

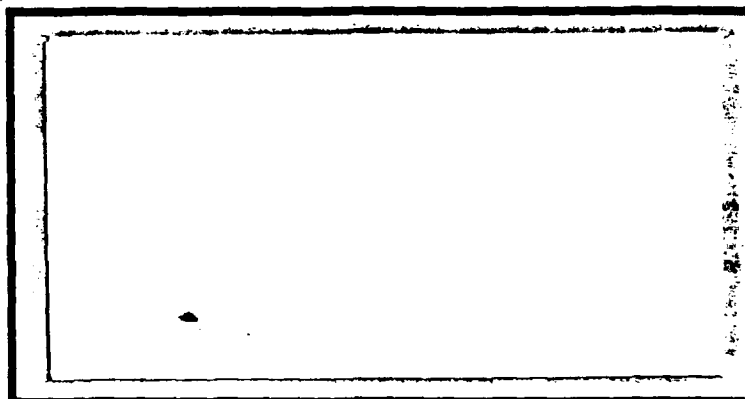
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DEFECTIVE PRICING: AN ANALYSIS OF
FACTORS AFFECTING THE
SIGNIFICANCE ISSUE

THESIS

Judith Ann Volpe
Captain, USAF

AFIT/GCM/LSQ/88S-11

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DEFECTIVE PRICING: AN ANALYSIS OF FACTORS
AFFECTING THE SIGNIFICANCE ISSUE

THESIS

Presented to the Faculty of the School
of Systems and Logistics
of the Air Force Institute of Technology
Air University
In Partial Fulfillment of the
Requirements for the Degree of
Master of Science in Contracting Management

Judith Ann Volpe, B.A.

Captain, USAF

September 1988

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Abstract

The Truth in Negotiations Act of 1962 was created to assure that the government obtains a fair and reasonable price for the goods and services it purchases by requiring contractors, in certain circumstances, to provide current, accurate, and complete cost or pricing data with which the government can establish a negotiation position. Failure to comply with the law normally constitutes defective pricing which entitles the government to a dollar for dollar reduction in the contract price based on the defective amount. One of the stipulations of the law is that the amount determined to be defective must have caused a significant increase in the contract price although the term "significant" has yet to be clearly defined. ^{This thesis examines} The issue of significance in defective pricing audits is the subject of this research. The objective was to demonstrate that significance should be viewed in terms of the value of the contract action being audited and that allegations of a small dollar value should not be issued because they detract from the overall effectiveness of the defective pricing program.

To substantiate that, manpower costs were developed using manhour estimates for the activities involved in the process: audit, analysis and negotiation, and legal review. ^{Using} The results of the study showed that the contract value of the action being audited impacted the amount of time it took

to settle a case and that the value of the allegation itself had little to do with the processing time.

In an environment of limited manpower resources, it is important to make effective use of those resources by maximizing the potential return on the time and effort expended. The information contained in this study will enable a contracting officer to make a more informed decision about whether a particular defective pricing audit should be pursued. (S.C.) ←

DEFECTIVE PRICING: AN ANALYSIS OF FACTORS
AFFECTING THE SIGNIFICANCE ISSUE

I. Introduction

Twenty-six years after its passage, Public Law 87-653, the Truth in Negotiations Act of 1962 (19), continues to generate controversy in government contracting. The law was created by a Congress which saw defense contractors with an unfair advantage during negotiations and consequently netting excess profits. The law requires that government contractors furnish cost or pricing data in support of noncompetitive proposals over \$100,000 and certify that, at the time of agreement on price, the data are current, accurate and complete. The law was created to "place the government on an equal footing, through informational parity, with contractors" (20:3) in an effort to assure that, in the absence of market competition, the prices the government pays for goods and services are fair and reasonable. Thus, whenever a contractor's failure to comply with the Act results in a higher negotiated price, the government is entitled to a dollar for dollar reduction in price. This failure to comply and attendant increased price is called defective pricing.

Problem Statement

Notwithstanding the provisions of the Act, the matter of defective pricing was largely neglected until 1981 when DOD issued its first policy for contract audit follow-up, DOD Directive 5000.42. That policy was superseded by DOD Directive 7640.2 in December 1982, a directive which has been revised twice since then, the most recent revision having been issued in February 1988 (see Appendix A). The directive provides guidance for contracting officers in their use of contract audit reports. It also requires that various types of audit reports, defective pricing audits among them, be tracked and that their status be reported semi-annually (6:4). Today, some six years since the 1982 directive was issued, despite close monitoring, more specific guidance, and increased management attention at the highest levels, the issue of defective pricing remains an enigma. Of particular concern is the length of time it takes to negotiate a settlement with a contractor.

In their 1984 study of the defective pricing resolution process, Brown and Ellis recommended several administrative ways to improve the processing time for defective pricing audits including:

- (1) centralize responsibility for the entire process into one office;
- (2) adopt more realistic milestones for completing various phases of the cycle; and
- (3) increase management attention to resolving defective pricing cases [2:94-96].

At that time, the researchers felt the processing time could be reduced to 225 days if their recommendations were implemented (2:106). Yet, despite the implementation of several of these recommendations, the processing time has not decreased as expected. The average age of the cases closed during FY 1987 was 507 days (23), only 18 days less than in 1984.

Ostensibly, there are other factors which affect the timely processing of these cases as is evidenced by the fact that there has not been a marked improvement in processing time in spite of various initiatives to reverse the trend. This study will focus on one of those other factors: the significance or materiality of the defective pricing audit report, that is, whether or not the amount of the cost questioned in the audit report represents a significant amount. Given the lengthy processing times and limited resources, the issue of significance with regard to defective pricing audit reports becomes increasingly important.

Justification

Whenever contracting by negotiation is anticipated for acquisitions in excess of \$100,000, defective pricing clauses are written into the pertinent solicitations and contracts. The basic defective pricing clause reads as follows:

...If any price, including profit or fee, negotiated in connection with this contract, or any cost reimbursable under this contract, was increased by any significant amount because (1) the Contractor or a subcontractor furnished cost or pricing data that were not complete, accurate, and current as certified in its Certificate of

Current Cost or Pricing Data, (2) a subcontractor or prospective subcontractor furnished the Contractor cost or pricing data that were not complete, accurate, and current as certified in the Contractor's Certificate of Current Cost or Pricing Data, or (3) any of these parties furnished data of any description that were not accurate, the price or cost shall be reduced accordingly and the contract shall be modified to reflect the reduction...[7:Part 52.215-22].

In recent years much attention has been given to the defective pricing issue in the context of what (precisely) constitute cost or pricing data. At issue are such things as whether or not executive memos and computer products are cost or pricing data, and differences of opinion among the DCAA, the contractor, and the contracting officer are not uncommon. Another issue which has contributed to the lesser emphasis on significance is that of the criminalization of the defective pricing process. For about 20 years after the passage of the Truth in Negotiations Act, defective pricing was a relatively dormant issue (18). Then, in the mid-1980s, fueled by allegations of rampant overpricing and misconduct in government contracting, interest in defective pricing was renewed as it provided a means by which the government could recoup monies from contractors. However, there is a distinct difference between what it means to allege defective pricing nowadays and what it meant prior to the recent publicity about contracting ills. Previously, implicit in the allegation was the idea that the defective pricing resulted from mismanagement or carelessness on the part of the contractor, while more recently it has been viewed as an indication of willful intent to defraud the government. Both

the question of what constitute cost or pricing data and the criminalization issue are controversial enough that the parties involved will probably agree to disagree for some time to come. As a result, the prerequisite that the defective data caused a significant increase in the contract price, though not forgotten entirely, has been relegated to a minor role in the defective pricing discussions.

Of particular interest to this study is this issue of significance or materiality. The law, as originally written and as recently revised, clearly states that the defective data must have caused a significant increase in the contract price. While the post award audit process (of which the defective pricing audit is a part) is a necessary oversight function designed to ensure the integrity of the acquisition process, it appears that the intent of the law as it relates to materiality is sometimes lost. Indeed, even the courts have had difficulty with the matter. In the past, they have interpreted "the term 'significant' so broadly as to render it practically meaningless. Data has been found to be significant if it would have any effect on price. It should also be noted, however, that inherent in all of the [rulings] is that some administrative discretion should be used in determining which [defective pricing] claims should be pursued and which should not" (1). Clearly, the term "significant" is a term which in the context of defective pricing defies precise definition. The determination as to

significance then becomes a matter for the contracting officer to decide on a case-by-case basis. Despite the difficulty which it would no doubt entail, there should be some guidance regarding the issue of significance. This guidance would take into account the value of the contract being audited, the value of the audit allegation, and the manpower costs associated with resolving defective pricing cases. Such guidelines would ensure a balanced perspective between the allegation and the cost to the government to pursue the allegation. In that way, the contracting officer, when faced with a defective pricing decision, could weigh the merits of the case in light of the guidance provided and decide whether or not to pursue the case further.

Research Objectives

The primary objective of this research is to provide the contracting officer with some guidelines with which to make decisions regarding the significance of certain defective pricing cases in light of the value of the contract and the manpower costs associated with auditing and settling defective pricing cases. In many cases, there is no question as to the merits of pursuing a defective pricing case. However, in those instances where the contracting officer may question the cost benefit of pursuing a case, especially if it is of a small dollar value, the information contained in this study will give the contracting officer the basis for making a more informed decision.

A second objective is to increase the awareness of government contracting personnel regarding the complexity of the defective pricing issue and to enhance their understanding of the roles and responsibilities of the Defense Contract Audit Agency (DCAA), a subject which will be addressed in the literature review.

Scope

Since Air Force Systems Command (AFSC) and Air Force Logistics Command (AFLC) together are responsible for obligating over 80 percent of the Air Force's contracting dollars (9:2), it stands to reason that they would also have a majority of the defective pricing cases. In fact, as of 30 September 1987, over 97 percent of the active defective pricing cases in the Air Force were within those two commands (10). In addition, roughly one-half of the cases involved Aeronautical Systems Division (ASD) contracts (8). Since all of the commands are governed by the same procedures for handling defective pricing audits (outlined in DOD Directive 7640.2), a detailed analysis of the ASD cases should provide insight into the problems associated with defective pricing processing. Therefore, the data for this study were limited to ASD cases as they were expected to reflect the Air Force situation in general.

Initially, the review was to have covered both open and closed cases. However, due to the potential sensitivity of

the open cases and the possibility of litigation, the scope of this study was confined to cases closed (or completed) during FY 1987. As with the open cases, ASD's closure rate as of 30 September 1987 was about 43 percent of the Air Force total (8) which serves to support the position that an analysis of ASD cases will be representative of the Air Force as a whole.

Literature Review

In order to appreciate the magnitude of the defective pricing issue, it is important to understand what defective pricing is. This section will trace the history of the Truth in Negotiations Act, Public Law 87-653, and its effect on DOD policy. The issue of accountability as it relates to defective pricing will also be addressed. It is also necessary to establish a frame of reference with regard to the nature of the relationship between the DCAA and the contracting community, particularly the contracting officer. This final portion of the literature review is considered essential to explain the role of the DCAA in the acquisition process as well as to provide some insight into the perceptions which the two activities have of each other.

