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REPORT TO
THE CONGRESS OF THE UNITED STATES

SURVEY OF REVIEWS
BY
THE DEFENSE CONTRACT AUDIT AGENCY
OF
CONTRACTORS' PRICE PROPOSALS SUBJECT TO
PUBLIC LAW 87-653

DEPARTMENT OF DEFENSE



BY
THE COMPTROLLER GENERAL
OF THE UNITED STATES

FEBRUARY 1967

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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February 15, 1967

To the President of the Senate and the
Speaker of the House of Representatives

The accompanying report presents the results of a nationwide survey which we made in response to interest expressed by the Committee on Government Operations, House of Representatives, in strengthening contract audit work in the Department of Defense.

Since July 1965 this audit work has been performed by the Defense Contract Audit Agency, a new agency formed at the direction of the Secretary of Defense by consolidating various contract audit staffs formerly assigned to the three military departments,

We directed our attention to the Agency's responsibility for making reviews of contract pricing proposals negotiated without the safeguards of competition. These reviews, which are made prior to negotiation with the contractor, constitute a substantial portion of the Agency's workload and are accorded the highest priority,

Our survey included work at Agency audit sites at 20 plants of private companies generally among the top 100 defense contractors in the United States.

The Agency is making significant progress. But our survey showed that, in order to operate more effectively with its workload of many thousands of contract pricing proposals totaling over \$40 billion annually, improvements are needed in four areas, as summarized below.

1. Prices of most defense procurement contracts are based largely on estimated costs in proposals submitted by contractors as a basis for negotiation. Nationwide and individual reviews in recent years by military procurement and audit organizations--as well as current surveys by the Defense Contract Audit Agency--have disclosed a need for major contractors to improve and incorporate into a formal system their estimating methods and procedures. This would provide greater management control over the estimating processes used in preparing price proposals, and facilitate review and negotiation.

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We brought this problem to the attention of top Defense officials in a preliminary report and in a special briefing. In January of this year, the Department released a Defense Procurement Circular, effective immediately, designed to attain a number of improvements, including :

Policy guidance to procurement officials and auditors,
Criteria for acceptable cost estimating systems.
Reasons why these systems benefit industry as well as Government.
Steps to be taken to correct present deficiencies.

This action by the Department is important and commendable, We are recommending in the report some steps to help carry out the new directive.

2. In a number of instances defense auditors did not review significant cost estimates in price proposals, This was due in part to a carryover of practices followed by former audit organizations when responsibilities for reviews of proposals were less than those currently specified in procurement regulations. The Department told us that actions are underway--or are planned--to correct this situation, We are recommending that the Secretary of Defense review these corrective efforts within the next year.

3. Defense auditors ordinarily were not receiving information from procurement officials on the usefulness of their audits in negotiations or on ways that their services could be more effective in future negotiations. The Department has acted on our proposal to provide this type of "feedback" to its auditors.

4. Defense auditors have experienced difficulties, when reviewing proposed contract prices, in obtaining what they considered to be sufficient access to contractors' records, The Department informed us that new guidelines had been issued to help resolve these access-to-records problems. If this action is supported by continuous assistance from procurement officials, at all levels, it should improve the situation.

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In a prior report to ~~the~~ Congress (B-158193, February 1966), we recommended that the Defense Department establish a regularly scheduled program to administer the defective pricing provisions required in certain types of negotiated contracts by Public Law 87-653--"The Truth in Negotiation Act."

This law provides for price adjustments in favor of the Government when it is found that established prices have been increased significantly because of defective data used in negotiations. A program for these reviews was established by the Defense Contract Audit Agency during 1964. Reviews have been initiated, and we plan to examine the progress of the program this year.

Copies of **this** report are being sent to the Director, Bureau of the Budget; the Secretary of Defense; and the heads of other agencies which make significant use of the services of the Defense Contract Audit Agency.



Comptroller General
of the United States

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SURVEY OF REVIEWS
BY
THE DEFENSE CONTRACT AUDIT AGENCY
OF
CONTRACTORS! PRICE PROPOSALS SUBJECT TO
PUBLIC LAW 87-653
DEPARTMENT OF DEFENSE

INTRODUCTION

The General Accounting Office has made a survey of reviews by the Defense Contract Audit Agency (DCAA) of contractors' price proposals subject to Public Law 87-653. We conducted this survey because of interest expressed by the Committee on Government Operations, House of Representatives, in strengthening contract audit work in the Department of Defense.

Our survey was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53); the Accounting and Auditing Act of 1950 (31 U.S.C. 67); and the authority of the Comptroller General to examine contractors' records, as set forth in contract clauses prescribed by 10 U.S.C. 2313(b).

This being our first survey of DCAA, we directed our attention primarily to DCAA's responsibilities for audit activities relating to noncompetitive proposals subject to Public Law 87-653 where the price negotiated is based largely on cost or pricing data furnished by the contractor. We concentrated on this area because of the large number and value of contracts negotiated by the Department of Defense (DOD) under noncompetitive conditions, the importance of DCAA's role in evaluating the contractor's cost and pricing data

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for use in contract negotiations, and the high priority and significant amount of effort DCAA **devotes** to this area. The scope of our survey is set forth on page 38.

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BACKGROUND

The Secretary of Defense on June 9, 1965, consolidated the contract audit functions of the Army, Navy, Air Force, and Defense Supply Agency by establishing DCAA under his direction, authority, and control. As of July 1, 1965, DCAA assumed responsibility for all contract audit work within DOD. The Assistant Secretary of Defense (Comptroller) was assigned the responsibility for providing primary direction to the Director, DCAA, on the principles and policies to be followed in connection with technical, organizational, and administrative matters relating to contract audits.

DCAA was established to increase the efficiency and to lower the Government's cost of auditing defense contracts. The establishment of a single contract audit organization at the Defense agency level was to permit contract audit to become a more effective force than when it was fragmented in the military departments. Also, contract audit now presents a single face, at the DOD level, both to the contractors and to the procurement agencies of the military departments.

Headquarters, DCAA, is located in Cameron Station, Virginia, and its seven regional offices are located in principal cities throughout the continental United States. Under their supervision, as of March 1, 1966, there were **308** field audit offices located throughout the country and overseas in the form of resident, branch, procurement liaison, and suboffices. These field offices, which were assigned about 85 percent of the authorized **3,883** personnel spaces in fiscal year 1966, have direct dealings with the contractors and perform the audit work. The remaining 15 percent of the authorized force was assigned to headquarters and regional policy and supervisory functions. **The** authorized audit staff includes

975 personnel spaces transferred from the Army, 1,141 from the Navy, and 1,453 from the Air Force.

A resident office is responsible for the DCAA mission generally at one contractor location and is physically located at the contractor's plant. Branch offices are located in larger industrial cities to serve smaller defense contractors in a designated area on an itinerant or suboffice basis, except for those contractors assigned to a resident office. Procurement liaison offices have been established on a full- or part-time basis at major military procurement and contract administration centers to provide necessary coordination with procurement and contract administration officials.

The types of contract audits performed by DCAA include reviews of prices on proposed and existing contracts whether they are based on estimated or actual costs of performance; examination of cost-reimbursement claims; and special types of reviews, such as estimating procedures surveys, accounting system surveys, and contract termination audits. In addition to providing contract audit services to DOD, DCAA provides services to other Government agencies, such as the National Aeronautics and Space Administration (NASA). The DCAA audits must conform to the policies, procedures, and guidance prescribed in its Defense Contract Audit Manual and the Armed Services Procurement Regulation.

