importance of their work in relation to other agency work. It is at the regional and headquarters levels that this responsibility is placed and better discharged. It is an important responsibility since, like most federal agencies, DCAA has limited resources relative to its potential work load. Hence, it is at the higher organizational levels that the task of judging the relative importance of all the Agency's work and for managing its limited resources to make sure that the most important work can get done is placed. To provide the information to make sound resource management decisions is one of the principal functions of DCAA's planning system.

DCAA's planning process generally consists of three phases—advance planning, requirements planning, and program planning.

Advance Planning

In advance planning, all significant auditable activities which affect the costs of government contracts are identified. This is done through a broad survey of the contractor's organization and operations and a review of the permanent files maintained by DCAA field audit offices. The permanent files contain the results of prior surveys and auditable areas and other information which the auditor can use to identify areas needing current audit attention, and to assess risks and benefits of performing or not performing certain audit work.

A vulnerability assessment is also to be performed. This is a series of tests of the contractor's accounting system, internal controls, and other activities which allows DCAA to judge the government's potential exposure to fraud, waste, and error. All major contractors and nonmajor contractors with an annual incurred cost dollar volume of $3 million or more are required to be subjected to the vulnerability assessment process.

The outcome of this phase of the planning process is an identification of potential auditable areas and an assessment of the risks involved in not performing audits in the areas.

Requirements Planning

From the universe of auditable areas, identified during the advance planning phase, field offices prepare a requirements plan. This plan presents the field offices' best estimates of the specific audits and associated hours required during the upcoming year. The plan includes expected "demand" or customer directed audits and prioritized discretionary audits of incurred costs. Because specific demand audits are seldom known in advance, field audit offices estimate the amounts based on projected contractor sales and historical data. To prioritize discretionary audits, field audit offices are to apply a Workpackage Risk Analysis Procedure (WRAP) to each proposed audit. WRAP is an analytical process designed to assist in identifying those workpackages or audit areas that have the greatest potential for charging government contracts with significant amounts of unacceptable costs. This process of identifying the relative risk of specific audit work from the total universe of auditable areas is one of the first steps in the development of the annual requirements plan. Once priorities are established, a cut off point of estimated savings per audit hour is identified. Therefore, those

assignments considered essential during the coming year are identified and the remainder can be deferred.

This information is then submitted to regional and headquarters levels where it serves as a basis for resource requests and allocations.

Program Planning

Since the resources needed to execute the requirements plan are generally greater than the resources available and allocated, the field audit office and regional management must make adjustments in the work load to match the authorized staff level. They must decide whether (1) certain work can be eliminated, (2) certain work can be deferred, or (3) more resources need to be requested. Ordinarily, the first option is appropriate only when the difference between required and authorized staff is not significant.

Conclusion

DCAA's planning system provides the general processes for systematically identifying its work load, establishing its work priorities, computing its resources requirements, and reconciling differences between work requirements and available resources. If properly implemented, it can provide DCAA management and others with reasonable assurance that the most important work is being identified, and can serve as a basis for managing personnel resources.

Inconsistent Implementation of Planning System Detracts From Usefulness of Results

A well designed planning system is fundamental to identifying and prioritizing effective work and sound resource management. Top management is not likely to receive the information it needs to make proper judgments on the work needed to be done or the resources needed if the system is not reasonably implemented. The more decentralized an organization, the more important it is for a headquarters level to receive consistent and comparable information.

Because of differences in the way field offices implement the planning system, the information generated by the system and provided to higher level DCAA management may not be reliable enough to (1) assure that the Agency's most important work is being identified and (2) provide a sound basis for managing its personnel resources.

Specifically, we found that

- vulnerability assessments were not always performed,

- permanent files were sometimes incomplete and not up-to-date,
- WRAP was not applied on a uniform basis, and
- the creditability of requirements plans were reflected in their limited use.

Vulnerability Assessments Not Always Done

As mentioned earlier, a vulnerability assessment is an important feature of DCAA's planning system. It provides the bases for the DCAA auditor to assess the government's potential exposure to fraud, waste, and error. The greater the risk, the more important the need for audit coverage.

Of the 20 field audit offices we visited, we found that 4 had not done required vulnerability assessments. Two others had performed some, but not as many as were required. These 6 offices were responsible for about 2,700 government contracts with estimated annual costs of $3 billion annually.

Field office managers gave the following reasons for not making the assessments:

- They had little effect on prioritizing and assigning hours to specific audits.
- They are a useless exercise because resources are insufficient to perform the field office's required audit work.
- The assessments are a time-consuming process which the region no longer stresses and do not contribute to the field office manager's knowledge of the contractor.

We believe vulnerability assessments are important because they require the field office manager to make a formal, disciplined assessment of a contractor's accounting and internal controls as a basis for establishing and prioritizing audit work. This process is necessary to ensure that the government's interests are protected and that field office staffing requests are based on a disciplined assessment of risk at each contractor location.

It would also appear that because resources are limited, both regional and headquarters management need this information to better target resources to those contractors where the risk is greatest.

Permanent Files Incomplete and Not Current

Permanent files are fundamental to planning because they provide valuable information on the contractor's organization and operations and on potential auditable areas. Field offices are required to maintain permanent files on a current basis and they are to contain an overall general survey of the contractor as well as separate files for each identified auditable area. The purpose of the general survey is to identify areas of the contractor's operation requiring review.

While all of the field offices maintained some permanent files, we found the following problems in the files we reviewed: no general survey file, lack of separate permanent files for each auditable area, outdated permanent file information, and varying levels of permanent file detail on nonmajor contractors.

DCAA may need to provide more definitive guidance on maintaining permanent files. We noted that existing guidance did not define when or how often a general survey needed to be performed or updated, or the detail required in the permanent files for nonmajor contractors.

WRAP Not Always Done

WRAP is an essential aspect of planning and resource management because it assists DCAA in identifying areas of high potential for cost savings or cost avoidance. By applying WRAP, DCAA can (1) better identify those areas having the greatest potential for charging government contracts with significant amounts of unacceptable costs and (2) target its resources to those areas of greatest risk or benefit.

If the WRAP process is to be of maximum benefit in DCAA's resource management, it must be applied consistently and uniformly. We found that this was not being done. Specifically, we found instances where field offices did not (1) apply WRAP to all planned discretionary audits and (2) establish cut off points for its audit work.

WRAP Not Applied to All Discretionary Work

WRAP's primary purpose is to prioritize audit work. If all planned discretionary audits do not apply this procedure, the discipline involved in the prioritizing process is affected and the assurance that the most important work is being scheduled is thereby reduced.

We found that 10 of the 20 field offices we reviewed did not adhere to the requirements of WRAP. Specifically,

- one field office did not apply WRAP to any of its planned audit work,

- one field office did not apply WRAP to all proposed discretionary audits,
- seven field offices did not apply WRAP to audits of overhead costs, and
- one field office applied WRAP to only overhead and operations audits.

Also, we found that 4 of the 10 field offices did not base the staff estimates in their requirements plans on the WRAP results. Rather, they estimated the staff hours required for all discretionary audits based on the total estimated annual dollars to be audited without regard to the specific workpackages that should be done.

Cut Off Points Not Established

Cut off points are established to separate that body of work which must be done from that which can be deferred. Once this is done, field offices can determine the resources needed to do the required work. If cut off points are not established, that is, if field offices include in their requirements plan all potential audit work, then resource requirements are overstated and reflect work which need not be done during the current planning period.

We found that 8 of the 20 field offices included in our evaluation had not established cut off points and had included audit work in their requirements plan without considering whether it could be justified based on risk.

Creditability of Requirements Plan Reflected in Its Limited Use

DCAA top management appears to be aware of the limitations of the requirements plan prepared by its field activities. We found that over the last few years, DCAA Headquarters made resource allocations in an increasingly judgmental manner, and for 1984 made no allocation analysis at all. Headquarters' officials told us that they suspected that field audit offices were altering their reported data to appear more favorable for increased staffing.

Similarly, there has been reduced reliance on requirement plan data on DCAA staffing requests to DOD. The staffing level request in DCAA's fiscal year 1983 budget justification to the Secretary of Defense was directly supported by field office requirements plan data. However, management judgment was increasingly applied to field office data in supporting budget requests for future years.

Recorded Work Backlog—An Unverifiable Indicator of Audit Risk or Staff Needs

Each year when field audit offices prepare their requirements plan, the dollar value assigned to their work includes an estimate for unaudited cost from prior years, or a backlog of discretionary audit work. The work backlog included in DCAA's requirements plan has increased from $28 billion in 1980, to a total of $60 billion in 1984. A steady increase is projected to a high of $92 billion by the end of 1987. On the surface, this condition indicates that DCAA does not have enough staff to perform its audits; therefore, a substantial amount of contract dollars are not being audited—a risky situation.

We attempted to determine whether the recorded backlog was a valid indicator of an amount of risk being assumed by the field audit offices and whether it was, or could be used, to justify the need for additional resources. We found that although DCAA accounted for the dollar value of unaudited costs from prior year's work in its requirements plan, these dollar values are not part of the computations used to determine resource needs—audit hours, not dollar values, form the basis for computing resource needs.

For example, under DCAA's planning process, each field office identifies the discretionary work or workpackages it considers necessary to cover a contractor's incurred costs for the coming year. At this time, work will receive a WRAP analysis and priorities will be assigned. Workpackages are then assigned audit hours. The total of these hours forms the basis for estimated staff needs included in the requirements plan. It is important to note, that DCAA zero bases its discretionary work each year. That is, workpackages are not automatically carried over from one year to the next. Each year the field office managers are to determine the workpackages and priorities for that year, which may or may not include previous years workpackages. If the workpackages are not included in the next years level of effort, their identity is lost and they will not be considered in future years.

The value of work to be performed is computed by assigning a portion of unaudited carryover of cost or backlog and a portion of the estimated current year costs to each workpackage. This results in a unit cost per hour of audit. To determine the workpackage cost, when audits are performed, the hours consumed are multiplied by the hourly cost. If the cost is more than the estimate the backlog is reduced, if less, it is increased. At the end of the year, the net value of over or under workpackage audit hours is either added to or subtracted from the backlog. In addition, the value of the unaudited workpackages is added to the backlog.

