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# Inspector General

United States  
Department of Defense



Followup Review

August 31, 2009

Defense Contract Audit Agency  
Audit Work Deficiencies and Abusive  
Work Environment Identified by the  
Government Accountability Office

Report No. D-2009-6-009

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### **Acronyms**

CAS	Cost Accounting Standards
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
EELV	Evolved Expendable Launch Vehicle
FAO	Field Audit Office
GAGAS	Generally Accepted Government Auditing Standards
GAO	Government Accountability Office
PM&HS	Program Management and Hardware Support
RAM	Regional Audit Manager
SMC	Air Force Space and Missile Systems Center

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MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY  
DIRECTOR, DEFENSE CONTRACT MANAGEMENT  
AGENCY  
COMMANDER, AIR FORCE SPACE AND MISSILES  
SYSTEMS CENTER

SUBJECT: Followup Review on Defense Contract Audit Agency Audit Work  
Deficiencies and Abusive Work Environment Identified by the Government  
Accountability Office (Report No. D-2009-6-009)

We are providing this report for your review and comment. We received requests for this review from the Chairman and Ranking Member of the Senate Committee on Armed Services and the Under Secretary of Defense (Comptroller)/Chief Financial Officer. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Air Force Space and Missile Systems Center and the Defense Contract Management Agency comments were responsive. The Defense Contract Audit Agency comments were partially responsive. As a result of management comments, we added Recommendation D.4 to the Director, Defense Contract Audit Agency. We request additional comments on Recommendations B.1.a, D.1, D.2, D.3 and D.4 by September 30, 2009.

Please provide comments that conform to the requirements of DoD Directive 7650.3. If possible, send management comments in electronic format (Adobe Acrobat file only). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature.

We appreciate the courtesies extended to the staff. Questions should be directed to

[REDACTED]

b(6)

Charles W. Beardall  
Deputy Inspector General  
for Policy and Oversight

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# Followup Review on Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office Report

## Results In Brief

### What We Did

We reviewed Defense Contract Audit Agency (DCAA) audit documentation and interviewed auditors for the 13 cases at the 3 DCAA Western Region Field Audit Offices identified in the Government Accountability Office (GAO) report “DCAA AUDITS: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated.” We also reviewed current audits replacing deficient audits identified by GAO. We visited 2 DCAA Western Region field audit offices and interviewed 68 audit employees, including supervisors and managers, to assess whether an abusive work environment existed.

### What We Found

Employee concerns with (1) time pressures, (2) uncompensated overtime, (3) changes to audit results and opinions, and (4) unprofessional behavior created a work environment not conducive to performing quality audits. Additionally, we found a flawed audit may have allowed a contractor to recover \$271 million in unallowable costs (Case 2). DCAA provided ineffective audit advice and services to a contracting officer (Case 3). DCAA has insufficient evidence to support a contractor’s participation in the direct bill program (Case 4). Seventeen of 18 forward pricing audits did not comply with standards (Case 8). DCAA did not adequately qualify the audit results on a compensation system (Case 9). DCAA had

insufficient evidence to support a purchasing system audit opinion (Case 10). DCAA did not have sufficient basis for dropping four findings (Case 11). DCAA did not report a contractor’s uncompensated overtime practice and increased the risk of cost mischarging (Case 12).

### What We Recommend

We recommended that DCAA rescind five audit reports and notify contracting officials not to place reliance on the reports’ conclusions. We also recommended that DCAA address management actions and behaviors that have a negative impact on the work environment. Additionally, we recommended that DCAA create a mechanism for reporting external impairments to auditor independence in the DCAA Contract Audit Manual (Case 2). We recommended that the Commander, Air Force Space and Missiles Systems Center suspend future payments for certain unabsorbed costs on the affected contract and that the Executive Director, Contracts, Defense Contract Management Agency, reassess the identified advance agreements pending receipt of newly initiated DCAA audits (Case 2). We made additional recommendations to improve DCAA audits in relation to Cases 3, 4, 8, 9, 11, and 12.

### Management Comments

DCAA concurred with 22 of 24 recommendations, concurred in principle on 1 recommendation, and reserved comment on 1 recommendation. We request that the DCAA reconsider its position on the

recommendation (B.1.a) to rescind DCAA Audit Report No. 4461-2006A210000001, dated May 8, 2006, and comment on it in response to this final report. We also request that DCAA reconsider its responses to recommendations D.1, D.2, and D.3, which did not meet the intent of the recommendations, and comment on them in the final report. Additionally, the proposed revision to the DCAA policy on the direct bill program is not sufficient to ensure that only nonmajor contractors with approved billing systems participate in the direct bill program. Therefore we have added recommendation D.4 and DCAA should also comment on it. The Air Force Space and Missile Systems Center concurred with recommendations B.2.a and b. The Defense Contract Management Agency concurred with recommendations B.3.a and B.3.b.

United States Department of Defense  
Office of Inspector General  
Project No. D2008-DIP0AC-0259.000  
Report No. D-2009-6-009  
August 31, 2009

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# Introduction

## Objective

We conducted this review to followup on audit work deficiencies identified at three Defense Contract Audit Agency (DCAA) Western Region field audit offices (FAOs) and abusive work environment issues identified at two DCAA Western Region FAOs by the Government Accountability Office (GAO). We also followed up on our prior oversight work performed under Project No. D2006-DIP0AC-0229, “Review of Audit Assignments Related to Defense Hotline Complaint No. 98871 Concerning Audit Issues at the Defense Contract Audit Agency,” discussed in our memorandum dated January 24, 2007. We evaluated whether DCAA completed and planned actions fully address the GAO concerns and whether the actions are sufficient to correct the identified deficiencies. In the future, we will followup on DCAA corrective actions.

## Background

In November 2005, the DoD Hotline received a complaint alleging that 10 audits issued by a DCAA Western Region FAO did not comply with generally accepted government auditing standards (GAGAS). Because of the nature of the allegations, the complaint was referred to the DoD Inspector General, Defense Criminal Investigative Service for review. We assisted the Defense Criminal Investigative Service in reviewing the allegations involving the 10 audits and issued a memorandum dated January 24, 2007, to them on the results of the review.

On July 22, 2008, the GAO issued report GAO-08-0857 entitled, “Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated.”<sup>1</sup> GAO reported on 13 cases involving 76<sup>2</sup> audits that did not comply with GAGAS. Further, GAO reported that an abusive work environment existed at two FAOs. The 13 GAO cases included the 10 audits that we previously reviewed.

In July 2008, the Senate Committee on Armed Services and the Under Secretary of Defense (Comptroller)/Chief Financial Officer requested that we review the GAO identified work deficiencies and the DCAA completed and planned actions taken in response to the GAO report. Appendix F provides specific responses to the Senate Committee’s questions.

## Defense Contract Audit Agency

DoD Directive 5105.36, “Defense Contract Audit Agency,” established DCAA as a separate organization under the direction, authority, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. The primary mission of DCAA is to perform contract audits for DoD. DCAA also provides accounting and financial advisory services regarding

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<sup>1</sup> Of the 13 cases, Location 3 had 1 case, Location 1 had 2 cases, and Location 2 had 10 cases. In FYs 2004-2006, Location 2 performed 1,256 audit assignments, for an average of 418 assignments per year.

<sup>2</sup> Case 3 involved 3 defective pricing audits (Finding C); Case 8 involved 62 forward pricing audits (Finding E); and the other 11 cases covered 1 audit each.

contracts and subcontracts to DoD Components that perform procurement and contract administration duties. In addition, DCAA performs contract audit services for non-DoD Federal organizations on a reimbursable basis.

**DCAA Organization and Functions.** In FY 2008, DCAA performed 30,352 audits involving examination of approximately \$458 billion. At present, DCAA consists of approximately 4,000 people located in approximately 95 FAOs throughout the United States, Europe, the Pacific, and Southwest Asia. The agency consists of a Headquarters, five regions, and the Field Detachment (for classified audits). Regional directors are responsible for planning, managing, and accomplishing the agency mission in assigned geographical areas to include managing personnel and resources in their individual regional offices and various FAOs within their regions. The Field Detachment director has the same responsibility for worldwide DCAA contract audits of compartmented programs and the personnel and resources assigned to the Field Detachment.

DCAA audits help determine adequacy of contractors’ estimating, budgeting, billing, and accounting systems; compliance with the cost accounting standards (CAS) and disclosed accounting practices; and allowability of incurred costs charged to the Government in accordance with the Federal Acquisition Regulations and the Defense Federal Acquisition Regulation Supplement. DCAA also audits forward pricing proposals<sup>3</sup>, estimates of cost and profit supporting price proposals submitted by contractors in connection with award, and administration, modification, or repricing of Government contracts.

Consistent with the GAO report, we use, throughout this report, the case<sup>4</sup> numbers, and contractor<sup>5</sup> and location identifiers as indicated in the table below.

<b>Table 1. Contractors and DCAA FAOs by Case Number</b>		
<b>Case 1</b>	<b>Contractor A*</b>	<b>Location 1</b>
<b>Case 2</b>	<b>Contractor A*</b>	<b>Location 1</b>
<b>Case 3</b>	<b>Contractor B</b>	<b>Location 2</b>
<b>Case 4</b>	<b>Contractor C</b>	<b>Location 2</b>
<b>Case 5</b>	<b>Contractor C</b>	<b>Location 2</b>
<b>Case 6</b>	<b>Contractor D</b>	<b>Location 2</b>
<b>Case 7</b>	<b>Contractor D</b>	<b>Location 2</b>
<b>Case 8</b>	<b>Contractor E*</b>	<b>Location 3</b>
<b>Case 9</b>	<b>Contractor D</b>	<b>Location 2</b>
<b>Case 10</b>	<b>Contractor F</b>	<b>Location 2</b>
<b>Case 11</b>	<b>Contractor F</b>	<b>Location 2</b>
<b>Case 12</b>	<b>Contractor C</b>	<b>Location 2</b>
<b>Case 13</b>	<b>Contractor G</b>	<b>Location 2</b>

\*Top Ten DoD Contractors (FY 2008, USA spending.gov)

<sup>3</sup> Forward pricing proposals are audits of estimated future costs of proposed contractor pricing, proposed contract change orders, costs for redeterminable fixed-price contracts, and costs incurred but not yet covered by definitized contracts.

<sup>4</sup> GAO used “case” to identify the allegations addressed in their report. A case may include 1 or more audits.

<sup>5</sup> In this report we used the same method of identifying contractors as GAO did, by using letters (e.g. “a,” “b,”). Table 1 above identifies the contractors associated with each case.

## Generally Accepted Government Auditing Standards

DoD Instruction 7600.2 dated April 27, 2007, “Audit Policies,” requires that all independent audit and attestation engagements of DoD organizations, programs, activities, and functions be conducted in accordance with the GAGAS as issued by the Comptroller General of the United States. GAGAS provides the framework for auditors to perform high-quality audit work with competence, integrity, objectivity, and independence. Under GAGAS, auditors must prepare audit documentation in sufficient detail to provide a clear understanding of the work performed, including the nature, timing, extent, and results of audit procedures performed; the evidence obtained and its source; and the conclusions reached. The audit documentation should contain support for the report’s findings, conclusions, and recommendations.

## Report Organization

For 8 of the 13 cases and the DCAA work environment at 2 audit offices identified by GAO in its July 2008 report, we identified issues with the appropriateness of actions taken and/or the quality of audit work and addressed these issues in Findings A through I. For the remaining 5 cases, we determined that DCAA had taken corrective actions that we considered sufficient to address deficiencies identified by GAO or corrective actions were still ongoing or planned so we were unable to perform an analysis at the time of this review. We addressed those 5 cases in Appendix D. The table below provides information on where the various cases are discussed within this report.

<b>Table 2. Report Organization by Case Number</b>			
	<b>Work Environment</b>	<b>Finding A</b>	<b>Page 4</b>
<b>Case 1</b>	<b>Follow-on Survey of Contractor A’s Estimating System</b>	<b>Appendix D</b>	<b>Page 61</b>
<b>Case 2</b>	<b>Continuing Audit Issues on Evolved Expandable Launch Vehicle</b>	<b>Finding B</b>	<b>Page 13</b>
<b>Case 3</b>	<b>Audits of Defective Pricing on Freight-out Charges</b>	<b>Finding C</b>	<b>Page 29</b>
<b>Case 4</b>	<b>Audit of Billing System</b>	<b>Finding D</b>	<b>Page 35</b>
<b>Case 5</b>	<b>Estimating System Audit of Contractor C</b>	<b>Appendix D</b>	<b>Page 62</b>
<b>Case 6</b>	<b>Accounting System Audit of Contractor D</b>	<b>Appendix D</b>	<b>Page 62</b>
<b>Case 7</b>	<b>Cost Accounting Standard 403 Compliance Audit of Contractor D</b>	<b>Appendix D</b>	<b>Page 62</b>
<b>Case 8</b>	<b>Forward Pricing Audits</b>	<b>Finding E</b>	<b>Page 40</b>
<b>Case 9</b>	<b>Audit of Compensation System</b>	<b>Finding F</b>	<b>Page 44</b>
<b>Case 10</b>	<b>Audit of Purchasing System</b>	<b>Finding G</b>	<b>Page 46</b>
<b>Case 11</b>	<b>DCAA Audit of Billing System</b>	<b>Finding H</b>	<b>Page 48</b>
<b>Case 12</b>	<b>Labor Floor Check</b>	<b>Finding I</b>	<b>Page 52</b>
<b>Case 13</b>	<b>Cost Accounting Standard 418 Compliance Audit of Contractor G</b>	<b>Appendix D</b>	<b>Page 63</b>

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# Findings

## A. Work Environment

Work environment conditions existed at DCAA Locations 1 and 2 that may have contributed to the lack of compliance with GAGAS for the audits reviewed at Locations 1 and 2. Audit employees expressed concerns with time pressures related to performance measures and described incidences of unprofessional behavior. These conditions may have contributed to deficient audit work. Although we attempted to determine if these conditions constituted an abusive work environment, we could not find consistent criterion or definitions for what conditions reflect a “generally abusive” work environment. Nonetheless, some employees may have considered the work environment conditions to be abusive. The instances of work environment issues identified support the need for DCAA to continue to assess the environment and take additional corrective actions.

**Background.** In the July 2008, GAO report on DCAA audits and compliance with GAGAS, GAO reported that DCAA managers took improper disciplinary actions against staff at two locations, attempted to intimidate auditors to prevent auditors from speaking with investigators, and created a generally abusive work environment. GAO cited incidences of verbal admonishments, reassignments, and threats of disciplinary actions against auditors who raised questions about management guidance to omit audit findings or change audit opinions.

**Results of DoD Office of Inspector General Review.** We interviewed all available audit personnel, 97 percent of the currently assigned personnel, at Locations 1 and 2. At Location 1, we interviewed a total of 31 individuals, 29 audit personnel currently assigned to the office and 2 individuals that previously worked at the office. At Location 2, we interviewed 100 percent of the 36 audit personnel currently assigned to the office and 1 individual that had recently moved to another office, for a total of 37 interviews. The audit personnel interviewed included FAO managers, supervisors, and auditors. We did not evaluate performance improvement plans, performance evaluations, and similar personnel actions; nor did we address matters submitted to the Office of Special Counsel. See Table 3 for the results of our interviews of 68 audit personnel at DCAA Locations 1 and 2.

<b>Interview Topics</b>	<b>Number of individuals who answered YES</b>	<b>Number of individuals who answered NO</b>
Received instruction from management to withhold information from investigative agencies	1 (1%)	67 (99%)
Experienced pressure because of unreasonable performance measures	32 (47%)	36 (53%)
Worked uncompensated overtime <sup>6</sup>	26 (38%)	42 (62%)
Had a supervisor change or direct a change to audit results and opinions	12 (18%)	56 (82%)
Witnessed unprofessional behavior in the office	22 (32%)	46 (68%)

These instances could have negatively impacted the work environment enough to affect the quality of some audits. Recent DCAA corrective actions taken in response to the GAO report may help to prevent future occurrences.

**Withholding Information.** One of 68 employees interviewed responded “yes” when asked whether management had ever instructed them to withhold information from investigative agencies. The employee had received a memorandum from DCAA dated August 31, 2007, that instructed the employee not to provide documentation to anyone outside the agency, including Government investigators, under threat of disciplinary action. This matter related to allegations the employee had submitted to the Office of Special Counsel. Conversely, the other 67 employees interviewed all said that management had never directed them to withhold information. When asked whether they had been or knew anyone who had been threatened with disciplinary action, 1 of the 67 employees did remark that they knew about the August 31, 2007, DCAA memorandum the other employee had received.

**Pressures Related to Performance Measures.** Twenty of 31 employees at Location 1 and 12 of 37 employees at Location 2 or 47 percent of all employees interviewed said that DCAA performance measures created undue pressure to complete audits in unreasonable timeframes. The most frequently cited performance measures were the 30-day due dates for forward-pricing audits, the September 30 year-end deadline for programmed audits, and budgets for performing audits that are based on overall averages rather than individual audit situations. Ten of the audits reviewed and determined as not complaint with GAGAS were programmed audits and issued in the last half of September, implying that pressures to meet fiscal year-end performance measures may have contributed to the deficient audit work.<sup>7</sup>

<sup>6</sup> Uncompensated overtime represents time worked and not charged on the employee’s time log and, therefore, unpaid or uncompensated time worked.

<sup>7</sup> September 30 is the end of the Government fiscal year.

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When questioned whether they were ever asked to perform an audit in an unreasonable time, one employee stated, “Yes, we rush assignments out to meet internal due dates.” Another employee said, “Yes, I was asked to complete a proposal audit in 21 hours.” The employee said that completing the audit in a short time frame would compensate for other audits that took longer and improve the overall average. In addition, at Location 1, some employees commented that the pressure to meet various performance measures also led to a high turnover of auditor trainees in that office.

Thirty-six of the 68 employees (53 percent) did not think management had ever asked them to perform an audit in an unreasonable amount of time. Several employees said that when they needed more time to complete an audit than originally budgeted, they would discuss the work and additional time needed with their supervisor. One employee stated, “I have always been given budget [number of hours allotted to perform the audit] increases as long as I’ve been able to support why it’s needed.” The same employee stated that due dates could also be extended when justified.

**Uncompensated Overtime.** Thirty-eight percent or 26<sup>8</sup> of 68 employees interviewed stated that they worked uncompensated overtime. Sixty-five percent or 20 of 31 audit employees interviewed at Location 1 stated that they worked uncompensated overtime to complete audits within budgeted hours and to meet other DCAA performance measures. On average, these employees estimated they worked roughly seven uncompensated overtime hours per week.

Six of the 37 employees (16 percent) at Location 2 stated that they worked uncompensated overtime for reasons other than meeting performance measures. The reasons these employees cited included doing research, catching up on a few things, and making up for time spent at the office socializing with co-workers. The remaining 31 employees said they did not work uncompensated overtime.

Of the total 68 employees interviewed, 42 employees (62 percent) said they do not work uncompensated overtime. When asked, they responded that they charged all the hours they work. A least two employees said they used to work on their own time, but not any more. They said they worked uncompensated overtime when they were new to DCAA and still learning.

During a prior review of Location 2, we found that the audit staff was working a significant amount of uncompensated overtime. On October 5, 2006, we issued a memorandum informing the Director, DCAA, of the condition. DCAA management communicated to the audit staff at Location 2 that management did not expect the staff to work uncompensated overtime and encouraged the staff to discuss audit budgets with their supervisors.

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<sup>8</sup> Of the 26 employees who stated that they worked uncompensated overtime, 20 were at location 1 and 6 were at location 2.

**Changing Audit Results and Opinions.** Twelve of 68 employees described having their audit results or findings changed by management. One employee said the supervisor changed the opinion to make it a stronger result. Another employee explained that a prior FAO manager changed the opinion because DCAA policy at that time required the auditor to demonstrate the significance of the condition's impact or report the condition as a suggestion for improvement. Therefore, because the auditor could not monetize or quantify the condition, the FAO manager would not issue a negative opinion report.

Many of the supervisors and auditors commented that the primary reasons for changing opinions and findings included management determining there was insufficient support for the findings, and disagreeing on materiality or the significance of the issues. Changing the opinions and findings based on these reasons may be the appropriate action for the supervisor to take; however, the supervisor is also responsible to ensure that any changes are adequately supported and properly documented in the audit documentation.

██████████ responsible for 9 of the 13 cases identified as not complying with GAGAS (Cases 3 through 7, 9, and 11 through 13). ██████████

██████████ The DCAA policy is that the supervisory auditor is responsible to ensure that each audit is conducted in accordance with GAGAS. Six of the nine cases ██████████ were responsible for that did not comply with GAGAS were also identified as being in the group of eight that had the audit opinions or findings changed without sufficient documented support. Therefore, in relation to the six cases with unsupported opinions or findings, ██████████ did not properly perform their duties. In addition, the supervisors issued the audit reports associated with five of the six cases in the last half of September, which suggests that pressures to meet the September 30 performance measure negatively affected the quality of these audit reports. See Table 4 for a list of the cases associated with these audits.

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<b>Table 4. Cases Identified Where Management Changed the Audit Opinion or Findings</b>		
<b>Location in Report</b>	<b>Case Number</b>	<b>Title</b>
Appendix D	1	Follow-on Survey of Contractor A's Estimating System
Finding B	2	Continuing Audit Issues with Contractor A Related to a 2006 DCAA Proposal Audit (Evolved Expendable Launch Vehicle)
Finding C	3*	Audit of Defective Pricing on Freight-out Charges
Finding D	4*	Audit of Billing System
Appendix D	5*	Estimating System Audit of Contractor C
Appendix D	6*	Accounting System Audit of Contractor D
Appendix D	7	Cost Accounting Standard 403 Compliance Audit of Contractor D
Finding I	12*	Labor Floor Check

\* Reports issued in last two weeks of the fiscal year.

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The other 56 employees answered that management had not changed their audit results or opinions. Some employees stated that when the supervisor thought a change was necessary, the supervisor would discuss it with them and they would reach an agreement. One employee said that the supervisor discussed the findings during the audit so there were no changes at the end.