With respect to reviews of contractor activities, the role of DCAA differs from that of the General Accounting Office in that DCAA primarily performs an advisory audit service for the contracting officer and it acts as a part of a team of technical advisors to the contracting officer. Therefore, it plays an operational role and its activity cannot be said to have the attributes of an internal audit function.

Also, the audits performed by DCAA are confined to contractor activity, while the audits of our Office, as part of the legislative branch, cover the entire procurement and negotiation process involving both contractor activity and Government agency activity. A more detailed discussion of the relationships between DCAA and our Office and a comparison of the authority and responsibilities of the two organizations can be found in appendix V.

As a result of the passage by the Congress of Public Law 87-653, "The Truth in Negotiation Act," effective December 1, 1962, contractors are required to submit cost and pricing data under certain noncompetitive price proposals exceeding \$100,000 and to certify that such data are current, accurate, and complete. The law also provides for price adjustments in favor of the Government if it is later found that any defective data in proposals have significantly increased the prices negotiated.

To administer the defective pricing provisions in this act, DCAA established a program in March 1966 for regularly scheduled postaward audits of selected contracts, as recommended in a prior General Accounting Office report to the Congress (B-158193, February 1966). At the time our survey was in progress, DCAA had not had the opportunity to implement the new program.

The principal DOD and DCAA officials responsible for administration of the activities discussed in this report are listed in appendix I.

SURVEY FINDINGS AND RECOMMENDATIONS

NEED FOR DOD PROGRAM TO ASSIST DCAA IN CARRYING OUT ITS RESPONSIBILITY FOR REVIEW OF CONTRACTORS' ESTIMATING SYSTEMS

The Department of Defense has assigned **DCAA** the responsibility for establishing and managing a regular program for conducting reviews of estimating systems of all major defense contractors in the United States. The purpose of the program is to substantially expedite the review of individual pricing proposals and, in general, to bring about more effective application of audit and procurement effort in the evaluation of proposals and negotiation of prices.

Nationwide and individual reviews made in the past several years by military procurement and contract audit organizations have shown a need for major contractors to improve and formalize their estimating systems. Although some progress has been achieved in the area, recent DCAA surveys and our own survey indicate that substantial improvements are still necessary. For example, several of the contractors included in our survey had not formalized their estimating methods and procedures and, of those who had, some provided only limited guidance to the estimator.

For the past 15 years the bulk of defense business with contractors, currently approximating some \$30 billion¹ annually, has been priced to a great extent on the basis of contractors' estimates of cost. The lack of significant progress in contractors' estimating systems from which such cost estimates are developed has been due, in our opinion, to the absence of a Department of Defense top-level policy (1) that its major contractors should, as a matter of sound business practice, have good estimating systems, (2) that the systems should be formal and reduced to writing, (3) that the systems should meet certain minimum acceptable standards, and

¹ DCAA workload exceeds \$40 billion--not all proposals requiring review result in contract awards.

(4) that significant deviations should be disclosed when the systems are not followed in actual practice.

As discussed in more detail in the sections of the report which follow, these policy determinations appear necessary in order for DCAA to efficiently and effectively carry out a program for reviews of the systems and for the DOD procurement process to fully realize the intended benefits of such reviews.

DCAA's responsibility for and objectives of performing estimating systems reviews

The Armed Services Procurement Regulation (ASPR) has provided, since October 1, 1965, that DCAA establish and manage a regular program for conducting reviews of contractors' estimating systems. A DCAA auditor captains **the** survey team making such reviews and is assisted by representatives of the administrative contracting officer's staff, such as price analysts and engineering specialists.

DCAA's major objectives in evaluating the contractors' estimating systems are to provide the auditors with the knowledge of the reliance that can normally be placed on the accuracy and reliability of the contractors' individual pricing proposals and to recommend corrections in the contractors' procedures where necessary. In addition, DCAA believes that the information obtained by the auditor while performing the survey will permit him to substantially expedite the review of individual pricing proposals and bring about a more effective application of audit and procurement effort in the evaluation of proposals and negotiation of prices.

DCAA had previously provided some guidance on conducting estimating surveys in its manual. To carry out the new responsibility, DCAA developed a special survey program and issued it to the field in January 1966. This program was intended to include the best concepts that had been developed in the estimating systems review

programs used by both audit and procurement personnel in the past. The program was to be field tested during the first half of calendar year 1966 at several contractor locations, and evaluations of the program were to be submitted to DCAA Headquarters. The program, when approved, will be applied generally to major contractors having annual Government sales in excess of \$15 million under negotiated contracts.

Although a few survey reports of individual contractors had been completed as of June 30, 1966, none of the regional offices had submitted their evaluations of the test program to DCM Headquarters. We were informed that demands on the auditors' time for the review of proposals and other higher priority work had caused this program to be delayed.

Prior surveys and studies have disclosed need for improving and formalizing contractors' estimating systems

For several years there has been continued recognition of the need to review contractors' estimating systems. For example, in December 1957 the Air Force issued guidelines which recognized the need for a systematic review of contractors' estimating systems. About 6 months later the Navy and Army audit organizations were assigned similar responsibilities. Similarly, the military procurement organizations, including the recently established Defense Supply Agency, issued guidelines providing for reviews of contractor estimating systems.

During our survey we obtained copies of some of the reports which were made on prior reviews of contractors' estimating systems. These reviews were conducted on both a nationwide and an individual survey basis, and their results are discussed in the sections of the report which follow.

Nationwide survey by Air Force Systems Command--1962

In 1962 management survey teams from the Air Force Systems Command conducted surveys of 24 major contractors and subsequently issued a report summarizing their more significant findings. The nationwide survey which dealt with contractors' management policies, procedures, and practices, was made because of concern over the steadily increasing costs of new weapons systems.

The Air Force report summarizing the results of the nationwide survey included findings dealing with controls over accounting and estimating data. These findings included the use of poorly defined estimating systems and procedures and the use of questionable and obsolete estimating factors. The Air Force identified 15 fundamental causes of the accounting and estimating deficiencies in

its report, two of which are of particular concern to the subject of this report. They were (1) the lack of a formal, centralized estimating system and (2) the lack of a mutual understanding as to what constituted an acceptable estimating system. The report included recommendations directed to both Air Force activities and contractors concerning the need for improving estimating methods and systems and the need for both review and training programs.

Study by defense-industry committee--1963

In 1963 a defense-industry committee made a study concerned with the numerous cases of overpricing of defense contracts which had been publicized in recent years. The study committee, which included members of industry and DOD, found it could not determine the magnitude of the overpricing problem. The committee noted that agency contract auditors said they did not always have sufficient time to review contractors' pricing proposals in depth but in a recent year they had questioned about \$800 million of cost and pricing data in such proposals.

The committee stated that it found no fundamental issues which needed resolving, but it concluded that there was a need for better communication by DOD as to what is expected of contractors in preparing price proposals. The committee observed that some improvement was needed in contractors' estimating methods and that more of the contractors' estimating methods and procedures should be formalized.