Although the backlog is not used in determining resource needs or the risk of not performing audits, it could be erroneously interpreted as such. This method of calculating backlog does not provide a verifiable measure of needs and risks. However, if it were computed differently it could be used for that purpose.

During our review, DCAA Headquarters, in its planning directive for management year 1985, stated that the plan should separately identify the hours of work and dollars related to a contractor's current and prior year. Also, the hours required to review contractor operations, procedures, and practices for prior year costs will be limited to compliance or attest type reviews (primarily Mandatory Annual Audit Requirements (MAARs)). This approach should help DCAA management, through a more verifiable backlog measurement, in determining the risk associated with not performing audits and the resources needed to minimize these risks.

Follow-Up on Peer Reviews Needs to Be Improved

DCAA Headquarters has a program for periodic formal evaluations of regional and field office operations to ensure compliance with agency directives and to evaluate the effectiveness of their performance. These evaluations are referred to as general purpose surveys or peer reviews. Peer review teams are comprised of 6 to 12 experienced field office chiefs and specialists headed by a regional audit manager. All team members are selected from regions other than the one under review. Reviews are generally 1 month in duration, which includes 2 weeks at the regional headquarters and 2 weeks at an assigned field office. About 10 field audit offices are selected for each review and both regional and field office reviews are done using a standard set of guidelines. Frequency of evaluations has varied, but each region usually is reviewed every 3 to 4 years. In connection with the Federal Managers Financial Integrity Act of 1982 (Public Law 97-255), DCAA recently certified that two regions would be evaluated per year, requiring 3 years to cover all regional offices and selected field offices in each region.

We examined prior peer review results and learned the extent to which findings were promptly acted on. These peer reviews were done between 1980 and 1982.

We found that some of the problems we identified with DCAA's implementation of its planning system had also been disclosed by the peer review groups. For example, table 2.1 compares our findings with the results of recent DCAA peer reviews.

Table 2.1: Similar Problems Identified by Us and DCAA Peer Reviews

Management issue	DCAA region where we identified issue	Same problem identified by DCAA regional peer review
Vulnerability assessment of contractors not performed	Atlanta Los Angeles San Francisco	Atlanta (1982)
Priority analysis (WRAP) not consistently applied or properly used	Boston Los Angeles San Francisco	Atlanta (1982) Los Angeles (1980) San Francisco (1981)

According to DCAA Headquarters, no formal follow-up process for implementing the results of the peer reviews is available. We were told, however, that DCAA plans to establish a follow-up procedure once a computer-based system becomes operational. We agree that a formal follow-up system is needed.

Planning System Changes After Our Analysis

During the period of our work, DCAA began a study of its field audit requirements and subsequently established the MAARS program. This program requires performance of certain audit requirements at major contractor locations. Also, the program objective document issued by DCAA Headquarters to request the field office requirements plan for management year 1985 included changes and clarifications in the planning process. While we did not have an opportunity to assess the effect of these changes, we believe consistent implementation by field audit offices could eliminate some of the situations we found. Our observations on the planning system changes and potential benefits are discussed in the following sections.

MAARs Implemented to Ensure Compliance With Auditing Standards

Field audit office managers expressed concern during an April 1981 conference that (1) DCAA was reaching a point where its work load exceeded available resources and (2) increasing productivity expectations in planning and executing work plans may have an adverse influence on the DCAA auditors' ability to comply with generally accepted auditing standards. The ad hoc committee established to review this issue identified 30 audit requirements they considered as the minimum essential needed to ensure adequate audit coverage. These requirements became the MAARS program which was field tested at two major contractors in each DCAA region during management year 1983. After analyzing the results, DCAA executives concluded that only 20 of the 30 requirements need to be met on an annual bases to determine whether a contractor's incurred

costs are reasonable, allocable, and allowable. Examples of those requirements are as follows:

- Update internal control survey.
- Analyze annual contract costs and reconcile to books.
- Update permanent files.
- Perform labor floor checks and other tests to ensure reliability of labor charges.
- Analyze selected indirect cost accounts.

DCAA Headquarters implemented the MAARS concept on May 31, 1983, in a memorandum to its regional directors. A formal documentation process was established for all contractors having an annual volume of auditable cost over $100 million. Also, the concept is to be considered in planning and scheduling work on cost incurred by other contractors. The use of MAARS began with those contractor fiscal years beginning on or after January 1, 1983. The annual aspect of MAARS represents the costs incurred within a contractor's fiscal year. The work may be done in cycles or as part of routine audit assignments.

We have not had an opportunity to evaluate the effect MAARS will have on DCAA's planning process. However, many of the problems we noted in our assessment of the planning process involved inconsistent use of agency directives at the field office level rather than process problems. Therefore, the procedural changes made under the new MAARS concept can only improve DCAA's planning process and audit coverage if management ensures that all field audit offices consistently implement the new changes.

Management Year 1985 Program Objective Document

The 1985 program objective document which provides direction for preparing field audit plans sets forth several changes in the planning process. In transmitting the program objectives to its field offices, DCAA Headquarters expressed its belief that implementing the new procedures would help to streamline the planning process and promote consistency in terms of plan structure, determining hours required, and dollars reported. We noted the following changes which relate to the problems we found in our review and believe that consistent implementation should have a positive effect on DCAA's planning system:

- The hours required to review contractor operations, procedures, and practices for prior year costs will be limited to compliance and attest type reviews (primarily MAARS) which can be done on a retroactive

basis. Therefore, the backlog of work and its reflection of risk will be clearly identified at each field office.

- The requirements plan will separately identify the hours of work and dollars related to the contractor's current and prior fiscal years.
- At the end of each management year, responsible management personnel will make an assessment of audit accomplishments and specifically identify by year all audit efforts necessary to complete the audit of the current and prior contractor fiscal years.

Conclusions

In any organization, a particularly important role of top management is to assure compliance with established policies and procedures. The degree to which management needs to be involved in assuring compliance (i.e., the intensity of its oversight) is frequently a function of how much reliance it can place on field level activities to comply with policies and procedures. The greater the likelihood of significant deviation, the greater the need for management oversight.

We believe the inconsistencies in implementing DCAA's planning system and the apparent lack of action on its peer review results cast doubts as to the sufficiency of top management oversight of field operations, and the credibility of the information generated by the system. If field offices realize that the system is being used in managing resources, it is likely that the system will be taken more seriously. Increased use of its peer review function to guide top management in how much it can increase its reliance on the system appears worthy of serious consideration.

We are not suggesting that top management rely totally on its planning system or its requirements plan as the basis for managing resources. Information systems are tools which support management judgment, not replace it. We are, however, suggesting that DCAA attempt to have its planning system better serve management by increasing its reliability.

DCAA might also benefit by carefully reviewing the clarity of its guidance. The inconsistencies in implementing the planning system with respect to maintaining permanent files (see p. 21) application of the WRAP (see p. 21) may be the result of confusion on the part of field audit office personnel as to exactly what is required.

Recommendations

We recommend that the Secretary of Defense instruct the Director, DCAA, to ensure that field audit offices adhere to the planning system to provide information which is reliable for approving work plans and managing resources. As a minimum, we suggest that the Director, DCAA,

- reemphasize to all field offices the importance of adhering to agency planning system requirements;
- ensure that the results of the agency's peer review function are acted upon; and
- as conditions permit, rely more heavily on the planning system as a basis for resource management.

Agency Comments and Our Evaluation

DOD agreed with our recommendations and noted that actions have been taken or are planned in several areas to demonstrate DCAA management's resolve to properly identify resource requirements, prioritize its work, and provide customers quality service in a reasonable time. DOD indicated that a number of remedies are being taken as follows:

- DCAA is currently developing recommendations for expanded coverage of planning and management controls in formal training courses for supervisory auditors. Also, DCAA has established a Planning Process Review Committee to perform a detailed study of its planning process.
- Permanent files should be maintained and kept current and DCAA needs to provide more definitive guidance on maintaining those files. DCAA is reviewing its guidance and will instruct its field offices on the essential file content.
- While DCAA made its resource allocation for fiscal year 1984 in a judgmental manner, this does not indicate a trend in resource allocation. DOD stated that DCAA has implemented a new staff allocation model which would allocate auditors for fiscal years 1985 and 1986 on the basis of requirements and performance data.
- After completing our field work, DCAA's planning system was changed to require separate identification of auditable dollars, including backlog, by contractor fiscal year. Also, WRAP will now be applied to both current and prior year dollars.
- DCAA's follow-up procedures have not been formally published. DOD stated that DCAA's peer review procedures are currently being revised and will be issued as a formal regulation.

The Assistant Secretary of Defense's (Comptroller) office will continue to monitor DCAA's progress in these areas and has a management review of DCAA's planning system underway.

While agreeing with our recommendations, DOD expressed reservation about the significance of our reported findings on DCAA's planning system. DOD stated that only about 20 percent rather than 50 percent of DCAA's staffing requirements are actually related to discretionary effort and, thus, subject to the planning system procedures that were discussed in our draft report.

The statement of work division by type shown in our draft report stated that differences existed among field offices as to demand versus discretionary audit classifications. Also, we stated that work in certain categories was generally considered demand in nature and in total, this work involved about 50 percent of DCAA's annual direct work load. We could find no clear distinction in DCAA directives to classify the remaining work during our review and since differences existed among the DCAA field offices, we could not make a definitive computation of demand versus discretionary audit effort. We agree that all work in the categories making up the 50 percent shown in our draft report would not be subject to the planning system procedures discussed in the preceding sections. However, we believe the portion is greater than the 20 percent claimed by DOD.

The vulnerability assessment and WRAP planning procedures discussed above apply primarily to audits classified as incurred cost which represented about 33 percent of DCAA's direct audit effort in management year 1985. DCAA's planning directive to field offices for management year 1985 included the first definition of demand work we found during our work. Essentially, it stated that demand work consisted of any audit which was specifically requested and/or has a specific due date.

We agree that more than 50 percent of DCAA's work is of the type which would be classified as demand because it is usually done only on request. For example, forward pricing (45 percent) and special audits (6 percent) are done at the specific request of contracting officers. Also, defective pricing audits (3.5 percent) are not subject to WRAP or the other planning procedures we discussed in our draft report.