Historical Perspective. The Truth in Negotiations Act grew out of a concern in the 1950s, supported by General Accounting Office (GAO) audits, that defense contractors were realizing excess profits on government contracts due in large part to the fact that, in the absence of competition, the

government was compelled to rely on whatever cost data the contractor chose to furnish. The GAO found that contractors were not disclosing cost information relevant to the negotiation, the effect of the nondisclosure being that the government paid a higher price than it would have had the nondisclosed cost data been revealed (4:Part I). Public Law 87-653 was an attempt by Congress to assure that in the absence of competition, both parties to a negotiation were equally informed on matters of cost. The law applies to all contracts in excess of \$100,000 with the exception of contracts whose price is based on (1) adequate competition; (2) an established catalog or market price; or (3) a price set by law or regulation. Under the provisions of the law, when defective pricing is found, the government is entitled to a reduction in the contract price. However, the courts (the Armed Services Board of Contract Appeals and the Court of Claims) have stated that in order to effect a price reduction, the government must demonstrate that it relied on the defective data. Proving that the data were defective, in and of itself, does not warrant a price reduction. Nonetheless, in the absence of evidence to the contrary, the courts have generally maintained that "the 'natural and probable consequence' of nondisclosure is an increase in the contract price and thus, to prove otherwise is the responsibility of the contractor" (4:Part I).

Much of what has been written on defective pricing is descriptive in nature rather than analytical. For the most

part, the literature has a legal bent, that is, the researchers use case law to describe and support a point of view. Given the abstract terms commonly associated with this area: cost or pricing data, disclosure, and reliance, that tendency is understandable. Solimine, for example cited several court decisions to show that the burden of proof in a defective pricing claim is on the government to show:

- (1) that certain data reasonably available to the contractor were not disclosed to the government;
- (2) that the undisclosed data were cost or pricing data;
- (3) that the government relied on non-current, inaccurate, or incomplete data in developing its position and negotiating a price; and
- (4) that these factors caused an increase in the price to the government [4:App IV].

While legal precedent is extremely important in that it has shaped much of the DOD policy in the area, the concern here is more with how defective pricing is currently being dealt with by the DOD and the acquisition community.

Current Trends. The defense acquisition environment of the early 1980s was characterized by media accounts of out-of-control cost overruns, contractors making windfall profits on defense procurements, and spare parts horror stories. As a result, the public demanded more accountability by those responsible. The Truth in Negotiations Act which provides the government with remedies for defective pricing, is an integral part of assuring that accountability and protecting the government's interests in the marketplace. Within the DOD, there has been an increased focus on, and awareness of,

the importance of defective pricing. The performance appraisals of acquisition officials are now annotated to include comments regarding the individual's "effectiveness in resolving and dispositioning audit findings and recommendations in a timely manner while fully protecting the Government's interest" (5:3; 6:2). Another change brought on by the increased attention to defective pricing was that the contract audit arm of DOD, the DCAA, experienced a significant increase in personnel. From 1982 to 1986, auditor authorizations rose from 3,748 to 6,061 (12:12). Consequently, the number of defective pricing audits increased as well. In 1984, for example, DCAA conducted 1,170 defective pricing reviews and returned findings on 32 percent of them while in 1986, the Agency completed 2,243 audits with positive findings resulting in about 45 percent of the cases. Even more significant are the dollar figures associated with those findings. In 1984, the DCAA recommended price adjustments totalling \$112 million; in 1986, the figure rose to \$1.618 billion, an increase of 1,344 percent (4:Part I). The increase in defective pricing audits was due in large measure to the efforts of the Department of Defense's Office of the Inspector General (DOD/IG) which, since its formation in 1982, has encouraged the DCAA to increase its proportion of defective pricing cases to total workload. As a result, the defective pricing audit effort more than doubled from 1984 to 1986 (4:Part I).

The tremendous increase in defective pricing audits has made it difficult to manage the contract audit follow-up process and has prompted the Air Force to comment that while defective pricing audits are necessary, they are "generally quite complex...and are extremely time consuming for the contracting activity involved...moreover [they] generally represent an attempt to treat only the symptoms of an underlying estimating system problem" (13:8). Consequently, the Air Force recommended more reviews of contractor estimating systems and less defective pricing audits (13:12). Clearly, the trend has been toward more and better accountability by both the government and the defense industry.

Establishing a Frame of Reference. As has already been mentioned, it is important to understand that the matter of defective pricing is a sensitive one. For many, it is an unpleasant aspect of the acquisition process, because along with an allegation of defective pricing comes implications of negligence and mismanagement at best, and deceit and fraud at worst. Undeniably, there is some degree of conflict and disagreement between the audit and contracting communities regarding defective pricing and how to handle it, but such disagreements are not limited to defective pricing. Rather, these two activities, auditing and contracting, often do not see eye-to-eye on acquisition-related issues. In order to appreciate the impact the differing points of view have on the defective pricing issue, it is necessary to understand

the relationship between the auditor and the contracting officer.

Much of the information available on this subject consists of the opinions of individuals in the defense acquisition community and the defense industry. Few studies have been conducted which address the auditor/contracting officer relationship. Thus, the bulk of the information here comes from two sources: (1) a Department of the Air Force Report on the DCAA (13), and (2) a graduate thesis by David Van Smith on contract audit follow-up (22). Although the latter study was completed in 1983, many of the perceptions and attitudes evident then are still prevalent today. However, before a discussion of the relationship begins, some background information about the DCAA might be helpful.

DCAA - The Organization. The DCAA was established in July 1965 by the Secretary of Defense, Robert S. McNamara, who saw the need for a single agency to conduct defense contract audits. Thus, to streamline the contract audit process and eliminate the duplication of effort and potential for conflicting audit recommendations and guidance, the internal audit organizations responsible for contractor audits in each of the military departments were consolidated into a single agency and the DCAA was formed. Its mission, as set forth in DOD Directive 5105.36, was to "perform all necessary contract audits for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all DOD components responsible

for procurement and contract administration" (14:15). The Agency was created primarily to increase efficiency and effectiveness in the contract audit area, and as such is responsible to:

- (1) assist the DOD officials in achieving the objective of prudent contracting by providing financial information and advice on proposed or existing contracts of contractors;
- (2) audit, examine, and/or review contractors' and subcontractors' accounts, records, documents and other evidence; systems of internal control to determine the acceptability of costs incurred and adequacy of contractors' accounting system; and
- (3) perform other auditing responsibilities and functions such as the examination of reimbursement vouchers received from contractors, establishing and maintaining liaison auditors when appropriate, and performing other functions as prescribed by the Assistant Secretary of Defense (Comptroller) [14:15].

Functionally, the DCAA is independent of the defense acquisition community: the Agency comes under the control of the Assistant Secretary of Defense (Comptroller). At the same time, the Department of Defense Inspector General (DOD/IG) has the responsibility to "develop policy and...monitor and evaluate program performance" (6:2) of the audit agency, among others. Hence, the DCAA comes under the purview of both offices.

To many in the defense acquisition community, since the DCAA performs a function integral to the weapon systems acquisition process, it should be organizationally tied to that function rather than to the Comptroller. It is an issue which has and will continue to generate controversy as proponents of both sides attempt, by their arguments, to sway

support in their favor. Those who favor a DCAA under the acquisition umbrella stress that presently the DCAA has no affiliation with, nor real commitment to, the procurement mission despite its integral role in the acquisition process. Those who argue in favor of an organizationally independent DCAA stress the importance of autonomy of the audit function. For the foreseeable future, it appears that the DCAA will remain under the supervision of the Assistant Secretary of Defense (Comptroller). Given that structure, there can be little doubt as to the independence of the Agency, a necessary element for instilling public confidence in the systems acquisition process.

DOD/IG Influence. This review would not be complete without some discussion of the DOD/IG role as it pertains to the DCAA and defense contracting. While there are numerous areas where the DOD/IG's influence on the DCAA is felt in the procurement community, there is one area which has a direct impact on the conduct of business in weapon systems acquisition: the policy on contract audit follow-up. This policy encompasses a broad spectrum of issues, not all of which will be addressed here. Those issues of particular interest can be found in the 1986 and 1988 versions of DOD Directive 7640.2 and will be discussed later. As the authority behind the directive, it is the DOD/IG's intent to assure contract quality through close monitoring of contract audit reports and resolution activity.

Contract Audit Follow-up Policy. From its inception, DOD Directive 7640.2 met with criticism both from within the DOD as well as from defense contractors (22:8). The DOD's first attempt at a formal contract audit follow-up system (DOD Directive 5000.42) was a dismal failure due to a lack of definitive guidance and a lack of commitment on the part of procurement management personnel (21:1). It was superseded by DOD Directive 7640.2 issued 29 December 1982. The new directive sought to correct many of the weaknesses of the first, but it is debatable whether or not it was effective in meeting its objectives. Despite a majority opinion (77 percent) in the Van Smith survey that the directive was clear in its objectives, 55 percent of the contracting respondents felt the directive would not achieve those objectives (22:43). Contracting respondents, concerned about the encroachment on the contracting officer's authority, expressed those concerns in comments such as:

The impact from this directive is very important. The contracting officer is singularly responsible for all aspects of the award of a contract. The auditor is supposed to be a team member, no more, no less. This policy change makes the auditor much more powerful with no check or balance on the quality of the audit [22:66, 67].

The hardest thing for a government bureaucrat to do consistently is act independently and forcefully. The system produces conformity and fosters the abdication of responsibility. Under the new followup system, weak contracting officers will become weaker, strong ones will be more frustrated [22:67].

By contrast, while half of the auditors in the survey agreed that the contracting officer's authority was

diminished, they felt there was a definite need to more closely monitor the contracting officer's actions. One auditor's comments captured that concern very well:

There is no change in the contracting officer's authority. He may still deviate from audit recommendations. However, now he must document, explain, and in some cases have an independent review of his decision. To the extent that his independent decision-making flexibility is constrained by the justification requirement, the directive could be viewed as beneficial [22:68].

Despite the fact that the Van Smith study is five years old, the comments and observations are still timely as is evidenced by the fact that similar comments were expressed in the Air Force Report on the DCAA issued in June 1987.

Air Force Report on the DCAA. In June 1987, the Air Force, in compliance with Title III of the Goldwater-Nichols Department of Defense Reorganization Act of 1986, issued a report on the DCAA. Among other things, the act required an assessment of the efficiency and effectiveness of the DCAA in providing contract audit support to the military components (13:1). Given their understanding of the mandate for review, the Air Force study team's approach was to accurately portray the effectiveness of the DCAA from the customer's point of view; that is, through the use of personal interviews and questionnaires, the Air Force team sought to determine the degree of "customer satisfaction" contracting personnel experienced with the DCAA (13:1). While the Air Force study addressed numerous issues relating

to the DCAA, one is of particular interest: the erosion of contracting officer authority.

Although there is no hard evidence to support it, there is a perception in the contracting community that such things as: (1) a preoccupation with cost savings; (2) the designated independent senior acquisition official (DISAO) review of significant differences between the auditor and the contracting officer; and (3) the transfer of the authority to negotiate final overhead rates from the contracting officer to the DCAA have severely diminished the authority of the contracting officer. The Air Force study addressed each of these issues, relating perceptions by field contracting personnel as well as higher level officials.

Cost Savings. According to the study, there seemed to be a preoccupation in the procurement arena with cost savings. These "savings" have come to equate to effectiveness. In the area of defective pricing, for example, sustention rates are just such a measure. The sustention rate refers to that percentage of the cost questioned by the auditor which is upheld as a result of negotiations or as is reflected in the contracting officer's final decision when a negotiated settlement cannot be reached. This is particularly evident in the DOD/IG's analysis of the Semi-annual Contract Audit Followup Report. For the six-month period ending 30 September 1987, the DOD/IG commended ASD for achieving a 79 percent sustention rate on defective pricing cases and remarked that the figure was

34 percent higher than the DOD average (8). Admittedly, it is extremely difficult to accurately measure effectiveness; thus, surrogate measures are used. However, comparing the cost questioned in the audit to the cost sustained does little to address the quality of either the audit or the negotiation. Rather, this approach puts the contracting officer on the defensive because it assumes accuracy and quality on the part of the audit. Thus, if the sustention rate were lower than anticipated, the conclusion would be that the contracting officers had not been tough enough in their negotiations with contractors (13:13).