**Unprofessional Behavior.** Employees should have a work environment free from intimidation caused by “yelling” and other forms of unprofessional behavior. When asked whether they had witnessed any unprofessional behavior, of the 68 employees interviewed, 22 employees responded “yes” and 46 employees answered “no.” Approximately 43 percent or 16 of the 37 employees we interviewed (management and audit staff) at Location 2 cited repeated incidences of unprofessional behavior. The employees said they often overheard raised voices, including yelling between supervisors and auditors, and between administrative personnel and auditors. One supervisor admitted that they had “raised their voice in the heat of the moment.” Another supervisor said that an auditor yelled at the supervisor during a meeting. The same supervisor also recounted that the supervisor elevated the problem of an administrative employee’s repeated yelling and swearing to the FAO manager. The swearing stopped, but the yelling continued.

Six of 31 employees interviewed at Location 1 described incidences of unprofessional behavior. Three of the six employees reported a supervisor behaving unprofessionally. The employees described the supervisor as being “rude and unprofessional” and “very blunt and intimidating.” The other three employees reported that a senior official behaved unprofessionally by yelling and intimidating employees. Two employees at Location 2 also said that the same senior official acted unprofessionally when they worked at Location 1. [REDACTED]

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**DCAA Corrective Actions.** During our review, DCAA initiated several corrective actions in response to the GAO report.

- On July 31, 2008, DCAA issued a memorandum instructing that differences of opinion on audit issues be elevated to the Deputy Regional Director when an auditor is unable to reach a resolution through the supervisor, FAO manager, and regional audit manager (RAM). [REDACTED]

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- On September 12, 2008, DCAA management rescinded the August 31, 2007, memorandum restricting an employee from directly providing documents to investigative agencies and encouraged full cooperation with any investigations

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conducted by representatives of Government investigative authorities.

- On September 30, 2008, DCAA notified all employees that it had eliminated 18 prior productivity measures, developed 8 new performance measures, and re-emphasized its policy on zero-based budgeting.<sup>9</sup>
- DCAA began a DCAA-wide organizational assessment survey addressing work environment issues on October 6, 2008. DCAA also established a website for providing feedback on the inappropriate use of performance measures.
- On December 3, 2008, the Location 1 FAO manager notified all Location 1 employees that DCAA did not require anyone to work uncompensated overtime. The FAO manager instructed employees to notify management when they needed to work overtime because budgeted funds were available to meet workload peaks.
- On December 4, 2008, DCAA revised its guidance to remove any language that suggested consideration of program hours or productivity measures as a basis for determining the audit budget hours.
- DCAA is also performing an anonymous DCAA-wide organization assessment to address improvements in the Strategic Plan, staffing allocations, ethics, and leadership to be completed in 2009.

We will review the appropriateness, effectiveness, and implementation of the DCAA corrective actions during future oversight reviews.

## Management Comments and DoD IG Response to Finding

**DCAA Comments on the Finding.** DCAA emphasized that they take the results of our conclusions on the DCAA work environment seriously. DCAA went on to state that the DoD IG found no additional cases of DCAA inappropriately changing audit findings and the DoD IG “reported that, based on many of the auditor interviews, the audit opinions and findings were changed primarily because of insufficient support for the findings and disagreements on the significance of issues.” DCAA reiterated the various actions it has taken, including renewed emphasis on audit quality and engaging the Naval Post Graduate School to assess its culture and assist in completing its “cultural transformation.” The DCAA response pointed out that in addition to rescinding the letter that was the source of the instruction to withhold the information, [REDACTED]

b(6)

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<sup>9</sup> Zero-based budgeting is the process during which the supervisor and the auditor discuss and agree on the budgeted hours required to perform an audit based on the risk assessment, audit scope, and audit program.

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**DoD IG Response.** The additional actions taken by the Director, DCAA, are noteworthy. However, the DCAA response mischaracterized the DoD IG report conclusion on management inappropriately changing audit opinions and findings. The report conclusions on management making inappropriate changes to audit reports and the changes being made primarily due to insufficient support for the findings and disagreements on the significance of the issues should be put into the context of the review scope. We did not identify any additional audits where DCAA management inappropriately changed the report because we limited our review to the audits discussed in the GAO investigative report. The GAO review only involved the review of 13 cases, 10 of which were performed at Location 2. In FYs 2004-2006, Location 2 performed 1,256 audit assignments, for an average of 418 assignments per year. Given the large number of audit assignments during this timeframe and the limited scope of our review to 10 assignments, an expansion of the scope of our review may have resulted in our finding additional examples of management changes to reports for inappropriate reasons that were not well supported or documented.

## Recommendation, Management Comments and DoD IG Response

### Recommendation A. We recommend that the Director, Defense Contract Audit Agency:

1. Consider appropriate corrective action regarding the performance of the [REDACTED] [REDACTED] associated with the majority of the noncompliant audits reviewed.

b(6)

**DCAA Comments.** DCAA agreed with the recommendation. [REDACTED] mentioned in the recommendation are to re-take the supervisory courses at the Defense Contract Audit Institute. The Regional Director, Western Region, is to also examine external courses that may be of assistance in further developing their management skills. [REDACTED]

b(6)

**DoD IG Response.** DCAA comments were responsive.

2. Provide training and direction to all employees, regardless of position, on:
  - a. what is appropriate professional behavior;
  - b. how to handle situations involving unprofessional behavior; and
  - c. how to report unprofessional behavior.

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**DCAA Comments.** DCAA agreed with the recommendation. DCAA plans to finish researching outside organizations to provide the training by August 2009 and complete DCAA-wide training by the end of FY 2010.

**DoD IG Response.** DCAA comments were responsive.

- 3. Analyze the results of recent work environment assessments and surveys or other appropriate independent reviews of Defense Contract Audit Agency field audit offices' work environment.**

**DCAA Comments.** DCAA agreed with the recommendation. DCAA will continue to analyze the results of work environment surveys and assessments and take proactive action to address issues that surface. For example, DCAA is completing its assessment of the Office of Personnel Management survey results on the organizational environment; developing an implementation plan; and expecting to share the DCAA Headquarters assessment and an improvement action plan with the workforce by July 31, 2009.

**DoD IG Response.** DCAA comments were responsive.

- 4. Based on the analysis from Recommendation A.3, determine additional corrective actions required to address the pressures to work uncompensated overtime.**

**DCAA Comments.** DCAA agreed with the recommendation. However, DCAA stated that the survey results did not indicate that the pressure to work uncompensated overtime was a DCAA-wide issue. The Director will request the Regional Directors to reinforce to the DCAA workforce during their regular ongoing management and staff briefings that DCAA does not expect employees to work uncompensated overtime.

**DoD IG Response.** DCAA comments were responsive.

- 5. Provide a copy of the analysis and planned corrective actions from Recommendations A.3. and A.4. to the DoD Inspector General, Assistant Inspector General for Audit Policy and Oversight.**

**DCAA Comments.** DCAA agreed with the recommendation. DCAA will keep the DoD IG apprised of their corrective actions and provide the related supporting data. DCAA will provide to the DoD IG a copy of the results of the survey assessment provided to the workforce by August 31, 2009.

**DoD IG Response.** DCAA comments were responsive.

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- 6. Perform an employee survey or assignment review to determine whether Western Region has satisfactorily implemented the policy on differences of audit opinions.**

**DCAA Comments.** DCAA agreed with the recommendation. By December 2009, the DCAA Policy and Plans Directorate will perform a review (to include assignment reviews and surveys) to assess compliance with the DCAA policy on handling disagreements of audit opinions in the Western Region.

**DoD IG Response.** DCAA comments were responsive.

## B. Continuing Audit Issues with Contractor A Related to a 2006 DCAA Proposal Audit (Evolved Expendable Launch Vehicle) (GAO Case 2)

We confirmed the findings reported by GAO (Case 2) that (i) the audit engagement was impaired due to a lack of auditor independence, (ii) the DCAA working papers did not support the reported opinions included in DCAA Audit Report No. 4461-2006A21000001, dated May 8, 2006, and (iii) the draft audit opinion was changed without sufficient documentation.

**Background.** The following table depicts the evolution of unabsorbed Program Management and Hardware Support (PM&HS) cost at Contractor A and deferred production costs at the subsequent Joint Venture on the Evolved Expendable Launch Vehicle (EELV) Delta IV Buy III program. The numbers in Table 5 are not meant to be taken as a whole but are presented solely for clarification of the evolution of costs.

<b>Amount</b>	<b>Date</b>	<b>Description</b>
\$835 million	07/15/2003	Contractor's recognized / publicly reported losses on Delta IV Program (2003).
\$333.3 million	07/29/2005	Proposed and questioned unabsorbed PM&HS, in <b>first</b> Delta IV EELV Buy III proposal and <b>first</b> audit report.
\$634.5 million	12/13/2005	Contractor's losses on 14 awarded / launched missions.
\$133.3 million	01/23/2006	Proposed unabsorbed PM&HS, <b>second</b> Delta IV EELV Buy III proposal.
\$64.7 million	05/08/2006	DCAA questioned unabsorbed PM&HS cost, <b>second</b> audit report.
\$271.2 million	11/08/2006	Total unabsorbed PM&HS to be paid to the contractor over 8 years (\$271.2 million / 8 = \$33.9 million).
\$33.9 million	11/08/2006	Unabsorbed PM&HS annual payment to the contractor.
\$268 million	03/25/2008	Stipulated deferred production ceiling amount for the Joint Venture.
\$10.4 million	04/15/2008	Deferred Production recovered by the Joint Venture on two ordered missions (National Aeronautics and Space Administration).
\$114 million	04/21/2008	Proposed deferred production cost by the Joint Venture.

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On January 29, 2005, DCAA issued Audit Report No. 4461-2005A21000005 on the contractor's Delta IV EELV Buy III Launch Capability contract proposal. DCAA reported that the contractor-proposed \$333.3 million in unabsorbed PM&HS costs had been incurred in prior accounting periods and represented a potential noncompliance with CAS 406,<sup>10</sup> "Cost Accounting Period." DCAA also reported that the contractor had made no adjustment to recognize and eliminate losses on the Delta IV program. DCAA reported that the contractor's proposal was not an acceptable basis for the negotiation of a fair and reasonable price.

The contractor had reported in a July 2003 press release that it would take a \$1.1 billion loss against earnings, of which \$835 million were attributable to losses on its Delta IV Program.

After receipt of the first DCAA Audit Report No. 4461-2005A21000005, Air Force Space and Missiles Systems Center (SMC) attempted to negotiate the Buy III Launch Capability contract, but, among other issues, the contractor would not agree to the Air Force's position that the proposed unabsorbed PM&HS cost was potentially noncompliant with CAS 406 or represented losses incurred on other contracts, as reported by DCAA. As an alternative, SMC considered requesting a CAS waiver,<sup>11</sup> to include a waiver of CAS 406. However, before going forward with the CAS waiver proposal, SMC held a meeting of senior level officials from the Defense Contract Management Agency (DCMA), DCAA, and the contractor in an attempt to identify issues preventing SMC from negotiating a contract.

On January 23, 2006, SMC requested DCAA perform an audit of the contractor's upcoming revised Delta IV EELV Buy III Launch Capability proposal, which was projected to include \$133.3 million in contractor proposed unabsorbed PM&HS costs. The amount of unabsorbed PM&HS differed from the \$333.3 million included in the initial contractor proposal due to several factors, including a reduced period of performance (2 years versus 3 years).

On May 8, 2006, DCAA issued Audit Report No. 4461-2006A21000001. DCAA no longer reported that the contractor-proposed \$133.3 million in unabsorbed PM&HS costs represented a potential noncompliance with CAS 406. DCAA provided in a Scope of Audit Qualification that it could not quantify costs associated with the contractor's

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<sup>10</sup> CAS 406, "Cost Accounting Period," provides criteria for the selection of the time periods to be used as cost accounting periods for contract cost estimating, accumulating, and reporting. It requires a contractor use its fiscal year as its cost accounting period. A fiscal year is defined as the accounting period for which annual financial statements are regularly prepared, generally a period of 12 months, 52 weeks, or 53 weeks. CAS is a set of principles that establish practices to be applied and specify criteria to be employed in estimating, accumulating and reporting costs for Government contracts. Deviating from those criteria constitute a violation of Public Laws 91-379 and 100-679.

<sup>11</sup> The CAS Waiver, Federal Acquisition Regulation Part 9901.307, allows the CAS Board to exempt classes of contractors from CAS requirements and established procedures. The official records of the Board shall be documented with supporting justification for class category exemptions and individual waivers.

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reported loss on its Delta IV program, that some of the proposed unabsorbed PM&HS costs may not be allocable to the new contract, and that it was a procurement decision on whether to pay these costs.

DCAA stated that its audit of the proposed unabsorbed PM&HS cost pool was primarily focused on determining whether the proposed costs were appropriately identified as EELV Launch Capability effort. The second DCAA Audit Report No. 4461-2006A21000001 did not question any part of the proposed \$133.3 million as potentially noncompliant with CAS 406 or unallowable in accordance with Federal Acquisition Regulation 31.205-23, "Losses on Other Contracts."<sup>12</sup> However, the audit report questioned \$64.7 million of proposed \$133.3 million of unabsorbed PM&HS costs, based upon what the audit staff called lack of auditable support or because the costs were considered to be non-Launch Capability costs.

On April 21, 2008, SMC requested DCAA review a \$114 million proposal for deferred production costs submitted by the follow-on contractor to the Delta IV program, a joint venture that includes the original contractor. The proposed deferred production costs are from the same Delta IV Program described above and were estimated, in part, using the same lot cost accounting technique.

**DoD Office of the Inspector General Action to Withhold Payments.** The Deputy Inspector General for Policy and Oversight issued a Memorandum for Commander, SMC, and Director, DCMA, on October 20, 2008, recommending that:

- SMC take immediate action to withhold further payments to the Delta IV EELV Buy III contractor for unabsorbed PM&HS costs (the Air Force contractual arrangement provides for up to \$271 million in payments to the contractor, of which \$101 million has already been paid);
- SMC cease negotiations with the Delta IV Launch Services contractor on a \$114 million proposal for unabsorbed costs; and
- DCMA reassess the propriety of existing advance agreements involving the EELV program.

We based these recommendations on our preliminary findings that the DCAA audit was flawed. The DCAA audit failed to demonstrate that the contractor's proposal for recovery of the unabsorbed PM&HS costs excluded: (a) costs incurred in prior accounting periods and (b) losses incurred on other contracts.

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<sup>12</sup> Federal Acquisition Regulation 31.205-23, "Losses on Other Contracts," provides "An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts) is unallowable."

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The Commander, SMC, advised us by memorandum dated November 7, 2008, that SMC had taken action to suspend further payments and would not conduct further negotiations for unabsorbed costs until the matter was resolved. SMC also advised the contractor to fully cooperate with the pending DCAA audit.

The Executive Director, Contracts, DCMA, advised us by memorandum dated November 18, 2008, that DCMA concurred with our recommendation to reassess the Advance Agreements and that DCMA was awaiting a pending DCAA audit with respect to Federal Acquisition Regulation and CAS noncompliances associated with the Advance Agreements.

The two agreements at issue are (i) Advance Agreement on EELV Program Delta IV Lot Accounting, signed on November 13, 2006, and (ii) the Advance Agreement on EELV Program Delta IV Program Management and Hardware Support, signed on November 8, 2006. The first agreement provides that the DCMA Divisional Administrative Contracting Officer has found the contractor's Lot Accounting a compliant practice under the CAS. The second agreement provides that \$271,152,672 in unabsorbed PM&HS costs that were incurred prior to June 1, 2006, but were neither allocable to nor payable under prior contracts, may be reimbursed by the Air Force on future contracts as a fixed-price line item.

**Flawed DCAA Audit.** The DCAA RAM with responsibility for the audit of the contractor's updated Delta IV EELV Launch Capability proposal was not free from external impairments to independence as required by GAGAS and DCAA audit policy. See the section below on "Actions Demonstrating Impairment of Independence." Because of the actions of the DCAA RAM, the DCAA audit:

- failed to demonstrate that the contractor's proposed \$133.3 million in unabsorbed PM&HS costs complied with the Federal Acquisition Regulation, and
- allowed SMC and DCMA acquisition officials to negotiate a contract and applicable advance agreements free of a violation of CAS 406 and Federal Acquisition Regulation 31.205-23, "Losses on Other Contracts."

**Auditor Independence.** The General Standard on Independence included by the Comptroller General of the United States in the GAGAS provides, "In all matters relating to the audit work, the audit organization and the individual auditor must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments to independence." The Standard states specifically, "Auditors should avoid situations that could lead objective third parties with knowledge of the relevant information to conclude that the auditors are not able to maintain independence and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work." The Standard identifies three general classes of impairments to independence: personal, external, and organizational. Regarding external impairments, the Standard provides, "External

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impairments to independence occur when auditors are deterred from acting objectively and exercising professional skepticism by pressures, actual or perceived, from management and employees of the audited entity or oversight organizations.”

DCAA has incorporated the General Standard on Independence in its Contract Audit Manual. The Contract Audit Manual provides that (i) as a DCAA employee, the primary responsibility is to protect the interest of the Government and (ii) the auditor’s effectiveness depends on the ability to develop and evaluate facts and arrive at sound conclusions objectively (based on unbiased judgments) and independently (not subject to influence or control by others).

The Contract Audit Manual states:

In the DCAA environment, some of the external factors that can restrict the audit or infringe on the auditor’s ability to form independent and objective opinions and conclusions include: procurement or contracting officers’ interference in the scope and character of the audit that could modify audit results; denial of access to sources of information, such as books, records, and supporting documents or officials and employees of the contractor under audit; [and] actions by contractors significantly influencing the auditor’s judgment regarding the content of the audit report....

**Actions Demonstrating Impairment of Independence.** The DCAA RAM did not remain free in fact and in appearance from external impairments to independence and, therefore, failed the contract auditor’s primary responsibility to protect the interests of the Government. The following actions by the DCAA RAM during the DCAA audit of the contractor’s revised Delta IV EELV Launch Capability proposal demonstrate impairment to independence.

- The DCAA RAM attended a meeting of top leadership officials from SMC, DCMA, and the contractor at SMC on December 13, 2005. According to the former Executive Director, SMC, the meeting was held to identify ‘roadblocks’ that were preventing SMC from negotiating the Delta IV Launch Capability contract (Contract No. FA8816-06-C-0001). We found that:
  - Until this meeting, the DCAA RAM had supported the audit position reported in DCAA Audit Report No. 4461-2005A21000005, dated July 29, 2005, that the contractor’s proposed unabsorbed PM&HS costs were potentially noncompliant with CAS 406 and represented losses on other contracts.
  - At this meeting, the contractor provided SMC a schedule depicting a contractor loss position of \$634.5 million on its 14 awarded Delta IV EELV missions. SMC officials asserted to us that DCAA representatives received the schedule. However, the DCAA supervisor and lead auditor

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that performed the audit of the contractor's proposal advised us they had not been provided with, or made aware of, this schedule and the identified losses.

- SMC did not document the purpose and results of the meeting, including attendees, issues discussed, actions taken, and issues resolved.
- The DCAA RAM did not document in the audit file the results of the meeting, including the attendees, issues discussed, actions taken, and issues resolved.
- The DCMA Divisional Administrative Contracting Officer, in a written record of this meeting, states that the primary goal was to support SMC's 'top priority' of getting an unqualified DCAA followup audit report. This record also provides that DCAA would review events leading up to a previously issued potential CAS 406 noncompliance; DCAA would perform a walk-through of the contractor's accounting procedure; and a decision to reinstate a proposal by SMC to request a CAS waiver would be based on the DCAA opinion/recommendation to withdraw CAS 406.
- After this meeting, the DCAA RAM failed to exercise objective and impartial judgment on significant issues associated with conducting the audit and reporting on the work. At the January 19, 2006, walk-through, a contractor representative that had attended the same December 13, 2005, meeting at SMC advised DCAA that it would not have access to contractor financial records sufficient to evaluate the losses. We found the following.
  - The DCAA RAM did not act objectively and exercise impartiality when she unilaterally determined after attending the contractor's January 19, 2006, walk-through of its lot accounting practice that the contractor was in compliance with CAS 406. The DCAA auditor under the direction of the RAM that attended the same walk-through advised us that the contractor's walk-through did not address CAS compliance and, in fact, never mentioned CAS 406. Our review of the contractor's walk-through briefing slides found that none of the briefing slides addressed CAS compliance, including CAS 406.
  - Subsequent to the January 19, 2006, walk-through, the DCAA RAM inappropriately required the auditor to change the audit results. According to the supervisor, lead auditor, and FAO manager, the DCAA RAM directed the auditor to omit CAS 406 compliance testing and discussion of CAS compliance from the audit of the contractor's forthcoming update to its proposed unabsorbed PM&HS costs. We found no audit testing for CAS 406 compliance in the audit working paper files established by

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DCAA to document their audit of the updated contractor proposal for \$133.3 million in unabsorbed PM&HS costs.

- The RAM failed to demonstrate auditor independence and take action to pursue the denial of access to contractor records as provided by DCAA policy, and, according to the DCAA auditor at the meeting, agreed with the contractor's position on the denial. By not pursuing audit access to the contractor's accounting records, the DCAA RAM thwarted DCAA's ability to obtain sufficient evidence to demonstrate that the contractor had excluded from its unabsorbed PM&HS cost pool any part of the \$835 million in publicly reported losses the contractor had recorded on its Delta IV program.
- The DCAA RAM reported to her supervisor, the Regional Director for DCAA Western, on February 9, 2006, that CAS 406 was no longer an issue. However, she failed to report that this determination was not supported by the results of audit procedures and that her field audit staff disagreed.
- The DCAA RAM did not act objectively when overturning the audit judgment of the supervisor that the contractor's proposed \$133.3 million unabsorbed PM&HS costs were unallowable costs in accordance with Federal Acquisition Regulation 31.205-23, "Losses on Other Contracts," and that the contractor's use of a 15-year lot was an estimating system deficiency. Prior to the collapse of the commercial launch market, the contractor used a 2-year lot.
- The DCAA RAM directed the issuance of an audit report, DCAA Audit Report No. 4461-2006A21000001, dated May 8, 2006, that is not based on sound conclusions objectively arrived at through the development and evaluation of facts. By these actions the DCAA RAM was able to provide SMC with a DCAA audit report free of CAS noncompliances from which SMC could negotiate contractor unabsorbed costs on the Delta IV EELV Launch Capability contract.