Generally, the DCAA's planning procedures discussed in our report relate to incurred cost audit effort. This work is required in order for DCAA auditors to certify costs claimed on contractor's final payment claims. It is generally done in the areas and in the depth considered necessary by the field audit office manager to give assurance that costs claimed are allocable, allowable, and reasonable for payment. In management year 1985 DCAA requirement plans showed the cost value of proposed

incurred cost work to be $145.9 billion. Irrespective of whether the planning system applies to 50 or 20 percent of DCAA's audit work load, we believe this portion of their work load is critical and demands management's attention. Adherence to agency planning procedures is needed when significant dollars are involved. Further, DCAA has never been able to perform all the incurred cost (discretionary) work it plans for each year. Therefore, we believe planning systems such as those we evaluated, which assist in identifying resource needs and prioritizing work load, are vitally important to DCAA's ability to fulfill its total audit mission particularly in accepting incurred costs claimed under contracts. DOD agreed that our draft report accurately discussed the DCAA planning system for identifying and prioritizing work and computing resource requirements as it existed at the time of our audit work.

DOD agreed that vulnerability assessments were necessary; however, it could not determine from our draft report whether initial assessments or updates were involved. DOD noted that initial assessments are required and updates are made as future audits are completed and/or circumstances change. An annual update of assessments is not automatically required. Our work essentially addressed the absence of assessments which had not been updated since initially completed as far back as 1980. DOD stated that DCAA took action near the end of our field work to issue additional guidance to field activities to stress the importance of vulnerability assessments, the relationship with requirements and program planning, and the need to continuously update the forms on file.

DCAA Reports Are Used and Its Customers Are Generally Satisfied

Important measures of an organization's value are whether what it produces is used, and what its customers think of its products. We examined the use made by contracting officers of a selection of DCAA reports. The selection included audit work requested by contracting officers and discretionary audits. We also asked DCAA's customers how satisfied they were with the reports they received.

In 85 percent of the reports we reviewed, some part of DCAA findings were used in establishing the government's negotiating position or in administering existing government contracts. DCAA's customers were also generally satisfied with the quality of its work. At the same time, our discussions with and questionnaire responses from contracting personnel suggested that DCAA might further improve on its performance by (1) providing more detail on why costs are questioned and (2) expanding the scope section of its reports to more fully explain the work steps taken during the audit.

Products Generally Used

Because DCAA is only one member of the procurement team providing advice to the contracting officer, it is sometimes difficult to assess the true value of its work. Even though a contracting officer may not directly accept DCAA's opinions, it may still provide a point of view which when contrasted with other views received, will allow the contracting officer to make sounder judgments. Therefore, attempts to objectively measure from the records how audit work was used may be somewhat less than ideal. At the same time, when this information is used with other performance measures (such as customer satisfaction) and where the results support each other, they can be meaningful indicators of overall performance.

In 330, or about 85 percent of the 388 audit reports we reviewed, we were able to trace some part of the report findings to the government's negotiating position, as reflected in the written negotiation record, or to some other use. In 167 of the reports (43 percent), it appears that at least half of DCAA's advice was used and sustained. In cases where its results were not used, there were legitimate reasons why, such as the contractor providing new or more current cost data before or during negotiations, or establishing new forward pricing rates after DCAA had completed its audit. In other cases, the contracting officer, even though considering DCAA's results, relied more heavily on advice from other procurement experts.

Cases Where Reports Were Not Used

In 58, or 15 percent of 388 reports we reviewed, we were unable to find a connection between the DCAA report and records which would show how the report was used. In discussing these cases with the user, there appeared to be, in most cases, good reasons why the audit work could not be used, as shown in table 3.1.

Table 3.1: DCAA Reports

Reasons reports were not used	Number of reports
Audited proposal significantly revised	25
Procurement canceled	11
Proposal rejected	5
Unsatisfactory report	6
Other reasons	11
Total	**58**

Even though the above reports may not have been used, we found that the audit work generally satisfied the initial audit request, and some of the reports were used to prepare for negotiations that subsequently did not take place. Since the records do not clearly establish when the decision was made to cancel or change the procurement, we could not determine how much of this audit effort could have been avoided if DCAA had been notified by the contracting officer that the report was no longer needed.

Contracting officers considered only 6 of the 388 sample reports useless, because of auditor errors or a lack of supporting detail. For example, one price analyst had problems with the clarity and supporting detail in a report. The analyst said the report failed to show why costs were questioned, or how the questioned amounts were computed. After the price analyst pointed out these problems, DCAA issued supplemental data clarifying the report.

Customers Satisfied With Quality of Reports

Customers who received the DCAA reports we examined were generally satisfied with their overall quality. We asked DCAA's customers to rate their satisfaction with DCAA reports in terms of (1) usefulness, (2) accuracy, (3) thoroughness, (4) ease of understanding, (5) adequacy of support, and (6) timeliness. DCAA received the highest customer satisfaction levels on the accuracy, usefulness, and ease of understanding of its

reports (79, 75, and 72 percent, respectively, were very satisfied or satisfied). Lower customer satisfaction levels were received on thoroughness, adequacy of support, and timeliness (66, 60, and 55 percent, respectively). (See pp. 34 through 39 for summarized results.)