DISAO Review. Ever since the first policy for contract audit follow-up was issued in August 1981, there has been a requirement that an independent senior acquisition official preside over matters wherein there is a significant difference between the auditor and the contracting officer. However, the policy revision which was issued in 1986 leveled another blow against the contracting community in that the directive empowered the DCAA to challenge a contracting officer disposition, "whether endorsed by a DISAO or not, [which] was significantly adverse to the interests of the Government, in the opinion of the DCAA" (5:4). In addition to the DISAO review, the 1986 directive first addressed the accountability issue by requiring that the "performance appraisals of appropriate acquisition officials reflect their effectiveness in resolving and dispositioning audit findings

and recommendations in a timely manner, while fully protecting the Government's interests" (5:3), again presuming quality and accuracy in the audit. The Air Force team concluded that several of the revisions in the 1986 version of DOD Directive 7640.2 were detrimental to the authority of the contracting officer and served to further weaken an already tenuous relationship between DCAA and contracting personnel (13:14).

Final Overhead Rate Determination. Another factor which contributed to the erosion of contracting officer authority involved negotiating final overhead rates with contractors. In August 1985, the Deputy Secretary of Defense, William H. Taft, IV, transferred that responsibility from the Contract Administration Office to the DCAA. The message to contracting personnel was that they were not doing a good enough job at the negotiation table with the implication that the DCAA could probably do the job better (13:15).

In the wake of horror stories like dog kennel fees being charged to overhead accounts on government contracts, it was extremely difficult to convince the public and senior defense officials that contracting officers were earnest and competent. Nonetheless, that is the approach the Air Force study took. The Air Force was adamant that there is more to the negotiation process than reducing the issues to numbers.

Update. Since the Air Force study was completed, several of the recommendations which the Air Force made have

been implemented. Admittedly, the magnitude of the changes suggests that the Air Force Report alone was not responsible, but it is reasonable to assume that the Air Force approach of including people's perceptions regarding this emotional issue did have the intended effect. Several changes, a few of which will be discussed, are evident after a careful examination of the latest revision to DOD Directive 7640.2.

A rather subtle but significant change to the directive was one regarding the disposition of audit reports. For all intents and purposes, disposition is synonymous with case closure. The 1986 version read: "Disposition should take place as soon as possible after resolution and normally shall be completed within 12 months after a report is issued" (5:5). In the 1988 directive, the reference to the 12-month timeframe has been deleted (6:3). The implication of this change underscores the realization by the authors of the directive that the contract audit follow-up process is extremely complex and that reconciliation of the issues within a stipulated period of time cannot be mandated.

Although the requirement to reconcile differences between the auditor and the contracting officer has always been a part of the directive, the detailed language in the 1986 version stipulated precisely what the contracting officer had to do in resolving significant differences. The directive placed undue emphasis on the audit and relegated to lesser status the degree to which the contracting officer

could exercise his prerogative and deviate from that guidance. The February 1988 version dispensed with the DISAO and instead charged each military department with developing its own review procedure (6:2). Perhaps the most significant change was found in the policy statement which begins:

The responsibility for reaching agreement with the contractor is the contracting officer's and he or she has wide latitude in that regard...The contract audit follow-up system shall be structured in consonance with the independent, decision-making role of the contracting officer and the financial advisory role of the contract auditor [6:2].

Ostensibly, there is a renewed understanding of, and appreciation for, the authority of the contracting officer. It is therefore incumbent upon contracting officers to accept the responsibility invested in them as contracting officers and, of their own accord, to document, explain, and justify positions which differ significantly from the auditors'. It is really only through this type of effort on the contracting officer's part that the auditor will be made aware of the issues involved in the decision. Without feedback, the auditors will be unable to assess the effectiveness of their reports from a contracting point of view. The changes in the latest revision to DOD Directive 7640.2 signal a new phase in the auditor/contracting officer relationship.

II. Methodology

Introduction

This study was an in-depth analysis of the defective pricing cases closed by ASD during a one-year period, from 1 October 1986 - 30 September 1987. The data of interest included the following:

- (1) dollar value of the contract action audited;
- (2) dollar value of the defective pricing audit report;
- (3) dollar value of the final contract settlement; and
- (4) processing time for the case.

The data were expected to show that those defective pricing cases which were of a low dollar value were detrimental to the overall effectiveness of the defective pricing program. Audits with allegations below \$50,000 were considered low dollar value. The \$50,000 figure was based on the fact that in the sample studied, those audits below \$50,000 represented a minute percentage of the total allegation amount (.15 percent). At the same time, there were a sufficient number of those audits (approximately 11 percent of the sample) to ensure that an analysis of this nature would be meaningful. One of the reasons for the negative impact of the smaller dollar allegations was that the time necessary for processing a defective pricing case was believed to be virtually the same regardless of the allegation amount. Thus, the time spent pursuing the lower dollar allegations could have been better spent working on higher value cases.

To substantiate that claim, estimated manpower costs associated with the defective pricing process were developed in an attempt to monetize the effort which the government must put forth both to audit and process these cases.

The study consisted of two phases: (1) analyzing defective pricing cases closed during FY 1987; and (2) developing manpower cost estimates for personnel engaged in defective pricing activity: the auditors, price analysts, and legal advisors.

Case Files Review

The two Status Reports on Specified Contract Audit Reports (commonly called the Semi-annual Reports), were the source material for the defective pricing audits selected for this study (see Appendix B). While these reports include status on more than just defective pricing audits, the majority of audits reported are defective pricing audits. In the reports at Appendix B, the "Type of Audit" designation for a defective pricing audit is "4". For a detailed explanation of the management reporting system which AFSC uses, the reader should consult the AFSC Contracting Officer's Information Network (COIN) Operating Guide.

During the period under review, 82 of the 87 audits reported were defective pricing audits, but not all 82 audits were analyzed. A screening process was used to weed out certain of the defective pricing audits which, after an initial review, seemed inappropriate for this study. The

first criterion was that the case be closed. Twenty-four audits were eliminated from the study because they continued to be active despite having been reported as closed. The reason for that can be found in DOD Directive 7640.2. In accordance with the regulation, one way in which an audit may be closed is if it is superseded by another audit or if a supplementary audit is issued (6:2-2). Normally, superseded audits are those which display zero dollars in both the "Cost Questioned or Cost Avoidance" and "Cost Sustained" categories of the Semi-annual Report. The 24 audits in question, though closed, continued as active cases because superseding audits or supplementary audits were issued. As such, they were not appropriate for this review. The second stipulation for including an audit in the review was that the case file was available for examination. Case files included the Defective Pricing Office (ASD/PMF-X) files, the Liaison Auditor files, and/or the contract modification files. There were 10 audits which were excluded from the study because the case files could not be located. In addition, one audit was excluded because it was negotiated by the Administrative Contracting Officer, not ASD personnel. Another was eliminated because it was one of two audits covering the same effort. Both the DCAA and the GAO conducted audits, but the GAO audit was broader in scope and resulted in a larger dollar allegation than the DCAA audit. Thus, the GAO audit was included and the DCAA audit was not. Aside from the one GAO audit included in this study, there were two DOD/IG audits as well.

All three can be identified by the prefix "9988". The remainder of the audit reviews were conducted by the DCAA.

After the selection process was completed the case files for the 46 remaining audits (see Appendix C) were reviewed for pertinent facts and figures. Among the materials analyzed were: (1) audit reports; (2) legal opinions; (3) price negotiation memorandums; and (4) contract modifications. While not all the case files contained all of the materials mentioned above, there was sufficient information in each to determine what had transpired. Where data discrepancies appeared between the case file and the Semi-annual Report, the data in the case file were used.

Manpower Costs

One of the criteria for determining that cost or pricing data are defective is that it must be evident that such data caused a significant increase in the contract price. The term "significant" has never been clearly defined, and as might be expected, opinions on what is significant differ. From the ASD Pricing Office perspective, if the cost questioned in a defective pricing audit is of a small dollar amount relative to the contract action, the DCAA should consider not issuing the report (23). From the DOD/IG point of view, as implemented by the DCAA, whenever defective pricing is suspected, a defective pricing audit should be issued regardless of the dollar amount (15). Both opinions have merit: the former focuses on the efficient and

effective use of limited manpower while the latter reflects the obligation incurred by the government when entrusted with public funds, to ensure that they are spent judiciously. From these discussions came the idea to develop an estimate of the manpower costs associated with auditing, analyzing, and negotiating defective pricing cases and in that way provide the contracting officer with another aspect to consider when deciding how to approach a defective pricing case.

The manpower costs associated with the three major activities (auditing, contracting, and rendering legal opinions) were estimated based on information furnished by individuals responsible for those activities. These individuals, by virtue of their positions, were considered to be expert with regard to some facet of the defective pricing process. They were asked to estimate the number of hours per year they and/or their subordinates spent on an average defective pricing case. While they all provided the estimates, they also cautioned against generalizing given the uniqueness of each case.

In addition to manhour estimates, it was necessary to determine the appropriate wage rates to apply to the manhour estimates. The wage rates used were 1987 rates furnished by Detachment 1, 3025 Management Engineering Squadron (3). In their cost comparison studies, for civilian employees, they typically used a Step 5 wage (see Appendix D) adjusted to

include fringe benefits. The fringe benefit factor used was 29.65 percent, the 1987 factor. For military personnel, they used the rates stipulated in AFR 173-13, U. S. Air Force Cost and Planning Factors (11:34.2).

Audit. Ann Smith (17) provided the ideas summarized in the following four paragraphs. The initial defective pricing audit can be a very time consuming effort. It requires the auditor to examine at a minimum, the pre-award audit, the price negotiation memorandum, the statement of work, and the contractor's proposal. Defective pricing audits are mandatory for contracts of \$50 million or more. The manhours necessary to conduct an initial defective pricing audit on a contract of that magnitude are largely dependent upon the complexity of the contract and may take as few as 500 hours or as many as 3000 hours to complete. In this study, 1000 hours was the figure used, based on Smith's recommendation. For contracts of a lesser value, the time allotted for an initial defective pricing audit decreases substantially. For contracts valued between \$10 - \$50 million, 450 hours was the average time expected to complete the audit. Two hundred hours and 100 hours were the estimates for completing the initial defective pricing audits for contracts of \$1 - \$10 million and \$100,000 - \$1,000,000 respectively.

Given the complexity of this type of audit, experienced auditors (usually General Schedule (GS) 12 level) were generally assigned to conduct these audits. However, there were also other, less experienced auditors (GS-7, GS-9 and

GS-11 levels) who worked on the defective pricing audits as well. To compensate for the diversity of employee grades, a weighted average for the hourly wage was computed using the GS-12 wage and a combination of the GS-7, GS-9, and GS-11 wages. The GS-12 wage was given a weight of .67 while the GS-7, GS-9, GS-11 wages were themselves averaged and then given a weight of .33. The weights were based on discussions with a supervisory auditor whose subordinates included nine individuals who audited defective pricing cases.

Smith also pointed out that follow-up analysis is necessary each time a contractor submits a rebuttal to the audit allegations with a minimum of one rebuttal expected. Thus, follow-up audit time was estimated to be approximately 100 hours for contracts over \$50 million, 50 hours for contracts between \$10 - \$50 million, and 40 hours for all others.

Finally, in order to determine an approximate cost for each audit, the appropriate hourly estimate based on the negotiated dollar value of the contract action (or when that was not given, the amount audited figure contained in the audit report) was multiplied by the (weighted average) hourly wage. Unlike the other activities involved in the defective pricing process, the audit estimates were not based on hours per case per year. Rather, the dollar value of the contract being audited formed the basis for the manhour estimates in this area.