Based upon our review of the totality of events surrounding the audit and acquisition, we have concluded that during the DCAA audit of the contractor's updated Delta IV EELV Launch Capability proposal the DCAA RAM did not satisfy the General Standard of Independence issued by the Comptroller General of the United States. The DCAA RAM did not protect the interests of the Government as required by DCAA policy. We have also concluded that DCAA Audit Report No. 4461-2006A21000001, dated May 8, 2006, cannot be relied upon by acquisition officials as a basis to negotiate fair and reasonable contract prices.

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**Impact on Delta IV EELV Contract Acquisitions.** DCAA Audit Report No. 4461-2006A21000001, dated May 8, 2006, impacted EELV acquisition decisions as follows.

**Delta IV Launch Capability.** SMC relied on DCAA Audit Report No. 4461-2006A21000001 as the basis to negotiate a pool of unabsorbed PM&HS costs, called Deferred Support Costs, totaling \$271,152,672. This amount is to be billed on a fixed-price basis in eight yearly installments of \$33,894,084 each. Contract No. FA8816-06-C-0001, the Delta IV EELV Launch Capability contract, was signed on November 16, 2006, and included fixed-price line items for \$67,788,168 of unabsorbed PM&HS for 2 years. SMC exercised a contract option to extend the Launch Capability contract for 2 more years in 2007, including 2 years of unabsorbed PM&HS at \$33,894,084 per year.

Contract Clause, SMC-H019 Advance Agreements to Contract No. FA8816-06-C-0001 provides that advance agreements have been executed and control the specified cost charging areas for this and any successor contract. The clause provides that each Advance Agreement is an integral part of this contract and was a substantial factor in determining contract value. The clause ends by stating that the Lot Accounting Advance Agreement will also be incorporated into the EELV Launch Services Contract, if awarded.

**Advance Agreements.** DCMA relied on DCAA Audit Report No. 4461-2006A21000001 to enter into (i) an Advance Agreement on EELV Program Delta IV Program Management and Hardware Support, signed by the Divisional Administrative Contracting Officer on November 8, 2006, and (ii) an Advance Agreement on EELV Program Delta IV Lot Accounting signed by the Divisional Administrative Contracting Officer on November 13, 2006.

- The Advance Agreement on EELV Program Delta IV Program Management and Hardware Support provides, in part, that \$271,152,672 represents costs for program management and hardware support under the Delta IV program that were incurred and placed in an inventory account prior to June 1, 2006, but were neither allocable to nor payable under obligations or contracts entered into or performed prior to that date. It states that the Air Force has discussed the potential to compensate the contractor for such unreimbursed expenses on a separate line item on future contracts, and has agreed on a method by which the contractor may be paid a 1/8 share of such \$271,152,672 amount as a fixed-price contract line item in each year of future contracts, if awarded.
- The Advance Agreement on EELV Program Delta IV Lot Accounting provides, in part, that it is agreed that the undersigned Divisional Administrative Contracting Officer has found Lot Accounting a compliant practice under CAS. It also provides that this determination is not intended to and does not prevent the revocation, withdrawal, or other reconsideration of this determination if

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subsequent facts indicate that some aspect of this disclosed practice is noncompliant with CAS or Federal Acquisition Regulation.

**Delta IV Launch Services.** SMC has continued its reliance on DCAA Audit Report No. 4461-2006A21000001, dated May 8, 2006, and the DCMA Advance Agreement on EELV Program Delta IV Lot Accounting, signed by the Divisional Administrative Contracting Officer on November 13, 2006, to pursue getting another element of unabsorbed costs, deferred production costs, on contract. The costs resulted from the original contractor's venture into the commercial launch market and were incurred under the same circumstances as the unabsorbed PM&HS costs discussed above. However, the contractor is now a joint venture comprised of the original contractor and the second EELV contractor that provides the Atlas V launch vehicle. To date, SMC has:

- entered into an Advance Agreement dated March 25, 2008, with the Joint Venture for deferred production costs,
- circulated a draft contract clause (SMC-H0XX) that would recognize a liability not-to-exceed \$268,000,000 for the recovery of deferred production costs, and
- requested DCAA perform a contract audit of the Joint Venture's proposal for \$114 million in deferred production costs for compliance with Federal Acquisition Regulation and CAS. The DCAA audit is ongoing.

For the record, the Joint Venture had disclosed to SMC upon submittal of its \$114 million proposal that it had already recovered \$10.4 million in deferred production costs on two ordered missions from the National Aeronautics and Space Administration Geostationary Operational Environmental Satellites O and P.

**Joint Venture Assessment of Lot Accounting.** We note that the Vice President and Controller of the Joint Venture advised SMC by letter dated February 14, 2008, that the Joint Venture's review of the relevant accounting and auditing standards issued by the accounting profession had resulted in the Joint Venture concluding that generally accepted accounting standards did not allow the Joint Venture to continue the practice of lot accounting. The Joint Venture official indicated that lot accounting is not CAS compliant.

**DCAA Corrective Actions.** DCAA has initiated several contract audits that, if performed in accordance with GAGAS and DCAA policy, will remedy the deficiencies that occurred during the audit of the contractor's Delta IV EELV Launch Capability proposals. These include audits of contractor compliance with the following CAS:

- CAS 405, "Accounting for Unallowable Costs,"
- CAS 406, "Cost Accounting Period," and
- CAS 418, "Allocation of Direct and Indirect Costs."

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DCAA has also established contract audits to examine contractor compliance with Federal Acquisition Regulation Part 31, including Federal Acquisition Regulation 31.205-23, “Losses on Other Contracts,” and Federal Acquisition Regulation 31.109, “Advance Agreements.” We will review the sufficiency of the work performed by DCAA at a future date.

**Senior Official Investigations.** [REDACTED]

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**Criminal Investigations.** The Defense Criminal Investigative Service, DoD IG, continues to investigate the actions taken by acquisition officials relating to the Delta IV EELV contracts.

## Management Comments and DoD IG Response to Finding

**DCAA Comments.** The Director, Defense Contract Audit Agency, concurred with 4 of the 5 recommendations associated with GAO Case #2. The Director, DCAA, did not concur with the recommendation to immediately rescind DCAA Audit Report No. 4461-2006A210000001, dated May 8, 2006.

**Defense Contract Management Agency Comments.** The Executive Director of Contracts for DCMA concurred with the two recommendations to DCMA associated with GAO Case #2.

**Air Force Space & Missile Systems Center Comments.** The Air Force Space and Missile Systems Center concurred with the two recommendations to SMC; however, they further commented that the SMC Procuring Contracting Officer relied on the DCAA audits, the contractor’s certified cost and pricing data, as well as the advance agreements entered into by DCMA and the contractor. SMC drew the following three conclusions in relation to deferred costs. At the time of award, the Air Force, DCAA, and DCMA determined the Delta Expandable Launch Capability contract was consistent with all Federal laws, regulations and policies, and did not include any reimbursement for past losses. Deferred support costs [PM&HS costs] were recognized in an Advance Agreement executed by DCMA and the contractor prior to contract award. Deferred support costs are isolated as a stand-alone contract line item. If, as a result of subsequent DCAA reviews, a finding is made that the deferred support costs are unallowable, the Air Force is postured to take action to make an appropriate contract adjustment.

The SMC comments further stated that Table 4 of the DoD OIG draft report, “Proposed Costs and Payments – EELV,” appears to imply that the Delta IV deferred program management and hardware support costs, and deferred production costs, represent recoupment of contractor losses. The SMC comments also indicated that four SMC

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representatives present at an interview meeting with DoD OIG auditors do not recall one member using the terminology “roadblocks” in describing the purpose of the December 13, 2005, meeting, as the DoD OIG report states. Additionally, SMC maintains that contrary to the DoD OIG draft report that the contractor did not use a 15-year lot, and that the contractor always maintained that the lot was defined as 42 Common Booster Cores regardless of time and number of missions.

**DoD IG Response.** Though Air Force Space & Missile Systems Center concurred with the two recommendations made to SMC, we provide the following clarifications in relation to their comments to our findings on Case # 2. Two rows in “Table 4. Proposed Costs and Payments – EELV” identify contractor loss information. The first row identifies the \$835 million loss reported by the contractor on its Delta IV Program via a press release dated July 15, 2003. The third row identifies \$634.5 million in contractor losses included in a schedule the contractor provided to SMC at a December 13, 2005, meeting. Each item is provided to inform the reader of the report that losses on the contractor’s Delta IV Program existed prior to the execution of Air Force Contract No. FA8816-06-C-0001. As reported, the DCAA audit of the contractor’s proposal for recovery of unabsorbed program management and hardware support costs did not include audit procedures to demonstrate that the contractor had excluded these disclosed losses from its cost proposal. During DoD OIG site visits, SMC contracting officials advised us that they had not determined that the contractor had excluded the prior losses from its proposed PM&HS costs, but had instead relied upon the DCAA audit to determine compliance with the Federal Acquisition Regulations.

The notes taken by the DoD OIG auditors during a fact-finding discussion with SMC representatives held on September 30, 2008, indicate that one representative described his involvement in EELV Launch Capability contract negotiations “as a means to clear roadblocks and get things moving.” The representative provided the comment when discussing the efforts undertaken by SMC to (i) obtain a CAS waiver for the new contract, (ii) find a way forward regarding any previous DCAA reported potential CAS 406 noncompliance reported by DCAA in Audit Report No. 4461-2005A21000005, and (iii) persuade DCAA to recognize an alternative way forward that avoided DCAA reporting any CAS noncompliances in its subsequent report on the contractor’s revised Expandable Launch Capability proposal.

We agree with the statement provided by SMC that the contractor defined the lot as 42 Common Booster Cores. However, we note that at the time of the contractor's revised Delta IV EELV ELC proposal to the Government, DCAA was able to demonstrate using contractor provided cost and pricing data that, for its revised proposal, the time period for the lot was 15 years. DCAA arrived at this conclusion based on contractor provided records that demonstrated the proposed lot costs included (i) costs accumulated in the lot from 1997 through 2005, and (ii) an estimate for the costs to complete the lot through the last scheduled launch, which, according to contractor records, was scheduled to occur in November 2011.

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# Recommendation, Management Comments and DoD IG Response

## Recommendation B. 1. We recommend the Director, Defense Contract Audit Agency:

- a. **Immediately rescind Defense Contract Audit Agency Audit Report No. 4461-2006A21000001, dated May 8, 2006.**

**DCAA Comments.** DCAA reserved comments on Recommendation B.1.a. because it believes that the recommendation cannot be adequately evaluated until additional information is obtained. Further, the Director, DCAA, stated that DCAA would reserve comment on the issue because the DoD OIG did not obtain input or comments from the RAM involved in the case; that DCAA was informed by the DoD OIG that the RAM's comments were not obtained due to a separate on-going investigation of the same individual by the DoD OIG.

**DoD IG Response.** DCAA should rescind Audit Report No. 4461-2006A21000001, dated May 8, 2006. The Director, DCAA, did not provide any data or information for the DoD OIG to evaluate and assess regarding the findings in this case. The DoD OIG decision to not obtain the DCAA regional audit manager's comments as a part of this administrative investigation was made in consideration of the separate on-going investigation [REDACTED]

[REDACTED] The DCAA Director's response did not dispute the DoD OIG conclusion that the DCAA audit was flawed and did not demonstrate that the contractor's proposal for recovery of unabsorbed program management and hardware support costs excluded: (a) contractor costs incurred in prior accounting periods and (b) contractor losses incurred on other contracts. To protect the interests of the DoD and the Government, it is vital that DCAA Audit Report No. 4461-2006A21000001 be rescinded immediately.

b(6)

Leaving the report unrescinded may result in payment of up to \$170 million in additional questionable unallowable costs using the report as a basis (so far only \$101 million has been paid). Also, it is important that we not leave the report unrescinded given its potential for use as a basis for negotiating additional contract actions for deferred costs of \$268 million onto the Evolved Expendable Launch Services contract using the DCAA report. The separate on-going investigation of the former RAM by the DoD OIG should not preclude DCAA from taking the recommended action. Any action in relation to the former RAM can be delayed until completion of the separate investigation.

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Regarding the assertion that DCAA is reserving comment, the DoD OIG notes that DCAA officials have previously commented on this same issue. On July 3, 2008, the Assistant Director, Policy and Plans, DCAA, provided a letter to the GAO in response to corrective action briefings that the GAO had provided DCAA regarding the GAO Investigation of Hotline Allegations Regarding Certain Defense Contract Audit Agency Audits (Code 195132). Enclosed with the DCAA letter was a response from the DCAA Western Region, the region with management cognizance for the audit in question. In the Western Region response, signed by the same RAM but in her current capacity as the Deputy Regional Director, DCAA asserted that:

- They did not agree with GAO that pressures from the contractor and buying command affected the audit opinion, or that there were any independence issues.
- They believed the audit was performed in accordance with generally accepted government auditing standards issued by the Comptroller General of United States and that the audit opinion was supported by sufficient audit evidence.
- They were not aware of any factual data that supports the GAO assertion that this assignment lacked auditor independence.
- They stated that the CAS 406 noncompliance was resolved when DCAA gained a more thorough understanding of lot costing in January 2006.

We note that on June 23, 2009, the Assistant Director, Policy and Plans, DCAA, in an internal audit guidance memorandum concluded that the contractors' lot cost accounting practices used to estimate, accumulate and report unabsorbed costs on the CAS-covered Delta IV EELV contracts are not in compliance with CAS 406. The Assistant Director concluded that each of the following Advance Agreements should be rescinded:

- Delta IV Program Management and Hardware Support, dated November 8, 2006,
- EELV Program Delta IV Lot Accounting, dated November 13, 2006, and
- Deferred production costs Advance Agreement, dated March 25, 2008.

It is clear that the actions taken by the regional audit manager during the DCAA audit of the contractor's Delta IV EELV Launch Capability cost proposal resulted in a flawed audit report. However, DCAA continues to resist rescinding DCAA Audit Report No. 4461-2006A21000001, dated May 8, 2006. DCAA should immediately rescind this report to protect DoD interests. Therefore, we request that DCAA reconsider its position on this recommendation and comment on it in response to this final report.

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- b. Include the \$10.4 million of deferred production costs recovered by the Joint Venture contractor on Delta IV Launch Services contracts from the Government on two ordered missions (Geostationary Operational Environmental Satellites O and P) in the Defense Contract Audit Agency corrective action plan.**

**DCAA Comments.** DCAA agreed with the recommendation. DCAA is currently reviewing the facts associated with the \$10.4 million of deferred production costs associated with ordered missions Geostationary Operational Environmental Satellites (GOES) O and P. Preliminarily, we have determined that the GOES O and P missions were contracted for via a National Aeronautics and Space Administration firm-fixed price contract. DCAA will review the proposal for this contract and assess if it includes deferred production costs. If DCAA finds the proposal does include deferred production costs, DCAA will work with the contracting officer and pursue recovery of those costs. DCAA expects to complete its review by September 2009.

**DoD IG Response.** DCAA comments were responsive.

- c. Create a mechanism for reporting external impairments in the Quality Control System described in Chapter 2 of the Defense Contract Audit Agency Contract Audit Manual, where auditors can report suspected external impairments to auditor independence by co-workers, supervisors, or managers to the Defense Contract Audit Agency General Counsel.**
- 1) Document the reporting mechanism for external impairment, including policies and procedures, management controls, documentation requirements, etc, in the Defense Contract Audit Agency Quality Control System.**
  - 2) Provide procedures to include the reporting mechanism for external impairment in the Administration of the Defense Contract Audit Agency Quality Control System, also described in Chapter 2 of the Defense Contract Audit Agency Contract Audit Manual.**

**DCAA Comments.** DCAA agreed with the recommendation. The DCAA's Quality Control System already covers the reporting of external impairments. Contract Audit Manual Section 2-S10 Supplement - Description of DCAA Quality Control System, requires the reporting of external impairments. Contract Audit Manual Section 2-S 103.1b.(3) states:

Occasionally, factors external to DCAA may restrict the audit or interfere with the auditor's ability to form independent and objective opinions and conclusions. When a limitation is identified, every effort should be made to remove the limitation or, failing that, report the limitation. DCAA expects

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each auditor to exercise prudent judgment in establishing audit scope, auditing procedures, and appropriate reporting of results.

Contract Audit Manual Section 2-S103.1b(4) also states:

Each auditor is responsible for notifying his or her supervisor of any actual or potential personal or external impairment in writing.

Therefore, if an auditor believes an external impairment exists, it should be reported to the supervisor. However, to address the IG's concerns, DCAA will expand this guidance to address reporting that relates to suspected external impairments to auditor independence by co-workers, supervisors, or managers and require this reporting to the DCAA General Counsel's office. DCAA will revise their guidance by August 30, 2009.

**DoD IG Response.** DCAA comments were responsive.

- d. Establish a policy or procedure on coordination of audit procedures and positions between Defense Contract Audit Agency cognizant offices on the Delta IV Evolved Expendable Launch Vehicle and the Evolved Expendable Launch Vehicle joint venture.**

**DCAA Comments.** DCAA agreed with the recommendation. According to DCAA, this coordination process has already been established. Effective May 2009, the Rocky Mountain Branch Office will lead a bi-weekly teleconference to discuss major issues relating to the Delta IV Evolved Expendable Launch Vehicle and the Evolved Expendable Launch Vehicle joint venture.

**DoD IG Response.** DCAA comments were responsive.

- e. Issue audit guidance requiring the issuance of a separate Cost Accounting Standard noncompliance report whenever the auditor discovers instances of Cost Accounting Standard noncompliance during the performance of any type of forward pricing audit activity, as currently required by the Defense Contract Audit Agency Contract Audit Manual, Section 8-302.7.c.**

**DCAA Comments.** DCAA agreed with the recommendation. On June 17, 2009, DCAA issued an audit alert emphasizing the guidance contained in Contract Audit Manual 8-302.7.c that a separate CAS noncompliance audit report should be issued when the noncompliance is found in any DCAA audit.

**DoD IG Response.** DCAA comments were responsive.

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**Recommendation B. 2.** We recommend the Commander, Air Force Space and Missiles Systems Center:

- a. Abide by the actions identified in his November 7, 2008, memorandum to DoD Inspector General, including the actions to (i) suspend further payments for unabsorbed program management and hardware support costs under Contract No. An F8816-06-C-0001 and (ii) not conduct further negotiation for unabsorbed costs until this matter is resolved.
- b. Track and document all future contracting officer actions taken as a result of any audit reports issued by Defense Contract Audit Agency to remedy the deficiencies that occurred during the audit of the contractor's Delta IV Evolved Expendable Launch Vehicle Launch Capability proposals.

**SMC Comments.** By memorandum dated 18 May 2009, the Vice Commander, Headquarters Space and Missile Systems Center, Los Angeles Air Force Base, CA, agreed with Recommendation B.2 and stated they have taken action to implement it immediately.

**DoD IG Response.** SMC comments were responsive.

**Recommendation B. 3.** We recommend the Executive Director, Contracts, Defense Contract Management Agency:

- a. Abide by the actions identified in his November 18, 2008, memorandum to DoD Inspector General, including the plan to reassess the identified advance agreements pending receipt of the newly initiated Defense Contract Audit Agency audits.
- b. Track and document all future contracting officer actions taken as a result of any audit reports issued by Defense Contract Audit Agency to remedy the deficiencies that occurred during the audit of the contractor's Delta IV Evolved Expendable Launch Vehicle V Launch Capability proposals, including the proposed advance agreements.

**DCMA Comments.** The Executive Director, Contracts, Defense Contract Management Agency, agreed with Recommendation B.3.

**DoD IG Response.** DCMA comments were responsive.

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## C. Audits of Defective Pricing on Freight-out Charges (GAO Case 3)

DCAA took inadequate corrective actions in response to the prior DoD IG and GAO (Case 3) findings on the issuance of three defective pricing audit reports. DCAA rescinded the reports based on the GAO conclusion that they were not in compliance with GAGAS. However, DCAA did not explain to the contracting officer why it rescinded the defective pricing reports. DCAA also issued an untimely and inaccurate audit lead<sup>13</sup> in response to the GAO report. Moreover, DCAA provided ineffective audit services and advice when it performed incurred cost verification audits and declined to advise the contracting officer on the contractor's proposed settlement. Ultimately, the contracting officer settled the transportation (freight-out) costs issue with Contractor B and recovered \$71,000. Since the contractor failed to submit a detailed cost impact proposal, data necessary to accurately determine the amount overcharged to the Government does not exist.

**Background.** In September 2004, DCAA Location 2 issued three flawed defective pricing audit reports stating that freight-out charges included in the contractor's forward pricing rate for material handling did not constitute defective pricing. In January 2007, we notified DCAA that the audit working papers did not contain sufficient evidence as GAGAS requires in support of the final audit report conclusion. In July 2008, GAO also reported that DCAA did not perform sufficient audit work in support of the final audit opinion. The DCMA contracting officer independently pursued the freight-out cost issue as a noncompliance with CAS 405, "Accounting for Unallowable Costs," because the contracting officer and the contractor had mutually agreed that freight-out costs would be unallowable. DCAA performed incurred cost verification audits (in addition to the three defective pricing audits) to assist the contracting officer with the CAS 405 noncompliance. The contracting officer eventually resolved the potential noncompliance by recovering \$71,000 from the contractor.

**DCAA Corrective Actions.** In response to the DoD Inspector General and GAO findings, DCAA:

- issued an audit lead in July 2008, to DCAA offices cognizant over various Contractor B divisions, stating in part,

Our audit work disclosed that outbound freight on origin shipments was incorrectly charged indirect to a material handling pool rather than direct to the contract. Based on the contractor's agreement with the Administrative Contracting Officer, the contractor agreed that all transportation charges would be paid by the contractor, not the Government. Federal Acquisition Regulation

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<sup>13</sup> An audit lead is an alert to DCAA offices to identify high risk areas where additional audit work is advisable.

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47.104-2<sup>14</sup> is the governing regulation on fixed-price contracts. Your office may want to consider looking at the accounting practices for FOB [free on board] freight<sup>15</sup> (Origin) at location(s) under your cognizance.

- rescinded the three defective pricing audit reports in September 2008 and determined that no further followup action was needed because the contracting officer had settled the issue for \$71,000.