Figure 3.1: Customer Satisfaction With Accuracy

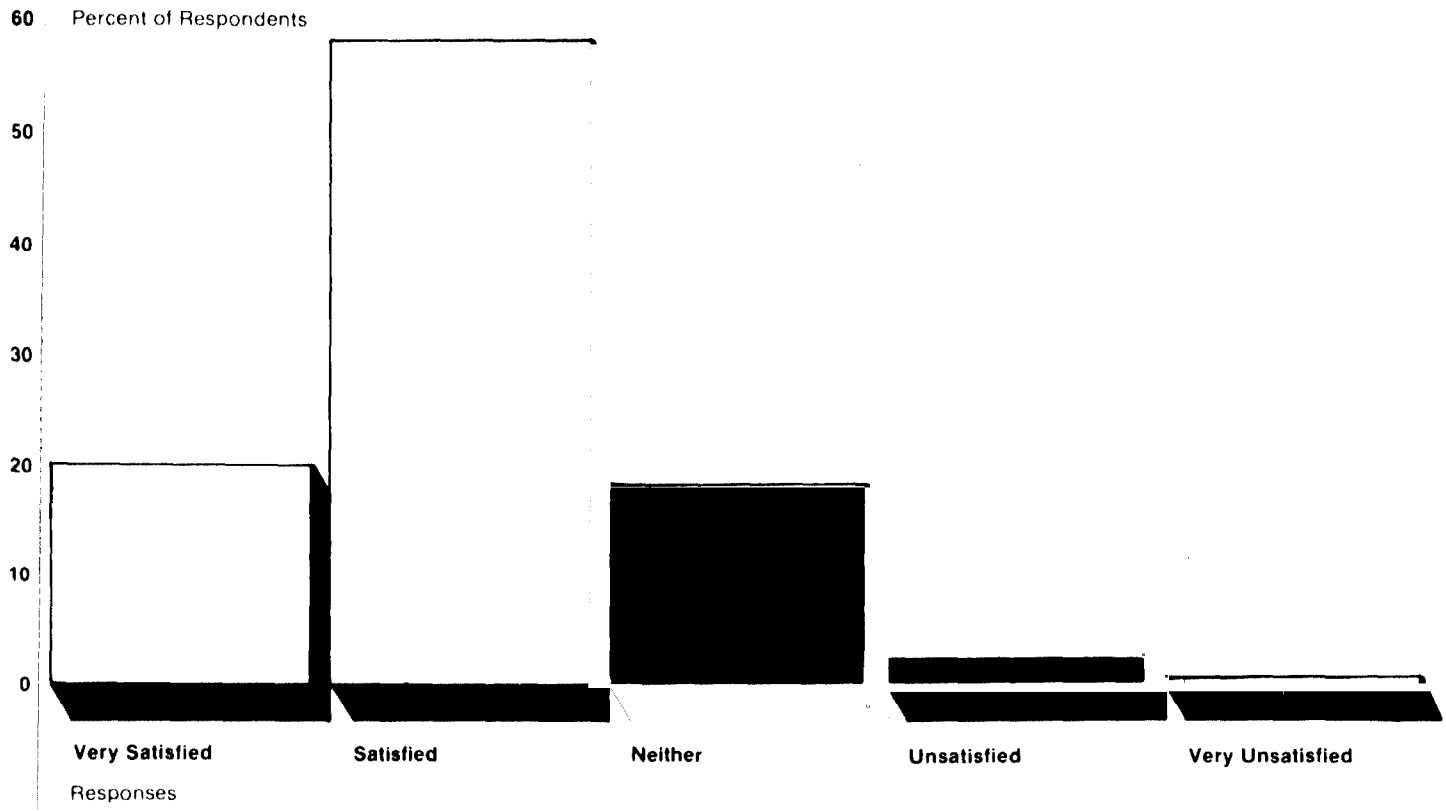


Figure 3.2: Customer Satisfaction With Usefulness

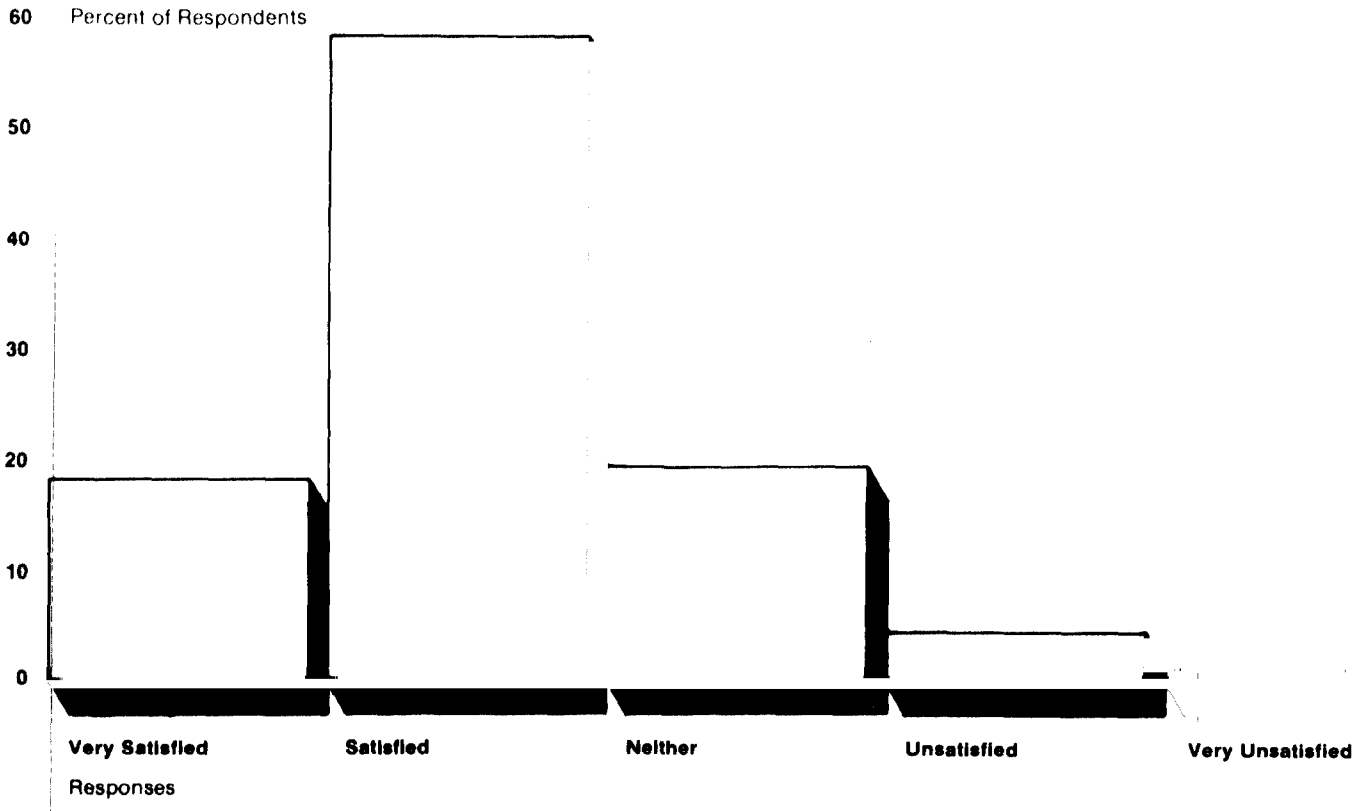


Figure 3.3: Customer Satisfaction With Ease of Understanding

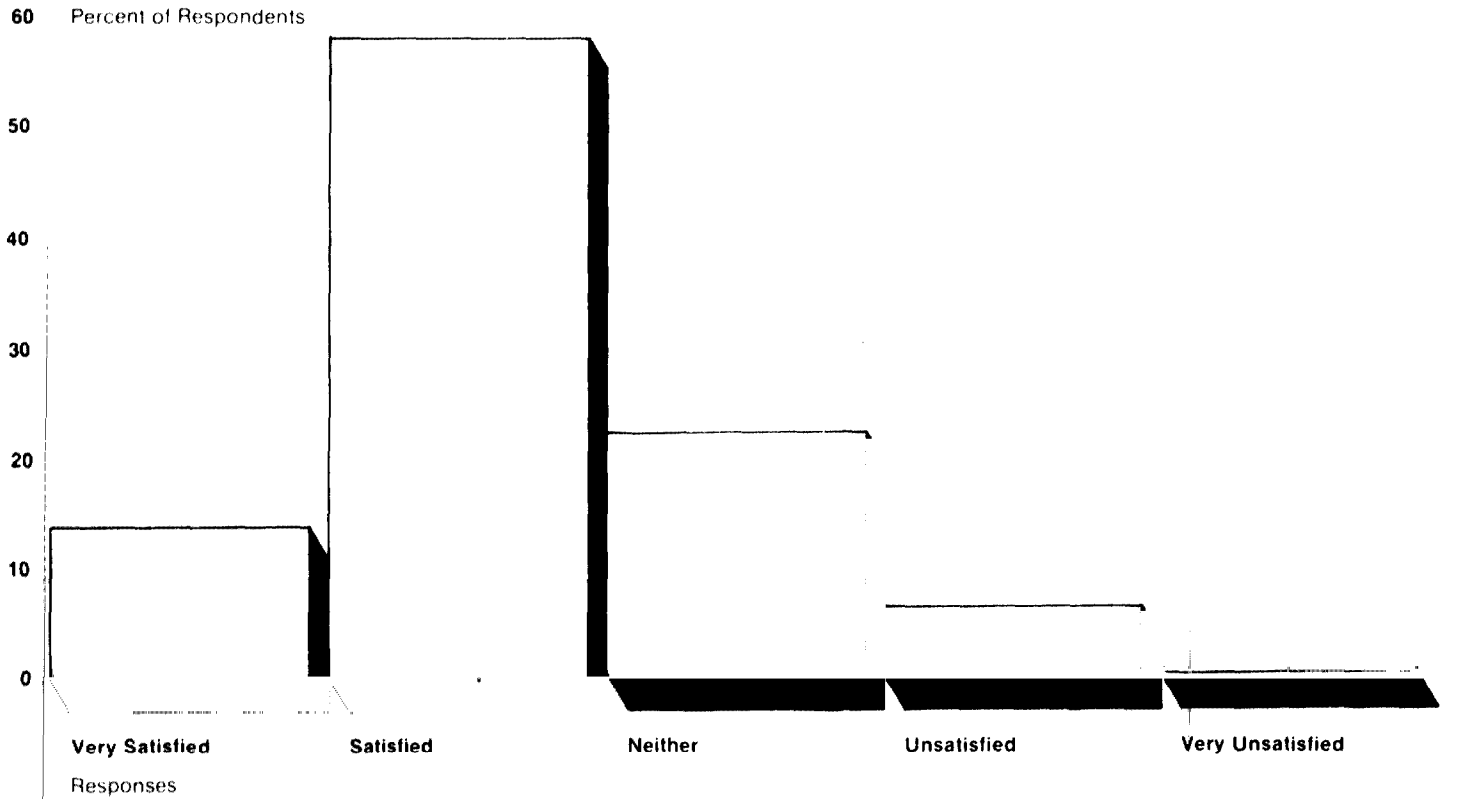


Figure 3.4: Customer Satisfaction With Thoroughness

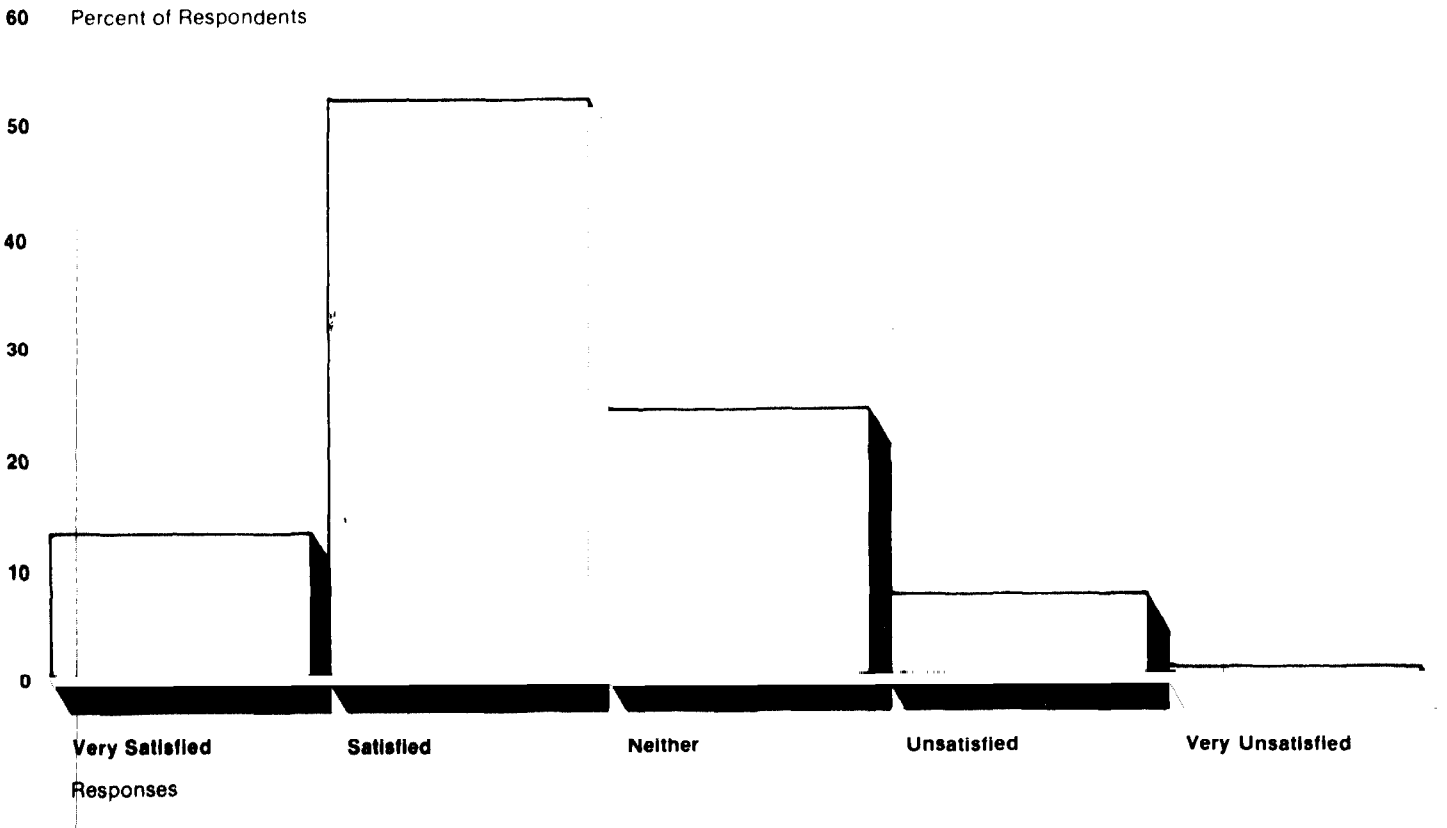


Figure 3.5: Customer Satisfaction With Adequacy of Support

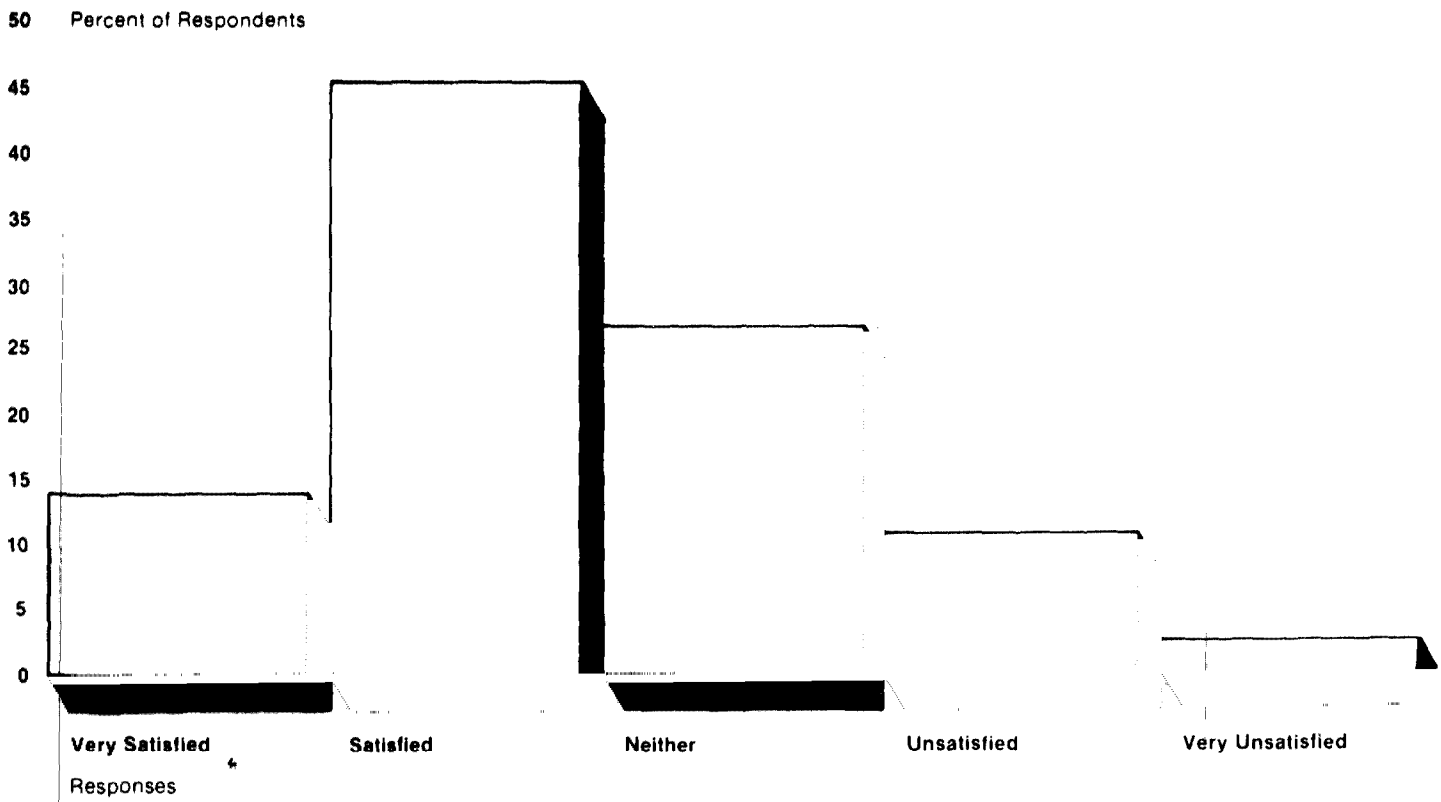
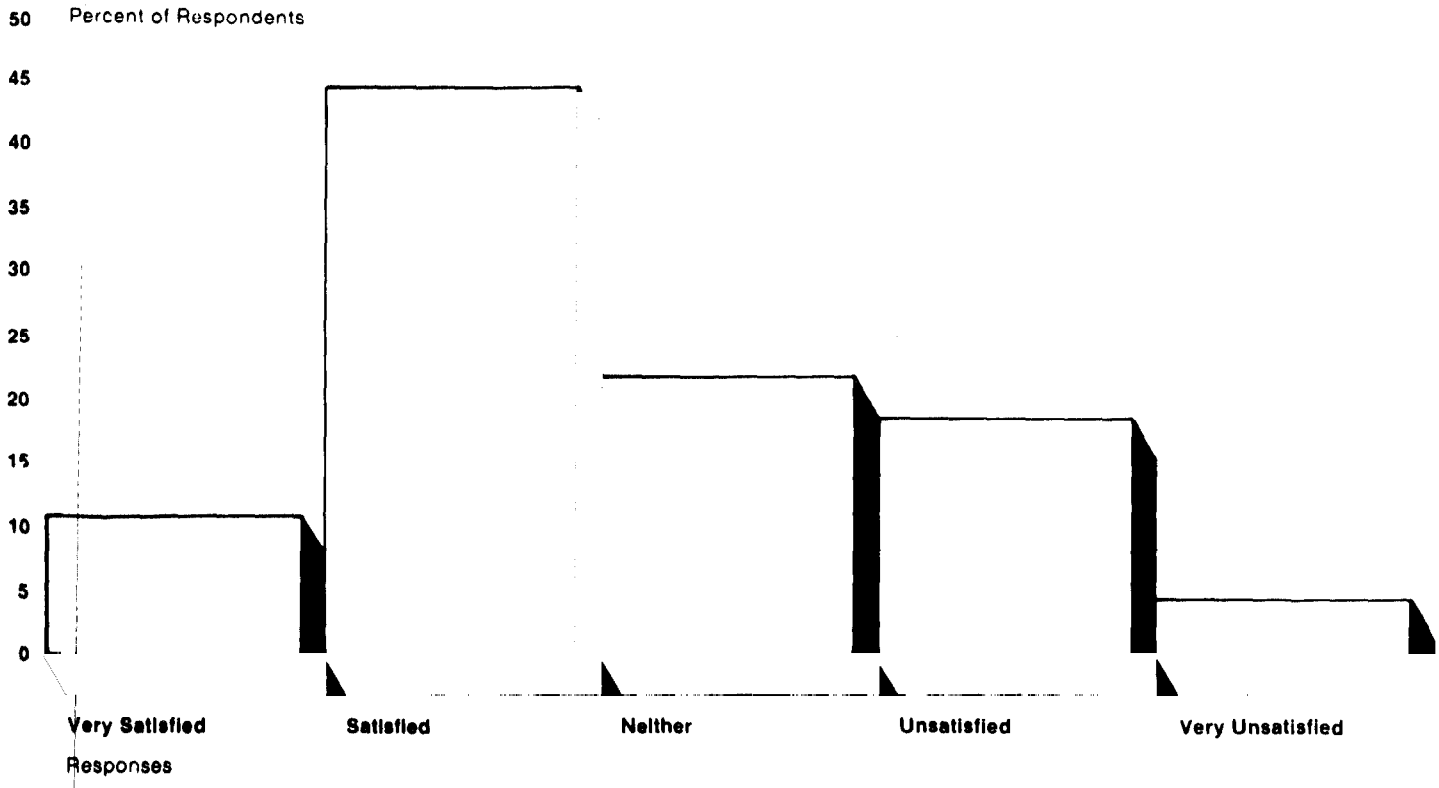


Figure 3.6: Customer Satisfaction With Timeliness



Again, we recognize that the validity of the questionnaire responses, if used alone, may be questionable because of the apparent close working relationship between the DCAA auditor and the contracting or other official. However, when used with more objectively verifiable measures of performance, it can provide corroborating information. In this instance, the generally positive questionnaire responses agree with the results of our review of the records on report use.

Timeliness of DCAA Reports

The lowest level satisfaction received out of the six measures discussed, was on the timeliness of DCAA reports. Twenty-three percent of respondents were dissatisfied or very dissatisfied. We reviewed the timeliness of DCAA's reports as part of our examination of the uses made to the reports.

We found that about 47 percent of the 388 sample reports we reviewed were received by the customer after the requested due date. However, only a few delayed negotiations, and none had an identifiable effect on contract price. About half of the late reports were issued within 15 days. However, some of these late reports concerned routine matters which did not appear time critical. DCAA sometimes provided verbal audit results by the requested date and forwarded the written report later. Also, they often negotiated and met a revised due date.

The Federal Acquisition Regulations require contracting officers, in establishing a report due date, to allow as much time as possible for the audit work. If the auditor cannot meet the due date, additional time can be requested, subject to the contracting officer's approval.

