

United States General Accounting Office

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Report to the Chairman, Subcommittee on
Oversight and Investigations, Committee
on Energy and Commerce, House of
Representatives

December 1988

CPA AUDIT QUALITY

Arthur Young and
Company's Work at
Bell Helicopter
Textron Inc.





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

Accounting and Financial
Management Division

B-219869

December 19, 1988

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

This report responds to your March 30, 1988, request that we review certain aspects of Arthur Young and Company's audits of Textron Inc.'s consolidated financial statements as they relate to Bell Helicopter Textron Inc. You expressed concern about accounting and internal control problems reported by the Defense Contract Audit Agency (DCAA) at Bell during the period 1982 through 1985. You asked us to determine if Arthur Young was aware of these problems and considered their impact in designing its audit scope and rendering an opinion on Textron's consolidated financial statements. In addition, you asked us to review the circumstances surrounding Bell's hiring of Arthur Young staff who had worked on the Bell segment of the Textron audit.

For the years 1982 through 1985, Arthur Young audited Textron's consolidated financial statements. We found that Arthur Young's audit work at Bell included adequate consideration and evaluation of the accounting and internal control problems DCAA reported and the possible impact of DCAA's findings on Textron's financial statements, and that the financial statements and disclosures related to the DCAA findings were fairly stated.

We also asked Arthur Young to provide information about Bell's hiring of two Arthur Young auditors who previously worked on the Bell portion of the Textron engagement. Arthur Young's response is included in this letter. We found no evidence that the two employees were inappropriately involved in the Bell audit.

Background

Bell is a wholly owned subsidiary of Textron and, according to Arthur Young's engagement plan, conducts most of its manufacturing operations out of its Fort Worth, Texas, plant. In 1985, Bell's assets accounted for about 15 percent of Textron's assets for its consolidated subsidiaries, totaling \$4.3 billion, and its sales represented about 21 percent of Textron's sales of about \$4 billion. Further, government contracts accounted

stated that the financial impact was not readily ascertainable and recommended that the Army not settle the contracts in dispute until more data could be obtained.

The possible financial impact of DCAA's findings on Bell, and in turn, Textron, was further complicated by a federal grand jury investigation of Bell's activities for possible criminal violations, which lasted over 3 years. From the beginning of the investigation in June 1984, the possibility existed that Bell's management could have been cited in criminal proceedings whose outcome might have had a direct and material effect on Textron's consolidated financial statements.

The investigation was formally concluded on March 11, 1988, with a declination of prosecution by the U.S. Attorney's Office in Texas and a "global"¹ settlement. This settlement resolved over 100 DCAA reports and letters covering a variety of DCAA's concerns involving Bell's poor accounting and internal control system used for its government contracts. The settlement required Bell to make direct cash payments of approximately \$67 million, which included \$46 million attributable to savings clause contracts. It also included another \$20 million in other concessions, for a total settlement of about \$87 million.

Bell had previously recorded an accrued liability of \$42 million attributable to savings clause contracts, and had also accrued amounts for certain contracts which did not contain savings clauses. In addition to Bell providing these accruals in its accounts, Textron discussed the existence of these disputed charges in notes to its consolidated financial statements.

Objectives, Scope, and Methodology

We performed our work at the request of the Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce. Our objective was to determine whether Arthur Young was aware of and adequately considered DCAA's audit findings at Bell when performing its audit of Textron. This required us to evaluate whether Arthur Young did sufficient audit work, particularly in the areas of inventory and inventory control systems—a crucial part of Bell's financial systems—to satisfy itself that there were no material errors in the

¹In this type of settlement, compensation is based on overall accounting systems problems, rather than on separate issues associated with individual DCAA reports.

Arthur Young Performed Work at Bell in Areas DCAA Found to Be Weak

We determined that, in the course of performing its audit work at Bell, Arthur Young was aware of, and considered, the major problem areas DCAA reported. These were (1) commingling of government and commercial inventories and poor inventory cost control, (2) alleged excess profits on government contracts, (3) alleged inaccuracies in a special liability account for amounts Bell calculated it owed the government on certain contracts, and (4) reduction in progress payments to Bell. The work of DCAA and Arthur Young differed in terms of scope, objective, methodology, and the ultimate use of the audit reports. As a result, it was reasonable for DCAA and Arthur Young to perform work at different levels of detail.

Commingled Inventories and Poor Inventory Cost Control

We reviewed Arthur Young's inventory and internal control working papers for its 1982 through 1985 audits of Bell and found that they were comprehensive and adequately prepared and that they contained evidence of supervisory review. Concerning the impact of reported inventory system problems at Bell, Arthur Young representatives stated that while the firm considered the effect of DCAA's problems with Bell's cost accounting system, it believed that the amounts involved—in excess of the amount Bell had already booked as a liability—would not materially impact on the consolidated financial statements of Textron.