**DoD IG Review of DCAA Corrective Actions.** We determined that the corrective actions are inadequate.

- **Inadequate Audit Lead.** We noted three significant problems with the audit lead.
  - 1) DCAA did not issue the audit lead in a timely manner. DCAA issued the audit lead in July 2008, one year after the contracting officer made his final determination on the freight-out costs. DCAA knew of the noncompliance as early as 2004 and had ample opportunity to issue the audit lead three years before the contracting officer's July 2007 settlement.
  - 2) DCAA failed to convey in the audit lead that the freight-out cost issue involved a CAS 405 noncompliance. The lead also failed to identify the applicable years of the CAS noncompliance. As a result, the cognizant auditors only evaluated the contractor's practice in 2008 and forward but did not evaluate the practice from 2003 to 2007.
  - 3) The audit lead is unclear with respect to the allowability of the freight-out costs. While the lead states that the contractor should pay for freight-out costs, it also indicates that the contractor should charge them direct to the contract. Since these costs are unallowable in accordance with CAS 405, during the period from 1998 through 2003, the lead should have clearly stated that freight-out costs must not be charged on Government contracts, either as a direct cost or an indirect cost. In fact, the audit lead should have indicated that from 2003 forward, the contractor agreed to use the Government Transportation System.
- **Rescission of Defective Pricing Audit Reports.** In its September 2008, memorandum, DCAA did not explain to the contracting officer why it rescinded the three defective pricing audit reports. Without this explanation, the memorandum gives the impression that defective pricing may still exist.

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<sup>14</sup> Federal Acquisition Regulation 47.104-2(b) states in part when "advantageous" to the Government; the contracting officer may require the contractor to prepay the freight charges.

<sup>15</sup> F.O.B. Origin means free of expense to the Government.

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The memorandum should have explained that DCAA rescinded the audit reports because the audit work did not comply with GAGAS and stated the reasons for no longer pursuing the defective pricing issue.

- **Ineffective Audit Services and Advice.** DCAA failed to provide effective audit services and advice to the contracting officer in his pursuit of the potential CAS 405 noncompliance. As requested by the contracting officer, DCAA performed three incurred cost verifications. However, the contracting officer could not use these verifications because the contractor had charged the Government for the negotiated freight-out costs, not the incurred freight-out costs. Therefore, DCAA should have recommended to the contracting officer that it perform an analysis of negotiated costs rather than incurred costs. As a result, DCAA wasted auditor and contracting officer resources in performing and analyzing the results of the incurred cost verifications. DCAA should rescind the incurred cost verification audit reports since they do not reflect the negotiated freight-out costs charged to the Government, and because the contracting officer could mistakenly use the reports for unintended purposes.

In addition, the DCAA supervisor did not provide effective advice when the contracting officer requested DCAA's assistance to evaluate the proposed settlement of freight-out cost. The DCAA supervisor declined to comment on the proposed settlement because it is "... really a negotiated amount not a calculated amount and not within DCAA's realm of cognizance because we can't comment on negotiable items." DCAA should have recommended that the contracting officer continue to pursue a detailed cost impact proposal from the contractor and point out his authority to withhold payments in accordance with Federal Acquisition Regulation 30.604(h)(4)(i)(2) if the contractor does not provide the proposal in a timely manner. Further, DCAA should have advised the contracting officer that the impact on the Government may be significantly higher than the proposed settlement. Absent a detailed cost impact, DCMA did not have the data necessary to determine the contractor's freight-out overcharge to the Government.

We noted that these actions may not have been approved by or coordinated with the FAO manager. The supervisor signed the incurred cost verification audit reports (as well as the defective pricing audit reports) on behalf of the FAO manager, and did not consult with the FAO manager prior to responding to the contracting officer's request for audit assistance. In August 2008, DCAA revised its procedures to require a FAO manager's signature on all DCAA audit reports.

As a result of DCAA's actions, the contracting officer did not receive the data necessary to make an informed decision on the CAS 405 noncompliance and negotiate a fair and reasonable settlement on behalf of the Government. Without a cost impact proposal the amount of Government loss cannot be determined. The Government cannot reopen the noncompliance because the contracting officer's \$71,000 settlement is final and irrevocable.

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## Management Comments and DOD IG Response to Finding

**DCAA Comments.** DCAA agreed to explain to the contracting officer why it rescinded the reports. However, DCAA disagreed that the rescission of the defective pricing audit reports gave the impression that defective pricing may exist. In support of issuing the incurred cost verification audits, DCAA stated, “It should be noted that DCAA provided the incurred cost verifications at the request of the contracting officer.” DCAA defended the supervisor’s decision not to comment on the proposed settlement by stating, “the DCAA supervisor did advise the contracting officer on the inadequacy of the contractor’s cost impact submission, but did not believe it was appropriate to comment on the *contracting officer’s negotiation position*, as that is beyond the role of the independent audit....An independence concern may exist if DCAA were to provide an opinion on a negotiation position.” (emphasis added)

**DoD IG Response.** DCAA comments were responsive. However, we disagree that issuing the incurred cost verifications was justified simply because the contracting officer asked for them. As the independent audit advisor to the contracting officer, DCAA had an obligation to recommend alternative audit procedures or approaches that would have better assisted the contracting officer in evaluating the noncompliance.

In responding to the contracting officer, DCAA did not advise the contracting officer on the inadequacy of the contractor’s cost impact submission. We also disagree with the DCAA position that advising the contracting officer on the contractor’s proposed settlement may have created an independence concern. The contracting officer asked DCAA to review the contractor’s proposed cost impact, not his negotiation position. Reviewing the contractor’s cost impact methodology would not have violated the independence standards established in GAGAS or the DCAA mission established in DoD Directive 5105.36. The supervisor’s refusal to assist the contracting officer was inconsistent with the DCAA Contract Audit Manual, Section 15-403.2, which states:

The auditor will act as the accounting advisor to the contracting officer in the negotiation process. In this capacity, provide the contracting officer financial information and audit counsel which will assist in the conclusion of a fair and reasonable price agreement with the contractor. Whether in actual attendance at the conference or through support from the audit office, the auditor.... (c) will evaluate any additional cost information the contractor may submit. (Emphasis added)

Therefore, DCAA should have reviewed the adequacy of the contractor’s cost impact calculation and advised the contracting officer accordingly. Not doing so resulted in DCAA’s failure to fulfill its duty as an effective audit advisor. Nevertheless, the DCAA concurrence with Recommendation C.1. below, involving branch manager approval of responses to contracting officer requests for audit assistance, will help to improve DCAA advice and services provided at DCAA Location 2.

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# Recommendation, Management Comments and DoD IG Response

## **Recommendation C.** We recommend that the Branch Manager, Defense Contract Audit Agency Location 2:

- 1. Require branch manager approval in responding to contracting officer requests for audit assistance.**

**DCAA Comments.** DCAA agreed with the recommendation. Due to conditions found at this FAO, DCAA will institute additional management controls for a one-year time period commencing July 1, 2009. The branch manager will approve all correspondence responding to contracting officer requests for audit assistance for this time period for other than forward pricing audits. DCAA believes limiting this process to other than forward pricing audits will meet the DoD IG's objectives based on the conditions found in this case and make it manageable for the FAO to implement. During this time, the branch manager will provide the necessary supervisory feedback to ensure supervisors are supportive to the contracting officers' requests while maintaining the necessary auditor independence required by the standards. After this time period, the branch manager will assess the need to further continue this process and provide her recommendation to the Regional Director for his decision.

**DoD IG Response.** DCAA comments were responsive. On July 31, 2009, DCAA location 2 issued a Standard Procedure supplement for delegation of signature authority for audit reports and other audit related office documents.

- 2. Issue a memorandum to the contracting officer to explain why the Defense Contract Audit Agency rescinded the three defective pricing audit reports.**

**DCAA Comments.** DCAA agreed with the recommendation. By May 31, 2009, DCAA will issue the memorandum to the contracting officer that the three reports were rescinded due to the audit work not complying with GAGAS. DCAA will also clarify to the contracting officer that this does not mean that defective pricing was found.

**DoD IG Response.** DCAA comments were responsive. On May 29, 2009, DCAA location 2 issued a memorandum to clarify to the contracting officer that resending the three defective pricing audit reports may have given the impression that defective pricing may exist, when in fact, DCAA audit did not disclose defective pricing.

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**3. Rescind the three incurred cost verification Audit Report Numbers 4181-2003I17900009, 4181-2003I17900010, and 4181-2003I17900011.**

**DCAA Comments.** DCAA agreed with the recommendation. Although DCAA believes it complied with the contracting officer's request to address the DoD IG's concerns, DCAA will rescind the subject reports by May 31, 2009. To address the DoD IG's concerns DCAA will state that these reports are being rescinded since the DoD IG concluded that these reports were not value added to the contracting officer in his pursuit of a final settlement.

**DoD IG Response.** DCAA comments were responsive. On June 3, 2009, DCAA location 2 issued a memorandum to the contracting officer rescinding the three incurred cost verification audit reports.

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## D. Audit of Billing System (GAO Case 4)

DCAA corrective actions are not sufficient to address all concerns identified in the GAO (Case 4) and DoD Inspector General reviews of Contractor C's<sup>16</sup> billing system audit. The FAO did not remove Contractor C from the direct bill program even though it did not have sufficient evidence to support Contractor C's participation. Direct bill authorization allows a contractor to submit vouchers directly to Government disbursing offices without DCAA review and provisional approval, thereby increasing the Government's risk of overpaying Contractor C. Existing DCAA guidance does not adequately address contractor participation in the direct bill program. Therefore, revisions to audit guidance are needed to help ensure that only contractors with acceptable billing system internal controls are allowed to direct bill.

**Background.** In a report dated September 16, 2005, DCAA issued an opinion that Contractor C's billing system and related internal controls were adequate. DCAA, acting as the representative of the contracting officer, is allowed to authorize contractors that maintain adequate billing systems and related internal controls to submit interim public vouchers directly to Government disbursing offices. The FAO approved Contractor C for direct billing based on this audit. Both the DoD Inspector General and GAO reviews of the billing system audit concluded that: the audit report opinion was not adequately supported by the working papers, the draft audit opinion was changed without sufficient documentation, and the auditor did not perform sufficient work to support conclusions.

**DCAA Corrective Actions.** DCAA is taking various corrective actions that, when completed, should resolve all concerns except for guidance on contractor participation in the direct bill program. The FAO notified the DCMA Administrative Contracting Officer on May 22, 2008, that the billing system audit report should no longer be relied on. The FAO also planned to complete an audit, Assignment No. 4181-2008K17740003, by January 23, 2009, that would determine the adequacy of the accounting system for segregation and billing of costs; specifically addressing concerns identified by the GAO and DoD Inspector General reviews such as the monitoring of indirect billing rates and billing in compliance with applicable regulations and contract provisions; and covering the annual testing of contractor eligibility for the direct bill program.<sup>17</sup> DCAA Headquarters has also taken multiple corrective actions related to working paper documentation, oversight of audits, and the overall work environment that they believe will improve all DCAA audits. See Appendix C for additional details. We will evaluate all corrective actions once completed to ensure DCAA has adequately addressed concerns related to Contractor C's billing system audit.

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<sup>16</sup> Contractor C produces and supports military display systems, global position systems, and satellite communications system. For calendar year 2004, Contractor C generated sales over \$99 million, including \$92 million from DoD contracts.

<sup>17</sup> DCAA previously referred to this as the annual testing of paid vouchers which includes a review of paid vouchers submitted directly to Government paying offices.

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**Contractor Eligibility to Direct Bill.** DCAA did not remove Contractor C from the direct bill program even though it did not have sufficient evidence to support Contractor C's original admittance nor its continued participation. As discussed above, the billing system audit did not contain sufficient evidence to support the audit opinion that Contractor C's billing system was adequate. The ongoing surveillance of the billing system that the FAO performed in the FY 2004 incurred cost audit<sup>18</sup> and the annual testing of contractor eligibility also did not sufficiently document the auditor's understanding and evaluation of the significant billing system internal controls as required by DCAA guidance. Finally, the FAO has not yet completed a review of billing system controls associated with a new accounting system that Contractor C implemented. Therefore, Contractor C's participation in the direct billing program is inappropriate at this time.

**Incurred Cost Audit.** In the FY 2004 incurred cost audit, the FAO did not identify or evaluate Contractor C's significant billing system internal controls on a completed "Survey of Contractor's Organization, Accounting System, and System of Internal Controls" questionnaire, as required, to support nonmajor<sup>19</sup> contractor's participation in the direct bill program. Instead, the FAO used a contractor-completed Internal Controls questionnaire which only marked "yes" for the question on the contractor's billing system policies and procedures.

**Annual Testing of Contractor Eligibility.** During the annual testing of contractor eligibility, performed under Audit Assignment No. 4181-2007A11050004, completed on August 7, 2007, the FAO did not include any information related to significant billing system internal controls. The FAO based its conclusion that no significant exceptions warranting further review of the billing system or removal of Contractor C from direct billing existed solely on a review of paid vouchers. A paid voucher review, even when no errors are identified, does not provide the evidence needed to document the significant internal controls or support a conclusion that they are operating effectively.

**Accounting System Audit.** In Assignment No. 4181-2008K17740003, the FAO identified that Contractor C implemented a new accounting system in May 2008. Because the FAO has not completed the review of the new system's billing controls, no evidence exists to support an opinion that adequate billing internal controls exist in the new system.

**DCAA Guidance on Direct Bill Program.** Current DCAA guidance is not sufficient to ensure that FAOs are adequately evaluating nonmajor contractors' significant billing system internal controls to support continued participation in the direct bill program. Adequate billing system internal controls are essential for contractors to participate in the

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<sup>18</sup> DCAA completed the audit in December 2007. This is the latest incurred cost audit that DCAA has completed on Contractor C.

<sup>19</sup> A nonmajor contractor is one with less than \$90 million in auditable contract dollars.

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direct bill program. The FAOs are not required to perform the annual testing of contractor eligibility at nonmajor contractors and, when performed, auditors are directed to examine the Internal Controls questionnaire completed during the annual incurred cost audit. However, the Internal Controls questionnaire guidance does not state that auditors must perform an evaluation of internal controls to support the contractor's continued participation in the direct bill program. As a result, DCAA needs to revise the guidance to ensure auditors perform adequate steps and obtain sufficient evidence related to the billing system internal controls. Additionally, DCAA guidance does not address actions the FAOs should take when it is determined that sufficient evidence does not exist to support the authorization to participate in the direct bill program. DCAA is responsible for authorizing contractors to direct bill and should, therefore, revise and clarify its current guidance to address these issues. Otherwise, DCAA may allow contractors that should not qualify to participate in the direct bill program, thus increasing the Government's risk of overpaying contractors.

**Subsequent DCAA Actions.** On January 14, 2009, DCAA Headquarters provided a copy of the FAO January 7, 2009, memorandum rescinding Contractor C's direct bill authorization. The FAO had identified deficiencies in Contractor C's billing system including failure to use approved provisional billing rates and prevent errors in vouchers. DCAA informed us in its response to our draft of this report that a May 1, 2009, DCAA report cited the contractor's accounting system as being inadequate for accumulating and billing costs under Government contracts. DCAA recommended the contracting officer pursue contract payment withholds until the contractor corrects its system. The contractor will remain off direct billing until the contractor has corrected its system and DCAA completes a followup audit to ensure the contractor has implemented corrective actions.

## Recommendation, Management Comments and DoD IG Response

**Recommendation D.** We recommend the Director, Defense Contract Audit Agency:

- 1. Revise guidance on ongoing surveillance for nonmajor contractors to ensure field audit offices gather and maintain sufficient evidence related to evaluation of billing system internal controls to support the contractor's continued participation in the direct bill program.**

**DCAA Comments.** DCAA agreed in principle with the recommendation and explained its planned approach. By September 30, 2009, DCAA will complete an assessment of the current guidance for ensuring that sufficient evidence is obtained to support the nonmajor contractor's continued participation in the direct bill program. DCAA has preliminarily concluded that the annual testing for contractor eligibility

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for direct bill assignment is sufficient evidence to support a nonmajor contractor's eligibility for continuing on the direct bill program and, in October 2008, emphasized to its auditors that a sufficient number of paid vouchers should be reviewed during this assignment to provide reasonable assurance that the contractor's procedures continue to be acceptable for direct billing. DCAA believes this is sufficient evidence as all payments are provisional and subject to later audit, and the risks do not warrant an evaluation of the billing system internal controls. DCAA agreed to require annual testing at all nonmajor contractors with over \$15 million in auditable costs and will test vouchers at contractors with less than \$15 million, at least once every three years.

**DoD IG Response.** The DCAA proposed action does not meet the intent of our recommendation. An evaluation of the billing system internal controls is required for all contractors, no matter the amount of auditable costs, to participate in direct bill. The Defense Federal Acquisition Regulations Supplement 242.803(b)(i)(C) states the contract auditor may authorize direct billing for contractors with approved billing systems. Neither the annual testing for contractor eligibility for direct bill nor the postaward accounting system review for nonmajor contractors provides adequate coverage of the billing system and its internal controls. Therefore, these assignments are not considered sufficient to support a nonmajor contractor's continued participation in direct bill. DCAA should consider additional options to comply with the existing regulations requiring contractors to have an approved billing system to participate in direct bill. Therefore, we request that DCAA reconsider its response to this recommendation.

**2. Direct Headquarters Quality Assurance Division to perform a review of nonmajor contractors' participation in the direct bill program to verify that sufficient evidence exists to support their participation.**

**DCAA Comments.** DCAA agreed with the recommendation but offered an alternative approach. DCAA proposed that its Headquarters Policy and Plans Directorate perform the review after implementation of the revised DCAA policy, which is described in their response to Recommendation D.1. above. DCAA believed it would be more appropriate for the Policy and Plans Directorate to perform this review, as the Integrity and Quality Assurance Directorate is dedicated to performing internal quality assurance reviews. DCAA estimated the review would be completed by September 2010.

**DoD IG Response.** The DCAA proposed action does not meet the intent of our recommendation. The recommendation was made to address our concern that DCAA has not reviewed nor tested the billing system and its internal controls at some nonmajor contractors currently participating in the direct bill program. Additionally, as indicated in our response to the DCAA comments on Recommendation D.1. above, the proposed revision to DCAA policy is not sufficient to ensure only nonmajor contractors with approved billing systems participate in the direct bill program.

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Therefore, we have added Recommendation D.4 to the report to address this concern. Once DCAA has determined the appropriate approach to assessing nonmajor contractors' eligibility to participate in direct bill and issued the guidance, a review to verify proper implementation should be conducted. Therefore, we request that DCAA reconsider its response to this recommendation.

**3. Issue guidance requiring immediate removal of a contractor from direct bill when sufficient evidence is not available to support the authorization to direct bill.**

**DCAA Comments.** DCAA agreed with the recommendation and explained actions already taken and planned. On April 15, 2009, DCAA issued guidance requiring DCAA to take major contractors off the direct bill program within 30 days and commence a new billing system audit unless the current contractor billing system had been audited and deemed to be adequate. DCAA also reiterated its planned approach for nonmajor contractors as explained in the DCAA response to Recommendation D.1. above, with an estimated completion date of March 2010 for the FY 2010 reviews. DCAA plans to remove nonmajor contractors from direct bill within 30 days when deficiencies are identified. DCAA also restated its opinion that its proposed process would provide sufficient evidence to support a contractor's participation in the direct bill program.

**DoD IG Response.** See our response to the DCAA comments on Recommendation D.1. above regarding our disagreement with the proposed revision to DCAA policy. We consider the guidance for major contractor participation in direct bill issued on April 15, 2009, to be reasonable; however, DCAA should take similar actions to cover all nonmajor contractors' participation in direct bill. We have added Recommendation D.4 to the report to address our concern that ineligible nonmajor contractors may be participating in the direct bill program increasing the Government's risk of overpayments occurring. Therefore, we request that DCAA reconsider its response to this recommendation.

**4. Remove, within 60 days of the issuance of this report, all nonmajor contractors participating in the direct bill program for which DCAA has not performed a current billing system review including testing of key internal controls.**

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## E. Forward Pricing Audits (GAO Case 8)

DCAA corrective actions addressed some issues identified by the GAO report; however, additional actions are needed in relation to forward pricing audits<sup>20</sup> performed at Location 3.<sup>21</sup> DCAA should take additional actions to improve audit documentation, determine that improvements in audit quality have been achieved and sustained in Location 3 audit work, and mitigate potential adverse impacts on contract awards based on inadequate DCAA forward pricing audits.

**Background.** The GAO review questioned the reliability of at least 62 forward pricing audit reports issued in FY 2004 through FY 2006 based on two former supervisors<sup>22</sup> comments. During interviews, the former supervisors at Location 3 told GAO investigators they did not always review working papers on forward pricing audits before the report was issued. The supervisors approved and signed 62 of 113 reports issued by Location 3 during FYs 2004 through 2006. Trainee auditors performed 18 of the 62 forward pricing audits. The retired supervisors said that the trainee auditors did not have the knowledge or experience necessary to perform the complex audits they were assigned to. The supervisors also stated that due to time constraints for completing audits, they were unable to provide the supervision necessary for effective trainee auditor performance such as ensuring that supervisory review comments are properly addressed before finalizing and issuing an audit report.

**DoD IG Review.** Our review concluded that 17 of 18 forward pricing audits performed by trainee auditors did not comply with the applicable GAGAS.<sup>23</sup> The 18 forward pricing audits consisted of 9 agreed-upon procedures, 8 price proposals, and 1 specified cost element. The 17 audits had one or more of the following deficiencies:

- lack of professional judgment;
- appropriate procedures/criteria not defined;
- inadequate documentation or insufficient evidence;
- inadequate supervision; and
- failure to comply with all reporting requirements.

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<sup>20</sup> Examples of forward pricing audits include price proposals, integrated product team, specified cost elements, agreed-upon procedures, and forward pricing rate agreements. No opinion is issued on agreed-upon procedures.

<sup>21</sup> Contractor E at Location 3 is a publicly traded company that designs Government business and defense weapons systems.

<sup>22</sup> Both supervisors retired in early 2007.

<sup>23</sup> GAGAS incorporates the general standard on criteria for attestation engagements and requires auditors to also follow all the GAGAS general standards when performing work in compliance with GAGAS. It also incorporates the American Institute of Certified Public Accountants fieldwork and reporting standards for attestation engagements. Additionally, GAGAS provides additional fieldwork and reporting standards for attestation engagements performed in compliance with GAGAS.

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**Corrective Actions from the FY 2006 DCAA External Quality Control System Review.**<sup>24</sup> Our review of the agreed-upon procedures identified deficiencies similar to those found in the FY 2006 external quality control system review. The FAO performed all 9 agreed-upon procedures reviewed prior to DCAA implementing recommendations from the FY 2006 external quality control system review. We recommended that DCAA:

- consolidate all guidance on performing agreed-upon procedures in a separate Contract Audit Manual section;
- revise the agreed-upon procedures pro forma report;
- identify and track all agreed-upon procedures; and
- require management to monitor agreed-upon procedures to ensure that they are performed in accordance with GAGAS.