Contracting personnel appear to have adopted a 30-day period as an unofficial standard for completing the audit. They routinely allow 30 days for the audit whether or not the report is needed at that time. In fact, we found that many negotiations were conducted long after the audit reports were received.

It appears that a request date closer to the negotiations date would help DCAA schedule its work and provide timely audit coverage of high priority assignments. It should also result in fewer audit reports not being used.

On the other hand, procurement officers sometimes face extremely short time frames for negotiating a contract, and considering the audit work required, allow DCAA a limited time. Even though DCAA may assign a larger staff to such an audit, it must often limit its audit scope to produce the report by the requested date. For example, one audit report we reviewed dealt with a $375 million proposal negotiated by the Army for target acquisition equipment. The contracting officer requested verbal comments from DCAA in 3 days and the written report in 2 weeks. To meet the due dates, DCAA reduced audit effort in the cost elements of engineering material, labor hours, and warranty costs.

Suggestions for Improving Audit Reports

Twenty-five percent of the users of the 388 reports we reviewed believed DCAA could improve the usefulness of its audit reports by (1) providing more detail on why costs are questioned and (2) expanding the scope section to more fully explain the work steps taken during the audit.

DCAA Should Provide More Details on Questioned Costs

Contracting personnel said that some reports do not contain enough detail to allow them to effectively negotiate questioned costs or practices. Negotiators said that they generally cannot convince a contractor to accept a DCAA finding unless sufficient facts and supporting details are provided. They believe that more detail in the audit report would help them better negotiate for the government in meetings with contractors.

The need for more report detail was also identified in a May 1984 DOD survey of its contracting offices. Forty-eight percent of the 1,253 contracting officers responding to the survey cited the need for auditors to provide more detailed rationale for positions taken in their reports.