Nationwide review by Army Audit Agency--1964

During fiscal year 1964 the Army Audit Agency (AAA) conducted a comprehensive review of the estimating practices being followed by 36 of its largest defense contractors. In its report dated May 1965, AAA stated that, of the total proposed prices of \$2.3 billion

reviewed at the 36 contractors' plants, it had questioned about \$222 million and considered another \$77 million as unresolved. The AAA stated further that it thought the questionable items included in price proposals, defense-wide, could approach \$1 billion annually. The AAA concluded that:

"*** approximately 60 percent of the systems reviewed were not adequate for producing reliable cost estimates. Systems in this category generally did not provide for (i) publication and updating of formalized procedures and practices, (ii) clear delineation of estimating responsibilities, (iii) effective coordination between accounting, operating and estimating functions, (iv) preparation and maintenance of sufficient detail in support of cost estimates, or (v) over-all review of estimating practices and individual bid proposals. Numerous instances were noted where supporting data were not maintained, were incomplete, not readily available for examination, or could not be identified as to source. In some instances, significant dollar estimates had been made by engineering personnel based on their general experience in the particular product field.

"On an over-all basis, our examinations served generally to reaffirm the continued existence of the same types of deficiencies that have caused pre-award analyses and negotiation problems in prior years. Many contractors, including some receiving multimillion dollar defense awards, had no formalized written procedures. In some instances, though reasonably adequate procedures had been established, there was inadequate intracompany coordination, or insufficient control and review to properly measure and evaluate results."

The AAA stated that one of the basic causes of the problems was that contractors showed little interest in employing controlled and consistent estimating procedures when competition was lacking. The AAA recommended that (1) contractors with defense contracts in excess of a prescribed annual dollar volume be required to formalize

their estimating procedures, including responsibilities for the development of source data, preparation of proposals, and internal review and approval, (2) these systems be subject to periodic Government review and approval, and (3) an effective action program be instituted to provide positive incentives to the contractor for reliable estimates.

This report was issued in 1965 just prior to the time DCAA assumed responsibility for matters relating to contract audits. We were informed that, because this report was developed by contract auditors rather than as part of the Army's regular internal audit program, the report, by regulation, could not be sent to management levels as an action document. However, the report was sent for informational purposes to many high level officials within DOD and NASA. We were unable to find any evidence that action was taken on the report.

Current DCAA surveys indicate conditions not significantly improved

Results of DCAA work done under its special test program up to the time of our survey indicated that the conditions found in prior reviews had not significantly improved. For example:

1. A DCAA survey report dated June 15, 1966, covered one of the contractors that had been included in the earlier nationwide AAA review. DCAA noted in its report that the contractor did not have written estimating methods and procedures. In the report DCAA stated:

"The absence of detailed current written procedures, and lack of uniform practices, is a major contributing factor to the conditions noted throughout the report and further highlighted to the extent that in the nine-month period commencing July 1, 1965, we questioned approximately \$3,700,000 of twenty-two proposals aggregating \$18,200,000."

DCAA recommended that the contractor reduce its estimating procedures and methods to writing and include certain

specific procedures to improve the system. In reply, the contractor indicated that, while it did not agree that written procedures were a prerequisite for consistent and effective estimates, the contractor believed they would benefit its estimating function.

2. In another instance, AAA evaluated a contractor's methods and procedures and found several deficiencies including an absence of detailed procedures for estimating various cost elements. As a result, AAA stated that, unless corrective action was taken, there would be no assurance that the conditions leading to questionable costs would not continue. About 17 months later, during the evaluation of the contractor's proposal, DCAA again identified some of the same deficiencies. Further, as late as May 1966, the contractor had not implemented detailed procedures for estimating various cost elements.
3. In May 1964 Navy personnel evaluated another contractor's estimating procedures and methods for price proposals and found several deficiencies including a lack of written estimating procedures. According to a more current DCAA survey at June 1966, the contractor still had not prepared written estimating procedures.
4. In another current survey, DCAA noted that a contractor did not have formalized procedures. In its report, dated September 16, 1966, DCAA stated:

"Current procedures and practices employed by the contractor in estimating costs under proposed contracts do not, in many instances, provide the assurance that amounts proposed are reasonable. Most significant were the needs for formalized policies and procedures, ***."

DCAA also stated that the absence of management direction and guidance, which are normally provided by such procedures, is a leading cause of the specific adverse conditions described in its survey report.

Proper management seems to require that all important procedures and methods be reduced to writing and periodically reviewed

and tested to ensure compliance and effectiveness and that top management's policies are carried out at all levels of the organization. The applicability of this principle to contractors' estimating systems is found in the DCAA review program, as follows:

"The estimating function is such an important one that direction and guidance for its implementation must be in a form that not only assures its complete understanding but also precludes any possibility of misunderstanding. The formal written statement of policies and procedures, rather than the informal one based on established customs of the organization, is almost mandatory for the purpose of multi-division and multi-plant companies, and in companies where a considerable number of people participate in the estimating function. Both the policies and the related implementing procedures should fully reflect the application of sound financial management." (Underscoring supplied.)

The DCAA program also provides that the survey teams will consider whether the contractors' written procedures provide for (1) consistency in the application of policies, (2) use of the most accurate, complete, and current cost and pricing data at the time the estimate is prepared, (3) specific guidance and policy direction for the development of each element of cost making up an estimate and proposal, (4) a requirement for disclosure and explanation of any substantial deviations from the established procedures, (5) a prescribed organizational structure for review and approval of estimates, and (6) established procedures for the orderly flow of documentation and data in buildup and support of the estimate.

Many contractors in our survey did not have formalized procedures, or provided only limited guidance, for developing basic elements of cost

At 19 contractor locations we inquired into the extent to which the contractors' estimating policies and procedures were formalized and provided guidance to estimators for developing material and labor costs--the two most basic elements of cost found in the majority of price proposals. We did not make a complete evaluation of the estimating systems and did not test the systems to determine whether compliance resulted in the submission of reliable proposals to the Government.

We found that several contractors had no formalized procedures for developing these costs although some of the contractors did have policy statements or informed us that they were in the process of developing written procedures.

Many of the contractors did have some type of formalized procedures; however, the extent of guidance provided for the development of material and labor costs varied considerably. For example, some contractors' procedures provided their estimators with suggestions only, some provided reasonably detailed guidance, and others apparently permitted considerable latitude in the development of cost. To illustrate, one contractor provided a few general introductory statements in its procedures with respect to estimating one basic element of cost (material) and then indicated that the estimator should use a particular source of cost data "as appropriate."

Because some procedures did not specifically provide for management approval when significant deviations were made from the procedures, it appeared to us that, in actual practice, other procedures could have been used by the estimator and still have been considered acceptable.

Conclusion and DOD action

Many thousands of contract pricing proposals must be reviewed by DCAA annually. Cost and pricing data questioned in such proposals have been estimated to be as high as \$1 billion annually.

(See p. 11.) We recognize that some amounts questioned in proposals are later upheld or supported during negotiations; nevertheless, a substantial amount of Government resources has been, and still is, required to review contract pricing proposals in detail and to identify and support items questioned for the purpose of negotiations. These negotiations are sometimes protracted and additional reviews of revised proposals are required.

We believe that, where the contractor's estimating process is poorly designed or described, DOD, as well as the contractor's top management, ought to be particularly concerned about what governs the quality of the cost and pricing data found in the proposals and about the efficiency and effectiveness of audits and price negotiations that must be conducted under such circumstances.

This subject was included in a preliminary draft report sent to the Department of Defense for comment. Also, because of the subject's importance and the lengthy history of problems in the area (see pp. 9 to 13), we performed a special briefing for top DOD officials in November 1966 on the need for a DOD program to have contractors improve and formalize their cost estimating systems. This briefing dealt with (1) the various potential benefits to DOD and industry from the adoption of such a program, (2) a history of the early pioneering **work** done by the military departments in their efforts to have contractors' improve their estimating systems, (3) the conditions that currently exist, (4) some comments on what we visualize in an acceptable estimating system, and (5) some actions we thought DOD should take to initiate its program.