In November 2006, DCAA developed training specific to agreed-upon procedures and in September 2008, included sections in Contract Audit Manual specific to performing and reporting on agreed-upon procedures engagements. DCAA also required RAMs and FAO managers to approve the proposed procedures and review agreed-upon procedures reports before issuance. These corrective actions, when properly implemented, should improve the DCAA performance of agreed-upon procedures. We will review the effectiveness of the DCAA corrective actions relating to agreed-upon procedures when we perform the FY 2009 peer review.

**DCAA Headquarters Corrective Actions.** DCAA Headquarters has taken multiple corrective actions related to working paper documentation, oversight of audits and the overall work environment that they believe will improve all DCAA audits. See Appendix D for additional details. DCAA also issued the Computer Managed Training Library<sup>25</sup> Course 1269, “Working Paper Documentation,” in May 2007, and updated it in August 2008, to incorporate recent guidance and to reemphasize existing guidance. However, DCAA does not require auditors to take this course. Additionally, on August 29, 2008, DCAA Headquarters issued revised guidance on delegation of signature authority policy requiring the FAO manager to sign all audit reports. The former supervisors signed all 18 forward pricing reports reviewed thus eliminating a key management control. A higher-level manager review of an audit report should help ensure the soundness of the audit logic used and the accuracy of the audit report issued.

**DCAA FAO Organizational Changes.** Effective October 12, 2008, Location 3 was reorganized into two separate DCAA FAOs which should help to reduce the supervisory span of control. Prior to the reorganization, Location 3 had 6 supervisory auditors and 44 auditors. One former supervisor also told GAO that they supervised a team with seven auditor trainees. Now each FAO has 4 supervisors and an average of 28 auditors. A team at the two offices generally includes two auditor trainees and four experienced

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<sup>24</sup> Another name for this review is a peer review.

<sup>25</sup> The Computer Managed Training Library is the DCAA advanced distributed learning system. These courses are technology-based, self-paced learning modules.

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auditors allowing a supervisor more time to provide adequate supervision. This organizational change should help the two FAOs comply with GAGAS and DCAA guidance.

**DCAA FAO Corrective Actions.** For 47 of the 62 audit reports that related to negotiated contract pricing actions, DCAA issued a memorandum to the requestors on September 2, 2008, informing them that the audits were not in compliance with GAGAS and that no reliance should be placed on the audit conclusions. For the 15 audits that did not result in a contract award, DCAA placed memorandums dated September 2, 2008, in the Integrated Recorded Information Management System<sup>26</sup> for the applicable audits stating that the audits were not in compliance with GAGAS. The FAO also selected two firm-fixed price pricing actions for postaward review based on the dollar values of the proposal (\$64 million and \$11 million<sup>27</sup>) and GAO findings. The FAO should, however, perform additional postaward reviews to mitigate the risk or potential negative impact on the firm-fixed price contract awards. In particular, the 11 firm-fixed price contract awards based on audit reports issued prior to the supervisor signing off on all working papers should be considered high risk. The FAO should select additional firm-fixed price awards for postaward review from this group.

## Recommendation, Management Comments and DoD IG Response

### Recommendation E.1. We recommend the Director, Defense Contract Audit Agency:

- a. **Include the revised Computer Managed Training Library Course 1269, “Working Paper Documentation,” in the required auditor training curriculum.**

**DCAA Comments.** DCAA agreed with the recommendation. DCAA will require all auditors to complete the subject training by November 30, 2009. DCAA will include the substance of the CMTL in the training curriculum during its revision as part of the Strategic Plan Objective on life-cycle training.

**DoD IG Response.** DCAA comments were responsive.

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<sup>26</sup>Integrated recorded information management system is the primary DCAA record storage and retrieval mechanism. Audit offices are required to save all official working paper audit files in integrated recorded information management system.

<sup>27</sup> One proposal was \$64 million and was selected because it was the largest firm-fixed price pricing action. The second was for \$11 million and was selected because it was the largest firm-fixed price pricing action where the work papers were approved after report issuance.

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- b. Direct the Quality Assurance Division to perform an internal quality assurance review of Location 3 and the new field audit office to assess the quality of current audit work and followup on appropriate actions to correct any identified deficiencies.**

**DCAA Comments.** DCAA agreed with the recommendation and will perform a quality assurance review by December 2009 at Location 3 and the new field audit office.

**DoD IG Response.** DCAA comments were responsive.

**Recommendation E.2.** We recommend the Resident Auditor, Defense Contract Audit Agency Location 3, perform postaward reviews of all firm-fixed priced contracts, including any associated forward pricing rate agreements, awarded over \$10 million where the supervisor approved the working papers after report issuance as discussed in Case 8 of the GAO investigative report.

**DCAA Comments.** DCAA agreed with the recommendation and will complete the postaward audits of the firm-fixed price contracts awarded over \$10 million by June 2010.

**DoD IG Response.** DCAA comments were responsive.

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## F. Audit of Compensation System (GAO Case 9)

While DCAA issued a new audit report on the compensation system that, in our opinion, adequately addresses the DoD Inspector General and GAO (Case 9) concerns regarding sufficiency of audit evidence, DCAA did not adequately qualify the results of the new audit report. The report qualification does not include or adequately explain the circumstances which significantly impacted the scope and results of the audit. Further, the auditor also did not plan additional audit procedures or obtain FAO manager approval for a large budget increase. DCAA needs to issue a supplemental audit report to correct the report qualification paragraph.

**Background.** In Audit Report No. 4181-2005I13020001, September 30, 2005, DCAA issued an opinion that a contractor's compensation and related internal controls were adequate. In January 2007, we notified DCAA that the audit did not include sufficient evidence to support the audit opinion and recommended that DCAA rescind the report. In July 2008, GAO also reported that DCAA did not obtain sufficient evidence in support of the opinion. DCAA initially refused to rescind the report, but it initiated another compensation system audit. DCAA eventually rescinded the original report (Audit Report No. 4181-2005I13020001) on September 15, 2008.

**DCAA Corrective Actions.** Under Audit Report No. 4181-2007I13020001, June 13, 2008, DCAA issued a new compensation system audit report stating that the compensation system was "inadequate in part." In Audit Report No. 4181-2007I13020001S1, September 5, 2008, DCAA supplemented the new report to incorporate \$2.4 million in unreasonable compensation costs.

**DoD IG Review of DCAA Corrective Actions:** We reviewed supplemental Audit Report No. 4181-2007I13020001S1 to determine if it complies with GAGAS and related DCAA policy. While the supplemental audit includes sufficient evidence in support of the opinion, we noted the following deficiencies.

- **Inadequate Qualification** – The purpose of a qualification is to disclose any circumstances which have a significant impact on the conduct, scope or results of an audit. DCAA failed to adequately qualify the results of the compensation audit for the three circumstances described below.
  - 1) The qualification included on Pages 2 and 3 of the report does not sufficiently or clearly explain why the auditor could not evaluate the reasonableness of fringe benefits. For example, DCAA cites a CAS 403 noncompliance as a reason for not evaluating fringe benefits but the CAS 403 noncompliance, as described, would not preclude the auditor from determining the reasonableness of fringe benefits.

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- 2) DCAA should have qualified the audit results of unreasonable executive compensation costs for the lack of executive job descriptions. As emphasized in current DCAA guidance and DCAA Audit Report No. 4181-2005I13020001, job descriptions are critical for ensuring a valid comparison to external pay surveys. Therefore, the auditor may have disclosed a significantly higher or lower amount of unreasonable executive compensation costs if job descriptions were available.
  - 3) DCAA did not qualify the audit results for any subsequent audits that may supplement the audit findings on fringe benefits, as Contract Audit Manual 5-812.3b. requires.
- **Inadequate Planning.** The auditor performed additional audit procedures as a part of the supplemental audit but did not prepare planning documents to demonstrate adequate planning and approval of the additional steps.
  - **Budget Increase Not Approved.** During the audit, the auditor requested a budget increase of 340 hours. While the auditor obtained approval for the increase from his supervisor, he did not obtain approval from the FAO manager as the DCAA FAO procedure requires.

## Recommendation, Management Comments and DoD IG Response

**Recommendation F.** We recommend the Branch Manager, Defense Contract Audit Agency Location 2, issue a supplemental audit report to correct the report qualification.

**DCAA Comments.** DCAA agreed with the recommendation and will supplement Audit Report No. 4181-2007I13020001S1 by September 30, 2009, to address our concerns. DCAA is also assessing the guidance contained in Contract Audit Manual 5-812.3 and the need for including a qualification on fringe benefits in every compensation system audit report.

**DoD IG Response.** DCAA comments were responsive.

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## G. Audit of Purchasing System (GAO Case 10)

We confirmed the GAO (Case 10) finding that the DCAA working papers for an audit of a contractor's purchasing system and related internal controls do not include sufficient evidence in support of the reported audit opinion, as GAGAS 6.04 b requires. The auditor did not perform sufficient independent tests to ensure that the contractor complies with established policies and procedures or that the key controls are operating effectively. While DCAA relied on the DCMA contractor purchasing system review and contractor internal reviews, the auditor did not follow DCAA procedures for establishing reliance on these reviews. In addition, the auditor did not properly date the working papers in accordance with DCAA policies. DCAA performed another audit of the purchasing system and related internal controls. We will review the adequacy of it in a followup review.

**Background.** In Audit Report No. 4181-2005A12030001, dated September 29, 2005, DCAA issued an opinion that a contractor's purchasing system and related internal controls were "adequate." In July 2008, GAO reported that the working papers did not include sufficient evidence to support the final opinion. According to GAO, DCAA relied on the DCMA contractor purchasing system review in which the conclusions were based word for word on the contractor's response to a questionnaire without independent testing of controls.

**DCAA Corrective Actions.** DCAA did not agree with the GAO but stated that it would address the GAO concerns in a new audit of the purchasing system and related internal controls. On January 23, 2009, DCAA issued its new purchasing system Audit Report No. 4181-2008A12030001. We will review the adequacy of the new purchasing system audit and provide our results in a subsequent report.

**DoD IG Review of DCAA Audit.** We reviewed the report and working papers to determine if it complies with GAGAS and related DCAA policies. We noted the following noncompliances:

- **Insufficient Evidence to Support Audit Opinion** – The working papers do not include sufficient evidence in support of the audit opinion. The auditor did not perform sufficient independent tests to ensure that the contractor complies with established policies and procedures or that key controls are operating effectively. Specifically, the auditor did not conduct sufficient independent tests in the following areas of the purchasing system:
  - Purchase Orders and Contract Clauses
  - Management of Purchasing
  - Selecting the Source
  - Pricing and Negotiation
  - Subcontract Award and Administration

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Therefore, the working papers do not comply with GAGAS 6.04 b., requiring sufficient evidence to provide a reasonable basis for the conclusion expressed in the report. Although the auditor relied on the results of the DCMA contractor purchasing system review and contractor internal reviews, the auditor did not follow DCAA policies in Contract Audit Manual 4-1000 for placing reliance on those reviews. For example, the auditor did not sufficiently document the basis for evaluating the competence, independence, and objectivity of the reviews, and did not document the review of working papers supporting the review conclusions to ensure that the review tests satisfied the audit objectives. Accordingly, DCAA and contracting officials should not rely on the DCAA audit conclusions.

- **Working Papers Not Dated.** The auditor did not properly date most of the working papers in accordance with Contract Audit Manual 4-403j. The auditor dated most working papers as “August, 2005,” without recording the day of the month that the auditor completed the working papers.

**Subsequent FAO Actions.** On January 15, 2009, shortly after we notified DCAA of our draft results, DCAA rescinded Audit Report No. 4181-2005A12030001. Therefore, we deleted a planned recommendation to rescind the report.

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## H. DCAA Audit of Billing System (GAO Case 11)

We confirmed the GAO (Case 11) finding that the DCAA working papers for a billing system audit report failed to provide adequate support for dropping billing system internal control weaknesses found by the first auditor. The supervisor and first auditor assigned to this audit had disagreed over whether the internal control weaknesses represented significant weaknesses. DCAA has since clarified its guidance on determining the significance of internal control weaknesses. In noncompliance with DCAA policies, DCAA also did not immediately pull the contractor's direct billing authority or perform a peer review of the audit. DCAA rescinded the billing system audit report in response to our draft findings. DCAA should promptly incorporate the guidance clarifications in the DCAA Contract Audit Manual.

**Background.** In Audit Report No. 4181-2006I11010001, dated December 21, 2007, DCAA Location 2 reported that a contractor's billing system was "inadequate in part" because the contractor did not adjust its interim billings for indirect costs due to changes in the anticipated or actual final indirect rates. In July 2008, GAO reported that DCAA dropped several other deficiencies without documenting adequate supporting rationale in the working papers. The first auditor assigned to the audit uncovered the other deficiencies, but DCAA management replaced the first auditor with a second auditor who dropped the deficiencies with management concurrence. In addition, GAO found that DCAA retained the contractor's direct billing privileges despite issuing an "inadequate in part" opinion.

**DCAA Corrective Actions.** DCAA did not agree with the GAO findings but elected to perform a paid voucher review that would address some of the concerns that the first auditor and GAO expressed. On April 9, 2009, DCAA issued the results of the paid voucher review under Report No. 4181-2008A11015003. DCAA reported that reliance cannot be placed on the contractor's interim vouchers due to significant deficiencies.

**DoD IG Review of Billing System Audit.** We reviewed the report and working papers to determine if it complied with GAGAS and related DCAA policy. We noted the following:

- **Dropped Findings:** The working papers do not include sufficient evidence to support dropping four findings that the first auditor uncovered. Table 6 below discusses the DCAA rationale and the results of our review of the four dropped findings.

<b>Table 6. Working Paper Findings Dropped From Case 11 Audit Report, DCAA Rationale and Review Conclusions</b>		
<b>Dropped Finding</b>	<b>DCAA Rationale</b>	<b>DoD IG Review Results</b>
The contractor has no procedures for evaluating and monitoring subcontractor accounting and billing systems.	Contractor revised its procedures for reviewing subcontractor accounting and billing systems.	The second auditor did not test the procedures for compliance before deleting the finding. DCAA should have reported the finding until the auditor verified that the contractor implemented the procedure.
The contractor lacks procedures to ensure timely processing of contract administration adjustments.	The impact on the Government is insignificant and Federal Acquisition Regulation does not require the contractor to maintain a schedule of adjustments.	The working papers do not provide any evidence that the impact to the Government is insignificant. The first auditor's finding is consistent with DCAA policies for auditing billing systems. Therefore, DCAA should have reported this finding.
The contractor lacks procedures to ensure timely processing of offsets.	Offsets were infrequent and there was no harm to the Government.	The working papers did not include sufficient evidence to conclude that offsets were "infrequent." The first auditor's finding was consistent with DCAA policies for auditing billing systems. Therefore, DCAA should have reported this finding.
The contractor does not withhold the required amount from the fixed-fee portion of individual delivery orders on indefinite delivery and indefinite quantity contracts in accordance with contract terms.	Testing on contracts done by the second auditor found no problems. Withholdings are not required on individual delivery orders of indefinite delivery and indefinite quantity contracts per Federal Acquisition Regulation 16.5.	Testing performed by the second auditor was flawed because it did not include indefinite delivery and indefinite quantity contracts in his limited sample of five contracts. The first auditor found that the failure to withhold amounts violated the contract terms. Therefore, DCAA should have reported this finding.

Because the FAO dropped potentially significant findings, contracting officers should not rely on the report to make contracting decisions and auditors should not use it as a basis to reduce testing in related areas.

- Debate over the Significance of Draft Billing System Deficiencies.** The supervisor and first auditor spent considerable time and resources debating whether the first auditor's draft billing system deficiencies were significant. The supervisor directed the auditor to quantify the "effect" on the Government in accordance with Contract Audit Manual 10-409(a)(5), "Statement of Condition

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and Recommendations,” for each draft deficiency. In many cases, however, the auditor could not quantify a specific harm to the Government due to the nature of the deficiency or because the contractor did not maintain the records necessary to quantify the impact. For example, the first auditor found that the contractor had no procedures for processing offsets, but the auditor could not determine the associated impact because the contractor did not keep records on offsets. Before being removed from the audit, the first auditor tried to convince the supervisor that the deficiencies nevertheless represented significant internal control weaknesses that should be reported as deficiencies in accordance with Contract Audit Manual 5-109(d).

We noted a similar occurrence on another audit performed at DCAA Location 1. The DCAA Location 1 FAO manager directed an auditor to change several internal control weaknesses from deficiencies to “Suggestions to Improve the System” because the auditor could not quantify a specific dollar impact to the Government for each deficiency. Unlike reported deficiencies, the contractor is not required to take corrective action in response to reported “Suggestions to Improve the System.”

In a March 2008, Memorandum for Regional Directors, DCAA clarified its guidance on determining the significance of internal control weaknesses. The memorandum clarifies that all internal control weaknesses which result in, or could result in, unallowable costs being charged on Government contracts should be reported as a deficiency (not a suggestion) unless the potential unallowable cost is clearly immaterial. The clarification should help auditors and supervisors determine the significance of internal control weaknesses and avoid similar disagreements. However, as of July 27, 2009, DCAA had not incorporated the clarified guidance in the DCAA Contract Audit Manual.

- **Improper Approval of Direct Billing Authority.** Even though DCAA reported that the billing system was “inadequate in part,” DCAA initially decided to retain the contractor’s direct bill authority. The auditor stated in the working papers that the decision was based on the “limited impact for the one reported significant deficiency (\$186,000), the contractor’s plans to correct the deficiency, and positive results on paid voucher reviews.” This decision did not comply with Contract Audit Manual 6-1007.2 which clearly states that a major contractor must have an adequate billing system to be eligible for direct billing. Therefore, although DCAA rescinded the direct bill authority three months later, DCAA should have immediately pulled the direct billing authority after issuing the “inadequate in part” opinion.
- **No Peer Review.** The auditor did not obtain a peer review of this assignment as DCAA policy requires.

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**DoD IG Review of Corrective Actions.** DCAA did not complete its paid voucher review in time for us to consider it as part of this review. We will address the adequacy of the paid voucher review in a subsequent report.

## Recommendation, Management Comments and DoD IG Response

**Recommendations H. 1.** We recommend the Director, Defense Contract Audit Agency, promptly incorporate its clarified procedures on reporting internal control deficiencies into the Defense Contract Audit Agency Contract Audit Manual.

**DCAA Comments.** DCAA agreed with the recommendation and will incorporate the new internal control guidance in the Contract Audit Manual by September 2009.

**DoD IG Response.** DCAA comments were responsive.

**Recommendations H. 2.** We recommend the Branch Manager, Defense Contract Audit Agency Location 2, immediately rescind Audit Report No. 4181-2006I11010001 and notify contracting officials who received the report not to place any reliance on its conclusions.

**DCAA Comments.** DCAA agreed with the recommendation and rescinded Audit Report No. 4181-2006I11010001 on April 13, 2009. On April 9, 2009, DCAA issued a flash report on billing system deficiencies found during its contractor eligibility for direct bill assignment. DCAA will perform a full billing system audit in the near future.

**DoD IG Response.** DCAA comments were responsive. It should be noted that DCAA rescinded Audit Report No. 4181-2006I11010001 on April 9, 2009, not April 13.

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## I. Labor Floor Check (GAO Case 12)

DCAA corrective actions are not sufficient to address all concerns identified in the GAO (Case 12) and DoD Inspector General reviews of the DCAA labor floor check audit of Contractor C. The floor check audit included evidence that salaried employees worked uncompensated overtime but did not record all hours worked on their timesheets; however, the FAO did not report or pursue this issue until completing a current floor check audit. Because the deficiency was not pursued when initially identified, labor costs may have been overestimated on proposals or charged improperly to contracts for FY 2004 through FY 2007. A serious risk of mischarging costs to Government contracts exists when salaried employees do not record all hours worked. DCAA still needs to determine the significance of the deficiency during the affected time period.

**Background.** The purpose of a labor floor check is to test the contractor's compliance with its timekeeping internal controls and procedures and the reliability of employee time records, and to verify time is properly charged. Floor checks are an integral part of the audit coverage of labor costs and help ensure the accuracy of labor charges. When no significant deficiencies are identified, DCAA guidance directs FAOs to close an assignment with a memorandum for record prior to incorporating the results into the final incurred cost audit report.

In a memorandum for record dated September 30, 2005, DCAA concluded no significant deficiencies existed in Contractor C's timekeeping system based on the results of the labor floor check. Both the DoD Inspector General and GAO reviews of the labor floor check determined that the DCAA conclusions were not adequately supported by the working papers, draft conclusions were changed without sufficient documentation, and the auditor did not perform sufficient work to support the conclusions. Our review specifically noted that the working papers identified a potential significant uncompensated overtime deficiency that the FAO did not pursue. Uncompensated overtime represents hours worked by salaried employees in excess of an average of 40 hours per week without additional compensation.

**DCAA Corrective Actions.** DCAA is taking various corrective actions that, when completed, should resolve all concerns except for the potential impact of uncompensated overtime on FY 2004 through FY 2007 charged labor costs. The FAO has added a memorandum for record to the integrated recorded information management system rescinding the original memorandum for record on Contractor C's floor check audit because a post issuance review disclosed noncompliances with GAGAS.<sup>28</sup> The FAO also completed a current year labor floor check, Assignment 4181-2008K10310004, and issued an audit report on April 9, 2008, identifying eight significant deficiencies in

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<sup>28</sup> A memorandum to the Administrative Contracting Officer is not required because the audit office did not issue a report but closed the assignment with a memorandum for record in accordance with DCAA guidance.

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Contractor C's labor practices, including a deficiency on recording uncompensated overtime. The FAO recommended Contractor C require employees to record all hours worked in the timekeeping system to ensure an equitable allocation of labor and indirect costs. Our evaluation of the current labor floor check determined the audit report conclusions were supported by the working papers and the audit complies with GAGAS.