DCAA Should Explain All Audit Steps

DCAA reports audit findings on an exception basis, only explaining questioned costs in the report. When requesting audits, some contracting officers ask DCAA to emphasize specific cost accounts; however, in its reports DCAA does not explain the audit steps taken unless it questions an element of the account. While this policy reduces the report narrative, contracting officers said that they are sometimes unsure whether their specific audit request was fulfilled, and would like to see more detail on the audit steps used.

Procurement System Problems Which Could Affect Negotiations

During the course of our work on the use of DCAA's audit results in contract price negotiations, we noted several problems in the procurement process that could affect the negotiation results. We did not pursue these individual cases to determine their significance in terms of number or dollar impact because we did not want to detract from the main objective of our current work. The types of problems we noted are as follows:

- Vague price negotiation memorandums make it difficult to determine how audit findings were used.
- Technical evaluations are not provided to DCAA in time to be incorporated in the audit report.
- When contractors' proposals are updated or revised after the audit, new information replaces some that DCAA reviewed; therefore, the contracting officer negotiates with some unaudited data.
- If negotiations under basic ordering agreements are very late, the contractor may be overpaid through provisional billings and the contractor receives a "free loan" until the overpayment is recovered.
- Contractors delay in providing supporting detail to auditors.
- Contractors submit inadequate support for proposals.

Although we did not pursue the individual problems, we are concerned with the potential for a significant effect on contract prices if these problems are widespread. Most of these problems will be considered as part of our reviews into the fairness and reasonableness of prices negotiated in defense contracts. (See p. 8.)

Conclusions

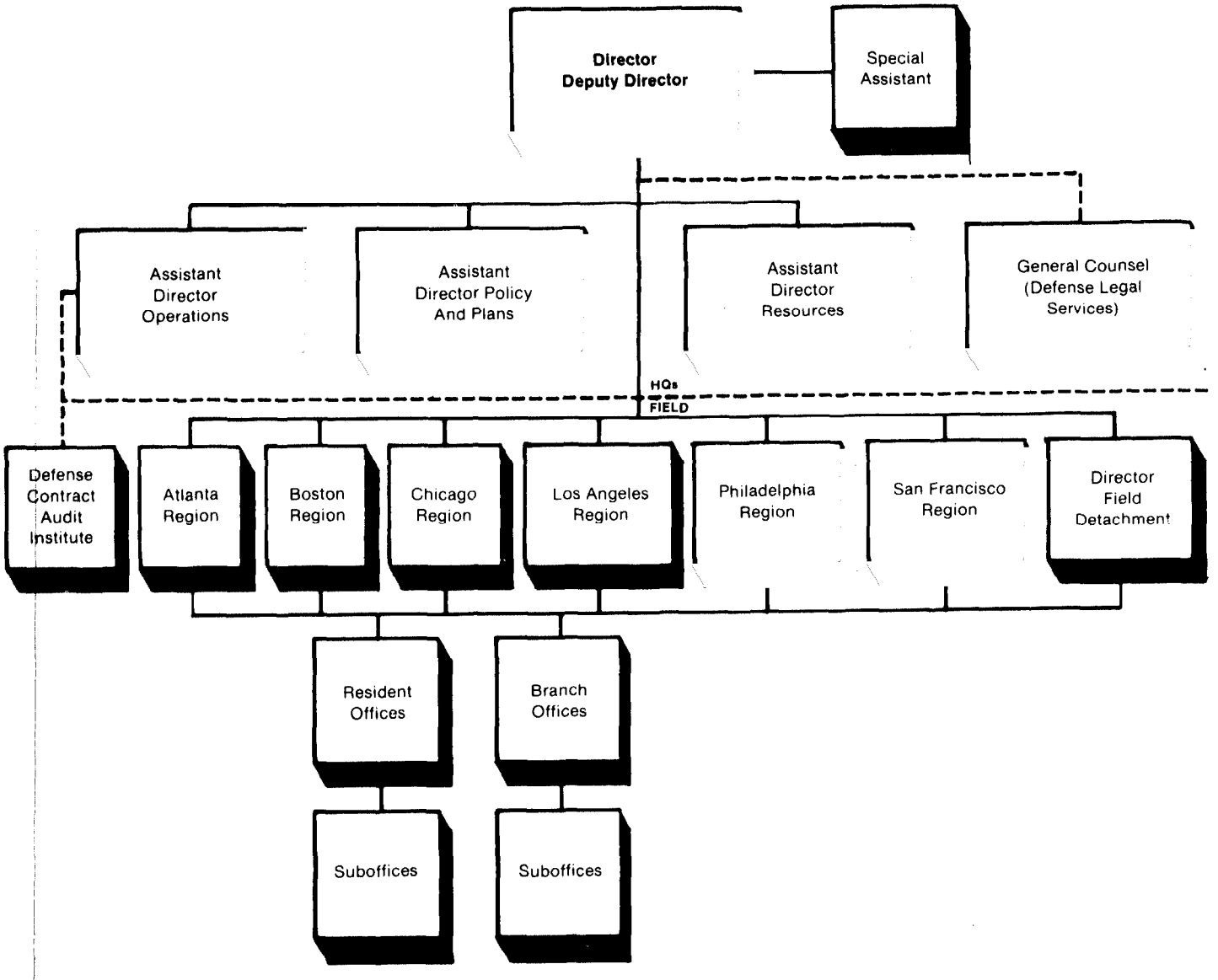
Overall, DCAA's customers appeared satisfied with the results of its audit work, and in a high percentage of the reports we reviewed, some part of DCAA's findings were used in establishing the government's negotiating position or in administering existing government contracts.

According to contracting personnel, DCAA could improve its reports by (1) providing more detail on why costs are questioned and (2) expanding the scope section to more fully explain the work steps taken during its audits. We believe that DCAA might benefit from further discussions with its customers on how to improve its work and reports.

Agency Comments and Our Evaluation

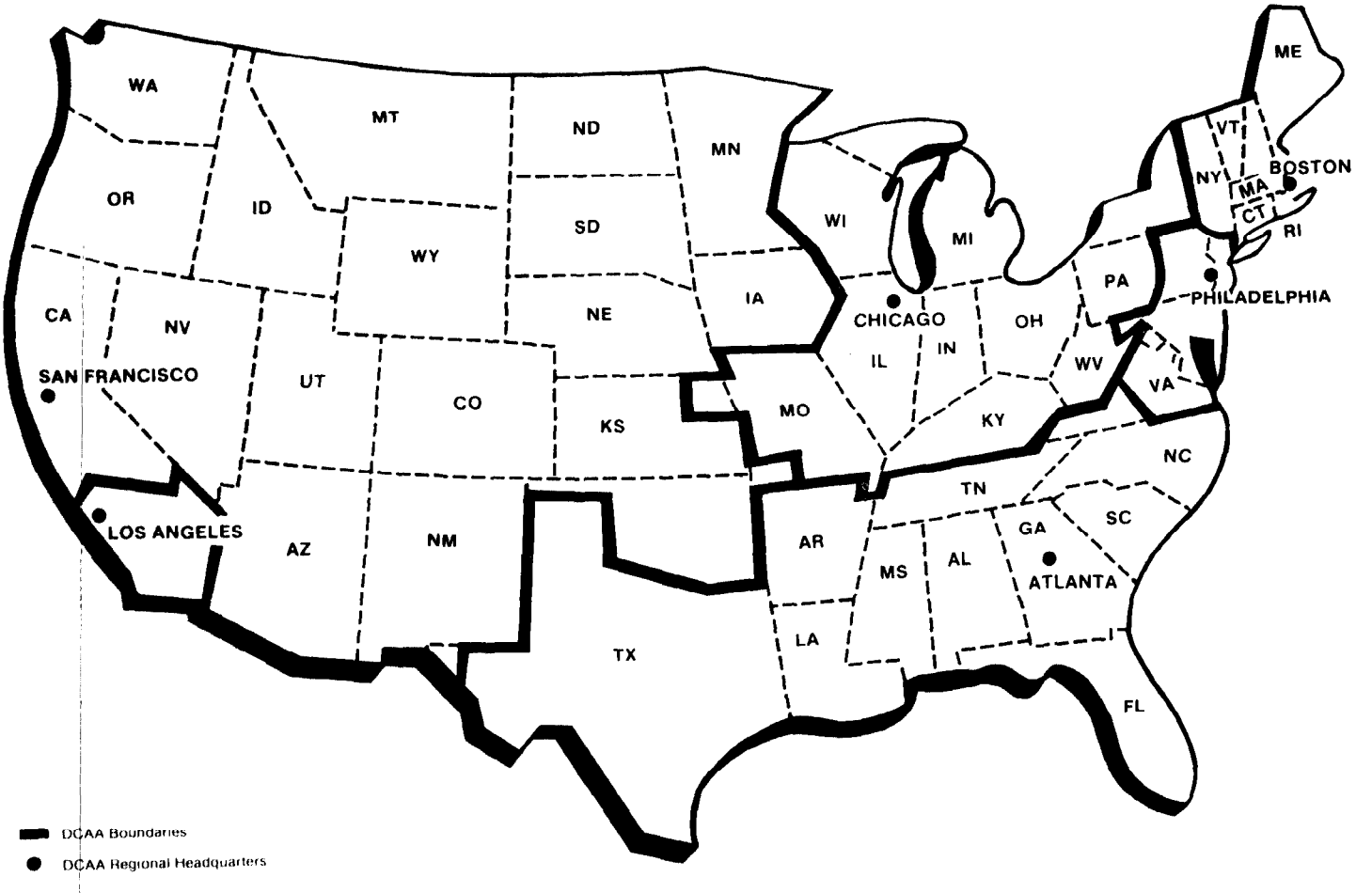
DOD concurred with our conclusions and stated that DCAA is studying the suggestions for audit report improvement and will take any action necessary to make reports more usable to procurement officials.