In the Department's comments furnished by the Deputy Secretary of Defense in a letter dated December 9, 1966, the Department informed us that it planned to publish guidance to its procurement and administration officials on the matter. (See app. II.) Thereafter, in January 1967 the Department of Defense released a Defense Procurement Circular effective immediately, pending its publication in a revision to the Armed Services Procurement Regulation.

This circular (see app. VI) provides, among other things, (1) DQD policy and guidance in the area, (2) some criteria to be considered in determining acceptability of an estimating system, (3) some reasons why the establishment, maintenance, and consistent use of formal cost estimating systems by contractors is to the mutual benefit of the Government and industry, and (4) steps to be taken to have estimating systems improved and to correct deficiencies which continue to have an adverse effect on pricing. These steps include sending copies of system survey reports, with a copy of the official notice of corrective action required, to each purchasing and contract administration office doing substantial business with the contractor and bringing problems to the attention of procurement officials at a level necessary to bring about corrective action.

Recommendation

We believe that the action taken by the Department is a major step forward and is commendable. Because of the importance of the matter, the lengthy history of problems in the area, the need for extensive coordination with industry, and the inherent difficulties in implementing new policies and procedures in such a far-flung organization as the Department of Defense, we recommend that the Secretary of Defense provide for appropriate monitoring of implementation of the new circular. We are suggesting below for the

Secretary's consideration, some actions which could be a part of the monitoring program.

1. Establish a joint DOD-industry committee to further develop and refine minimum standards that an estimating system should meet in order to be considered acceptable. Some of the standards mentioned in the Defense circular and others that we believe should be considered are listed in appendix III.
2. Disseminate information in various Defense publications explaining the reasons why acceptable estimating systems would be beneficial to both the contractor and DOD. The more important benefits that we believe could result, some of which are mentioned in the Defense circular, are listed in appendix IV.
3. Establish a listing of major defense contractors that are subjects to pricing reviews on a repetitive basis and therefore should, as a matter of sound business practice, have formal and well-managed estimating systems.
4. Establish, by mutual agreement with each contractor management, the approximate time when the contractor will have completed development of an estimating system which meets the prescribed minimum standards of acceptability.

The danger in not performing this step is that Government resources may be expended in reviewing estimating systems that are not well developed, are not fully reduced to writing, do not have the support of the contractor's top management, and are not followed in actual practice.

5. Once a contractor's top management has represented that its estimating system meets the prescribed minimum standards, have on-site DOD audit and technical personnel evaluate the effectiveness of the system in the examination of individual pricing proposals with the objective of requesting the contractor to strengthen the system in the areas where this is found necessary. The contractor's responsiveness to these requests and the demonstrated reliability of its estimating system can be taken into consideration in determining the nature and extent of review to be made of subsequent proposals and in negotiating rates of profit.

6. Designate a top official within the Department of Defense to be responsible for the program and monitor its progress on the basis of quarterly or semiannual reports from DCAA.

NEED FOR ACTION TO ENSURE ADEQUATE SCOPE
OF REVIEW OF CONTRACT PRICING PROPOSALS

We found that in a number of instances limited or no work was done by DCAA auditors in significant estimated cost areas of contractors' pricing proposals. It appears that the auditors' reviews could have contributed significantly to a more comprehensive evaluation of the proposals and helped support price negotiations.

The significant areas not reviewed were usually assigned to procurement technical personnel, whereas procurement regulations provide that the auditor and technical personnel, each a specialist in his own field, should make complementary analyses of estimated cost areas with a common objective. Procurement regulations require also that technical personnel coordinate their findings with the auditor and that the auditor include the financial effect of such findings in the audit report. We found that in most cases the technical findings, although apparently made available to contracting officials, either were not furnished to the auditor or were not made available to him in sufficient time to include them in the audit report.

ASPR gives the auditor responsibility
for determining the scope of audit

The ASPR provides guidance on the use of the services of contract auditors in evaluating price proposals. The responsibility of the DCAA auditor in the audit of price proposals is set out in **ASPR**, as follows:

"Within the time available the overall scope and depth of the audit review will be determined by and be the full responsibility of the contract auditor. ***
If the time available is not adequate to permit

satisfactory coverage of the proposal, the auditor will so advise the contracting officer and indicate the additional time needed."

The ASPR provides further that only the auditor has general access to the contractor's books and financial records supporting proposed cost or pricing data.

The principal areas of review included in most contract price proposals generally consist of cost estimates for labor, material, and overhead. Since overhead factors are frequently predetermined and are, in many instances, intensively reviewed by the DCAA auditor once or twice a year for application to all proposals, the primary aspects of the review of most individual price proposals are, in our opinion, the method and manner by which the contractor estimates (1) the kinds and quantities of material and labor required to perform the contract and (2) the prices for material and the labor hourly rates.

Procurement regulations show that the review of certain of the above areas will require effort by both the auditor and the technical specialists to obtain maximum benefit from the different experience and background of these specialists. ASPR provides:

"In order to provide the contracting officer with maximum support, it is essential that there be close cooperation and communication between the contract auditors and the production and other technical specialists on the staff of the ACO [administrative contracting officer]. Such coordination will be accomplished in a manner which will minimize duplication of analysis. *** The analyses by technical and audit personnel are of mutual interest, and information relating thereto shall be exchanged throughout the review process. It is recognized that the duties of auditors and those of other technical specialists in many cases require both to evaluate the same elements of estimated costs. While they shall review the

data jointly or concurrently wherever possible, each shall render his services within his own area of responsibility. For example, on quantitative factors (such as labor hours), the auditor will frequently find it necessary to compare proposed hours with hours actually expended on the same or similar products in the past as reflected on the cost records of the contractor. From this information he can often project trend data. The technical specialist may also analyze the proposed hours on the basis of his knowledge of such things as shop practices, industrial engineering, time and motion factors, and the contractor's plant organization and capabilities. The interchange of this information will not only prevent duplication but will assure adequate and complementary analysis. (Underscoring supplied.)

The DCAA contract audit manual requires the auditor to qualify his report to contracting officials when the audit coverage has been limited, giving the circumstances and reasons for the limitation.

In a number of instances limited or no work was performed by the DCAA auditor in significant estimated cost areas of price proposals

We found that, of the 77 audit reports on price proposals included in our survey, about one fourth of the proposals were for items and services the cost of which appeared to be based largely on engineering-type judgments. The remaining three fourths of the proposals were for production-type items. On the proposals for production-type items, sufficient cost and pricing data may have been available for the auditor to furnish, in many cases, assistance to procurement officials in evaluating the reasonableness of significant cost estimates contained in the proposals. We found, however, that the auditor did not perform a review of significant costs in over one third of these proposals. Usually the advisory reports did not clearly show the reasons why certain areas were not covered, although this is required by DCAA's contract

audit manual. The following examples illustrate some of the various situations we found regarding the scope of audits.

1. We found that on one contractor's major proposals, the DCAA auditors agreed to a segregation of the work between the auditors and the procurement service representatives. For example, the auditors were responsible for reviewing the estimated labor rates and the service representatives were responsible for reviewing the estimated labor hours. Procurement personnel stated that the segregation of tasks was made to prevent duplication of effort and that it was not intended to limit the auditors' scope. We found, however, that the auditors generally limited their scope to those cost areas specifically requested by the contracting officer or as agreed to with the service representative.
2. The following example indicates that, had the auditor failed to review one area of the proposal--estimated labor hours--his judgment of the overall proposal could have been affected.