Due to the deficiencies DCAA identified in the labor floor check audit, the FAO also planned to complete a labor charging audit, Assignment No. 4181-2008K13500001, by December 16, 2008,<sup>29</sup> to further review the unrecorded uncompensated overtime deficiency and labor charging patterns to determine the potential impact on the Government. However, based on discussions with the FAO, this audit is not addressing the unrecorded uncompensated overtime issue in FY 2004 through FY 2007 labor costs. To adequately determine the impact of uncompensated overtime, DCAA must perform a comprehensive analysis of labor time charges which also includes interviewing employees over multiple pay periods. Because this issue can impact the review of contract costs in various types of DCAA audits, the FAO must also consider the effect of uncompensated overtime in the ongoing review of Contractor C's estimating system (see Appendix D, Case 5) and forward pricing audits. DCAA Headquarters has also taken multiple corrective actions related to working paper documentation, oversight of audits, and the overall work environment that they believe will improve all DCAA audits. See Appendix C for additional details. We will evaluate corrective actions once completed to ensure DCAA has adequately addressed concerns related to the floor check audit.

**Incurred Cost Audits.** DCAA has not identified all necessary actions required to determine and mitigate the impact to the Government resulting from Contractor C not identifying or recording uncompensated overtime and the DCAA failure to recommend that Contractor C correct a potentially significant deficiency in labor estimating and charging practices. The FAO did not rely on Contractor C's labor floor check audit when performing the FY 2004 incurred cost audit. Instead, the auditors included additional audit steps in their review of labor costs meant to address the uncompensated overtime issue. However, it is not clear how a review of labor adjusting entries or a comparison of forecasted headcount to actual headcount in different departments would sufficiently address unrecorded uncompensated overtime. The FAO did not take exception to labor costs in their final report on FY 2004 incurred costs issued on December 26, 2007. The FY 2005 through FY 2007 incurred cost audits have not yet been completed. To adequately address the issue after the fact may require significantly more effort, but DCAA should identify additional audit steps that will do so and ensure that the FAO executes them appropriately.

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<sup>29</sup> DCAA issued this audit report on April 29, 2009. See DCAA comments to our recommendation for further information.

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## Recommendation, Management Comments, and DoD IG Response

**Recommendation I.** We recommend the Branch Manager, Defense Contract Audit Agency Location 2, perform the actions required to identify any negative impact to the Government as a result of the unrecorded uncompensated overtime issue for FY 2004 through FY 2007.

**DCAA Comments.** DCAA agreed with the recommendation. DCAA expected to finish performing audit steps identifying any negative impact to the Government as a result of the unrecorded uncompensated overtime for the time period 2004 through 2008 by August 31, 2009. On April 29, 2009, DCAA reported several deficiencies with the contractor's labor system (4181-2008K13500001), including the contractor's practice of not reporting uncompensated overtime. Also on April 29, 2009, DCAA reported that the contractor's cost estimate development portion of its estimating system (4181-2008K24010001) was inadequate because of several deficiencies, including the unreliable estimates based on the contractor not recording all hours worked. Finally, on May 1, 2009, DCAA reported that the contractor's accounting and billing systems (4181-2008K17740003) were inadequate for accumulating and billing costs under Government contracts. In all three reports DCAA recommended the contracting officer pursue a suspension of contractor payments.

**DoD IG Response.** DCAA comments were responsive.

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# Appendix A. Scope and Methodology

We conducted this review from August 2008 through April 2009, in accordance with Audit Policy and Oversight Operating Procedures, which comply with the Quality Standards for Federal Offices of Inspector General issued by the Council of the Inspectors General on Integrity and Efficiency.<sup>30</sup> The Operating Procedures require, in part, that personnel are free from personal and external impairments to independence in their work and that sufficient credible evidence is compiled to support conclusions and opinions. We examined DCAA audit documentation for the 2003 through 2007 audits identified in the GAO report “DCAA AUDITS: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated.”

We interviewed the auditors and examined audit documentation from 1998 through 2008 for audits performed at the three DCAA Western Region FAOs. We assessed the audits for compliance with the GAGAS versions 2003 and 2007 as applicable.

We reviewed the corrective actions taken by DCAA in response to the deficiencies identified in the GAO report. We reviewed current audits that replaced deficient audits for compliance with GAGAS, memoranda to contracting offices and memoranda for audit files, and interviewed auditors performing current audits.

We visited two DCAA Western Region FAOs and interviewed 68 audit employees to assess whether an abusive work environment existed.

For Case 2, we visited the DCAA Western Regional Office located in La Mirada, CA, as well as a DCAA FAO located in Colorado that is under the cognizance of the DCAA Central Region. We visited the Air Force Space & Missiles Systems Center, Los Angeles Air Force Base, El Segundo, CA; and the DCMA Space & Missiles Systems Division, Carson, CA. For Case 3, we visited the DCMA Santa Ana Contract Administration Service Office, Santa Ana, CA. At these locations, we interviewed Government procurement personnel and examined audit and contract records and case files necessary to understand the key issues involved in each case.

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<sup>30</sup> The Inspector General Reform Act of 2008 created the Council of the Inspectors General on Integrity and Efficiency combining what were formerly known as the President’s Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. This publication was issued by these two predecessor organizations in October 2003.

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## Appendix B. Prior Coverage

During the last 5 years, the GAO and the Inspector General DoD have issued 7 reports related to DCAA. The unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov/>, and unrestricted DoD Inspector General reports can be accessed at <http://www.dodig.mil>.

### GAO

GAO Report No. GAO-08-857, “DCAA AUDITS: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated,” July 22, 2008

### IG DoD

Inspector General DoD Report No. D-2007-6-006, “Review of the Defense Contract Audit Agency Quality Control System,” May 1, 2007

Inspector General DoD Report No. D-2007-6-005, “Congressional Inquiry Concerning Allegations at the at the Defense Contract Audit Agency Lockheed Martin Rockville Resident Office,” April 25, 2007

Inspector General DoD Report No. D-2007-6-001, “Report on Defense Hotline Compliant Concerning Audit Issues at the Defense Contract Audit Agency Northrop Grumman Newport News Resident Office,” October 11, 2006

Inspector General DoD Report No. D-2006-6-003, “Defense Hotline Compliant Concerning Management Issues at the New York Branch Office,” April 5, 2006

Inspector General DoD Report No. D-2005-6-005, “DoD Hotline Allegations Concerning Postaward Audits at the Defense Contract Audit Agency, Boeing Huntington Beach Resident Office,” May 4, 2005

Inspector General DoD Report No. D-2005-6-002, “Congressional Inquiry into Allegations Concerning an Abusive Work Environment at the Defense Contract Audit Agency New York Branch Office,” March 8, 2005

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# Appendix C. DCAA-Wide Corrective Actions

In response to the GAO report, DCAA Headquarters took multiple corrective actions to the audits identified as deficient and established an assessment team to determine whether policy changes and further guidance was necessary to correct possible systemic issues. DCAA Headquarters also issued a series of memorandums providing policy and guidance and re-emphasized existing policies addressing procedures for disagreement on audit findings, adequacy of working paper documentation, participation in integrated product teams, audit quality, report signature authority, cooperation with investigative agencies, and performance measures. See details below. We had not assessed the impact of the DCAA-wide corrective actions at the time of this report. We will evaluate the implementation and results, when possible, during the FY 2009 DCAA peer review and in future oversight reviews.

## DCAA Corrective Actions Related to Agency Management

**Cooperation.** On August 8, 2008, the DCAA Director issued a memorandum that GAO and DoD Inspector General had various in-process and future reviews planned and stressing that all DCAA employees cooperate fully with reviewers.

On September 12, 2008, the DCAA Director issued a memorandum to all employees emphasizing the DCAA policy encouraging employees to cooperate with any investigations conducted by representatives of Government investigative authorities.

**Assessment Survey.** DCAA Headquarters notified all DCAA employees on September 29, 2008, that the Office of Personnel Management would conduct a DCAA-wide organizational assessment survey. The assessment results would address DCAA work environment, highlight risks, and pursue needed improvements. DCAA encouraged all employees to participate in the survey and assured them the responses would be collected and processed in a confidential manner.

**DCAA Action Plan.** DCAA Headquarters issued a memorandum on October 1, 2008, to all DCAA employees providing an update to the DCAA action plan in response to the GAO report. The updated plan included the progress to date on the assessment of:

- staff requirements,
- performance measures,
- participation in integrated product teams,
- report signature authority,
- organizational assessment survey,
- realignment of the regional quality assurance function, and
- the DCAA-wide organizational assessment.

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As of the date of the memorandum, DCAA had requested additional staff from the Under Secretary of Defense (Comptroller)/Chief Financial Officer and was working with the DoD to address staffing needs. In addition, DCAA realigned the regional quality assurance function to DCAA Headquarters and was planning the DCAA-wide organizational assessment addressing improvements in the Strategic Plan, staffing allocations, ethics, and leadership to be completed by the end of 2009. DCAA issued memoranda providing guidance on participation in integrated product teams, report signature authority, and performance measures (see section below for more information).

**Organizational Realignment.** On December 31, 2008, DCAA issued Memorandum for Regional Directors 08-DQA-013(R), revising the DCAA Instruction 7640.20, “DCAA Quality Assurance Program.” The instruction’s revisions included:

- the realignment of the Regional Quality Assurance function as a Headquarters element,
- the institution of a process for the Quality Assurance Division to perform followup reviews,
- the requirement for Regional Directors and the Field Detachment Director to develop comprehensive action plans for those FAOs that were determined to have an assignment lacking professional judgment in the headquarters-led internal quality assurance review, and
- the incorporation of a provision to include appropriately cleared independent reviewers as part of the Quality Assurance teams reviewing Field Detachment FAOs.

## Corrective Actions Resulting in New Policies

**Participation in Integrated Product Teams.** DCAA Headquarters issued Memorandum for Regional Directors 08-PAS-024(R), on August 5, 2008, discontinuing DCAA participation in integrated product team and other teaming arrangements. DCAA directed the FAOs to forward the guidance to the contracting officers notifying them that DCAA would no longer participate in integrated product teams, but would perform audits of a contractor’s management-approved final proposals upon the contracting officer’s request.

**Signature Authority.** Based on recommendations from the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DCAA revised Regulation 5600.1, “Delegation of Signature Authority for Audit Reports and Other Audit Related Documents,” to state that FAO managers could not re-delegate signature authority for audit reports, memorandums issued to close or cancel assignments, DCAA Form 1s<sup>31</sup> and rate agreement letters. DCAA issued Memorandum for Regional Directors 08-D-008(R) on August 29, 2008, announcing the change in policy.

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<sup>31</sup> The purpose of a DCAA Form 1 is to initiate Administrative Contracting Officer action in rendering a final decision on the questioned costs associated with reimbursement.

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The FAO managers were also reminded that as the end of FY 2008 approached, managers were not to issue reports just to meet fiscal year due dates. Before issuing a report, sufficient audit work must be performed and differences of opinions on draft audit issues had to be resolved.

**Performance Metrics.** In a memorandum to DCAA employees, 08-D-009(R), dated September 30, 2008, DCAA Headquarters eliminated 18 of their prior performance measures, developed 8 new performance measures, maintained 1 measure but only at the agency level, and provided 3 informational (no goals) performance measures. DCAA reassessed the new performance measures through focus groups and, for various reasons, decided not to change any measures but to reassess them again after the one year mark when more data would be available. DCAA reemphasized its policy on zero-based budgeting and appropriate consideration of budget revisions when the scope changes. The DCAA Contract Audit Manual Chapter 3, “Audit Planning,” Section 103(d) was modified on December 4, 2008, to reflect the changes.

**Internal Control Deficiencies, Weakness, and Audit Opinions.** DCAA issued Memorandum for Regional Directors 08-PAS-043(R), on December 19, 2008, clarifying what constitutes a significant deficiency/material weakness. In addition the Memorandum for Regional Directors established new guidance on reporting audit opinions on contractors’ internal control systems; audit reports on contractors’ internal controls that report any significant deficiencies/material weaknesses will include an opinion that the system is inadequate. DCAA will no longer report “inadequate in part” opinions.

**Limited Scope Audit Reports on Internal Controls.** DCAA issued Memorandum for Regional Directors 08-PAS-041(R), on December 19, 2008, requiring that when internal control deficiencies are identified in other than an internal control audit (e.g., forward pricing proposal audit) the FAOs should not wait to perform a full system review to report the deficiencies. The FAOs should (1) issue a flash report to report the potential deficiencies, and (2) establish a separate limited scope audit assignment to review the control activities related to the applicable control objective. The limited scope audit assignment should be completed as soon as possible (preferably within 30 days) after the condition is identified. When the control activities audited are not adequate to ensure that the control objective is accomplished, the audit report will report that the system is inadequate and recommend that the contracting officer disapprove the affected portions of the system (when applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs.

**Denial of Access to Records Due to Contractor Delays.** On December 19, 2008, DCAA issued Memorandum for Regional Directors 08-PAS-041(R), providing guidance for when the contractor does not provide documentation in support of an audit in a timely manner. The Memorandum for Regional Directors requires the auditor to:

- (1) follow the procedures for denial of access to records,
- (2) take appropriate actions to effect a suspension or withhold of any unsupported costs billed to the Government until the data is received and a determination is made regarding the allowability of the costs, and

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- (3) question the unsupported costs in the audit report if the supporting documentation is not received prior to completion of fieldwork.

The guidance further instructs the auditor to follow the procedures even when the contractor concurs to the questioned costs based on the lack of support. When the records are alleged to have been destroyed, lost, or stolen, auditors should obtain a written statement from appropriate high-level contractor management (i.e., at a level no lower than the business segment vice president or chief financial officer) to that effect with a detailed explanation of the circumstances.

## Emphasis of Existing DCAA Policy

**Handling Disagreements on Audit Findings.** DCAA issued Memorandum for Regional Directors 08-PAS-022(R) on July 31, 2008, to re-emphasize and clarify existing guidance on DCAA procedures on disagreements between management and auditors regarding audit findings. Unresolved differences of opinion between supervisors and auditors should be elevated to the FAO manager, then to the RAM, and ultimately to the Deputy Regional Director, when necessary. When the difference cannot be reconciled and management changes the audit results, management and auditor should document the disagreement, maintain the original audit documentation in the superseded file, and document the change with support for the change in the audit file.

**Working Paper Documentation.** DCAA issued Memorandum for Regional Directors 08-PAS-023(R) on August 1, 2008, to reemphasize GAGAS requirements and Contract Audit Manual guidance on what constitutes proper audit documentation. In addition, the staff was reminded that the DCAA CMTL Course 1269, "Working Paper Documentation," provides an overview of audit documentation requirements.

**Reemphasizing Quality.** DCAA Headquarters issued a memorandum to all DCAA employees on August 6, 2008, designating August 2008, as audit quality month and directing the FAOs to hold a stand-down day to facilitate open discussions on audit quality and to address issues such as the risk-based audit approach.

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## Appendix D. DCAA Corrective Actions for Specific Cases

DCAA Headquarters has taken multiple corrective actions related to working paper documentation, oversight of audits, and the overall work environment that they believe will improve all DCAA audits. See Appendix C for additional details. In our opinion, DCAA has completed actions for Cases 1 and 13 necessary to address the specific concerns identified in the GAO report. Actions are completed on Case 5 but still need to be reviewed to verify proper implementation. Actions are still in process for Cases 6 and 7. We will evaluate all corrective actions once completed to ensure DCAA has adequately addressed the areas of concern.

### GAO Case 1-Follow-on Survey of Contractor A's Estimating System

GAO and DoD Inspector General reviews of Contractor A's<sup>32</sup> estimating system audit concluded the audit did not comply with GAGAS because working paper documentation did not support the audit report conclusions. In addition, GAO identified an impairment to auditor independence. DCAA has taken various corrective actions that should resolve all concerns.

The FAO completed two subsequent estimating system audits, under Assignment Nos. 4461-2003B24010001 and 4461-2006B24010001 dated September 24, 2003 and September 13, 2007, respectively. We reviewed the only audit still in use by Government representatives, Assignment No. 4461-2006B24010001, and determined it complied with GAGAS. The FAO has also added a memorandum for record to integrated recorded information management system documenting that a post issuance review of the audit disclosed noncompliances with GAGAS; however, a letter was not issued to the Administrative Contracting Officer as the original audit had already been superseded by a more current audit.

The impairment to independence resulted because the FAO participated in an IPT that included reviewing Contractor A's draft labor estimates. Due to the independence concerns, DCAA Headquarters issued Memorandum for Regional Directors 08-PAS-024(R) dated August 5, 2008, effective on that date, discontinuing all participation in integrated product teams. DCAA Headquarters also issued Memorandum for Regional Directors 08-PAS-026(R) on August 11, 2008, establishing the guidelines for when DCAA can provide audit services, as necessary, to assist the contracting officer in determining a fair and reasonable price without being a team member of an integrated product team. The guidelines included:

- a contracting officer requests the audit services;
- the audit covers a "management approved" proposal or part of a proposal, and not a draft proposal; and

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<sup>32</sup> Contractor A is a major aerospace company that is among the five largest defense contractors.

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- an audit report is issued reflecting an independent opinion that is not influenced by the contractor or Government officials.

## **GAO Case 5-Estimating System Audit of Contractor C**

GAO and DoD Inspector General reviews of the DCAA audit of Contractor C's estimating system concluded the audit did not comply with GAGAS because working paper documentation did not support the audit report conclusions. DCAA took various corrective actions that, if properly completed, should resolve all concerns. The FAO notified the DCMA Administrative Contracting Officer on June 27, 2008, that they should no longer rely on the original audit report. The FAO had completed its audit of the cost estimating development portion of the contractor's estimating system and issued its report (4181-2008K24010001) on April 29, 2009. DCAA reported the contractor estimating system as inadequate and recommended the contracting officer disapprove the system and pursue withholds of contract payments.

## **GAO Case 6-Accounting System Audit of Contractor D**

GAO and DoD Inspector General reviews of the DCAA audit of Contractor D's<sup>33</sup> accounting system concluded the audit did not comply with GAGAS because working paper documentation did not support the audit report conclusions. DCAA is taking various corrective actions that, when completed, should resolve concerns.

The FAO estimated completing a full accounting system review under Assignment No. 4181-2008I17740002, by early September 2009, which is to include steps to address the miscoded corporate cost deficiency identified but not pursued during the noncompliant audit. Additionally, the FAO manager explained that auditors would also followup on potentially miscoded costs during the incurred cost audits for FY 2005 through FY 2007. The FAO notified the Administrative Contracting Officer on September 18, 2008 that they should no longer rely on the original audit report that was rescinded.

## **GAO Case 7-Cost Accounting Standard 403 Compliance Audit of Contractor D**

GAO and DoD Inspector General reviews of the DCAA audit of Contractor D's compliance with CAS 403, "Allocation of Home Office Expenses to Segments," concluded the audit did not comply with GAGAS because the working paper documentation did not support the audit report conclusions. In addition, GAO noted the FAO issued two CAS 403 audit reports that were contradictory. DCAA is taking various corrective actions that, when completed, should resolve concerns.

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<sup>33</sup> Contractor D is the corporate office of a publicly traded engineering, construction, maintenance, and project management company. For calendar year 2006, Contractor D reported over \$14 billion in revenue, including \$2.9 billion in revenue from Government business.

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The FAO is addressing the potential deficiencies identified, but not pursued in the noncompliant GAGAS audit, under multiple DCAA audit assignments. On October 24, 2008, the FAO issued Report No. 4181-2008I1920006, finding that the contractor was noncompliant with CAS 403 under 8 conditions, including noncompliant allocations of various expenses. The FAO also plans to issue a CAS 416, “Accounting for Insurance Cost,” compliance audit, Assignment No. 4181-2008I194160000, by February 19, 2010. The FAO is also addressing the miscoded corporate cost issue in an accounting system audit, Assignment No. 4181-2008I17740002.<sup>34</sup> The issue of a Contractor D segment adding general and administrative expenses to corporate costs being passed through the segment to other segments is being addressed under Assignment No. 4411-2006N11070001 which the DCAA FAO cognizant of that segment estimates will be issued in February 2010.

The FAO issued two audit reports on compliance with CAS 403 that partially contradicted each other. The FAO issued a report on December 30, 2005, concluding that Contractor D complied with CAS 403 from January 1, 2004 through September 15, 2005. However, on September 21, 2007, the FAO issued another report concluding Contractor D was noncompliant with CAS 403 from January 1, 2004 though December 31, 2004. The reports were contradictory, in part, because the second report covered 12 months also covered by the first report. As a result of the GAO and DoD Inspector General reviews, the FAO issued a September 18, 2008, memorandum notifying the Administrative Contracting Officer that the December 30, 2005, audit report was being rescinded, and should no longer be relied on. This action nullified the issue of the contradictory reports. However, because multiple DCAA audits can identify noncompliances that could result in this type of situation recurring, DCAA Headquarters is considering adjusting the standardized final audit report language for CAS noncompliance audit reports.

## **GAO Case 13-Cost Accounting Standard 418 Compliance Audit of Contractor G**

GAO review of the DCAA Location 2 audit of Contractor G’s CAS 418 Assignment No. 4181-2006A19418002 concluded the audit did not comply with GAGAS because working paper documentation did not support the audit report conclusion.

The FAO concurred with the GAO findings and completed a new CAS 418 audit assignment No. 4181-2008D19418002. On June 4, 2008, the FAO issued its audit report stating that Contractor G complied in all material respects with the requirements of CAS 418. On September 15, 2008, the FAO notified DCMA that they should no longer rely on the original Audit Report No. 4181-2006A19418002. Based on our review of DCAA Location 2 corrective actions, we concluded that the actions are adequate and compliant with GAGAS.

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<sup>34</sup> This is the same assignment identified in the GAO Case 6-Accounting System section of our report.