DCAA Organization Chart



Appendix I

Regional Boundaries



Offices and Activities Visited to Assess Planning System Implementation

Atlanta Region:	
Atlanta Regional Office	Marietta, Ga.
Huntsville Branch Office	Huntsville, Ala.
Lockheed-Georgia Co., Resident Office	Marietta, Ga.
Martin Marietta Aerospace, Resident Office	Orlando, Fla.
Orlando Branch Office	Orlando, Fla.
Boston Region:	
Boston Regional Office	Waltham, Mass.
General Electric Co., Resident Office	Lynn, Mass.
Raytheon Corp., Resident Office	Andover, Mass.
UTC Sikorsky Aircraft Division, Resident Office	Bridgeport, Conn.
Waltham Branch Office	Waltham, Mass.
Los Angeles Region:	
Los Angeles Regional Office	Los Angeles, Calif.
General Dynamics Corp., Resident Office	San Diego, Calif.
Hughes Aircraft Co., Resident Office	Fullerton, Calif.
Pasadena Branch Office	Pasadena, Calif.
TRW, Inc., Resident Office	Redondo Beach, Calif.
Van Nuys Branch Office	Van Nuys, Calif.
San Francisco Region:	
San Francisco Regional Office	San Francisco, Calif.
Denver Branch Office	Denver, Colo.
East Bay Branch Office	Oakland, Calif.
Lockheed Missile and Space Co., Resident Office	Sunnyvale, Calif.
Martin Marietta Aerospace, Resident Office	Denver, Colo.
Phoenix Branch Office	Phoenix, Ariz.
Salt Lake City Branch Office	Salt Lake City, Utah
Sunnyvale Branch Office	Sunnyvale, Calif.
DCAA Headquarters:	Alexandria, Va.

Offices and Activities Visited to Assess Contracting Officers' Use of DCAA Reports

DCAA Offices:	
Boston Branch Office	Boston, Mass.
Denver Branch Office	Denver, Colo.
East Bay Branch Office	Oakland, Calif.
General Dynamics Corp., Resident Office	Fort Worth, Tex.
General Dynamics Corp., Resident Office	Pomona, Calif.
General Dynamics Corp., Resident Office	San Diego, Calif.
General Electric Co., Resident Office	Cincinnati, Ohio
General Electric Co., Resident Office	Lynn, Mass.
Hughes Aircraft Co., Resident Office	Fullerton, Calif.
Huntsville Branch Office	Huntsville, Ala.
Lockheed-Georgia Co., Resident Office	Marietta, Ga.
Martin Marietta Aerospace, Resident Office	Orlando, Fla.
McDonnell Aircraft, Resident Office	St. Louis, Mo.
Orlando Branch Office	Orlando, Fla.
Pasadena Branch Office	Pasadena, Calif.
Phoenix Branch Office	Phoenix, Ariz.
Sunnyvale Branch Office	Sunnyvale, Calif.
UTC Sikorsky Aircraft Division, Resident Office	Stratford, Conn.
Van Nuys Branch Office	Van Nuys, Calif.
Waltham Branch Office	Waltham, Mass.
Procuring Activities:	
Air Force Systems Command Aeronautical Systems Division	Dayton, Ohio
Army Missile Command	Redstone Arsenal, Ala.
Army Troop Support and Aviation Material Readiness Command	St. Louis, Mo.
Naval Air Systems Command	Washington, D.C.
Naval Sea Systems Command	Washington, D.C.
San Antonio Air Logistics Center	San Antonio, Tex.
Defense Contract Administration Services Management Area Offices:	
Boston, Mass.	
Denver, Colo.	
Huntsville, Ala.	
Orlando, Fla.	
Phoenix, Ariz.	
San Bruno, Calif.	
Van Nuys, Calif.	
Defense Contract Administration Services Plant Representative Office:	
General Dynamics Corp.	San Diego, Calif.

Air Force Plant Representative Offices:	
General Dynamics Corp.	Fort Worth, Tex.
General Electric Co.	Cincinnati, Ohio
Lockheed-Georgia Co.	Marietta, Ga.
Navy Plant Representative Offices:	
General Dynamics Corp.	Pomona, Calif.
General Electric Co.	Lynn, Mass.
McDonnell Douglas Corp.	St. Louis, Mo.
United Technologies Corp.	Stratford, Conn.

Comments From the Secretary of Defense

COMPTROLLER

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

1 4 AUG 1985

Mr. Frank C. Conahan
Director, National Security and
International Affairs Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) June 3, 1985 draft audit report (GAO Code 942193 and 942194) entitled, "Defense Contract Audit Agency Needs To Increase Its Management Oversight Of Planning Operations And Reports," (OSD Case 6771). Before commenting on the report findings and recommendation there are two matters which should be addressed.

The draft audit report includes a detailed discussion of the Defense Contract Audit Agency planning system, and outlines several differences in implementation among field audit offices. However, there is no indication in the report that vulnerability assessments and workpackage risk analysis apply only to discretionary work. This is a critical point in assessing the relative significance of the report findings. Contrary to the GAO assumption that about 50 percent of DCAA audits are discretionary at the field office level, only about 20 percent of staffing requirements are actually related to field office discretionary effort.

With the exception of our reservation as to the extent of the reported findings, the draft report accurately discusses the DCAA planning system for identifying and prioritizing work and computing resource requirements as it existed at the time of the GAO on site audit work. Recent actions taken or planned by DCAA will serve to improve the planning system and the associated resource allocations. Customer satisfaction with DCAA audit reports is expressed along with two suggestions for improving performance. DCAA is studying the suggestions for audit report improvement and will take any action necessary to make reports more usable to procurement officials.

Comments provided in the enclosure address each of the findings and the recommendation contained in the draft report. The Department appreciates the opportunity to comment on this draft report.

Sincerely,

Robert W. Helm

Enclosure

Robert W. Helm
Assistant Secretary of Defense
(Comptroller)

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GAO DRAFT REPORT - DATED JUNE 3, 1985
(GAO CODES 942193 AND 942194) - OSD CASE 6771

"DEFENSE CONTRACT AUDIT AGENCY NEEDS TO INCREASE ITS MANAGEMENT OVERSIGHT OF PLANNING OPERATIONS AND REPORTS"

RESPONSE TO THE GAO DRAFT REPORT

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FINDINGS

o **FINDING A: DCAA Planning System Provides For Identifying And Prioritizing Work And Computing Resource Requirement.** GAO reported that DCAA's planning system is basically a "bottom-up" system in that it is the field offices that identify the specific discretionary work that needs to be done, prioritize the work, and identify the resources needed to do it. According to GAO, the DCAA system recognizes the decentralized nature of the work and the fact that DCAA personnel located at or near contractor plants are normally in the best position to identify the work and the potential risks to the Government from not doing the work. GAO further reported that because such field offices normally are not in a position to judge the importance of their work relative to other work of the agency, responsibility for this determination is placed at the regional and headquarters levels. GAO found that DCAA's planning process generally consists of three phases--advance planning (identification of all significant auditable activities which affect the costs of Government Contracts), requirements planning (development of field offices' best estimates of the specific audits and associated hours required during the up-coming year), and program planning (decisions on allocation of resources). GAO concluded that DCAA's planning system provides the general process for systematically identifying its workload, establishing its work priorities, computing its resources requirements and reconciling differences between work requirements and available resources. GAO further concluded that if properly implemented, the DCAA planning system could provide management and others with reasonable assurance that the most important work of the Agency is being identified, as well as a basis for managing personnel resources. GAO finally concluded, however, that the inconsistencies in the implementation of the DCAA planning system cast serious doubt on the credibility of the information generated by the system. (pp. 10-15, GAO Draft Report)

Now on pp. 17-18.

ENCLOSURE

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DoD Response: DoD concurs. DoD concurs that DCAA has a planning system which provides for identifying and prioritizing its work, and for computing personnel resource requirements and that the Agency's most important work is being adequately accomplished. On the other hand, the draft GAO report does not place the observed inconsistencies in the planning system implementation in proper perspective.

Demand workload exists in all work categories cited in the draft report. Based on the DCAA Management Year 1986 Requirements Plan, for example, it is estimated that discretionary effort accounts for only about 20 percent of DCAA audit resources, not 50 percent as indicated on report page number five. Consequently, while GAO findings with regard to the performance of vulnerability assessments and the application of workpackage risk analysis procedures are valid, they relate to a relatively small percentage of the Agency's work.

DoD recognizes the value of sound work planning and has encouraged DCAA to refine and improve upon its system for identifying resource needs and work priorities. The vulnerability assessment and workpackage risk analysis techniques described in the draft report are an outgrowth of this process, as are the Mandatory Annual Audit Requirements referenced in the draft report. Steps to further enhance work planning will continue within DCAA.

The Agency Supervisory Training Committee is currently developing recommendations for expanded coverage of DCAA planning and management controls in formal training courses conducted for supervisory auditors. The Agency has also established a Planning Process Review Committee to perform a detailed study of its planning process. It is expected that the committee, with representatives from each of DCAA's six geographical regions, will define data base requirements planning data, and identify contractor performance indicators to highlight problem contractors.

These measures will improve DCAA's ability to identify resource needs and prioritize its work.

- **FINDING B: Vulnerability Assessments Are Not Always Performed.** GAO reported that vulnerability assessments provide the basis for the DCAA auditor to assess the Government's potential exposure to fraud, waste and error. GAO found, however, that four of the 20 FAO's it visited (DCAA has a total of 130 FAOs) did not perform the required vulnerability assessments and two more FAOs performed fewer than were required. According to GAO these six FAOs are

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responsible for about 2,700 contracts with annual costs of around $3 billion. GAO reported that FAO managers said the assessments were useless and time consuming, had little impact on priority or resources, detracted from the FAOs required audit work, and contributed nothing to the managers' knowledge of the contractor. GAO concluded, however, to the contrary--i.e., that vulnerability assessments are important because they require the manager to make a formal, disciplined assessment of a contractor's accounting and internal controls as a basis for establishing and prioritizing audit work, as well as provide a basis to better target scarce resources to those contractors where the risk is greatest. (pp. 16-17, GAO Draft Report)

Now on p. 20.

DoD Response: DoD concurs. DoD concurs that the vulnerability assessment procedure is a systematic technique for quantitatively measuring exposure to contractor fraud, waste and error. An evaluation of contractor internal controls is a significant aspect of the assessment process.

While DoD agrees that vulnerability assessments should be considered in requirements planning, the GAO report does not clarify the nature of observed deficiencies, other than to say that required vulnerability assessments were not performed. It cannot therefore be determined whether initial vulnerability assessments or updates are being questioned. In addition, the number of contractors and the estimated dollar exposure is not specified in the draft report. It should be understood that DCAA policy requires an initial completion of the full questionnaire, with updating as future audits are completed and/or circumstances change. An annual update is not automatically required.