The DCAA auditor at a contractor's plant questioned 3,300 direct labor hours included in a proposal. This resulted from the auditor's determination that the contractor's projected learning curve--a well-established method of estimating labor hours--should be revised because prior and concurrent production was not considered. About half the labor hours questioned by the auditor, as well as the related overhead and profit, were eliminated in the negotiations,

3. At another contractor's plant the DCAA auditors in some instances were requested to review only proposed material prices and labor rates. The administrative contracting officer told us that the review of labor hours was a technical determination and not within the scope of the auditor. However, as discussed in the previous example and the example that follows, the auditor can assist in the review of labor-hour estimates where historical experience is available, and the ASPR provides for such reviews.
4. The review of a proposal at one contractor's plant was apparently conducted as contemplated in the regulations. The

auditor and other technical specialists jointly reviewed the projected labor hours estimated by the contractor and recommended to the negotiator a disallowance of \$116,000 for labor hours. The contractor's estimate was reduced by \$89,000 in negotiations.

The DCAA auditor assigned to one contractor's plant told us that he could have reviewed the material costs included in the proposal but that the contracting officer wanted information only on labor and overhead rates. The DCAA resident auditor at another contractor's plant acknowledged that his reviews of proposals were tailored to fit the needs expressed by the procurement officials requesting the audit. At this same contractor's location, the procurement official responsible for requesting the audit told us that he limited the scope in his requests to what he thought the auditor could do within the time available.

Results of technical evaluations
frequently not furnished to the auditor

The need for timely reporting of the results of the technical evaluations to the auditor is recognized in ASPR which provides that:

"Reports of technical analysis and review should be furnished to the auditor at the earliest possible date and at least five days prior to the due date of the audit report to enable the auditor to include the financial effect of technical findings in the audit report ***."

In our survey of audit reports on 77 contract price proposals, we found that a technical evaluation was requested in 70 cases. For 51 of the 70 proposals, the results of technical evaluations either were not furnished to the auditor or were not furnished in sufficient time to enable him to include the financial effects of technical findings in the audit report.

Some procurement officials thought it was unnecessary to furnish technical reports to the auditors because the quality of the audit is not decreased if the auditor does not receive the technical report and because the auditor generally performs only the routine functions of computing the financial effect of the technical findings which can be done by procurement personnel. As recognized in the ASPR, however, the interchange of information between the auditor and other technical personnel will not only prevent duplication but will also ensure adequate and complementary analysis.

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The varying practices found in our survey may, to some extent, be due to difficulties associated with habits formed or practices followed by personnel formerly with the predecessor contract audit

organizations. For example, some of the former audit organizations had assumed lesser responsibilities than those currently specified.

Conclusion and DOD action

In lieu of the practices found in our survey, it appears that DOD intended to have two separate activities--the auditor and technical specialists--provide complementary data for a common objective. Both activities are manned by specialists in their own fields who should be competent to undertake review responsibilities in their designated areas. Because of the importance of the areas reviewed by each specialist on the ultimate price the Government will pay the contractor, it appears that both specialists should fully and effectively perform their respective review responsibilities. Therefore, we proposed in our draft report that DOD take action to ensure that responsibilities for reviews of proposals are properly interpreted and carried out in accordance with procurement regulations.

The Deputy Secretary of Defense commented on our proposal in a letter dated December 9, 1966. (See app. II.) He stated that ASPR clearly delineates the roles of the members of the DOD pricing team and provides for all required coordination of team members. **He** stated also that the DCAA contract audit manual expresses policy and guidance for the auditor to assume the full role as set forth in **ASPR**. He stated further that ASPR and manual provisions are relatively new and that undoubtedly there are a few cases of misunderstanding on details.

He said that in accordance with our proposal the following actions had been taken or were planned:

1. In early September 1946, DCAA held an executive conference attended by all the agency's regional managers, as well as

other key regional and headquarters staff employees, during which the subject of "Total Responsibility for Price Proposals" was thoroughly discussed.

2. On September 20, 1966, the Director, DCAA, issued a letter to all responsible elements reiterating the need for DCAA to assume and perform all the functions assigned to the contract auditor by the ASPR.
3. Appropriate instructions will be issued to DOD procurement activities calling particular attention to the problem areas identified in this report.
4. To ensure proper implementation of existing regulations, periodic discussions at the headquarters level are being held between DCAA and contract administration officials. These discussions are directed toward clarification of any interface matters, and, as a result, guidance and resolution of problem areas are being furnished to the field activities on a current basis.

Recommendation

We believe that the actions taken or planned by DOD should improve the conditions noted in our survey. However, because of the possible impact on the ultimate price the Government will pay the contractor, the advantages of having complementary analyses of major cost elements as recognized in ASPR, and the need to change habits formed by audit and other technical personnel in the past, we believe that a follow-up review of this area would be appropriate. We therefore recommend that the Secretary of Defense institute such a review within the next year to ensure that responsibilities for reviews of price proposals are being effectively carried out.

NEED FOR PROCUREMENT ACTIVITIES TO FEED BACK
INFORMATION TO DCAA ON RESULTS OF CONTRACT
NEGOTIATIONS AND ON WAYS THAT AUDIT SERVICES CAN BE
MADE MORE USEFUL IN FUTURE NEGOTIATIONS

We found that the DCAA auditor did not ordinarily receive information (feedback) from procurement activities on the usefulness of his findings in negotiations and on ways that audit services could be more effective in future negotiations with the contractor. We noted that in several instances auditors did attend negotiations and thus may have learned, to some extent, how their audit services could be made more useful.

To determine the adequacy of feedback to the auditors, in our survey covering 77 contract price negotiations, we examined the DCAA audit reports and interviewed Government negotiators who had utilized these reports in contract price negotiations, DCAA liaison auditors at procurement centers, and the DCAA auditors who had submitted the reports.

In the majority of cases the auditors did not receive the record of contract negotiations. Although it appears that the record of negotiations should be made available to the auditor so that he will be aware of the results of his work, such records, in themselves, do not provide sufficient feedback to him since they are neither prepared solely for his benefit nor tailored to point out particular aspects of the negotiations which could be improved through more effective audit services.

The need for furnishing this kind of feedback information is recognized in the Armed Services Procurement Regulation Manual for Contract Pricing, dated October 1965. This guide, which provides a description of contract pricing techniques, shows that as a rule contracting officials:

"*** should evaluate the quality of the pricing assistance received. Whether the reports are good or bad, he should advise the sender of his opinion. Otherwise, the sender may operate in a vacuum with no sure knowledge of whether, in fact, he is satisfying the requirements of the requesting activity."

We did not find in the cases included in our survey any evidence of information having been received from contracting officials after the completion of negotiations offering constructive suggestions and comments as to how the audit services might be improved upon in future negotiations with the contractor. Since DCAA's chief function is that of advisor to contracting officials, it seems evident that effective channels of communication are essential for the proper functioning of both activities,

Some illustrations showing the type of feedback, which we believe could assist the DCAA auditor in increasing the effectiveness of future audit services, follow.