# Appendix E. Senate Request

<small>CARL LEVIN, MICHIGAN, CHAIRMAN</small>		
<small>EDWARD M. KENNEDY, MASSACHUSETTS</small>	<small>JOHN MCCAIN, ARIZONA</small>	
<small>ROBERT C. BYRD, WEST VIRGINIA</small>	<small>JOHN WARNER, VIRGINIA</small>	
<small>JOSEPH I. LIEBERMAN, CONNECTICUT</small>	<small>JAMES M. INHOFE, OKLAHOMA</small>	
<small>JACK REED, RHODE ISLAND</small>	<small>JEFF SESSIONS, ALABAMA</small>	
<small>DANIEL K. AKAKA, HAWAII</small>	<small>SUSAN M. COLLINS, MAINE</small>	
<small>BILL NELSON, FLORIDA</small>	<small>SABY CHAMBLISS, GEORGIA</small>	
<small>E. BENJAMIN NELSON, NEBRASKA</small>	<small>LINDSEY O. GRAHAM, SOUTH CAROLINA</small>	
<small>EVAN BAYH, INDIANA</small>	<small>ELIZABETH DOLE, NORTH CAROLINA</small>	
<small>HILLARY RODHAM CLINTON, NEW YORK</small>	<small>JOHN CORNYN, TEXAS</small>	
<small>MARK L. FRYOR, ARKANSAS</small>	<small>JOHN THUNE, SOUTH DAKOTA</small>	
<small>JIM WEBB, VIRGINIA</small>	<small>MEL MARTINEZ, FLORIDA</small>	
<small>CLAIRE McCASKILL, MISSOURI</small>	<small>ROGER F. WICKER, MISSISSIPPI</small>	
<small>RICHARD D. DEBOES, STAFF DIRECTOR</small>		
<small>MICHAEL VINCENT KOSTIW, REPUBLICAN STAFF DIRECTOR</small>		

**United States Senate**  
COMMITTEE ON ARMED SERVICES  
WASHINGTON, DC 20510-6050

July 24, 2008

Mr. Gordon S. Heddell  
Acting Inspector General  
Department of Defense  
400 Army-Navy Drive  
Arlington, Virginia 22202-4704

Dear Mr. Heddell:

Earlier this week, the Government Accountability Office (GAO) issued a report entitled “DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet professional Standards Were Substantiated.” The report finds that: (1) “contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions, and opinions of three audits”; and (2) “DCAA managers took actions against staff at two locations, attempting to intimidate auditors, prevent them from speaking with investigators, and creating a generally abusive work environment.” DCAA disputes both of these findings.

The Committee and the Department rely heavily upon the independence and ethical conduct of our auditors to ensure proper oversight of the billions of dollars that we spend on the national defense every year. The two findings quoted above, if accurate, raise serious concerns about whether that reliance is well placed.

Accordingly, we ask that you review the GAO report and the DCAA response to that report and conduct any additional audit or investigative work that you believe is needed to determine whether the two quoted findings are supported by the evidence. If you conclude that the GAO findings are accurate, we ask that you make appropriate recommendations to the Secretary

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of Defense and the Committee as to accountability for any ethical violations or failures of leadership and any other remedial actions that may be required to address the problems that you identify.

Thank you for your attention to this request.

Sincerely,



John McCain  
Ranking Member



Carl Levin  
Chairman

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# Appendix F. Answers to Senate Committee on Armed Services Questions

By letter dated July 24, 2008, (see Appendix E) the Chairman and Ranking Member, Senate Armed Service Committee, asked us to determine whether two findings in the GAO report were supported by evidence. This appendix summarizes the results of our review regarding those findings.

**Finding 1:** "...contractor officials and the DoD contracting community improperly influenced the audit scope, conclusions, and opinions of three audits..." The GAO attributed this statement to Cases 1, 2, and 8. We found information supporting the GAO statement in one case (Case 2), but did not find supporting information for the other two cases (Cases 1 and 8).

Case 2. We determined in Case 2 that contractor officials and the DoD contracting community improperly influenced the scope, conclusions, and opinions of the audit. Our conclusions based on our review of Case 2 are contained in Finding B of this report. See pages 17 and 18 under "Actions Demonstrating Impairment of Independence," for discussion of this issue.

Case 1. We determined in Case 1 that contractor officials and the DoD contracting community<sup>35</sup> did not improperly influence the audit scope, conclusions, and opinions. DCAA conference notes documented that the contractor's representative "threatened" that if the report cited an "inadequate in part" opinion, the representative would escalate it to the highest level possible of the Government. Based on our experience, this type of response from contractors is not unusual, and we did not find evidence to indicate the contractor's "threat" impacted the review.

We did find that DCAA, by its own actions, impaired its independence. As part of an estimating system followup review, DCAA reviewed labor estimates for which it had previously provided feedback to the contractor on the draft versions as part of an integrated product team. In essence DCAA was reviewing its own work and had become part of the contractor's management control process contrary to the GAGAS independence standards. Although, we substantiated GAO's finding of impairment to DCAA independence, the corrective actions taken by DCAA relating to participating in integrated product teams in response to Case 1 should resolve the independence concerns. Further details on Case 1 are contained on pages 61 and 62 of Appendix D of this report.

Case 8. Our review of 18 of 62 price proposal audits performed by DCAA<sup>36</sup> at Location 3 did not confirm statements provided to GAO by two former supervisory auditors concerning undue pressure or influence by contracting officers causing external

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<sup>35</sup> DCAA is organizationally independent from the DoD contracting community, which consists of Military Department and Defense agencies acquisition and contracting officials.

<sup>36</sup> We reviewed the 18 audits performed by trainee auditors because GAO reported a concern that the trainee auditors at this location had not been properly supervised.

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impairments to DCAA auditors. The former supervisors cited short time frames of 20 to 30 days for completion of forward pricing audits as affecting the supervisors' ability to comply with GAGAS. The audit office performed 7 of 18 audits within 30 days. Seventeen of the 18 price proposal audits we reviewed did not comply with GAGAS. However, the GAGAS noncompliances did not appear to directly relate to the number of days allowed for audit completion.

**Finding 2:** "...DCAA managers took actions against staff at two locations, attempting to intimidate auditors, prevent them from speaking with investigators, and creating a generally abusive work environment."

We found one documented intimidating management action addressed to one individual. As described in Finding A, pages 4 – 10, we obtained sworn testimony from 68 current and former employees at the two locations of interest (97% of the employees). The only evidence we obtained regarding DCAA management preventing staff from speaking with investigators was the August 2007 memorandum addressed to one person. The memorandum cautioned that person not to share documentation or information for private purposes outside DCAA including pursuit of any complaints or other proceedings in any forum. That memorandum, which we considered both intimidating and substantively flawed, has been rescinded. No other employee told us that DCAA management asked that they not speak with investigators; directed them to withhold information; or prevented them from fully cooperating with investigators.

However, some employees told us they witnessed unprofessional behavior; felt undue time pressure because of unreasonable performance measures; and had their audit findings changed. We concluded that these factors in the work environment may have contributed to deficient audits. Although we attempted to determine if these conditions constituted an abusive work environment, we could not find a consistent criteria or definition for what conditions reflect a "generally abusive" work environment. Despite the lack of consistent criteria or definition, some employees may have considered the work environment conditions to be abusive.

# Defense Contract Audit Agency Comments



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

IN REPLY REFER TO

P 225.2 [D2008-DIP0AC-0259.000]

May 14, 2009

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

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft  
Report, *Follow-up Review on Defense Contract Audit Agency Audit Work  
Deficiencies and Abusive Work Environment Identified by the Government  
Accountability Office (Project No. D2008-DIP0AC-0259.000)*

Thank you for the opportunity to respond to the subject draft report, *Follow-up Review on  
Defense Contract Audit Agency Audit Work Deficiencies and Abusive Work Environment  
Identified by the Government Accountability Office*, provided to DCAA on April 14, 2009. We  
recommend the distribution of the subject report be limited due to the personnel issues identified.  
We believe that the personal privacy information contained in Findings A and B of this report is  
exempt from public release. As discussed between Ms. Diane Stetler, DoDIG, and Mr. Ken  
Saccoccia, DCAA, we will provide in a separate memorandum the portions of the report and this  
response that we believe should be exempt from public release.

DCAA concurs with all the DoDIG recommendations, except recommendation B.1.a.,  
which we believe cannot be adequately evaluated until additional information is obtained.  
DCAA is committed to taking the necessary corrective actions to protect the Government's  
interests. In the draft report, the DoDIG acknowledges several of the corrective actions DCAA  
has taken that they believe will correct the noncompliances reported by the GAO. Since the  
issuance of the DoDIG draft report, DCAA has completed several additional actions to which we  
note in the comments below. The following are DCAA's clarifying remarks to specific  
statements included in the narrative section of the draft report and DCAA's response to each of  
the recommendations directed to DCAA.

One of the most significant findings by the GAO is the conclusion that contracting  
officials and the DoD contracting community improperly influenced the audit scope and  
conclusion in three cases. The DoDIG substantiated the GAO findings in only one of the cases.  
In this case, the DoDIG is currently investigating the allegations of misconduct. [REDACTED]

b(6)

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P 225.2 [D2008-DIP0AC-0259.000]  
SUBJECT: Follow-up Review on Defense Contract Audit Agency Audit Work Deficiencies and  
Abusive Work Environment Identified by the Government Accountability Office  
(Project No. D2008-DIP0AC-0259.000)

Another significant finding by the GAO relates to GAO's report that DCAA management inappropriately changed the audit findings. The DoDIG found no additional cases of this and reported that, based on many of the auditor interviews, the audit opinions and findings were changed primarily because of insufficient support for the findings and disagreements on the significance of the issues. The DoDIG recognized that these may be appropriate reasons for changing the findings and opinions, provided the changes were adequately supported and documented. Since the issuance of the GAO report, DCAA has continually emphasized, through executive briefings and policy guidance, the need for adequate working paper documentation. DCAA is committed to continue to emphasize this important requirement of the auditing standards.

**A. Work Environment**

**Comments on Report Narrative:**

We take the results of the IG's conclusions on DCAA's work environment very seriously and concur with all the DoDIG recommendations. As noted by the DoDIG, DCAA has taken considerable actions to address the issues identified. One of the most important actions that we believe will improve DCAA's environment is DCAA's renewed emphasis on quality audits and the elimination of the prior productivity measures. However, we recognize this may not be sufficient to address the work environment and culture issues identified by the DoDIG. We have engaged the Naval Post Graduate School to assess DCAA's culture and assist in completing our "cultural transformation." The Post Graduate School has already commenced its efforts and will be meeting with the DCAA Executive Steering Committee in June 2009. We believe the results of these assessments and resulting actions will significantly improve the DCAA work environment.

In the DoDIG summary chart on the feedback received from the employee interviews, the IG reports that only one employee (out of all the employees interviewed) states that they received instruction from management to withhold information from investigative agencies. As the DoDIG notes in its Appendix F, this is the same employee already reported on by the GAO and no additional employees interviewed received this type of direction. In addition to rescinding the letter that was the source of the instruction to withhold the information, the

[REDACTED]

b(6)

As already noted by the DoDIG in its draft report, the DCAA Director has issued several memoranda strongly encouraging DCAA employee cooperation with investigative authorities.

**DoDIG Recommendation A.** We recommend that the Director, Defense Contract Audit Agency:

P 225.2 [D2008-DIP0AC-0259.000]

SUBJECT: Follow-up Review on Defense Contract Audit Agency Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office  
(Project No. D2008-DIP0AC-0259.000)

1. Consider appropriate corrective action regarding the performance of [REDACTED] associated with the majority of the non-compliant audits reviewed. b(6)

**DCAA Response: Concur.** [REDACTED] mentioned in the recommendation will re-take the supervisory courses at our Defense Contract Audit Institute. The Regional Director, Western Region, will also examine external courses that may be of assistance in further developing their management skills. [REDACTED]

b(6)

2. Provide training and direction to all employees, regardless of position, on:
  - a. what is appropriate professional behavior;
  - b. how to handle situations involving unprofessional behavior; and
  - c. how to report unprofessional behavior.

**DCAA Response: Concur.** DCAA has begun researching the best source for providing this training. To ensure objectivity and effectiveness, we plan to engage an outside organization to conduct the training on an Agency-wide basis. We plan to complete our research by August 2009 and provide the necessary training by the end of FY 2010.

3. Analyze the results of recent work environment assessments and surveys or other appropriate independent reviews of Defense Contract Audit Agency field audit offices' work environment.

**DCAA Response: Concur.** We will continue to analyze the results of work environment surveys and assessments and take proactive action to address the issues that surface. For example, we are completing our assessment of the OPM survey results on the organizational environment. We have developed an implementation plan and expect to share the DCAA Headquarters assessment with the workforce by July 31, 2009, with a definitive action plan for improvement.

4. Based on the analysis from Recommendation A.3, determine additional corrective actions required to address the pressures to work uncompensated overtime.

**DCAA Response: Concur.** As stated above, we will continue to analyze the results of the work environment surveys and assessment and take proactive actions to address issues that surface. However, based on the OPM survey results, there was no indication that the pressure to work uncompensated overtime is an Agency-wide issue. However, as part of briefing the Executive Steering Committee on the results and actions stemming

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P 225.2 [D2008-DIP0AC-0259.000]

SUBJECT: Follow-up Review on Defense Contract Audit Agency Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office  
(Project No. D2008-DIP0AC-0259.000)

from this DoDIG review, the Director will request the Regional Directors to reinforce to the DCAA workforce during their regular ongoing management and staff briefings that there is no expectation to work uncompensated overtime.

5. Provide a copy of the analysis and planned corrective actions from Recommendations A.3. and A.4. to the DoD Inspector General, Assistant Inspector General for Audit Policy and Oversight.

**DCAA Response: Concur.** DCAA will keep the DoDIG apprised of our corrective actions and provide the related supporting data. We will provide to the DoDIG a copy of the results of our OPM survey assessment that we provide to the workforce by July 31, 2009.

6. Perform an employee survey or assignment review to determine whether Western Region has satisfactorily implemented the policy on differences of audit opinions.

**DCAA Response: Concur.** By December 2009, the DCAA Policy and Plans Directorate will perform a review (to include assignment reviews and surveys) to assess compliance with the Agency's policy on handling disagreements of audit opinions in the Western Region.

**B. Continuing Audit Issues with Contractor A Related to a 2006 DCAA Proposal Audit (Evolved Expendable Launch Vehicle) (GAO Case 2)**

**DoDIG Recommendation B.1.** We recommend the Director, Defense Contract Audit Agency:

- a. Immediately rescind Defense Contract Audit Agency Audit Report No. 4461-2006A210000001, dated May 8, 2006.

**DCAA Response:** We reserve comments on Recommendation B.1.a because the DoDIG did not obtain input or comments from the Regional Audit Manager mentioned in the draft report. We do not know whether her input or comments would change the conclusion of the DoDIG. We were informed by the DoDIG that her comments were not obtained due to a separate on-going investigation of the same individual by the DoDIG. This response was discussed with Mr. Don Horstman, Deputy Inspector General, Policy and Oversight, by the Director, DCAA, on April 30, 2009 and he agreed with DCAA reserving comment pending completion of the separate investigation.

- b. Include the \$10.4 million of deferred production costs recovered by the Joint Venture contractor on Delta IV Launch Services contracts from the Government on two ordered

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missions (Geostationary Operational Environmental Satellites O and P) in the Defense Contract Audit Agency corrective action plan.

**DCAA Response: Concur.** We are currently reviewing the facts associated with the \$10.4 million of deferred production costs associated with ordered missions Geostationary Operational Environmental Satellites (GOES) O and P. Preliminarily, we have determined that the GOES O and P missions were contracted for via a NASA firm-fixed price contract. We will review the proposal for this contract and assess if it includes deferred production costs. If we find the proposal does include deferred production costs, we will work with the contracting officer and pursue recovery of those costs. We expect to complete our review by September 2009.

- c. Create a mechanism for reporting external impairments in the Quality Control System described in Chapter 2 of the Defense Contract Audit Agency Contract Audit Manual, where auditors can report suspected external impairments to auditor independence by co-workers, supervisors, or managers to the Defense Contract Audit Agency General Counsel.
  - 1) Document the reporting mechanism for external impairment, including policies and procedures, management controls, documentation requirements, etc., in the Defense Contract Audit Agency Quality Control System.
  - 2) Provide procedures to include the reporting mechanism for external impairment in the Administration of the Defense Contract Audit Agency Quality Control System, also described in Chapter 2 of the Defense Contract Audit Agency Contract Audit Manual.

**DCAA Response: Concur.** The DCAA's Quality Control System already covers the reporting of external impairments. CAM Section 2-S10 Supplement – Description of DCAA Quality Control System, requires the reporting of external impairments. CAM Section 2-S103.1b.(3) states:

Occasionally, factors external to DCAA may restrict the audit or interfere with the auditor's ability to form independent and object opinions and conclusions. When a limitation is identified, every effort should be made to remove the limitation or, failing that, report the limitation. DCAA expects each auditor to exercise prudent judgment in establishing audit scope, auditing procedures, and appropriate reporting of results.

CAM Section 2-S103.1b(4) also states:

5

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Each auditor is responsible for notifying his or her supervisor of any actual or potential personal or external impairment in writing.

Therefore, if an auditor believes an external impairment exists, it should be reported to the supervisor. However, to address the IG's concerns, we will expand this guidance to address reporting that relates to suspected external impairments to auditor independence by co-workers, supervisors, or managers and require this reporting to the DCAA General Counsel's office. We will revise our guidance by June 30, 2009.

- d. Establish a policy or procedure on coordination of audit procedures and positions between Defense Contract Audit Agency cognizant offices on the Delta IV Evolved Expendable Launch Vehicle and the Evolved Expendable Launch Vehicle joint venture.

**DCAA Response: Concur.** This process has already been established. Effective May 2009, the Rocky Mountain Branch Office will lead a bi-weekly teleconference to discuss major issues relating to the Delta IV Evolved Expendable Launch Vehicle and the Evolved Expendable Launch Vehicle joint venture.

- e. Issue audit guidance requiring the issuance of a separate Cost Accounting Standard noncompliance report whenever the auditor discovers instances of Cost Accounting Standard noncompliance during the performance of any type of forward pricing audit activity, as currently required by the Defense Contract Audit Agency Audit Manual, Section 8-302.7.c.

**DCAA Response: Concur.** By July 2009, DCAA will issue an audit alert emphasizing the guidance contained in CAM 8-302.7.c that a separate CAS noncompliance audit report will be issued when the noncompliance is found in any DCAA audit.

### C. Audit of Defective Pricing on Freight-out Changes (GAO Case 3)

#### Comments on Report Narrative:

Based on the findings by the GAO, DCAA rescinded three postaward audits reports due to the audits not complying with GAGAS. On September 15, 2008, we informed the contracting officer that the reports should not be relied upon and no further action was necessary since the contracting officer settled the issue. The DoDIG report states that DCAA did not explain to the contracting officer why it rescinded the defective pricing reports. The DoDIG believes the rescission of the reports gives the impression that defective pricing may exist. We disagree, as we stated in the memorandum that no further action is necessary.

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Nevertheless, we will communicate with the contracting officer to ensure his understanding as to why the reports were rescinded and that no defective pricing exists.

The DoDIG concluded that DCAA provided ineffective audit services and advice when it performed incurred cost verification audits and declined to advise the contracting officer on the contractor's proposed settlement. It should be noted that DCAA provided the incurred cost verifications at the request of the contracting officer. Additionally, the DCAA supervisor did advise the contracting officer on the inadequacy of the contractor's cost impact submission, but did not believe it was appropriate to comment on the contracting officer's negotiation position, as that is beyond the role of the independent audit. DCAA's role is to provide an independent audit to assist the contracting officer in making a final determination. An independence concern may exist if DCAA were to provide an opinion on a negotiation position.

In response to the DoDIG comments on the lack of clarity in the audit lead, we will re-issue the audit lead to clarify the material handling costs represent unallowable costs as determined by the ACO and will specify the appropriate time period.

**DoDIG Recommendation C.** We recommend that the Branch Manager, Defense Contract Audit Agency Location 2:

1. Require branch manager approval in responding to contracting officer requests for audit assistance.

**DCAA Response: Concur.** Due to conditions found at this FAO, DCAA will institute additional management controls for a one-year time period commencing July 1, 2009. The branch manager will approve all correspondence responding to contracting officer requests for audit assistance for this time period for other than forward pricing audits. We believe limiting this process to other than forward pricing audits will meet the DoDIG's objectives based on the conditions found in this case and make it manageable for the FAO to implement. During this time, the branch manager will provide the necessary supervisory feedback to ensure supervisors are supportive to the contracting officers' requests while maintaining the necessary auditor independence required by the standards. After this time period, the branch manager will assess the need to further continue this process and provide her recommendation to the Regional Director for his decision.

2. Issue a memorandum to the contracting officer to explain why the Defense Contract Audit Agency rescinded the three defective pricing audit reports.

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**DCAA Response: Concur.** By May 31, 2009, DCAA will issue the memorandum to the contracting officer that the three reports were rescinded due to the audit work not complying with GAGAS. We will also clarify to the contracting officer that this does not mean that positive defective pricing was found.

3. Rescind the three incurred cost verification Audit Report Numbers 4181-2003117900009, 4181-2003117900010, and 4181-2003117900011.

**DCAA Response: Concur.** Although we believe DCAA complied with the contracting officer's request to address the DoDIG's concerns, DCAA will rescind the subject reports by May 31, 2009. DCAA will state that these reports are being rescinded since the DoDIG concluded that these reports were not value added to the contracting officer in his pursuit of a final settlement.

#### D. Audit of Billing System (GAO Case 4)

##### Comments on Report Narrative:

On May 1, 2009, DCAA issued its report on the contractor's accounting system and found the system was inadequate for accumulating and billing costs under Government contracts. In the report, we recommended the contracting officer pursue contract payment withholds until the contractor corrects its system. The contractor will remain off direct billing until the contractor has corrected its system and DCAA completes a follow-up audit and ensures the contractor has implemented corrective actions.

**DoDIG Recommendation D.** We recommend the Director, Defense Contract Audit Agency:

1. Revise guidance on ongoing surveillance for nonmajor contractors to ensure field audit offices gather and maintain sufficient evidence related to evaluation of billing system internal controls to support the contractor's continued participation in the direct bill program.

**DCAA Response: Concur in principle.** By September 30, 2009, DCAA will complete its assessment of the current guidance for ensuring that sufficient evidence is obtained to support the nonmajor contractor's continued participation in the direct bill program. We have already begun our assessment and, preliminarily, we have concluded that our assignment for annual testing for contractor eligibility for direct bill is sufficient evidence to support a nonmajor contractor's eligibility for continuing on the direct bill program. We believe this is sufficient evidence as all payments, whether they are subject to direct bill or not, are provisional and subject to later audit. For nonmajor contractors, we do not believe the risks warrant an evaluation of the billing system internal controls. During the annual testing of contractor eligibility for direct bill assignment, we perform a review of

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contractor billings to ensure that they have been provisionally paid in accordance with contracts terms and conditions. In October 2008, we issued guidance emphasizing the need to ensure a sufficient number of paid vouchers are reviewed during this assignment to provide reasonable assurance that the contractor's procedures continue to be acceptable for direct billing. However, we agree with the DoDIG that current Agency guidance states that an annual testing is not required at all nonmajor contractors. To address these concerns, we will revise our Agency guidance to require these reviews to be performed on an annual basis at contractors with ADV greater than \$15 million. We will continue to sample the contractors at less than \$15 million, but ensure the testing occurs at least every three years.