Near the completion of GAO field work under this review, DCAA Headquarters issued additional guidance to field activities on the subject of vulnerability assessments which stresses their importance, their relationship with requirements and program planning, and the need for continous updating of the forms. An abbreviated internal control questionnaire for use in developing vulnerability assessments at smaller contractors was also developed and issued for field use. "No" answers in certain sections of the questionnaire are intended to identify potential problem areas for field audit office managers.

The additional emphasis being placed on the timely completion of vulnerability assessments should eliminate the observed problem and will contribute to a better allocation of auditor resources.

- **FINDING C: Permanent Files Are Incomplete And Not Current.** GAO reported that the FAOs are required to maintain

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permanent files and to keep them current. While all FAOs maintained permanent files, GAO found some of the files (1) had no general survey file, (2) lacked separate files for each auditable area, (3) contained outdated information, and (4) included varying levels of detail on nonmajor contractors. GAO concluded that DCAA needs to provide more definitive guidance on maintaining permanent files. (pp. 17-18, GAO Draft Report)

Now on p. 21.

DoD Response: DoD concurs. DoD concurs that DCAA policy requires that permanent files be maintained and kept current and that DCAA needs to provide more definitive guidance on maintaining permanent files. DCAA is reviewing its guidance on permanent file content and, after assuring that differentiation between essential and desirable content is identified, will instruct its field offices to comply. Followup DCAA management reviews will be performed.

- **FINDING D: Work Package Risk Analysis (WRAP) Not Always Done.** GAO described WRAP as an essential aspect of planning and resource management, which assists DCAA in identifying areas of high potential for cost savings or avoidance. At 10 of the 20 FAOs visited, however, GAO found that the WRAP was not being applied consistently and uniformly--i.e., (1) WRAP was not applied to all planned discretionary audits, (2) some staff hour estimates were not based on WRAP results, and (3) cut off points were not established by 8 of the 20 FAOs. Because WRAP helps identify areas of high potential for cost savings or avoidance, helps DCAA target its resources to those areas of greatest risk or benefit, and is essential to DCAA planning and resource management, GAO concluded it must be applied consistently and uniformly. (pp. 18-20, GAO Draft Report)

Now on p. 21.

DoD Response: DoD concurs. DoD concurs that WRAP aids DCAA field activities in planning and resource management. DoD agrees that WRAP should be used as a planning tool where appropriate and that cut off points should be used as directed by Agency guidance. A May 31, 1984 Memorandum for Regional Directors reemphasized the importance of compliance with Agency procedures. Followup DCAA management reviews are being performed to assure compliance.

- **FINDING E: Credibility Of Requirements Plan Reflected In Its Limited Use.** GAO reported that the staffing level request in DCAA's FY 1983 budget justification was directly supported by FAO requirements plan data, while in FY 1984 DCAA headquarters made no allocation analysis. GAO found that, over the last few years, DCAA headquarters has made resource allocations in an increasingly judgmental manner.

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GAO further found that this is apparently due to DCAA headquarters officials' suspicions that field offices were altering their reported data to justify increased staffing. GAO concluded that the inconsistencies in the implementation of DCAA's planning system cast doubts on the credibility of the information generated by the system. GAO also concluded that DCAA top management appears to be aware of the limitations of the requirements plans prepared by its field activities. (pp. 20-27 GAO Draft Report)

Now on p. 22.

DoD Response: DoD partially concurs. The DoD agrees that DCAA's FY 83 budget justification was directly supported by FAO requirements plan data. The DoD also agrees that for FY 1984, DCAA made its resource allocation in a judgmental manner. This could have cast doubt on the credibility of the system's information, but does not indicate a trend in the use of judgmental resource allocation. The fact is that FY 1984 was unique due to the unexpected provision of an additional 400 positions by the Congress. Further, DCAA has since implemented a new Staff Allocation Model to improve the allocation of auditors for fiscal years 1985 and 1986. The new model allocates resources on the basis of requirements and performance data.

o **FINDING F: Recorded Work Backlog An Unverifiable Indicator Of Audit Risk Or Staff Needs.** GAO reported that the dollar value of the FAOs annual requirements plans includes an estimate for unaudited cost from prior years. GAO further reported that this backlog of audit work totalled $28 billion in 1980, $60 billion in 1984, and is projected to be $92 billion by the end of 1987. Although DCAA accounted for the dollar value of the backlog, GAO found that it is not a part of the resource calculations. GAO also found that prior year unaudited work packages that are not included in the next year's level of effort lose their identity for consideration in future years. GAO concluded that while the backlog indicates that DCAA may not have sufficient staff, the backlog cannot be used as a verifiable measure of needs and risks. Although the backlog is not currently used in determining resources or risks, GAO concluded that it could be used for that purpose if the identity of unaudited work packages and their required resources were maintained over time. (pp. 20-22, GAO Draft Report)

Now on pp. 23 and 24.

DoD Response: DoD concurs. Subsequent to the completion of GAO field work the DCAA planning system was changed to require the separate identification of auditable dollars, including backlog, by contractor fiscal year. Moreover, WRAP is now applied to both current and prior year dollars.

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- **FINDING G: Follow-up On Peer Reviews Needed.** GAO reported that DCAA headquarters has a program for periodic formal evaluations (called peer reviews) of regional and FAO operations to assure compliance with agency directives and to evaluate the effectiveness of their performance. GAO examined peer reviews conducted between 1980 and 1982 and found that some of the problems with DCAA's implementation of its planning system identified in this report had also been disclosed by the peer reviews. GAO also found there is no formal followup process to assure implementation of peer review results. GAO reported that DCAA has expressed an intention to establish such a follow-up procedure once a computer-based system becomes operational. GAO concluded that a formal follow-up system is needed. GAO further concluded that the apparent lack of action on peer review results casts doubt on the sufficiency of top management oversight of field operations. (pp. 23-24, 27, GAO Draft Report)

Now on pp. 24 and 25.

DoD Response: DoD concurs. DoD agrees that DCAA has a program for periodic evaluations of regional and FAO operations to assure compliance with Agency directives and to evaluate the effectiveness of performance. DoD also agrees that followup procedures have not been formally published.

Peer review results are reported to the Agency Deputy Director who tasks the Regional Director to take appropriate corrective action and to report the corrective actions taken. An oversight review is included as part of the subsequent peer review of that region. Peer review procedures are currently being revised and will be issued by DCAA as a formal regulation. The target date for completion of this action is July 1985.

- **FINDING H: DCAA Makes Planning System Changes.** GAO reported that during the period of its audit, DCAA established the Mandatory Annual Audit Requirements (MAARS) program and in the 1985 Program Objective Document set forth several changes in the FAO planning process. GAO found that the MAARS program established a formal documentation process for all contractors with an annual volume of auditable cost over $100 million; setting out requirements that must be met on an annual basis to render an opinion on whether a contractor's incurred costs are reasonable, allocable, and allowable. GAO further found that the 1985 planning directive stated the hours and dollars related to a contractor's current and prior year should be separately identified, and the hours required to review a contractor's operations, procedures and practices for prior year costs

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will be limited to compliance or attest type reviews. GAO concluded that the procedural changes under the MAARS concept can only improve DCAA's planning process and audit coverage and the 1985 Program Objective Document changes can have a positive effect if management ensures that all FAOs consistently implement the changes. (pp. 24-27, GAO Draft Report)

Now on pp. 25-27

DoD Response: DoD concurs. The MAARS were implemented in January 1983 and were the result of concerns expressed by DCAA field audit chiefs during a 1981 management conference, and are now applicable to all contractor locations. The MAARS and the other planning system changes initiated by DCAA will improve audit coverage of DoD contractors.

- **FINDING I: DCAA Reports Are Generally Used.** GAO examined how selected DCAA reports were used. GAO found that in 85 percent of the reports it reviewed, some part of the reports' findings were traceable to the Government's negotiating position. GAO further found that in 43 percent of the reports, at least half of DCAA's advice was used and sustained. GAO concluded that for these reports where DCAA's advice not be used, the audit work generally satisfied the audit request, and there appeared to be good reasons for not using the report. GAO found that contracting officers considered only six of the 388 reviewed reports to be useless due to auditor errors or lack of supporting detail. (pp. 29-31, GAO Draft Report)

Now on pp. 32-33.

DoD Response: DoD concurs.

- **FINDING J: Customers Are Satisfied With The Quality Of DCAA Reports.** GAO surveyed DCAA's customers as to the quality of the reports received in terms of (1) usefulness, (2) accuracy, (3) thoroughness, (4) ease of understanding, (5) adequacy of support, and (6) timeliness. GAO found a higher customer satisfaction with the accuracy, usefulness, and ease of understanding of the reports; and lower levels of satisfaction for thoroughness, adequacy of support and timeliness. GAO found timeliness to be the measure receiving the least satisfaction from customers. GAO concluded that the customers were generally satisfied with the overall quality of DCAA reports. GAO further concluded, however, that according to contracting personnel, DCAA could improve its reports by providing more detail on why costs are questioned, and by expanding the scope section to more fully explain the work steps taken. GAO also concluded that DCAA might be well served by further discussions with its customers about how its work and reports could be improved. (pp. 31-38, GAO Draft Report)

Now on pp. 33-40.

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DoD Response: DoD concurs. DCAA will continue to make every effort to increase contact with procurement officials, which is already a stated management goal. In addition, the suggestion concerning the scope section will be reviewed.

RECOMMENDATION

Now on pp. 27 and 28.

RECOMMENDATION: GAO recommended that the Secretary of Defense instruct the Director, DCAA, to assure that field audit offices adhere to the planning system in order to provide information which is reliable for approving work plans and managing resources. (p. 28, GAO Draft Report)

DoD Response: DoD concurs. DoD agrees the DCAA field activities should adhere to DoD and Agency guidance on the subject of work planning. Furthermore, actions already taken or planned by DCAA demonstrate management's resolve to properly identify resource requirements, prioritize its work, and provide customers quality service in a reasonable time. The Assistant Secretary of Defense (Comptroller) will continue to monitor DCAA progress in all of these areas. A management review of DCAA program planning is currently in progress.

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