Legal Assistance. The cost estimate for legal assistance was calculated similarly to that for the auditors. Since there was one lawyer whose time was dedicated to analyzing defective pricing cases, the calculation was more straightforward. The lawyer estimated he spent approximately 40 hours per case per year (18). That figure was then multiplied by the hourly rate for a GS-14, the lawyer's grade. In consideration of the potential for litigation which exists on every defective pricing audit, an additional \$30,000 per case was added to the final cost figure (16). Aside from the attorney's time to prepare a case, the litigation cost included estimates for such things as fees for expert witnesses and the cost associated with taking depositions.

Price Analysis. In the defective pricing office itself, the manhour estimate per case per year was 120 hours (23). There were four analysts assigned to the office, one of whom was a GS-13 with the remaining three being GS-12s (23). Assuming equal effort by all four, a weighted average was calculated to obtain an hourly wage rate. The GS-12 rate was given a weight of .75 while the GS-13 rate was given a weight of .25. The time spent by a GS-5 procurement clerk was estimated at 40 hours per case per year (23).

Other Personnel. Manpower costs were also calculated for both the supervisory auditor and the chief of the defective pricing office. The manhour estimates for those individuals were 14 hours (17) and 40 hours (23)

respectively. Those estimates were multiplied by the hourly rates for a GS-13 and an Air Force major.

The liaison auditor, as the DCAA representative, performs a multitude of functions with respect to defective pricing cases. He is available for consultation on audits, coordinates meetings between contracting personnel and the cognizant DCAA activity, and attends negotiations when requested. As such, the time spent by the liaison auditor on an average defective pricing case was estimated at 25 hours per year (15). The liaison auditor position is a GS-14 position; thus, the hourly estimate was calculated by multiplying the appropriate wage rate by the manhour estimate of 25 hours.

Limitations and Assumptions

Before using the results of this study to provide support for a decision, the contracting officer should consider several things. First, it was assumed that the way in which ASD handles defective pricing cases is representative of the Air Force as a whole or at least of AFSC and AFLC which are responsible for all but a small percentage of the defective pricing cases in the Air Force. To the extent that all DOD components are required to comply with the guidance in DOD Directive 7640.2, the assumption should cause no real concern. However, it is important to remember that at ASD, the defective pricing function is centralized which has enabled them to operate more

efficiently and effectively at least with respect to one measure: sustention rates. For the six-month period ending 30 September 1987, the ASD sustention rate, at 79 percent, was slightly higher than the Air Force average by seven percentage points (8).

A second consideration for the contracting officer deals with the manpower computations. By glancing at the Semi-annual Report data used, it is obvious that most cases are not completed in the same year in which the defective pricing audit is issued. Only two of the audit reports in the sample fell into that category. Despite that, all of the manpower computations were made using only 1987 figures to keep the computations straightforward and to underscore the fact that the manhour estimates, not the wage rates, were considered to be the more critical of the two elements.

A third matter which should be noted was that the same audit manhour estimates were used for all of the audits including the three which were not conducted by the DCAA. The assumption was that a defective pricing audit should take about the same amount of time to complete regardless of the agency conducting the audit.

Finally, this study was limited to cases closed by ASD during one fiscal year, 1987. No analysis was done to determine whether or not the level of defective pricing activity in FY 1987 was comparable to other years; rather the assumption was that FY 1987 was a representative year.

Depending on the specifics of the particular defective pricing audit under consideration and the contracting activity involved, these limitations and assumptions may be of special interest to the contracting officer.

Summary

The goal of this research was to provide the contracting officer with some information on defective pricing processing times and the manpower costs associated with pursuing defective pricing allegations to enable him to evaluate particular cases where the benefit to the government may be questionable.

Manhour estimates were developed based on information provided by those individuals responsible for the three major aspects of the process: audit, analysis and negotiation, and legal advice. That information was used in conjunction with the appropriate wage rates to develop the estimated manpower costs of pursuing defective pricing audit allegations.

In the next chapter, the total cost to prepare and process a defective pricing audit will be compared to the cost sustained to determine whether or not the government's return on investment is reasonable. Processing times and the value of the contracts involved will also be reviewed.

III. Analysis and Findings

Introduction

In this chapter, the estimated total cost of conducting a defective pricing audit and then processing it will be discussed. The discussion will focus on how the total cost was developed based on the methodology explained in the previous chapter and what the results mean for the contracting officer.

Cost Computations for Audit

The manpower cost estimates for the initial defective pricing audit were based on contract value. For contracts in excess of \$50 million, audit costs were estimated at \$23,496; for contracts between \$10 - \$50 million, audit costs amounted to \$10,680; for contracts valued between \$1 - \$10 million, audit costs were \$5,126; and for contracts of \$100,000 - \$1,000,000, audit costs were estimated at \$2,990.

Besides the initial defective pricing audit, the audit cost estimates included one follow-up review; that is, the auditor was given the opportunity to review and comment on the contractor's response to the initial audit. Normally a follow-up review resulted in the audit activity issuing a written response which was either a supplement or a memorandum. Of the 46 defective pricing cases studied, 12 of the audits had one supplement, one audit was supplemented twice, and two of the audits had been supplemented three

times. For the three audits with more than one supplement, additional hours were assessed for the subsequent follow-up reviews which would have necessarily preceded the issuance of the second and third supplementary audit reports.

Cost Computation for Analysis, Negotiation, and Legal Advice

The manpower cost estimates for processing a defective pricing case amounted to \$7055 per case per year. This amount included the time spent by ASD/PMF-X personnel (four analysts and a procurement clerk), the liaison auditor, the attorney, the supervisory auditor, and the ASD/PMF-X chief.

Unlike the audit estimates which were based on the value of the contracts audited, the processing cost was based on an average time spent per case per year. A dollar figure for processing each of the 46 cases was developed by determining the age of the case, dividing by 365, then multiplying by \$7055.

Age of Cases at Completion

An important aspect of the total cost computation which may not be obvious is the time it takes to process the audit once it is issued. Based on the current tracking procedure as outlined in DOD Directive 7640.2, the true age of an audit report may not be apparent. As has been previously mentioned, an audit may be reported as closed if it is superseded by a new audit report or if it is supplemented. Thus, while the analysis of a particular defective pricing

audit simply continues on until it is settled, the age of the case is represented by the date the most recent supplement was issued making it virtually impossible to determine the true age of the case. As a result of the tracking procedure then, if an audit has been supplemented, the reviewer will know that from the audit report number but will not be able to tell from the Semi-annual Report alone how old the case is. Therefore, for the purposes of this research, the age of a defective pricing case at completion was based on the date of issuance of the initial audit, and the closeout date was taken from the Semi-annual Report category, "Date of Disposition". Thus, for the 31 audits in the study for which no supplement had been issued, the age of the case was determined from the data contained in the Semi-annual Report. However, for the remaining 15 audits, the initial audit dates were obtained from the case files.

One of the goals of this research was to show that the value of a contract impacted the length of time it took to process a defective pricing case and that issuing and processing audits with insignificant allegation amounts were detrimental to the overall defective pricing program because they took valuable time away from the pursuit of the more substantial defective pricing audits. In an effort to provide support for that belief, two relationships were studied: the age of cases at completion vis-à-vis the cost questioned, and with regard to the contract value.

According to the data, the time to process a defective

pricing case varied greatly. In FY 1987, the age of cases closed ranged from 63 days to 2,224 days. Given the tremendous swing, the more accurate measure of central tendency proved to be the median, which was 604 days. The allegation amounts ranged from \$18,499 to \$31,367,399. Again, these figures were those which appeared in the initial audits. Based on a data sort, there appeared to be no correlation between the allegation amount (cost questioned) and the age of a case at completion (see Appendix C for data). With respect to the objective previously stated, that means those cases of a low dollar value did not take any less time to settle than cases of a high dollar value. For example, the case which took the least amount of time to process, 63 days, was for an allegation of \$134,233 and was fully sustained. The case which took the longest to settle, 2,224 days, was for \$3,340,898 and was negotiated for \$1,269,941. The largest allegation amount in the sample, \$31,367,399, took 1523 days to settle at a value of \$2,568,042, approximately two years less time than the oldest case in the study which had an allegation amount of one-tenth the latter's value. In numerous other instances, there were substantial differences in the age of cases whose cost questioned amounts were very close.

In the second comparison of age to contract value, there did appear to be a correlation between the contract value and the case age. As the value increased, so did the length of

time to complete the case. Given that in weapon systems procurement, the expectation is that as contract value increases so does complexity, this correlation is understandable. The median age of cases whose contract value was between \$100,000 - \$10,000,000 was 553 days. The median age of cases for contracts valued between \$10 - \$50 million was 604 days and was 754 days for contracts over \$50 million.

Cost Computation for Total Cost

A total cost figure was computed for each of the 46 cases in the study. It included the audit and processing costs for each case and a potential litigation cost of \$30,000. The litigation cost represented the potential for litigation which exists for every defective pricing case that is pursued in the event no agreement can be reached between the contracting officer and the contractor whereupon the contracting officer will issue a final decision which the contractor may then dispute. As such, the potential litigation cost is something which the contracting officer should consider when determining whether or not a particular defective pricing audit merits attention.

For each case, the total cost was compared to the cost sustained, and in 12 of the 46 cases (26 percent) the cost to pursue the case was nearly three times greater than the monies returned to the government. However, the total amount of the cost sustained for the entire 46 cases far outweighed the cost incurred. Based on the information compiled in this

study, the monies recouped from contractors based on defective pricing allegations was \$32 million, approximately 11 1/2 times the amount spent, a substantial return on investment, but one which could have been greater had there been some mechanism by which to scrutinize the 12 cases which cost more to process than was sustained. Returning again to the idea that serious consideration should be given to not issuing defective pricing audits of less than \$50,000, that would have eliminated five of the twelve audits in question particularly if the allegation amount would have been assessed in light of the contract value. The five cases mentioned above had allegation amounts which averaged .88 percent of their contract values. The remaining seven cases included allegations ranging from \$61,632 to \$4,694,620 and represented anywhere from .65 percent to 62 percent of the value of their respective contracts. Thus, by virtue of the allegation amount alone, those seven audits would have been pursued.

Based on the computations described here, an average total cost to the government for auditing, analyzing, and negotiating a defective pricing case was \$57,212 which was based on the 46 defective pricing cases closed at ASD during FY 1987. That figure consisted of the audit costs weighted according to the number of audits conducted in each of the four contract value categories. Hence, 46 percent, 21 audits, were on contracts between \$10 - \$50 million; 43 percent, 20 audits, were on contracts in excess of \$50

million; nine percent, four audits, were on contracts of \$1 - \$10 million; and the remaining two percent, one audit, was on a contract of less than \$1 million. The median processing time of 604 days was incorporated and \$30,000 in potential litigation costs were also added.

Summary

The analyses described in this chapter provided a basis for developing manpower cost estimates for the personnel involved in the defective pricing process. They further revealed that there was an apparent correlation between the contract value and the time it took to settle a defective pricing case with the audits of contracts in excess of \$50 million having taken approximately five months longer than audits of contracts between \$10 - \$50 million. Overall, the data showed that the median processing time was 604 days.

At this point, a contracting officer faced with evaluating the significance of a defective pricing audit would have sufficient information for determining the approximate cost to the government for auditing, analyzing, and processing a defective pricing audit. Here again, it is important to note that the experts who provided the manhour data upon which these analyses were based commented on the uniqueness of each defective pricing case and cautioned against generalizing. The results here are intended to be used within the context of the case under evaluation.

IV. Conclusions and Recommendations

The issue of defective pricing is one facet of the acquisition process which lends itself to controversy. The law is ambiguous and recent attempts at clarification have been unsuccessful. In recent years, the criminal implications associated with defective pricing have made it all the more controversial.