The cause of one of DCAA's major findings was Bell's use of a materials requirement planning (MRP) system which commingled government and commercial inventories. According to DCAA, this materials planning and cost accounting system transferred or assigned parts to various contracts at a cost that was not always accurate. MRP systems, developed in the 1960s and 1970s and currently in widespread use among defense manufacturers, were designed to maximize productivity and minimize costs by releasing parts from inventories to meet production schedules. MRP systems assign parts to contracts when they are needed, which reduces the need for maintaining larger quantities of inventory. While Bell believed that MRP systems function most effectively when inventories are commingled, cost accounting standards prohibited this practice for government contracts.

From 1982 when the MRP system was installed until the 1985 audit, DCAA had written several reports for the Army objecting to Bell's commingling of inventories. DCAA based its findings, in part, on the difficulty in tracking the original cost of parts as parts were moved between contracts. DCAA reported that Bell transferred parts from one contract to another

parts. Arthur Young observed Bell personnel as they performed the inventory counts.

Third, Arthur Young evaluated and was satisfied that Bell had properly established a liability account to book amounts owed back to the government as a result of excess profits Bell earned on many contracts. We discuss this liability account, and DCAA's reported concerns about the amount established as a liability, later in this report.

Arthur Young's conclusions about inventory costing problems at Bell were based on its inventory and internal control work. Bell is primarily a manufacturing concern and, in 1985, maintained 70 percent of its assets, net of unliquidated progress payments, in the form of inventory. In 1985, Arthur Young spent about 50 percent of the 2,600 staff hours devoted to the Bell portion of the Textron audit on its review of internal accounting controls and inventory valuation.

Reported Excess Profits on Government Contracts

Based on our review of Arthur Young's working papers and its audit procedures relating to verifying profit rates on government contracts, we believe Arthur Young performed sufficient audit work in this area to support its conclusion that Bell's profits were not inflated. Questions raised by DCAA regarding Bell's excess profits on government contracts were resolved in the global settlement between the Army and Bell in March 1988, and DCAA's reports pertaining to this issue were closed.

In April 1984, DCAA reported on Bell's profit for several spare parts contracts for selected pricing periods. It concluded that Bell's costs—expenses to complete the contracts, such as cost of materials—were significantly overstated in each pricing period examined, and, consequently, Bell's profit on spare parts contracts was possibly 2 to 3 times greater than Bell had reported.

In terms of the financial impact associated with this finding, DCAA stated that actual profit realized could not be accurately computed until each pricing period was closed and excess parts and costs were removed from the contract. However, DCAA concluded that Bell's cost data was unreliable and that the government should not use it to make any agreements or settlements with Bell.

We reviewed Arthur Young's working papers on Bell's reported profit for 1984 and discussed the substance of DCAA's findings with Arthur Young personnel. We found schedules, financial summaries, and other

showed that Bell voluntarily booked liabilities for certain contracts which did not contain savings clauses.

Progress Payment Reductions

Because of Bell's contract costing problems, DCAA recommended, in March 1984, that the Army suspend some progress payments until Bell corrected the problems with its accounting system. In July 1985, the Army reduced Bell's progress payments by 50 percent because of continued accounting system problems. However, because the Army did not follow proper procedures, it had to refund to Bell the money withheld, plus interest.

Arthur Young's 1985 working papers showed that it was aware of the reduction in the progress payments and had considered the possible effects on Textron's financial statements. The audit working papers disclosed the circumstances surrounding these suspended payments, the amount withheld as of the end of 1985 (\$32 million), and actions being taken by Bell so that progress payments could be resumed.

We discussed this reduction in progress payments with Arthur Young's General Counsel and were told that Arthur Young had considered the reduction's possible financial impact on the parent company, and found it to be negligible. Arthur Young concluded that, based on Bell's actions to improve its accounting system, this action was temporary and that progress payments would be resumed shortly. Further, it did not believe that this action materially impacted on Textron's consolidated financial statements in 1985, despite the fact that \$32 million of progress payments were withheld. Based on the analyses it documented in its working papers, we believe Arthur Young's conclusions are supported and reasonable.

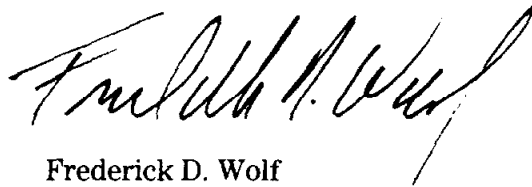
Arthur Young's Statement About Change of Employment

Two Arthur Young employees had previously worked on the Bell portion of the Textron audit and subsequently left for employment at Bell. According to the Arthur Young General Counsel, neither employee performed substantive work on the engagement in the year they were negotiating employment at Bell.