1. At one location certain overhead costs questioned by the DCAA auditor were reinstated in negotiations because procurement personnel believed that the auditor's study was based on data not sufficiently current. We believe that this information should have been referred back to the auditor for his evaluation and use in developing information for future price negotiations, since the type of cost questioned in this instance was recurring in nature and, therefore, was applicable to most proposals submitted by the contractor.
2. In surveying the results of a series of DCAA advisory reports at another location, we found that there was general nonuse of the auditors' findings or, in some instances, overall price changes were clouded as to whether price reductions were based on auditors' findings. Also, in a few cases negotiations were held before the auditors' reports were received. In commenting on DCAA services, contracting officials told us that there was a need for less qualifications, more timely reporting, more realism in

developing and reporting findings, and more supporting data in reports.

We recognize that to some extent these conditions may have been brought on by circumstances beyond the control of the auditor. However, appropriate feedback would, in our opinion, help resolve the problems involved and ultimately result in increasing the usefulness of audit services in negotiations.

3. In our survey in another region of the results of 10 contract negotiations, we found that \$1.1 million of estimated costs in contract proposals had been questioned. Of this amount, \$369,000 represented costs questioned by the auditor and \$740,000 represented technical representatives' findings. About 80 percent of the questioned costs were upheld in negotiations. Contracting officials informed us that they were generally satisfied with the audit reports we had selected for review.

However, these and other procurement officials suggested certain improvements which they stated applied generally to all DCAA reports. For example, they said that there should be closer coordination between the auditor and the technical personnel who review other aspects of the contractor's price proposals and that the auditor should not merely place a dollar value on recommendations of technical personnel. Instead, when cost experience is available, they said, the auditor should include such experience in his evaluation. (This subject is discussed in more detail in another section of our report concerning the auditors scope of review, beginning on p. 20.)

Other procurement officials expressed opinions that audit reports should contain more detail, be more specific, and reach firm conclusions and recommendations with less unresolved issues. Some officials indicated that the greater detail should include such things as the basis for contractors' proposals and additional

support for reasons why costs are questioned and/or why costs not questioned are considered reasonable.

Other procurement officials said that some audit reports were limited in their usefulness because of qualifications or unresolved issues. One official indicated that, if it was necessary to show unresolved costs, the reports should set forth more information on the reasons that costs cannot be resolved and suggestions for resolving them.

In addition, some procurement officials commented that DCAA auditors should make more progress in analyzing forecasts and trend data. A price analyst said auditors in many cases relied too much on historical cost data. He indicated that auditors should express opinions on the reasonableness of cost projections on the basis of an evaluation of the same type of pricing data as that considered by the contractor in his proposal rather than on the basis of strictly historical cost data,

Conclusion and DOD action

In view of the need for maximum cooperation and understanding of the type of information required for effective price negotiations, we believe that arrangements should be made providing for the dissemination of information and ideas from the negotiators directly to the auditors on pertinent issues and principles dealt with in negotiations. Such feedback could be used to create and maintain a team concept and allow the auditor and procuring official to reach common understandings as to the needs for future negotiations. In our opinion this feedback could include comments on such matters as specific problems encountered in resolving questioned costs, contractors' positions not adequately refuted, areas requiring more in-depth analysis, problems of clarification, and

other areas of special concern or interest to procurement officials.

Therefore, in a draft of this report we proposed that the Department of Defense arrange for its procurement officials to provide the results of negotiations to DCAA auditors and, in addition, to provide information, where appropriate, on ways the auditors can improve their services and strengthen the Government's position in future price negotiations with the contractor.

In a reply to our draft report, dated December 9, 1966 (see app. II), the Deputy Secretary of Defense stated that DOD concurred in our proposal and that the ASPR Committee had approved an amendment to ASPR which would require the contracting officer to forward a copy of the negotiation memorandum to the DCAA auditor. He said that the contracting officer would also be required to furnish, where appropriate, suggestions designed to improve the effectiveness of audit support in future procurements.

NEED FOR EFFECTIVE MEANS TO DEAL
WITH ACCESS-TO-RECORDS PROBLEMS

During our survey, as well as surveys by the Army Audit Agency and DCAA, problems of access to contractors' records were noted which appear traceable to differing interpretations by agency auditors and the contractors as to what constitutes the underlying data and records that should be evaluated to render an informed report on price proposals.

For noncompetitive procurements and modifications which are estimated to exceed \$100,000, contractors are generally required to submit cost or pricing data in support of their proposals. The contractor, by submission of the proposal (DD Form 633 series), grants the contracting officer or his representative the right to examine, for the purpose of verifying the cost or pricing data submitted, the records which will permit adequate evaluation of such cost or pricing data, along with the computations or projections used therein.

Prior to the contract negotiations, the contracting officer normally requests DCAA to perform a review. Access to the contractor's underlying cost data (both factual and forecasted) is necessary and essential to enable the auditor to perform his review and submit an informed opinion on the reasonableness of the contractor's proposal. These data, according to ASPR, embrace more than historical data and include vendor quotations, unit cost trends such as those associated with labor efficiency, and make-or-buy decisions or any other management decisions which could reasonably be expected to have a significant bearing on the proposed costs. Whether or not all these data will be required by the auditor depends on the circumstances of the particular proposal, the auditor's judgment, and his overall experience with the contractor.

The DCAA contract audit manual provided that if the auditor is refused free access to the contractor's records supporting the price proposal, he is required to report the refusal to the contracting officer who attempts to resolve the access problems with the contractor. If this fails, the contracting officer is to report the problem to higher levels within the agency.

DCAA auditors at several locations advised us that they were experiencing varying degrees of access-to-records problems with contractors. The problems appeared to relate to differing interpretations of the kinds of underlying cost data that the auditors should obtain and review in order to express an informed opinion on the reasonableness of contractors' proposals. Some illustrations follow.

1. At one location, an auditor's advisory report on a review of a proposal for a fiscal year 1966 procurement showed that the contractor denied the auditor access to material cost experience under an existing fixed-price contract on the basis that the information was not current and was not used for the pricing of material. The report shows that the DCAA auditor believed that this restriction precluded an evaluation as to the reasonableness of proposed material amounts. The contractor's position in the material cost area appears to be in direct conflict with its position on other elements of cost included in the same proposal. The audit report shows that the auditor had full access to historical direct labor and manufacturing expense data under the existing fixed-price contract.

A top procurement official advised us that he was aware of this access problem and that after much debate, including discussions with his superior, it was decided that the contractor's position should prevail and the cost data could not be reviewed by the auditor. He indicated that no further actions had been taken to resolve the problem but, in his opinion, **the** problem would be eliminated since it was planned to award an incentive-type contract for fiscal

year 1967. (Under this form of contract, the auditor will ordinarily have access to the contractor's historical records but for that contract only.)

2. **An** auditor at another location advised us that the effectiveness of audits was restricted to some degree by not having access to all data used by the contractor in preparing its proposals. The auditor stated that he did not have access to current quotations from suppliers but that he did have access to historical purchasing data (the reverse of the situation above).

As mentioned earlier in the report (see p. 10), during fiscal year 1964, the Army Audit Agency--one of **the** predecessor contract audit agencies--made a nationwide review of the cost- and price-estimating practices of 36 major defense contractors. In its report AAA stated:

"Problems of restrictions on audit access have been aggravated by controversial interpretations by industry as to (i) what comprises 'cost or pricing data,' (ii) the criteria for evaluating 'completeness and currency' of submitted data, and (iii) the conditions under which cost data submissions and certifications are required. As a result of controversies on these matters, procurements have been delayed or compromised, and more urgent procurement negotiations have had to be conducted without appropriate assurances as to the reasonableness of final price proposals."