There is no doubt that when defective pricing has occurred the government should be empowered to recoup the amount of overpayment. Nonetheless, timely investigation of the multitude of defective pricing audits is difficult at best. This study concentrated on the significance aspect of the defective pricing audit in an effort to provide the contracting officer with some means for evaluating those audits whose merits may be questionable with respect to the expected return on the investment of manpower. The study concluded that the manpower costs alone associated with conducting a defective pricing audit, analyzing and negotiating the case, and providing legal assistance can be substantial with a weighted average of approximately \$57,000 for the 46 cases reviewed.

Another finding of the study was that the time it took to process a case had little to do with the allegation amount. Rather there appeared to be a correlation between the contract value of the action audited and processing time: the greater the value the longer it took to settle the case.

Based on the results of this study, there are several things which can be done to ensure that the way in which the government approaches the defective pricing issue is the one which will best utilize manpower and effect the best return on investment. First, the Air Force should approach the DCAA about establishing some lower limit on the dollar value of defective pricing audits. Given the ever prevalent problem of limited manpower, it would benefit both the DCAA and the contracting community to be able to focus their attention on those efforts which best utilize that scarce resource. This research has established that there is certainly doubt that audits below \$50,000 reap any net benefit to the government. Indeed, the time spent pursuing the small dollar allegations is time taken away from the larger value audits which in turn causes longer delays in processing the larger dollar value allegations. On the surface, this recommendation may appear to run afoul of public policy, but that is not the intent. To make the recommendation more palatable, there could be a small number of audits below the \$50,000 threshold issued at random. The contracting officer would determine whether or not they should be pursued on a case-by-case basis. However, aside from a few small dollar defective pricing audits, so long as there is no evidence of fraud or wrongdoing, defective pricing audits of less than \$50,000 should not be issued.

Second, the Air Force should continue to promote cooperation and better communication between the contracting community and the DCAA, between contracting officers and auditors. The pervasive attitude with regard to government procurement activity and those who engage in it is one of mistrust, but, as is evidenced by the subtle changes in DOD Directive 7640.2, that attitude may be changing based on the understanding that government procurement is indeed a complex proposition wherein even those involved in the process know little beyond what is within their own realm of experience. It is, therefore, important that each knows the roles, responsibilities, duties, and obligations of the other. The various correspondence and in-residence courses offered by the Air University are a ready-made vehicle for disseminating that type of information.

Third, the Air Force should also provide wider distribution of studies like its own "Report on the DCAA." Such information would enable field personnel to keep abreast of the issues affecting them and the acquisition community at large.

The objective of an oversight program like the defective pricing program is to ensure that the government pays a fair and reasonable price for its goods and services and to provide the means for recoupment of funds when overpayment occurs. Through the implementation of the recommendations made here, that objective is all the more attainable.



Department of Defense
DIRECTIVE

February 12, 1988
NUMBER 7640.2

IG, DoD

SUBJECT: Policy for Followup on Contract Audit Reports

- References:**
- (a) DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," July 18, 1986 (hereby canceled)
 - (b) Office of Management and Budget (OMB) Circular A-50 (Revised), "Audit Followup," September 29, 1982
 - (c) DoD Directive 7650.3, "Followup on General Accounting Office, DoD Inspector General, Internal Audit and Internal Review Reports," March 19, 1985
 - (d) DoD Instruction 7600.2, "Audit Policies," January 10, 1985
 - (e) through (j), see enclosure 1

A. REISSUANCE AND PURPOSE

This Directive:

1. Reissues reference (a) to clarify responsibilities, reporting requirements, and followup procedures on contract and grant audits conducted by the Defense Contract Audit Agency (DCAA) and the Army Corps of Engineers.

2. Implements reference (b)

B. APPLICABILITY AND SCOPE

1. This Directive applies to the Office of the Secretary of Defense (OSD), the Military Departments, and the Defense Agencies (hereafter referred to collectively as "DoD Components").

2. Its provisions do not apply to the reports of the General Accounting Office (GAO), the Inspector General, Department of Defense (IG, DoD), and other DoD internal audit organizations. Followup policies and procedures for the reports of those organizations are contained in reference (c); however, the IG, DoD, and contract audit followup officials may formulate special procedures for followup on defective pricing reports of the IG, DoD, and the GAO.

C. DEFINITIONS

Terms used in this Directive are defined in enclosure 2.

D. POLICY

1. The responsibility for reaching agreement with the contractor is the contracting officer's, and he or she has wide latitude and discretion in that regard. The Department of Defense recognizes, under OMB Circular A-50 and DoD Instruction 7600.2 (references (b) and (d)), the need for contracting officers

to give full consideration to contract audit advice and to document the disposition of audit recommendations. The contract audit followup system shall be structured in consonance with the independent, decision-making role of the contracting officer and the financial advisory role of the contract auditor.

2. To accommodate the variances between contract audit reports and internal audit reports, this Directive prescribes special guidance for contract audit resolution, disposition, tracking, and followup status reporting.

3. In accordance with reference (b), the resolution and disposition of all contract audit reports shall be consistent with legal statutes, regulations, and DoD policy.

E. RESPONSIBILITIES

1. The Inspector General, DoD, (IG, DoD) shall develop contract audit followup policy, and shall monitor, coordinate, and evaluate contract audit followup systems in the Department of Defense. In discharging this responsibility, the IG shall:

a. Develop policy and provide guidance to DoD Components on matters covered under this Directive.

b. Monitor and evaluate program performance to ensure that the DoD Components and contract audit organizations effectively carry out their contract audit followup responsibilities in accordance with this Directive.

c. Identify cases or areas where contract audit followup procedures can be improved and recommend appropriate corrective action to the DoD Component head concerned.

d. Provide periodic reports on the status of DoD contract audit followup efforts, including those required by OMB Circular A-50 (reference (b)), to the Secretary of Defense.

2. The Secretaries of the Military Departments and the Directors of the Defense Agencies shall:

a. Designate a contract audit followup official to manage their Component's contract audit followup program.

b. Establish procedures as prescribed by Federal Acquisition Regulation (FAR) 15.807 (reference (e)), whereby contracting officers shall fully consider contract audit advice in the course of determining pre-negotiation positions that are subject to DoD Component review and clearance processes.

c. Direct periodic evaluations of their Component's followup systems to determine whether the systems are adequate and result in timely, appropriate resolution and disposition of audit reports.

d. Ensure that performance appraisals of appropriate acquisition officials reflect their effectiveness in resolving and dispositioning audit findings and recommendations in a timely manner, while fully protecting the Government's interest.

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e. Establish procedures for maintenance of up-to-date records on all applicable contract audit reports covered in section B., enclosure 4, of this Directive from receipt through disposition. For open reports, this includes written milestone plans for resolution and disposition as required by the Status Report on Specified Contract Audit Reports, attachment 1 to enclosure 3.

f. Establish procedures to monitor and ensure the proper, timely resolution and disposition of contract audit reports.

g. Establish procedures to ensure that the DoD Component's semiannual contract audit followup status report is prepared and submitted to the OIG in accordance with the procedures in subsection F.3., below, and enclosure 3 of this Directive.

h. Ensure that acquisition personnel in their Component are adequately trained in the utilization of contract audit reports and the requirements of the contract audit followup program.

3. The Director, Defense Contract Audit Agency (DCAA), and Heads of Other Contract Audit Organizations shall:

a. Provide timely and complete responses to any contracting officer or review official who requests factual information or further audit opinions regarding the audit issues under review.

b. Provide timely and complete support to the IG and any internal audit organization reviewing a DoD Component's contract audit followup system, in accordance with DoD Instruction 7600.2 (reference (d)).

c. Utilize the feedback provided by the contracting officials, including final disposition and negotiating memoranda, to analyze and improve audit procedures and practices.

d. Identify those contract audit reports that are reportable under subsection F.3., below, to the applicable DoD Component at the time of issuance, and provide a summary record of all such reports to the DoD Components at least semiannually. The record shall include the activity address numbers (Appendix N of DFARS (reference (f))) code for each report issued.

e. Forward all audit reports on auditor-determined, final indirect cost rates to the cognizant administrative contracting officer for resolution when agreement cannot be reached with the contractor.

F. PROCEDURES

1. General. Contracting officers and acquisition management officials shall pursue timely, proper resolution and disposition of contract audit reports. Resolution of contract audit reports, other than preawards, is required by P.L. 96-304 (reference (g)), as well as by OMB Circular A-50 (reference (b)), within 6 months of report issuance. Disposition should take place as soon as possible after resolution.

2. Tracking Requirements

a. All contract audit reports are to be tracked; however, only the reports specified in paragraph F.3.a., below, are to be reported. For preaward contract audits, specified in paragraph F.3.b., below, tracking may be accomplished using records maintained in official contract files.

b. Individual procurement or contract administration offices shall track and report the status of all specified contract audit reports from the date of receipt through final disposition. This information shall be maintained on a current basis and shall serve as the source document for followup status reports. Although the audit organization shall identify reportable contract audits, the ultimate decision resides with the procurement or contract administration office. Audit reports shall be dropped from the tracking system in the reporting period following closure.

3. Reporting Requirements. The DoD acquisition and contract administration organizations shall maintain timely and complete information regarding the status of reportable contract audit reports from the time the report is received through final disposition. For auditor-determined final indirect cost rate reports, a report is considered received for followup tracking purposes when it is received by the cognizant Administrative Contracting Officer (ACO) for resolution and disposition.

a. Reportable Audits include:

(1) Those containing findings and recommendations, whether or not the findings are qualified, covering estimating system surveys, accounting system reviews, defective pricing reviews, cost accounting standards (CAS) noncompliance issues, including CAS disclosure statements if they contain noncompliance issues.

(2) Those covering internal controls, operations audits, incurred costs, settlement of final indirect cost rates, final pricing submissions, termination settlement proposals, equitable adjustment claims, hardship claims, and escalation claims, if reported costs or rates questioned or qualified equal \$100,000 or more.

(3) Those final indirect cost rates where the auditor cannot reach an agreement with the contractor and forwards the audit report to the cognizant ACO for final decision.

b. Non-reportable Audits. Reports covering preaward proposals; forward pricing labor, overhead, and other advance rate proposals; progress payments; preaward surveys; proposals for change orders or modifications; assist audits; and closing statements are not to be reported. Should such audits contain reportable findings and recommendations, they are not to be treated as a reportable report; however, if deemed appropriate, the contracting officer should request the DCAA to issue a separate audit report addressing the reportable issues in detail. Reports containing only positive findings and recommendations, such as recommending that a contractor's proposed cost accounting standards change be approved, are not to be reported. Any interim report that will be incorporated into a future report shall not be reported. Final indirect cost audits that are auditor-determined are not to be reported if the auditor is successful in reaching an agreement on the rate(s) with the contractor.

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c. The DCAA shall provide to the Military Departments and the Defense Logistics Agency (DLA) listings of all reportable contract audit reports issued during the 6-month periods ending February 28 and August 31. Such data shall be furnished not later than 21 days after the close of each period.

d. The DoD Components shall submit reports on the status of reportable contract audits semiannually to the IG, DoD, within 30 calendar days of the end of the 6-month periods ending March 31 and September 30. The required formats are on attachments 1 and 2 to enclosure 3. These reports shall include the following data:

(1) For open reports. The report number, report date, contractor name, type of audit, costs questioned or cost avoidance, Armed Services Board of Contract Appeals (ASBCA) docket number (U.S. Claims Court case number) when the report is in litigation, date of request by an investigative agency for deferral of action on a report (when applicable), whether the report is resolved or unresolved, resolution target date, and disposition target date (attachment 1, enclosure 3).

(2) For reports closed during the reporting period. The report number, report date, contractor name, type of audit, date of disposition, costs questioned or potential cost avoidance, and costs questioned or avoidance sustained. Costs questioned and sustained shall be reported as zero when a report is superseded, replaced, or incorporated into a new report. In such cases, the Date of Disposition column should show the new report number with the date of the new report (attachment 2, enclosure 3).