According to the General Counsel, the senior employee—a partner in Arthur Young's Fort Worth office—made a decision to leave Arthur Young before beginning any discussion of employment at Bell. On July 25, 1985, the partner sent a memorandum to the Southwest Regional Managing Partners confirming his intention to withdraw from

This report was prepared under the direction of John J. Adair, Associate Director. Other major contributors are listed in the appendix.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Frederick D. Wolf".

Frederick D. Wolf
Director

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partnership and leave Arthur Young. Subsequently, it was agreed that he would continue to work at Arthur Young until he acquired another position, which he did on January 27, 1986. However, according to Arthur Young officials, the partner did not participate in any 1985 year-end work on the Bell audit, which coincided with his preliminary discussions about employment at Bell.

The other Arthur Young employee, a manager of the Bell portion of the Textron engagement, left Arthur Young on March 15, 1986, in response to an offer from Bell after the 1985 year-end audit, which was completed by early February 1986. He resigned from Arthur Young to join Bell as Director of Internal Auditing. We found no evidence that the two employees were inappropriately involved in the Bell audit.

Conclusions

Although DCAA reported significant accounting and internal control problems at Bell on individual government contracts, Arthur Young concluded that these problems would not materially affect Textron's financial statements beyond the amount already booked. We believe Arthur Young was aware of, and appropriately adjusted its audit scope to consider the potential impact of DCAA's reported problems on Bell's account balances. Last, we found that Textron's financial statements contained notes that disclosed contingencies at Bell and other subsidiaries. Therefore, we believe that it was reasonable for Arthur Young to render the opinion that Textron's consolidated financial statements were fairly presented.

Responsible representatives from Arthur Young provided comments on this report. We have incorporated these comments where appropriate.

We are sending copies of this report to the Chairman of Arthur Young; the Chairman of Textron; and interested congressional committees. Copies will also be made available to others upon request.

evidence in Arthur Young's working papers which showed that during its audit tests of inventory work-in-process, Arthur Young verified data that Bell used to compute profit rates on military contracts. Also, Arthur Young's working papers showed that it reviewed major contracts and corresponding modifications to these contracts and calculated estimated profits. Finally, according to Arthur Young representatives, the audit firm has been unable to identify profit rates in excess of those certified by Bell management.

Alleged Inaccuracies in the Savings Clause Account

In 1984, Bell and the government negotiated firm-fixed price contracts with savings clause provisions because of DCAA's concerns about Bell's past cost accounting practices. These savings clause provisions required Bell to recognize a liability to the government when profit rates on certain contracts exceeded the rates negotiated with the Army. Although DCAA reported that this account might be understated—that is, that profits were greater than Bell estimated—we concluded that Arthur Young performed sufficient work to examine the basis of, and verify the amounts in, the savings clause liability account. According to Arthur Young, Bell had made a reasonable estimate of excess profits and provided for a payback of the contract price to the government as deliveries and sales were recorded on contracts with savings clauses. Arthur Young determined that these amounts were properly classified as a liability on Bell's balance sheet.

Until the on-going settlement negotiations became final in March 1988, the amount Bell owed the government was uncertain. However, based on our review of Arthur Young's working papers and its audit procedures relating to estimating this savings clause liability, we believe Arthur Young performed adequate work to support its conclusion that the liability account was reasonably estimated.

Arthur Young and DCAA had different opinions about how to value this account until a final settlement could be made. DCAA reported several times that the amount owed the government could be greater than the amount booked because Bell's estimates were derived from unreliable financial records. DCAA believed it did not have reliable data on which to base an accurate estimate of the savings clause liability and, therefore, did not do so.

Arthur Young did not agree with DCAA's assessment for two reasons. First, Arthur Young verified all of the calculations related to this liability in its 1985 audit. In addition, Arthur Young's working papers

and assigned costs that could be higher or lower than the original acquisition cost. This occurred because Bell placed parts into inventory and assigned the parts an average cost. These parts were then made available for either government or commercial contracts based on production priorities. When the parts were used, the average cost was charged to the contract. As a result, DCAA determined and reported that the government was being overcharged on many spare parts contracts.

Although DCAA issued many reports on this issue, the financial impact of such findings was difficult to determine. DCAA estimated that Bell overcharged the government over \$100 million due to these and related problems discussed in this report.

DCAA had also reported on the makeup of certain manufacturing support pools—accumulated manufacturing costs used to compute overhead—and large, unfavorable cost adjustments to Bell's inventory accounts because parts were being transferred between various contracts. DCAA maintained that these accumulated costs for the manufacturing support pools and account balances inflated the amounts charged to government contracts. The DCAA reports included examples of noted problems but stated that the overall financial impact was not ascertainable.