The AAA said that the information which had been restricted included historical cost data, vendor material quotations, and support for projected overhead rates.

In a survey made in the early part of 1966, DCAA requested from field personnel their experience on access to records at various contractors' plants. The DCAA internal report on the survey at 164 locations indicates that access to various types of records was limited or denied by numerous contractors surveyed. The most

prevalent types of records restricted were not individual cost records but, rather, were budgets, financial statements, tax returns, board of director minutes, and internal audit reports. The survey report disclosed also that 10 contractors denied historical cost information to DCAA auditors in their review of proposed prices of follow-on procurements, which is similar to the findings disclosed in our survey and in the earlier AAA nationwide review. The DCAA survey report indicated that a proposed regulation was under consideration to establish guidelines for determining the need for records.

Conclusion and DOD action

We believe that the role of the contract auditor is a vital part of the overall procurement cycle and that his informed, unqualified, and timely report is most important in the final determination of equitable contract prices. Restrictions on audit may place the auditor in a position where he must submit qualified opinions. Access controversies delay procurement; frustrate negotiations; and tend to build up, to a certain degree, mistrust between the Government and contractor personnel.

We believe that when matters which cannot be resolved are referred to a centralized group within DCAA, they can be dealt with on a more uniform and effective basis. This group, working with DOD personnel, could judge the merits of both the auditor's request and the contractor's justification for denial and ensure that the problem is resolved or brought to the attention of top level DOD officials.

We therefore proposed in our draft report that DCAA (1) take action to complete the proposed regulation to provide guidelines for determining the need for records and (2) establish a special

group to monitor the effectiveness of this regulation and to help field personnel resolve significant access-to-records problems as they arise. We proposed **also** that special procedures be set up at the DOD and DCAA Headquarters levels to take appropriate action to resolve serious cases of access-to-records problems as they arise.

In a reply to our draft report, dated December 9, 1966 (see app. II), the Deputy Secretary of Defense stated that DCAA had issued a regulation on September 23, 1966, for the guidance of auditors in connection with access-to-records problems encountered. He also said that every effort would be made to resolve these problems at the field level but that, where further action is needed, the matter will be referred to Headquarters, DCAA, for action. He further stated that as necessary and appropriate, unresolved matters would be forwarded by DCAA to the Office of the Secretary of Defense for assistance,

We have reviewed the new DCAA regulation and have noted that it supersedes the DCAA contract audit manual instruction that provided only limited guidance to the auditors. The new regulation provides (1) guidance to ensure that auditors request only those records that are needed for the performance of particular audit functions, (2) procedures to be followed so that all access-to-records problems are pursued vigorously and timely, and (3) an expediting procedure to be followed when reviewing pricing proposals and time does not permit the use of regular procedures.

We believe that implementation of the new regulation and the other actions taken, coupled with the continuing support of procurement officials at all levels, should materially assist the auditor in resolving access-to-records problems.

SCOPE OF SURVEY

Our survey included **work** at 20 DCAA audit sites and at branch and regional offices supervising these sites. We obtained information on DCAA audits of 77 selected price proposals, most of which were performed during the first 6 months of 1966. We did not evaluate the quality of DCAA's audit work on individual assignments but, instead, we inquired into the general nature and scope of DCAA audits with particular emphasis on its ability to perform its mission, taking into consideration current authority, organization, and resources.

As the work of the DCAA is intimately involved with DOD procurement activities, our survey also included examinations of the records of and interviews with procurement and contractor personnel at many locations throughout the United States.

We obtained information on the acceptance of specific items in auditors' reports by procurement personnel and on the results ultimately achieved, with respect to these items, in price negotiations with the contractor. As a part of this phase of our work, we obtained from DCAA and procurement operating officials their suggestions as to improvements needed in advisory audit services or in the conditions under which such services are rendered.

We also obtained information on the level of communication between the auditor and those responsible for negotiating procurement to determine whether the auditor is apprised of problems encountered in negotiations to ensure the increased effectiveness of his services in negotiations.

'ENDIXES

PRINCIPAL OFFICIALS
OF THE DEPARTMENT OF DEFENSE
AND THE
DEFENSE CONTRACT AUDIT AGENCY
RESPONSIBLE FOR ADMINISTRATION OF THE
ACTIVITIES DISCUSSED IN THIS REPORT

~ Tenure of office
From To

DEPARTMENT OF DEFENSE

SECRETARY OF DEFENSE:

Robert S. McNamara	Jan, 1961	Present
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**ASSISTANT SECRETARY OF DEFENSE (COW-
TROLLER) :**

Charles J. Hitch	Feb. 1961	Aug. 1965
Robert N. Anthony	Sept. 1965	Present

DEFENSE CONTRACT AUDIT AGENCY

DIRECTOR :

William B. Petty	July 1965	Present
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DEPUTY DIRECTOR:

Edward T. Cook	July 1965	Aug. 1966
Bernard B. Lynn	Aug. 1966	Present

DEPUTY FOR AUDIT MANAGEMENT:

Bernard B. Lynn	July 1965	Aug. 1966
James Ruttenberg	Aug. 1966	Present

ASSISTANT DEPUTY FOR AUDIT MANAGEMENT:

James Ruttenberg	July 1965	Aug. 1966
Frederick Neuman	Aug. 1966	Present

PRINCIPAL OFFICIALS
OF THE: DEPARTMENT OF DEFENSE
AND THE
DEFENSE CONTRACT AUDIT AGENCY
RESPONSIBLE FOR ADMINISTRATION OF THE
ACTIVITIES DISCUSSED IN THIS REPORT (continued)

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
<u>DEFENSE CONTRACT AUDIT AGENCY</u> (continued)		
DEPUTY FOR RESOURCES MANAGEMENT:		
Harry W. Kettles	July 1965	Present
COUNSEL:		
Willard O. Vick	July 1965	Present
ASSISTANT DIRECTOR FOR REVIEW AND EVALUATION:		
Frank S. Howell	July 1965	Present
CHIEF, OPERATIONS DIVISION:		
Frederick Neuman	July 1965	Aug. 1966
L. M. Esposito	Aug. 1966	Present



THE DEPUTY SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

DEC 9 1966

Honorable Elmer B. Staats
Comptroller General
of the United States
General Accounting Office

Dear Elmer:

This is to provide comments on the draft GAO report "Survey of Contract Pricing Reviews by the Defense Contract Audit Agency" (OSD Case #2514) forwarded on August 25, 1966 by the Acting Director, Defense Division, General Accounting Office.

The report states that in this first survey of the Defense Contract Audit Agency (DCAA) you directed your attention primarily to DCAA's responsibilities for audit activities relating to noncompetitive proposals where the price is based largely on cost or pricing data submitted by the contractor.

The report indicates that no evaluation was made of the quality of the Agency's audit work but it was found that there is a need for action by the Department of Defense and the Audit Agency to improve certain conditions relating to areas reviewed. Following are DoD comments on each of your recommendations on improvements.

GAO RECOMMENDATION

DoD establish a requirement for **major** contractors doing business with the Government to develop and formalize acceptable estimating systems.

DOD COMMENTS:

We concur that the development and utilization of good estimating practices by contractors are desirable. We believe, in some instances, proposals prepared in accordance with estimating systems which have been examined previously and found acceptable will not require the degree of audit and other evaluation which would otherwise be necessary. We plan to publish guidance to our procurement and administration officials to encourage major Government contractors to develop and follow good estimating practices,

GAO RECOMMENDATION

DoD take action to assure that responsibilities for reviews of proposals are properly interpreted and carried out in accordance with procurement regulations.