4. Resolution of Contract Audit Reports

a. The DoD Component procedures for documenting and reviewing proposed prenegotiation objectives shall provide the independent review for internal control purposes prescribed by OMB Circular A-50 (reference (b)). For most contract audits reports, the contracting officer should obtain contractor comments, and such technical advice deemed necessary, prior to formulating a prenegotiation position. The additional information shall be shared with the auditor, as appropriate. If additional audit effort is required because of data presented by the contractor, the contracting officer shall promptly request such a review, and the audit organization shall give priority to providing the necessary additional audit support. If no additional audit effort is deemed necessary, the contracting officer shall communicate with the auditor on the proposed disposition, as necessary, to reach a fully informed decision. In documenting his or her prenegotiation position, the contracting officer should indicate whether the audit recommendations were accepted or, if not, whether the auditor has revised them. When the contracting officer disagrees with the audit position, the contracting officer's prenegotiation documentation should include the rationale for not accepting the audit advice. The post-negotiation documentation should include a summary of the field pricing report recommendations and the reasons for any pertinent variances from those recommendations.

b. For auditor-determined indirect cost rates, the auditor shall seek agreement with the contractor upon completion of the audit. If agreement is reached, the contractor and auditor execute a written understanding setting forth the final rates. If agreement is not reached, the auditor shall issue a notice of costs suspended and/or disapproved, and advise the contractor of its right to submit a claim to the ACO for any disapproved costs. If the contractor submits a written objection to the ACO, the ACO may communicate further with the contractor in order to reach an agreement. If the ACO disagrees with the audit recommendations, he/she complies with the procedures prescribed by his/her DoD Component for documentation and review prior to disposition. If the ACO agrees with the audit recommendations, he/she issues a final decision, after complying with the procedures prescribed by his/her DoD Component for documentation and review.

5. Notification of Final Disposition of Contract Audit Reports

a. Explicit and timely documentation and feedback on the final disposition of audit reports are essential. Therefore, the contracting officer shall promptly prepare a memorandum covering the disposition of all reports. The memorandum shall discuss the disposition of all recommendations and questioned and/or qualified amounts, including the underlying rationale for such dispositions. A copy of the memorandum shall be provided to the cognizant contract auditor before a report may be closed.

b. Existing feedback mechanisms, such as a price negotiation memorandum, DAR 3-811(a) (reference (h)), DFARS 15.808 (reference (f)), and FAR 15.808 (a) (reference (e)), or a written overhead negotiation memorandum, DAR 3-705(b)(5) (reference (h)), DFARS 42.706 (reference (f)) and FAR 42-705-1(b)(5) (reference (e)) should be used, when applicable. For all other actions, a similar document shall be prepared. To ensure that the final disposition of all audit reports is properly accounted for, the procurement or administrative contracting officer shall notify the cognizant audit office in writing of the cancellation of any acquisition action and of any unsuccessful offerors not receiving award of the contract or grant for which an audit report was issued.

6. Recovery of Funds. Policies regarding the DoD credit management and debt collection program are contained in the DoD Directive 7045.13 (reference (i)), Appendix E of the DAR (reference (h)), DFARS 32.6 (reference (f)) and FAR 32.6 (reference (e)) for contract debts. Any amount due the Government as a result of a contract audit is to be determined by the contracting officer negotiating a settlement with the contractor or by the contracting officer issuing a unilateral decision when negotiations prove fruitless. Upon completion of either action, a prompt demand for payment in writing should be made by the contracting officer citing the amount due with a copy of the demand provided to the payment office cited in the contract. The demand should include notice that any amount not paid within 30 days from the date of the demand shall accrue interest from the date of the demand at the prevailing Treasury Rate (Parts 32 of FAR and DFARS (references (e) and (f))) provide specific instructions for demand notices). General ledger accounts for recording accounts receivable and collections are detailed in Chapter 33 and Appendix B of DoD 7220.9-M (reference (j)).

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7. Coordination with Other Agencies. The cognizant contracting office responsible for acting on contract audit reports that affect contracts of other Government Agencies shall inform affected organizations of such actions.

G. INFORMATION REQUIREMENTS

The reporting requirements of this Directive have been assigned Report Control Symbol DD-IG(SA)1580.

H. EFFECTIVE DATE AND IMPLEMENTATION

This Directive is effective immediately. Forward one copy of implementing documents to the Inspector General, Department of Defense, within 120 days.



William H. Taft, IV
Deputy Secretary of Defense

Enclosures - 4

1. References
2. Definitions
3. Followup Status Reports
4. Contract Audit Reports Subject to Tracking, Reporting, Resolution, Disposition, and Notification Requirements

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REFERENCES, continued

- (e) Federal Acquisition Regulation (FAR)
- (f) DoD FAR Supplement (DFARS)
- (g) Public Law 96-304, "Supplemental Appropriations and Rescissions Act of 1980," July 8, 1980
- (h) Defense Acquisition Regulation (DAR)
- (i) DoD Directive 7045.13, "DoD Credit Management and Debt Collection Program," October 31, 1986
- (j) DoD 7220.9-H, "Department of Defense Accounting Manual," October 1983, authorized by DoD Instruction 7220.9, October 22, 1981

DEFINITIONS

1. Adverse Opinion Report. An audit report containing the statement that the contractor's proposal is not acceptable as a basis for negotiation of a price.
2. Closed Audit Report. An audit report that has been dispositioned by the contracting officer and closed for followup tracking purposes. See the definition for Disposition of Contract Audit Reports at 7, below.
3. Contract Audit Report. The contract auditor's written advice to a contracting officer advocating specific action on the part of the contracting officer or contractor and/or including highly qualified or adverse opinion information. An audit report could include amounts questioned or disapproved, exceptions to a contractor's system or operations (usually expressed in terms of cost avoidance), recommended price adjustments, or notification of a contractor's non-compliance with cost accounting standards.
4. Costs Questioned. a. The amount questioned in the audit report that the reporting contracting officer or auditor has responsibility and authority to disposition. Audit reports on final indirect cost rates (overhead) will typically have costs questioned relating to corporate allocations and costs questioned relating to divisional expenses. The divisional ACO should list only the amount questioned pertaining to division expenses which he or she is responsible for negotiating, and the corporate ACO should be reporting the costs questioned at the corporate level which he or she is responsible for negotiating. Each contracting officer should list the total amount questioned subject to negotiation AT THAT LEVEL, regardless of contract mix or percentage of commercial business. b. All costs set aside as "unsupported," qualified and/or adverse opinion amounts unless such amounts are disclaimed by the auditor because of requested assist audits or need for technical evaluation. Such amounts are not to be reported by the contracting officer until the assist audit and/or technical evaluation is incorporated by a supplemental report. At time of receipt, the amount questioned and the report date shall be revised for correction in the next semiannual report. c. Costs monetized as a result of a technical evaluation that are INCORPORATED into the audit report.
5. Costs Questioned Sustained. That portion of costs questioned and/or qualified by the auditor upheld as a result of actions taken by either the contractor or the contracting officer.
6. Disclaimed Opinion Report. Any audit denying the validity of a proposal when the scope of audit was so restricted that an audit opinion cannot be justified.
7. Disposition of Contract Audit Reports. Contract audit report disposition is achieved when: a. The contractor implements the audit recommendations or the contracting officer's decision; or b. The contracting officer negotiates a settlement with the contractor and a contractual document has been executed; or c. The contracting officer issues a final decision pursuant to the Disputes Clause, and 90 days elapse without contractor appeal to the Armed Services Board of Contract Appeals (ASBCA). Should the contractor appeal to the Claims Court within the 12 months after final decision, the audit must be

reinstated as an open report in litigation; or d. A decision has been rendered on an appeal made to the ASBCA or U.S. Claims Court and any corrective actions directed by the Board or Court have been completed and a contractual document has been executed; or e. Audit reports have been superseded by, or incorporated into, a subsequent report; or f. Any corrective actions deemed necessary by the contracting officer have been taken, so that no further actions can be reasonably anticipated.

In the case of divisional overhead audit reports, such reports may be considered dispositioned when the contracting officer has negotiated all local issues with the contractor and a written agreement detailing the results of the negotiations has been signed by both the contracting officer and the contractor and distribution has been made to DCAA. A cost accounting standard noncompliance report is dispositioned when the audit report on the related cost impact statement is received by the contracting officer, when required.

8. Highly Qualified Opinion Report. Qualified audit reports vary according to circumstances, but typically indicate a significant inadequacy in the cost or pricing data, denial of access to records, or noncompliance with cost accounting standards or acquisition regulation. For the purposes of followup coverage under this Directive, the audit report must specifically say that the results of audit are HIGHLY qualified:

9. Litigation. An audit report is considered to be in litigation any time an appeal has been filed with the ASBCA or any court concerning an audit recommendation and/or qualification identified in the audit report for a specific contractor. An audit report is also in litigation whenever the Government appeals a decision of the ASBCA or U.S. Claims Court, or there is other ongoing judicial action as a result of a contract audit.

10. Open Audit Report. An audit report that has not been dispositioned.

11. Overaged. An audit report that has not been dispositioned and is over 12 months old (from date of issuance) on the "as of" date of the status report.

12. Resolution. a. For reportable audits, the point at which the auditor and the contracting officer agree on the action to be taken on audit report findings and recommendations and/or qualifications; or, in the event of disagreement, when the contracting officer determines a course of action after following the DoD Component prenegotiation documentation and review procedures. Resolution must be supported by specific written documentation in the file. b. In the case of auditor-determined final indirect cost rates, resolution is achieved when an agreement is reached between the auditor and the contractor, or when agreement cannot be reached, a decision is rendered by the cognizant ACO after obtaining additional review, if required. c. For preaward audits, the point at which agreement is reached, a proposed negotiation objective is modified during review, a contract price negotiated, or proposed award canceled, whichever occurs first.

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FOLLOWUP STATUS REPORTS
RCS DD-IG(SA)1580

A. The reports shall provide the information detailed in paragraph F.3.d. of this Directive. All listed reports shall be tracked and reported through final disposition.

B. Each acquisition and contract administration contract audit followup official shall submit a semiannual status report in the attached format. Summary reports for DoD Components shall be submitted to the IG. The reports shall cover the semiannual periods ending March 31 and September 30 and shall be submitted within 30 calendar days after the end of the period. Items shall be removed from the tracking and reporting system in the period following that in which they appeared on the status report as being closed.

C. Each reporting activity shall cite the appropriate activity address number on the line requiring DoD Component. The activity address numbers are listed in Appendix N of DAR (reference (g)). Activities not assigned a number shall report by organization and address. Components reporting via an automated system may satisfy this requirement using their own location codes as long as an explanation is furnished with the submission.

Attachments - 3

1. Status Report on Specified Contract Audit Reports--Open Reports
2. Status Report on Specified Contract Audit Reports--Reports Closed During Period
3. Codes for Type of Audit

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STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
(Report Control Symbol DD-IG(SA)1580)

OPEN REPORTS

For period ending _____
DoD Component _____

Audit Report Number	Report Date	Contractor Name	Type of Audit ^{1/}	Costs Questioned or Cost Avoidance	Litigation ^{3/} in	Resolved or Unresolved ^{4/}	Resolution Target ^{5/} Date ^{5/}	Disposition Target ^{5/} Date ^{5/}
A. Overaged reports (over 12 months old)								
B. Reports 6-12 months old								
C. Reports less than 6 months old								
D. Reports in litigation								
E. Reports involved in criminal investigation ^{2/}								

^{1/} Use type or codes listed on Attachment 3
^{2/} If the investigative organization has requested deferral of resolution or disposition
^{3/} Docket/Case No. or no (N)
^{4/} Date of resolution or (U) if unresolved
^{5/} Year, month, day

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
 (Report Control Symbol DD-IG(SA)1580)

REPORTS CLOSED DURING PERIOD

For period ending _____
 DoD Component _____

Audit Report Number	Report 1/ Date	Contractor Name	Type of Audit 2/	Date of Disposition 1/	Costs Questioned or Cost Avoidance	Costs Sustained/Avoided
A. Reports listed as averaged in prior report						
B. Other reports closed during period						

1/ Year, month, day
 2/ Use types or codes listed on Attachment 3

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<u>Code</u>	<u>Type of Audit</u>
A	Estimating System Survey
B	Accounting System Review
C*	Internal Control Review
D	Defective Pricing Review
E	Cost Accounting Standards Noncompliance
F*	Operations Audit
G*	Incurred Costs
H*	Settlement of Final Indirect Cost Rate
I*	Final Pricing
J*	Terminations
K*	Equitable Adjustment Claims
L*	Hardship Claims
M*	Escalation Claims

*Reported costs or rates questioned and/or qualified must equal \$100,000 or more.