In reviewing Arthur Young's working papers, we found that Arthur Young was aware of Bell's practice of commingling parts between commercial and government contracts and aware that this system made it difficult to track original costs of parts for government contract reporting purposes. However, Arthur Young concluded that this was the most efficient method of controlling inventory and that for purposes of presenting consolidated financial statement information, Bell's accounting and inventory control system was acceptable.

Arthur Young documented three efforts by Bell to correct the problems DCAA noted. Based on the problems reported by DCAA over several years, Bell agreed to implement a new system in 1985 that would identify costs and quantities charged and claimed on each government contract separately. Arthur Young's 1985 working papers contain detailed information on a new MRP and Contract Control Costing System that was implemented at Bell in October 1985. Under this system, commingling of government and commercial inventories would no longer be necessary.

The second effort was the performance of a complete parts inventory in October 1985 to identify the existence and quantity of Bell-numbered

financial statements. This evaluation required us to make many judgments because the Arthur Young staff, like any experienced professional auditors, could have used various approaches in conducting such an audit.

To accomplish our objective, we reviewed Arthur Young's working papers at Bell for its 1982 through 1985 Textron audits. Because the accounting system and internal control weaknesses DCAA identified related primarily to inventory, we concentrated on reviewing the inventory and internal control working papers and related correspondence.

We also reviewed DCAA reports issued during the period 1983 through 1985 and discussed selected reports, findings, and issues with the DCAA resident auditor and the supervisory auditor responsible for several of DCAA's audits at Bell's Fort Worth, Texas, manufacturing plant. We also discussed the issues raised by DCAA with the commander, deputy commander, and contracting officer of the Department of the Army's Plant Representative Office at Bell's Fort Worth, Texas, plant.

Although our audit scope focused on problems identified by DCAA until late 1985, we also analyzed financial reports and disclosures of these issues made by Textron for 1986 and 1987 because many of DCAA's audit reports were still unresolved during this period and these unresolved audit issues could have had a financial impact on Textron until the global settlement was reached.

Last, to obtain information surrounding the former Arthur Young auditors who accepted employment at Bell, we interviewed Arthur Young's general counsel, assistant general counsel, client partner for the Textron engagement, and the current manager of the Bell audit. We did not interview the two former Arthur Young employees.

Our work was performed at Arthur Young's offices in Washington, D.C., and Fort Worth, Texas, and at DCAA's offices at Bell's Fort Worth, Texas, plant. We conducted our review from February through July 1988, in accordance with generally accepted government auditing standards. Responsible representatives from Arthur Young provided comments on this report.

for about 47 percent of Bell's total revenues in 1985; this amount has increased slightly since that time.

The role of an external auditor is different from that of DCAA. Arthur Young, as Textron's external auditor, was responsible for examining and rendering an opinion on Textron's consolidated financial statements in accordance with generally accepted auditing standards. Because events at Bell could have materially affected the consolidated financial statements of Textron, Arthur Young needed to satisfy itself that Bell's financial statements were properly stated. As part of its audits of Textron, Arthur Young performed substantial work at Bell. The purpose of this work was to support Arthur Young's opinion on Textron's consolidated financial statements—not to express a separate opinion on Bell's financial statements.

In contrast to an external auditor, the DCAA, as a government contracting officer's representative, is responsible for providing financial and accounting advice to Department of Defense procurement officials. The results of DCAA's audit work are used to negotiate contract prices and to administer defense contracts. DCAA's work at Bell focused on detailed cost accounting issues and regulations related to the company's government contracts. The scope of DCAA's reports focused on specific pricing periods or on selected government contracts at Bell.

During the period 1983 through 1986, DCAA issued numerous reports describing accounting and internal control problems at Bell. According to DCAA, these problems resulted in overcharges to the government of over \$100 million and included (1) commingling of government and commercial inventories and poor inventory cost control, (2) alleged excess profits on government contracts, and (3) alleged inaccuracies in a special liability account for amounts Bell calculated it owed the government on certain contracts. Based on its findings, DCAA recommended that the Army suspend progress payments to Bell until the company corrected problems with its accounting system, which the Army did.

In the first 6 months of 1984, DCAA issued several reports on problems with various aspects of Bell's poor inventory cost control. Some of these reports dealt with specific billing periods of particular contracts, but the financial or systemic impact was duplicated in more than one report. Further, in several of these reports, DCAA included the total cost of the contract (\$54 million in one report and \$275 million in another), as a questioned cost because it was unable to estimate the questioned costs for the specific pricing periods. Finally, in some other reports, DCAA

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