2. Direct Headquarters Quality Assurance Division to perform a review of nonmajor contractors' participation in the direct bill program to verify that sufficient evidence exists to support their participation.

**DCAA Response: Concur.** We believe it would be a better use of Government resources to perform this review after the implementation of the revised Agency policy, as described above. Once the policy has been implemented, the DCAA Policy and Plans Directorate will perform a review of nonmajor contractor participation in the direct bill program to ensure compliance with the policy. We believe it would be more appropriate for the Policy and Plans Directorate to perform this review, as the Integrity and Quality Assurance Directorate is dedicated to performing CIGIE-based reviews. We plan to complete our review by September 2010.

3. Issue guidance requiring immediate removal of a contractor from direct bill when sufficient evidence is not available to support the authorization to direct bill.

**DCAA Response: Concur.** On April 15, 2009, DCAA issued guidance requiring DCAA offices cognizant at major contractors to assess if the current contractor billing systems have been audited and deemed to be adequate. If not, the auditor was required to take the contractor off the direct bill program within 30 days and commence a new billing system audit. By September 2009, DCAA will revise Agency policy requiring eligibility for direct bill reviews to be performed annually at contractors with ADV greater than \$15 million. We will require completion of the FY 2010 reviews by March 2010. If deficiencies are found in these reviews, DCAA will remove the contractor from direct bill within 30 days. We will revise our guidance to require the performance of these reviews at contractors with ADV less than \$15 million on a three-year cyclical basis and take the contractor off direct bill, if deficiencies are found. We believe that by performing these annual reviews at nonmajor contractors with ADV greater than \$15 million, and cyclical reviews at contractors with ADV less than \$15 million, this process will provide sufficient evidence to support a contractor on direct bill.

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**E. Forward Pricing Audits (GAO Case 8)**

**DoDIG Recommendation E.1.** We recommend the Director, Defense Contract Audit Agency:

- a. Include the revised Computer Managed Training Library Course 1269, "Working Paper Documentation," in the required auditor training curriculum.

**DCAA Response: Concur.** We will include the substance of the CMTL in the training curriculum as we revise our training as part of our Strategic Plan Objective on life-cycle training. In the interim, we will require all auditors to complete the subject training by November 30, 2009.

- b. Direct the Quality Assurance Division to perform an internal quality assurance review of Location 3 and the new field audit office to assess the quality of current audit work and follow-up on appropriate actions to correct any identified deficiencies.

**DCAA Response: Concur.** We will perform a QA review by December 2009 at Location 3 and the new field audit office.

**DoDIG Recommendation E.2.** We recommend the Resident Auditor, Defense Contract Audit Agency Location 3, perform postaward reviews of all firm-fixed priced contracts, including any associated forward pricing rate agreements awarded over \$10 million, where the supervisor approved the working papers after report issuance, as discussed in Case 8 of the GAO investigative report.

**DCAA Response: Concur.** We will perform postaward audits of the firm-fixed price contracts awarded over \$10 million. We will complete these reviews by June 2010.

**F. Audit of Compensation System (GAO Case 9)**

**DoDIG Recommendation F.** We recommend the Branch Manager, Defense Contract Audit Agency Location 2, issue a supplemental audit report to correct the report qualification.

**DCAA Response: Concur.** We will supplement this report by July 31, 2009 to address the DoDIG's concerns. However, we are currently assessing the guidance contained in CAM 5-812.3 and the need for including a qualification on fringe benefits in every compensation system audit report.

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#### H. DCAA Audit of Billing System (GAO Case 11)

**DoDIG Recommendations H.1.** We recommend the Director, Defense Contract Audit Agency promptly incorporate its clarified procedures on reporting internal control deficiencies into the Defense Contract Audit Agency Contract Audit Manual.

**DCAA Response: Concur.** DCAA will incorporate the new internal control guidance in the CAM by September 2009. It should be noted that DCAA Policy and Plans delayed incorporating the March 2008 guidance into CAM because the guidance was being re-visited due to questions arising from the field and the on-going GAO review. In December 2008, DCAA issued revised comprehensive guidance to strengthen our reporting for compliance with GAGAS. The DCAA guidance was revised to (1) clarify reporting significant deficiencies, (2) eliminate the “inadequate in part” audit opinion, and (3) eliminate the reporting of suggestions for improvement.

**DoDIG Recommendation H.2.** We recommend the Branch Manager, Defense Contract Audit Agency Location 2, immediately rescind Audit Report No. 4181-2005A12030001 and notify contracting officials who received the report not to place any reliance on its conclusions. (Note: We confirmed with the DoDIG that the report number is a typographical error. It should cite Audit Report No. 4181-2006111010001.)

**DCAA Response: Concur.** DCAA rescinded Audit Report No. 4181-2006111010001 on April 13, 2009 and completed its contractor eligibility for direct bill assignment. During this assignment, DCAA found billing system deficiencies and issued a flash report on April 9, 2009. DCAA will perform a full billing system audit in the near future.

#### I. Labor Floor Check (GAO Case 12)

**DoDIG Recommendation I.** We recommend the Branch Manager, Defense Contract Audit Agency Location 2, perform the actions required to identify any negative impact to the Government as a result of the unrecorded uncompensated overtime issue for FY 2004 through FY 2007.

**DCAA Response: Concur.** DCAA is currently performing steps to identify any negative impact to the Government as a result of the unrecorded uncompensated overtime for the time period 2004 through 2008. We expect to complete our assessment by August 31, 2009. However, DCAA concentrated its efforts on assessing the current significance of this practice to prompt immediate corrective action, if necessary. On April 29, 2009, DCAA completed its labor charging practice assignment (2008K13500001) and reported several deficiencies with the contractor’s labor system. One of the major DCAA findings related to the potential

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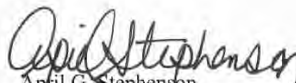
SUBJECT: Follow-up Review on Defense Contract Audit Agency Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office  
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significant impact to Government contracts of the contractor's practice of not reporting uncompensated overtime. DCAA recommended that the contractor revise its labor recording system to require all employees to record all hours worked, and also recommended the contracting officer pursue a withhold of contractor payments until the contractor takes corrective action. In addition, on May 1, 2009, DCAA incorporated these deficiencies into our audit of the contractor's accounting system and opined that the contractor's accounting and billing systems were inadequate for accumulating and billing costs under U.S. Government contracts. In this report, DCAA again recommended the contracting officer pursue a withhold of contractor payments until the contractor takes corrective action. In addition, as the IG noted, this deficiency also affects the contractor's estimates used in pricing proposals. We have completed our audit of the contractor's cost estimate development portion of its estimating system and concluded the system as inadequate. We have cited the contractor for several deficiencies, including the unreliable estimates based on the contractor not recording all hours worked. In this report, issued April 29, 2009, we recommended the contracting officer disapprove the contractor's system and pursue the suspension of contractor payments.

**K. Comment on Appendix D. DCAA Corrective Actions for Specific Cases**

In Appendix D, the DoDIG reports that the DCAA has satisfactorily completed the necessary actions with respect to the GAO reported Cases 1, 8, and 13. As part of this Appendix, the DoDIG also identifies the actions still in process relating to Cases 5, 6, and 7, to which the IG believes to be the appropriate actions. For Case 5, DCAA has completed its audit of the cost estimating development portion of the contractor's estimating system and issued its report on April 29, 2009. DCAA reported the contractor estimating system as inadequate and recommended the contracting officer disapprove the system and pursue withholds of contract payments.

Questions regarding this memorandum should be directed to the undersigned at (703) 767-3200 or Mr. Ken Saccoccia, Assistant Director, Policy and Plans Directorate at (703) 767-3280.

  
April G. Stephenson  
Director

# Department of the Air Force Headquarters Space & Missile Systems Center Comments



DEPARTMENT OF THE AIR FORCE  
HEADQUARTERS SPACE AND MISSILE SYSTEMS CENTER (AFSPC)  
LOS ANGELES AIR FORCE BASE, CALIFORNIA

18 May 2009

MEMORANDUM FOR DOD INSPECTOR GENERAL

FROM: SMC/CV  
483 N. Aviation Blvd  
El Segundo CA 90245-2808

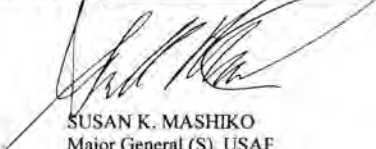
SUBJECT: Follow-up Review on Defense Contract Audit Agency Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office  
Reference: Project No. D2008-DIP0AC-0259-000

1. The Delta IV EELV Launch Capabilities (ELC) Contract was a complicated procurement action. Attached is a point paper which provides background information regarding the deferred costs associated with this procurement effort that were the primary concern in this report. Space and Missiles Systems Center's (SMC) comments to the subject report are included in Attachment 2. The comments are contained in Case B of the report and are reflected in blue italics.

2. Recommendation B.2 of the report is directed to SMC. We concur with Recommendation B.2 and have taken action to implement it immediately. Recommendation B.2.a was implemented 21 October 2008. Implementation of Recommendation B.2.b is ongoing.

3. If you have any additional questions, please contact either [REDACTED] or [REDACTED]

b(6)

  
SUSAN K. MASHIKO  
Major General (S), USAF  
Vice Commander

Attachments:  
1. Point Paper – Deferred Costs  
2. Comments

INTEGRITY, SERVICE, EXCELLENCE

POINT PAPER

ON

DEFERRED COSTS--EELV DELTA IV ELC CONTRACT

**PURPOSE**

- Provide information on the Launch and Range Systems Wing (LRSW) recognition of deferred costs under contract FA8816-06-C-0001 Delta IV Evolved Launch Capability (ELC) contract

**DISCUSSION**

- The Boeing ELC 2006 award was a difficult, first-of-a-kind evaluation; complexity introduced legitimate questions/challenges prior to negotiated award
  - Complexity recognized/worked by all involved agencies (Air Force, Defense Contract Audit Agency (DCAA), Defense Contract Management Agency (DCMA), and Boeing)
  - Initiated "Buy 3" strategy moving from commercial FAR Part 12 contract to FAR Part 15
  - Move to this new FAR Part 15 strategy created novel, complex accounting issues
    - Lot cost accounting involves allocation of costs, averaged over an agreed-to quantity of items, resulting in the deferral of recoupment of these costs until the last item is purchased
    - Realignment of life cycle (lot cost) accounting method to an annual Cost Plus Award Fee (CPAF) type contract prior to all costs being recouped under the initial lot cost method
      - Lot Cost Accounting was the approved accounting method for Boeing per an advance agreement executed by Boeing and DCMA
    - Quantifying "deferred support costs" (management and support labor costs accrued in prior years)
    - Determining firm subcontractor prices for large commercial lot buys
- SMC Procuring Contracting Officer (PCO) relied on DCAA audits, Advance Agreements entered into by the DCMA Divisional Administrative Contracting Officer (DACO)
- Results of Contract Management Board of Review for Advance Agreements (3-4 Nov 2006) also supported recognition of lot cost accounting and deferred support costs; board included senior representatives from DCMA, DCAA, SMC, and SAF/GC
- Advance agreement entered into between Boeing Launch Services and the USG 8 Nov 2006 agreeing that \$271,152,672 in costs were incurred and placed into inventory prior to June 1, 2006 but weren't allocable or payable under contracts prior to this date. Government agreed on a method to pay for 1/8 share of amount as fixed price line item of future contracts if awarded
- Advance agreement entered into between Boeing Launch Services and the USG 4 Nov 2006 where the DACO found Lot Accounting a compliant practice under the Cost Accounting Standards
- ELC settlement relied on DCAA Audits and Boeing's certified cost/pricing data, SMC technical evaluation, and DCMA rate checks; settlement position reviewed/approved by clearance authority prior to award

6 Nov 08,

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**CONCLUSION**

- At time of award, the Air Force, DCAA, & DCMA determined Delta ELC contract was consistent with all Federal Laws, Regulations and Policies, and did not include any reimbursement for past losses (prior bad business decisions)
- Deferred support costs were recognized in an Advance Agreement executed by DCMA and Boeing prior to contract award
- Air Force actions in awarding the ELC Contract were consistent within the Federal Acquisition Regulations, Air Force Policies and Regulations
- Deferred support costs are isolated as a stand-alone CLIN. If, as a result of subsequent DCAA reviews, a finding is made that the deferred support costs in question are unallowable; the Air Force is postured to take action to make an appropriate contract adjustment



**DEPARTMENT OF THE AIR FORCE**  
HEADQUARTERS LAUNCH AND RANGE SYSTEMS WING (AFSPC)  
LOS ANGELES AIR FORCE BASE CALIFORNIA

18 May 2009

MEMORANDUM FOR SMC/CV

FROM: LRSW/CV  
483 N. Aviation Blvd  
El Segundo, CA 90245-2808

SUBJECT: LRSW's Comments on the Follow-up Review on Defense Contract Audit Agency  
Audit Work Deficiencies and Abusive Work Environment Identified by the  
Government Accountability Office (Project No. D2008-DIP0AC-0259-000)

1. The following are LRSW's comments to subject report:

a. Page 11, Table 4. Proposed Costs and Payments – EELV. The sequence of events and amounts reflected in Table 4 appear to imply that the Delta IV deferred program management and hardware support costs, and deferred production costs, represent recoupment of contractor losses. If this is the intent, we believe this to be an unsupported conclusion. An attempt to clarify the raw information contained in the table follows.

(1) Amount \$333.3 million -- Total pool was \$445M. Boeing had anticipated repayment over a four year period. The ELC RFP covered three years period of performance; hence, Boeing proposed recoupment of 75% of the total pool over a three year period.

(2) Amount \$133.3 million -- In response to a lack of budget, AF opted not to negotiate any costs for FY08. In the Jan 2006 time period, the Contractor re-proposed the total pool of unabsorbed PM&HS at \$400M. The Contractor changed their assumptions regarding recoupment occurring over a four year period to recoupment over a six year period. The Government elected to negotiate only two years (06/07) because of insufficient budget to close on 2008.

(3) Amount \$64.7 million -- DCAA took exception to \$194.1M of the total \$400M cost pool proposed by the Contractor. Of the \$133.3M proposed for the two year ELC period of performance, DCAA questioned \$64.7M. The payment of \$67.7M represents two of the eight year period negotiated for recoupment by the contractor.

(4) Amount \$33.9 million -- \$33.9M represents annual amortization over EIGHT years. CLINs 1501 (FY06) & 1502 (FY07) were billed on Invoice SER0001 and paid on 8 Jan 07. CLIN 1503 (FY08) was billed on several invoices; 1<sup>st</sup> payment was on 19 Nov 07 and 2<sup>nd</sup> payment was on 25 Sep 08 for a total of \$24M (the remainder is on hold).

GUARDIANS OF THE HIGH FRONTIER

(5) Amount \$268 million -- Recognizing that SMC did not have an audit report addressing deferred production costs, the Contracting Officer obtained a NTE amount from ULA that could be used in the event a Government position on deferred production could not be determined prior to negotiating ELS award.

(6) Amount \$10.4 million -- Recommend obtaining NASA comment. SMC has no insight as to what NASA negotiated.

h. Page 15, paragraph starting "The DCAA RAM attended a meeting of top leadership ..." [REDACTED] all SMC representatives, were present at an interview meeting with DoDIG investigators and [REDACTED] (former SMC Exec Dir) in fall 08. These SMC representatives do not recall [REDACTED] using the terminology "roadblocks" in describing the purpose of the December 2005 meeting. In any event, the purpose of the meeting was to identify open Government and Contractor issues and discuss potential paths to resolution.

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c. Page 17, paragraph starting "The DCAA RAM did not act objectively when overturning the audit ..." The Contractor did not use a 15-year lot. The Contractor (Boeing) always maintained that Lot 949 was defined as 42 Common Booster Cores (CBC) irregardless of time and number of missions. Some missions use three CBCs (such as a heavy) versus one CBC for medium/intermediate.

d. Page 18, Advance Agreements. The Advance Agreement was to delay negotiations of Deferred Production Costs on any Delta ELS Contract pending audit of these costs by DCAA. Inasmuch as DCAA has completed the audit of Deferred Production Costs, the Government will be utilizing the DCAA recommendation in negotiating the Delta ELS missions.

e. Page 19, paragraph starting "For the record, the Joint Venture had disclosed to SMC upon submittal of its \$114 ..." The statement about NASA paying \$10.4 million for DPC cannot be verified by the SMC.

f. Page 19, paragraph starting "Joint Venture Assessment of Lot Accounting ..." When the original ILS Contracts were awarded in 1998, lot accounting was acceptable under the GAAP rules and prior to the Joint Venture.

g. Page 21, Recommendation B.2.a. SMC has implemented this recommendation by suspending further payments. The Contractor was paid \$24M of the \$33.8M in FY08 (the remainder has been put on hold as well as the FY09 funds per SMC direction) for Deferred Support Costs under the Delta ELC Contract pending a re-audit of these costs by DCAA which is ongoing.

i. Page 21, Recommendation B.2.b. SMC stands ready to take appropriate corrective actions to remedy any deficiencies that may have occurred resulting from the DCAA audit of the Contractor's Delta IV EELV ELC proposal and shall track and document all future contracting officer actions taken in this regard.

2. SMC has included two provisions in the ELC Contracts to prevent recovery of previous losses

a. All invoices and vouchers shall include the following statement: "No costs defined as "unrecoverable costs" in SMC-H030, Limitation of Recovery of Prior Costs, have been included in this invoice"

b. SMC--H030 LIMITATION ON RECOVERY OF PRIOR COSTS (JUN 2006)

a) The parties agree that Contractor's Contractor-Sponsored Research & Development costs associated with the OTA agreement will not be allowable or allocable costs to this Contract or any other future FAR Part 15 Contract. This limitation is consistent with the new EELV Acquisition Strategy as well as Cost Accounting Standards.

b) Under the Interdependent Initial Launch Services Contract No. F04701-98-D-0002 ("ILS Contract"), the Parties entered into contract modification P00057. The contract modification documents the Parties agreement for the release of the Government's asserted right to partially terminate the ILS Contract. The contract modification was executed by the Contractor on 16 October 2003. The cost of 11 specific, awarded missions increased by a cumulative total of \$146M based upon paragraph (b) of the contract modification (P00057). Under the terms of the modification, the Contractor agreed that it would not allocate the \$146M in increased costs to any of its future Government missions, and the costs were expressly deemed unrecoverable. Under the terms of P00057, the Contractor also agreed to a \$17M loss on NROL-25 based upon the price for the mission. The \$17M loss was expressly deemed unrecoverable, and the Contractor agreed the loss would not be allocated to any of its future Government missions. The \$146M in increased costs and the \$17M loss will collectively herein after be referred to as "Unrecoverable Costs."

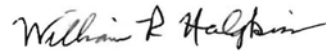
c) The Parties acknowledge and agree that the "Unrecoverable Costs" remain unrecoverable costs under the Contract. The Parties further agree that said costs will not be charged to the Government under this Contract. No portion of the Unrecoverable Costs will be included as part of any proposals for work to be performed under the contemplated Interdependent EELV Launch Service (ELS) Contract, as said proposals will be prepared using the capability provided by this Contract. Additionally, when common production lot 949 ("Lot 1") is closed (i.e., all Lot 2 end items have been allocated to contracts), the Contractor will provide documentation to the Government which demonstrates that at least \$146M in incurred costs remains unrecovered on the 11 missions listed in P00057,

paragraph (c)(ii). At such time, the Contractor will also provide documentation supporting the actual costs incurred on the NROL-25 mission.

d) This provision is not intended to, and does not, expand, limit, change or in any way affect the rights and obligations of the parties with regard to the ILS contract modification P00057. The Parties' rights and obligations with regard to the contract modification will continue to be governed by the terms of the ILS Contract as well as the terms of the contract modification itself.

3. If you have any additional questions, please contact either [REDACTED]  
or [REDACTED]

b(6)



WILLIAM R. HODGKISS, Colonel, USAF  
Vice Commander  
Launch and Range Systems Wing

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# Defense Contract Management Agency Comments



**DEFENSE CONTRACT MANAGEMENT AGENCY**  
6350 WALKER LANE, SUITE 300  
ALEXANDRIA, VA 22310-3241

MAY 1 - 2009

IN REPLY  
REFER TO

AQ

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT POLICY  
AND OVERSIGHT

SUBJECT: DoD IG Draft Audit Report, Project No. D2008-DIPOAC-0259.000,  
Followup Review on Defense Contract Audit Agency Audit Work  
Deficiencies and Abusive Work Environment Identified by the Government  
Accountability Office

This is in response to your April 15, 2009 request to provide comments on  
Recommendations B.3.a and B.3.b. of the subject report.

**Recommendation B.3.a.** We recommend the Executive Director, Contracts, Defense  
Contract Management Agency abide by the actions identified in his November 18, 2008,  
memorandum to DoD Inspector General, including the plan to reassess the identified  
advance agreements pending receipt of the newly initiated Defense Contract Audit  
Agency audits.

**Response:** Concur. As previously reported, DCMA has suspended any further deferred  
support payments subject to these advance agreements. DCMA is awaiting issuance of  
the in-process DCAA audit report and will make a determination on the compliance of  
the cost accounting practices, the potential cost impact to the Government, and  
disposition of the advance agreements. DCAA has not provided us a projected date for  
receipt of the audit report.

**Recommendation B.3.b.** We recommend the Executive Director, Contracts, Defense  
Contract Management Agency track and document all contracting officer actions,  
proposed and taken, as a result of any audit reports issued by DCAA to remedy the  
deficiencies that occurred during the audit of the contractor's Delta IV Evolved  
Expendable Launch Vehicle V Launch Capability proposals, including the proposed  
advance agreements.

**Response:** Concur. DCMA will track and document all contracting officer actions as  
recommended by the DoD IG. In addition, the actions will be subject to the DCMA  
Board of Review process.

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Please contact [REDACTED] at [REDACTED] if additional information is required.

b(6)



DAVID E. RIECI  
Executive Director  
Contracts

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Inspector General  
Department *of* Defense

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