3-3-1

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CONTRACT AUDIT REPORTS SUBJECT TO TRACKING, REPORTING,
RESOLUTION, DISPOSITION AND NOTIFICATION REQUIREMENTS

A. Reports Subject to Tracking

All contract audit reports. (For preaward contract audits, including change order proposals, tracking may be accomplished using records maintained in official contract files.)

B. Reports Subject to Tracking and Reporting Requirements of Subsections F.2. and F.3., Basic Directive:

1. All contract audit reports with findings and recommendations addressing:
 - a. Estimating system surveys
 - b. Accounting system reviews
 - c. Defective pricing reviews
 - d. Cost accounting standards noncompliance reviews

2. Reports that have findings, recommendations, and costs questioned and/or qualified of \$100,000 or more, and that address:
 - a. Incurred costs
 - b. Settlement of indirect cost rates
 - c. Final pricing submissions
 - d. Termination settlement proposals
 - e. Equitable adjustment claims
 - f. Hardship claims
 - g. Escalation claims
 - h. Internal controls
 - i. Operations reviews

3. All auditor-determined, final indirect cost rate disputes that are forwarded to the cognizant ACO for decision.

C. Reports Subject to Resolution

All contract audit reports.

Appendix B: Semi-annual Reports, FY 1987
Closed Cases

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
(REPORT CONTROL SYMBOL DP-K80(SA11580))

CLOSED - PREVIOUSLY REPORTED OVERAGE

FOR PERIOD ENDING 870331
DOD COMPONENT AERO SYS DIV

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR NAME	TYPE OF AUDIT	DATE OF DISPOSITION	QUESTIONED OR COST AVOIDANCE	COST SUSTAINED	IND	PREVIOUS LITIGATION
1441-2A420001	850227	LOCKHEED CORP, GEORGIA	4	861024	46132	7436	4	27469
1441-2A420002	850227	LOCKHEED CORP, GEORGIA	4	861024	41432	7893	4	27344
1441-3L420004	850428	LOCKHEED CORP, GEORGIA	4	861024	245049	20115	4	30045
1441-3L420005	850509	LOCKHEED CORP, GEORGIA	4	861024	62332	54067	4	30048
1481-2A420001-51	850624	UTC CORP, WY	4	870224	0	0	4	30334
2031-6A420006-65	861024	FAIRCHILD INDUSTRIES INC	4	860928	130000	1578238	4	30913
2031-1A420001-142	830021	FAIRCHILD INDUSTRIES INC	4	860728	30500	30000	4	30622
2031-1A420001-142-81	830021	FAIRCHILD INDUSTRIES INC	4	860728	371400	0	4	30643
2031-1A420001-142-82	831109	FAIRCHILD INDUSTRIES INC	4	860728	30000	0	4	30644
2031-1A420003-131-8-1	810309	FAIRCHILD INDUSTRIES INC	4	860728	30000	0	4	30645
2031-2A420001-74	820114	FAIRCHILD INDUSTRIES INC	4	860728	148251	74390	4	30646
2031-2C420001-72	840312	FAIRCHILD INDUSTRIES INC	4	860728	148251	30372	4	30647
2031-2C420004-74	840311	FAIRCHILD INDUSTRIES INC	4	860728	60748	30000	4	30648
3371-3A420004-81	811018	GENERAL MOTORS CORP	4	860728	1186000	20000	4	30649
3371-4A153004	831121	INTL BUS MACHINES CO	4	861115	47937	18878	4	30650
3421-5A420004	841030	INTL BUS MACHINES CO	4	861115	214747	85317	4	30651
7291-3B172001	850719	MCDONNELL DOUGLAS CORP	4	861125	0	0	4	30652
7471-5A420024-001	830416	FORD MOTOR COMPANY CORP	11	870121	422000	422000	4	30653
	850427	HUGHES AIRCRAFT COMPANY	4	870109	0	0	4	30654

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
(REPORT CONTROL SYMBOL DD-RIO(SA)1586)

CLOSED - ALL OTHER

FOR PERIOD ENDING 870331
DOD COMPONENT AERO SYR DIV

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR NAME	TYPE OF AUDIT	DATE OF DISPOSITION	COST		PREVIOUS LITIGATION
					QUESTIONS OR COST AVOIDANCE	COST SUSTAINED	
1441-3K420014	840508	LOCKHEED CORP, GEORGIA	4	861125	0	0	4
1481-4A420001/91	840213	UTC CORP, NYS	4	870112	0	0	4
2311-4A420003	840430	EATON CORPORATION	4	841201	0	0	4
3341-4A420004	840430	EATON CORPORATION	4	870108	0	0	4
3341-S-420004	851213	GENERAL ELECTRIC, EVEN	4	870210	186774	171748	4
4141-88172016	851001	TELEDYNE INCORPORATED	11	870131	121777	0	4
4241-5A420002-072	840225	INTER. TELE & TELES CORP	4	870108	0	0	4
4241-4A420002-073	840225	INTER. TELE & TELES CORP	4	870108	0	0	4
7301-4J420014-001	851114	BOEING COMPANY, SEATTLE	4	870112	148444	148444	4
9908-7A7-86-132	840829	NORTHROP CORPORATION	4	861031	134233	134233	4

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
(REPORT CONTROL SYMBOL DD-R80(SA)1580)

CLOSER - PREVIOUSLY REPORTED OVERAGE
FOR PERIOD ENDING 870930
DDO COMPONENT AERO SYS DIV

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR NAME	TYPE OF AUDIT	DATE OF DISPOSITION	QUESTIONED OR COST AVOIDANCE	COST SUSTAINED	IMD	PREVIOUS LITIGATION
141-3442007	840307	AMERICAN AIRLINES	4	870708	58430	58430	4	
141-34420104	851115	GENERAL DYNAMICS	4	870930	31745	31745	4	
131-5842013	860304	GENERAL DYNAMICS	4	870930	2352507	2094575	4	
131-48420109	870310	GENERAL DYNAMICS	4	870930	23441	23441	4	
141-5842000A	851113	LOCKHEED CORP. GEORGIA	4	870720	603561	546712	4	
141-54420012	850628	UTC CORP. WPA	4	870515	0	0	4	
141-5442002791	851231	UTC CORP. WPA	4	870520	0	0	4	
241-24420302-53A	866605	GENERAL ELECTRIC CO, VF	4	870407	331217	82563	4	
341-24420001	850627	MCDONNELL DOUGLAS CORP	4	870430	0	0	4	
341-244200251	850115	MCDONNELL DOUGLAS CORP	4	870430	0	0	4	
341-24420018-81	860310	MCDONNELL DOUGLAS CORP	4	870831	431314	496754	4	
341-34420002-5-1	850623	MCDONNELL DOUGLAS CORP	4	870831	1430183	1333000	4	
341-34420012	830731	MCDONNELL DOUGLAS CORP	4	870831	1564000	1518918	4	32762
341-344200135-1	850322	MCDONNELL DOUGLAS CORP	4	870831	2941081	2444972	4	
341-34420016-81	850130	MCDONNELL DOUGLAS CORP	4	870831	6723	6381	4	
341-34420003	850719	MCDONNELL DOUGLAS CORP	4	870430	0	0	4	
341-44420031	840228	MCDONNELL DOUGLAS CORP	4	870831	842203	842203	4	
4101-41420002-440	870630	INTL CORPORATION	4	870527	309235	80357	4	
4201-44420002-672	840225	INTER. TELE & TELE CORP	4	870929	225919	212425	4	
4201-44420006-73	840225	INTER. TELE & TELE CORP	4	870929	75015	68440	4	
4501-44420403-S-0352	850524	WESTINGHOUSE CORPORATION	4	870528	333742	154020	4	
7401-48420127-001	850529	BOEING COMPANY, WICHITA	4	870814	784220	0	4	

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
(REPORT CONTROL SYMBOL 9D-RED(SA)1580)

CLOSED - ALL OTHER

FOR PERIOD ENDING 870930
IND COMPONENT AERO SYS DIV

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR NAME	TYPE OF AUDIT	DATE OF DISPOSITION	QUESTIONED OR COST AVOIDANCE	COST SUSTAINED	JMD	PREVIOUS LITIGATION
1341-5842021481	840729	GENERAL DYNAMICS	4	870930	415334	415334	4	
1341-5842021781	860508	GENERAL DYNAMICS	4	870930	1059502	194619	4	
1341-6842010181	840730	GENERAL DYNAMICS	4	870930	110005	110005	4	
1341-6842010781	840731	GENERAL DYNAMICS	4	870930	1697722	1697722	4	
1341-78420114	870109	GENERAL DYNAMICS	4	870930	818750	818750	4	
1441-68420004	840419	LOCKHEED CORP, GEORGIA	4	870807	53404	51248	4	
1481-68420101	840430	UTC CORP, WPA	4	870515	0	0	4	
2311-6A420003-S1	841201	EATON CORPORATION	4	870407	0	0	4	
2311-6A420003-S2	870407	EATON CORPORATION	4	870415	0	0	4	
2311-6A420004-S1	870108	FATON CORPORATION	4	870415	0	0	4	
3321-6A420001	840430	GENERAL MOTORS CORP	4	870410	0	0	4	
3341-7-710062	841208	GENERAL ELECTRIC, EVAN	9	870430	169970	149970	4	
3421-1A420008-001S1	840528	MCDONNELL DOUGLAS CORP	4	870831	355800	78300	4	
3421-1A420030-001S 1	840710	MCDONNELL DOUGLAS CORP	4	870831	1407340	1249941	4	
3421-2A420002-S2	841126	MCDONNELL DOUGLAS CORP	4	870831	7051834	4413189	4	
3421-2A420015	841126	MCDONNELL DOUGLAS CORP	4	870831	5044922	4821793	4	
3421-3A420014-S1	840724	MCDONNELL DOUGLAS CORP	4	870831	3459972	3459972	4	
3421-5A420045-1	841225	MCDONNELL DOUGLAS CORP	4	870831	1081130	950000	4	
3421-5A420010	841211	MCDONNELL DOUGLAS CORP	4	870831	4557540	4134132	4	
3421-5A420035	840528	MCDONNELL DOUGLAS CORP	4	870831	201249	74958	4	
3421-6A420034	840409	MCDONNELL DOUGLAS CORP	4	870831	154131	140518	4	
3421-6A420117	840528	MCDONNELL DOUGLAS CORP	4	870831	242737	157077	4	
3421-6A420113	840523	MCDONNELL DOUGLAS CORP	4	870831	361481	171503	4	
3421-6A420114	840523	MCDONNELL DOUGLAS CORP	4	870831	223301	174019	4	
3421-7A420028	840513	MCDONNELL DOUGLAS CORP	4	870930	18499	11099	4	
4741-7A420002-145	870433	INTER. TELF & TELEF CORP	4	870423	141852	159905	4	
4741-7A420004-149	870424	INTER. TELF & TELEF CORP	4	870424	0	0	4	
4741-7A420007-145	870424	INTER. TELF & TELEF CORP	4	870423	0	0	4	
4741-7A420004-149	870424	ITT AVIONICS DIV	4	870915	14912	14912	4	
7191-5L 430,177,544	860417	ROCAWELL INTER. CORP	4	870513	0	0	4	
7401-5A420109-001-S1	840411	BOEING COMPANY, MICHITA	4	870520	0	0	4	
7471-6A420027-001	840430	HUGHES AIRCRAFT COMPANY	4	870817	4149914	0	4	
7471-7A420025-001	870414	HUGHES AIRCRAFT, IUCSON	4	870928	275801	0	4	
9988-0A420084-001	860523	BOEING COMPANY, MICHITA	4	870928	35834	0	4	

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
 (REPORT CONTROL SYMBOL DD-R10(SA)1580)

CLOSED - ALL OTHER

FOR PERIOD ENDING 870930
 DDH COMPONENT AERO SYS DIV

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR NAME	TYPE OF AUDIT	DATE OF DISPOSITION	COST QUESTIONED OR COST AVOIDANCE	COST SUSTAINED	PREVIOUS LITIGATION
9800-949-04-156	860926	GENERAL MOTORS CORP	4	870630	336398781	357829	4

Appendix C: Defective Pricing Cases Analyzed

DEFECTIVE PRICING CASES AT AERONAUTICAL SYSTEMS DIVISION
 CASES CLOSED DURING FY 1987 (1 OCTOBER 1986 - 30 SEPTEMBER 1987)
 (USING INITIAL AUDIT DATE AND COST QUESTIONED)

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR	DATE OF DISPOSITION	COST QUESTIONED	COST SUSTAINED
1. 1161-5I420097	850521	AMERICAN AIRLINES	870708	58430	58430
2. 1361-3A420106	851115	GENERAL DYNAMICS	870930	31745	31745
3. 1361-5D420213	860306	GENERAL DYNAMICS	870930	2352507	2094575
4. 1361-5D420214-S1	860729	GENERAL DYNAMICS	870930	615334	319904
5. 1361-5D420217-S1	850625	GENERAL DYNAMICS	870930	1892173	196019
6. 1361-6D420101-S1	860326	GENERAL DYNAMICS	870930	246089	110005
7. 1361-6D420102-S1	860303	GENERAL DYNAMICS	870930	3460975	1697722
8. 1361-6D420109	860310	GENERAL DYNAMICS	870930	23411	23441
9. 1361-7D420116	870109	GENERAL DYNAMICS	870930	818750	818368
10. 1441-2A420001	850227	LOCKHEED	861024	46152	7436
11. 1441-2A420002	850227	LOCKHEED	861024	61632	9893
12. 1441-3L420004	850628	LOCKHEED	861024	265049	20115
13. 1441-3L420005	850509	LOCKHEED	861024	62552	54067
14. 1441-5G420006	851113	LOCKHEED	870720	603561	546732
15. 1441-6G420004	860619	LOCKHEED	870807	53404	51268
16. 2143-4C420001-72	840312	FAIRCHILD	860930	148781	148781
17. 3361-5-420004	851213	GENERAL ELECTRIC	870210	186774	171768
18. 3421-1A420008-001-S3	810729	MCDONNELL DOUGLAS	870831	3340898	1269941
19. 3421-1A420030-001-S3	820521	MCDONNELL DOUGLAS	870831	14414655	6413189
20. 3421-2A420001-S1	850627	MCDONNELL DOUGLAS	870831	6809720	2006520
21. 3421-2A420002-S2	830630	MCDONNELL DOUGLAS	870831	31367399	2568042
22. 3421-2A420018-S1	840720	MCDONNELL DOUGLAS	870831	1699249	496751
23. 3421-3A420002-S1	831215	MCDONNELL DOUGLAS	870831	1785745	1133000
24. 3421-3A420012	830731	MCDONNELL DOUGLAS	870831	1565895	1518918

AUDIT REPORT NUMBER	REPORT DATE	CONTRACTOR	DATE OF DISPOSITION	COST QUESTIONED	COST SUSTAINED
25. 3421-3A420013-S1	831214	MCDONNELL DOUGLAS	870831	2326253	2664972
26. 3421-3A420014-S1	830630	MCDONNELL DOUGLAS	870831	2636076	950000
27. 3421-3A420016-S1	830630	MCDONNELL DOUGLAS	870831	572689	63381
28. 3421-5A420003-S1	850719	MCDONNELL DOUGLAS	870831	333560	140518
29. 3421-5A420004-S1	850719	MCDONNELL DOUGLAS	870831	16627175	4134132
30. 3421-5A420010	850326	MCDONNELL DOUGLAS	870831	201309	76958
31. 3421-6A420031	860228	MCDONNELL DOUGLAS	870831	842203	602876
32. 3421-6A420034	860609	MCDONNELL DOUGLAS	870831	242737	157097
33. 3421-6A420112	860520	MCDONNELL DOUGLAS	870831	361481	171503
34. 3421-6A420113	860523	MCDONNELL DOUGLAS	870831	223301	174019
35. 3421-6A420116	860523	MCDONNELL DOUGLAS	870831	18499	11099
36. 6141-4J420002-440	850630	AAI	870527	309235	80357
37. 6241-5A420002-072	860225	ITT	870929	225919	212625
38. 6241-6A420006-073	860225	ITT	870929	75815	68460
39. 6521-4A420403-S-0252	850524	WESTINGHOUSE	870528	333762	154020
40. 7381-6J420014-001	851114	BOEING	870112	148444	148444
41. 7401-4B420127-001	850529	BOEING	870814	784220	0
42. 7471-6A420027-001	860630	HUGHES AIRCRAFT	870817	4169916	0
43. 7471-7A420025-001	870616	HUGHES AIRCRAFT	870928	275801	0
44. 9988-9A9-86-096	860523	BOEING	870928	35836	0
45. 9988-9A9-86-132	860829	NORTHROP	861031	134233	134233
46. 9988-9A9-86-156	860826	GENERAL MOTORS	870630	357879	357878

Appendix D: Wage Rates for Civilian Employees

SHIFT DIFFERENTIAL	
Second — 7½ WG 10% GS	
Third — 10% WG 10% GS	

REGULAR SCHEDULE RATES Dayton, Ohio Wage Area Effective Dates: Wage — 14 June 1987 GS — 11 January 1987

BATTING LEADERS (1987)			
Step	WG - WL	WG - WS	GS
1	26 w/o	1, 2, 3	32 w/o
2	78 w/o	4, 5, 6	114 w/o
3, 4	104 w/o	7, 8, 9	156 w/o
5	—	10	—

C N	W L	W S	Step 1		Step 2		Step 3		Step 4		Step 5		Step 6		Step 7		Step 8		Step 9		Step 10	
			Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.	Year	Mo.
1			3619	4 01	3809	4 70	3999	4 31	4189	5 07	4379	5 22	4569	5 21	4759	5 21	4949	5 05	5139	5 01	5329	5 70
2			3816	5 10	3973	5 21	4130	5 29	4287	5 42	4444	5 49	4601	5 49	4758	5 41	4915	5 25	5072	5 19	5229	5 52
3			4013	5 05	4150	5 04	4287	5 03	4424	5 22	4561	5 41	4698	5 40	4835	5 70	4972	5 07	5109	5 16	5246	5 31
4			4210	5 26	4329	5 26	4448	5 27	4567	5 27	4686	5 28	4805	5 29	4924	5 29	5043	5 29	5162	5 29	5281	5 29
5			4407	5 20	4506	5 20	4605	5 20	4704	5 20	4803	5 20	4902	5 20	5001	5 20	5100	5 20	5199	5 20	5298	5 20
6			4604	5 14	4683	5 14	4762	5 14	4841	5 14	4920	5 14	5000	5 14	5079	5 14	5158	5 14	5237	5 14	5316	5 14
7			4801	5 08	4860	5 08	4919	5 08	4978	5 08	5037	5 08	5096	5 08	5155	5 08	5214	5 08	5273	5 08	5332	5 08
8			5000	5 02	5039	5 02	5078	5 02	5117	5 02	5156	5 02	5195	5 02	5234	5 02	5273	5 02	5312	5 02	5351	5 02
9			5197	5 01	5226	5 01	5255	5 01	5284	5 01	5313	5 01	5342	5 01	5371	5 01	5400	5 01	5429	5 01	5458	5 01
10			5394	5 01	5413	5 01	5432	5 01	5451	5 01	5470	5 01	5489	5 01	5508	5 01	5527	5 01	5546	5 01	5565	5 01
11			5591	5 01	5610	5 01	5629	5 01	5648	5 01	5667	5 01	5686	5 01	5705	5 01	5724	5 01	5743	5 01	5762	5 01
12			5788	5 01	5807	5 01	5826	5 01	5845	5 01	5864	5 01	5883	5 01	5902	5 01	5921	5 01	5940	5 01	5959	5 01
13			5986	5 01	6005	5 01	6024	5 01	6043	5 01	6062	5 01	6081	5 01	6100	5 01	6119	5 01	6138	5 01	6157	5 01
14			6175	5 01	6194	5 01	6213	5 01	6232	5 01	6251	5 01	6270	5 01	6289	5 01	6308	5 01	6327	5 01	6346	5 01
15			6383	5 01	6402	5 01	6421	5 01	6440	5 01	6459	5 01	6478	5 01	6497	5 01	6516	5 01	6535	5 01	6554	5 01
16			6591	5 01	6610	5 01	6629	5 01	6648	5 01	6667	5 01	6686	5 01	6705	5 01	6724	5 01	6743	5 01	6762	5 01
17			6800	5 01	6819	5 01	6838	5 01	6857	5 01	6876	5 01	6895	5 01	6914	5 01	6933	5 01	6952	5 01	6971	5 01
18			6990	5 01	7009	5 01	7028	5 01	7047	5 01	7066	5 01	7085	5 01	7104	5 01	7123	5 01	7142	5 01	7161	5 01
19			7180	5 01	7200	5 01	7219	5 01	7238	5 01	7257	5 01	7276	5 01	7295	5 01	7314	5 01	7333	5 01	7352	5 01
20			7370	5 01	7390	5 01	7409	5 01	7428	5 01	7447	5 01	7466	5 01	7485	5 01	7504	5 01	7523	5 01	7542	5 01

*Actual Rates Listed by Law in 2025-2026 Annual Salary Schedule
NOTE: (a) GS Rates Converted from Annual Salary to Hourly (Annual Salary ÷ 2087) Rounded to Nearest Cent
(b) Wage Rates Converted from Hourly Rates to Annual (Hourly Rate × 2087)

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The Truth in Negotiations Act of 1962 was created to assure that the government obtains a fair and reasonable price for the goods and services it purchases by requiring contractors, in certain circumstances, to provide current, accurate, and complete cost or pricing data with which the government can establish a negotiation position. Failure to comply with the law normally constitutes defective pricing which entitles the government to a dollar for dollar reduction in the contract price based on the defective amount. One of the stipulations of the law is that the amount determined to be defective must have caused a significant increase in the contract price although the term "significant" has yet to be clearly defined. The issue of significance in defective pricing audits is the subject of this research. The objective was to demonstrate that significance should be viewed in terms of the value of the contract action being audited and that allegations of a small dollar value should not be issued because they detract from the overall effectiveness of the defective pricing program.

To substantiate that, manpower costs were developed using manhour estimates for the activities involved in the process: audit, analysis and negotiation, and legal review. The results of the study showed that the contract value of the action being audited impacted the amount of time it took to settle a case and that the value of the allegation itself had little to do with the processing time.

In an environment of limited manpower resources, it is important to make effective use of those resources by maximizing the potential return on the time and effort expended. The information contained in this study will enable a contracting officer to make a more informed decision about whether a particular defective pricing audit should be pursued.

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