DOD COMMENTS:

ASPR paragraphs 3-801 and 3-809 provide a clear delineation of the roles of the members of the DoD pricing teams. Provision is also made for all required coordination of team members. Similarly, the Defense Contract Audit Manual (DCAAM 7640.1) expresses policy and guidance for the auditor to assume the full role as set forth in ASPR. The ASPR and DCAAM provisions are relatively new and undoubtedly there are a few cases of misunderstanding on details.

The Defense Contract Audit Agency held an Executive Conference in early September 1966, attended by all the Agency's Regional Managers, other key regional staff and all Headquarters' staff elements, during which the subject of "Total Responsibility for Price Proposals" was discussed thoroughly. Following this conference, the Director, DCAA, issued a letter (September 20, 1966) to all responsible elements reiterating the need for DCAA to assume and perform all the functions assigned to the contract auditor by the ASPR. Appropriate instructions will be issued to DoD procurement activities calling attention to particular problem areas mentioned in the GAO report as well as others as they are identified. In order to insure proper implementation of existing regulations, periodic discussions at the Headquarters level are being held between DCAA and contract administration officials of the military departments and the Defense Supply Agency (Defense Contract Administration Services). These discussions are directed toward clarification of any interface matters and, as a result, guidance and resolution of problem areas are being furnished to the field activities on a current basis.

In addition to these coordinated activities, DCAA has established specific Procurement Liaison Auditor (PLA) relationships with the major procurement activities of the military departments with the objective of insuring adequate audit support to the purchasing activities.

GAO RECOMMENDATION

DCAA (1) take action to complete the proposed regulation to provide guidelines for determining the need for records and (2) establish a special group to monitor the effectiveness of this regulation and to help field personnel resolve access to record problems as they arise. Recommend also that special machinery be set up at headquarters levels of procurement and DGAA to take appropriate actions to resolve serious cases of access to records problems.

DOD COMMENTS:

Under date of September 23, 1966, DCAA issued a regulation for the guidance of auditors in connection with problems encountered relative to access to contractor records (DCAA Regulation 7640.7, "Access to Contractors' Records"). This regulation provides guidance to insure that auditors request only records that are needed for the performance of the particular audit functions. Additionally, it provides for specific procedures to be followed so that all problems of unavailability of required records are pursued vigorously and timely. The channels of problem resolution are clearly stated, including referral to the contracting officers. ASPR 3.807.6 provides appropriate guidance with respect to the referral process to higher headquarters when the contracting officer is unable to resolve the problem or gain the necessary data.

Every effort will be made to resolve satisfactorily all problems at the field level. In those instances where further action is needed, the cases will be submitted to Headquarters, DCAA where action will be taken. As necessary and appropriate, unresolved matters will be forwarded by Headquarters DCAA, through appropriate channels to the Office of the Assistant Secretary of Defense (Installations and Logistics) for assistance.

GAO RECOMMENDATION

Arrangements be made whereby procurement officials provide (1) the results of negotiations to the **DCAA** auditor and (2) where appropriate, information on how the auditor's advisory services can be made more useful in future negotiations with the contractor.

DOD COMMENTS:

We concur in the recommendation for improving the feedback of information to the auditor. The ASPR Committee has approved an amendment to ASPR 3-811 which will require the contracting officer to forward a copy of the negotiation memorandum to the **DCAA** auditor whenever cost or pricing data are used in connection with a price negotiation in excess of \$100,000. The contracting officer will also be required where appropriate to indicate to the auditor areas where the audit report could be improved or furnish suggestions designed to improve the effectiveness of audit support in future procurements.

[See GAO note.]

GAO note: The deleted comments related to matters discussed in the draft report which are not discussed in this final report.

[See GAO note.]

We appreciate the opportunity to review and comment on your draft report.

Sincerely,

A handwritten signature in black ink, consisting of a large, stylized letter 'G' followed by a vertical line extending downwards.

GAO note: The deleted comments related to matters discussed in the draft report which are not discussed in this final report.

LISTING OF SOME SUGGESTED MINIMUM STANDARDS
THAT AN ESTIMATING SYSTEM SHOULD MEET
IN ORDER TO BE CONSIDERED ACCEPTABLE¹

1. Pinpointed responsibility within the contractor's organization for origination, review, and approval of estimates for proposals.
2. Ample guidance to estimators, which is reduced to writing, as to the methods and procedures to be followed in developing estimates for the basic elements of cost. These methods would vary from highly judgmental ones in nature in certain areas of research and development to highly factual ones in nature where sufficient prior production has taken place.
3. Identification of sources of data to be used in preparing the proposals and criteria to be used to ensure that the estimates are current, complete, and accurate and that they are appropriately supported.
4. Requirement for each phase of the estimating process to be performed by personnel with competence in their assigned areas of responsibility.
5. Management approval and explanation for significant deviations from the estimating system.
6. Consistency in the application of estimates to all types of work and all types of contracts.
7. Provisions for coordination and communication between various segments of the contractor's organization having information pertinent to price proposals.
8. Active support of management as evidenced by personnel training programs, flow charts depicting the sequential steps of estimating, and the forms to be used for this activity.

¹Some of these standards below were mentioned in the Defense Procurement Circular released in January 1967 that is discussed on p. 17 of the report.

**LISTING OF POTENTIAL BENEFITS THAT MAY RESULT
FROM A DEPARTMENT OF DEFENSE PROGRAM
TO HAVE CONTRACTORS
IMPROVE AND FORMALIZE THEIR ESTIMATING SYSTEMS**

Some of the more significant benefits¹ which we believe may eventually result from a DOD program to have contractors improve and formalize their estimating systems, in addition to enabling DCAA to effectively discharge its responsibility in ASPR for review of the systems, would be:

1. To help achieve closer pricing of DOD contracts--the primary basis from which DOD controls the efficient performance of its contractors.
2. To help contractors manage the preparation of their proposals and help top management assure itself that its policies are effective and are being carried out at all levels of the organization.
3. To help the contractor and DOD comply with the requirements of Public Law 87-653 and, over the long run, reduce or minimize overpricing questions.
4. To help improve the degree of reliability the contractor can place on its cost estimates when submitting proposals and negotiating prices and when bidding in competitive situations.
5. To help reduce the audit time needed to ensure that estimated costs are reliable, thereby alleviating the DCAA

¹About one half of the benefits listed below were mentioned in the Defense Procurement Circular released in January 1967 which is discussed on page 17 of this report.

workload, which amounted to many thousands of proposals valued at about \$40 billion¹ in DCAA's first year of operation.

6. To enable DCAA to provide more reasonable and effective audit coverage within the time restrictions brought on by compressed procurement schedules.
7. To help identify the underlying data that should be submitted or evaluated in the review of price proposals and thereby tend to minimize access-to-records problems.
8. To gradually strengthen the contractors' estimating practices and reduce the number of audit questions and length of audit, thereby expediting the procurement process and curtailing administrative costs incurred through protracted negotiations.
9. To help reduce the extent of detail and explanations now required for all cost estimates in individual proposals.
10. To help guide and train personnel (both contractor and DOD) in appropriate techniques for estimating cost in varying circumstances.
11. To the extent that well developed estimating systems improve the reliability of data in pricing proposals and help strengthen contract auditing, they would reduce the need for postaward audits by both DCAA and the GAO.

¹The DCAA workload exceeds defense expenditures in this area for several reasons. For example, not all the price proposals that must be reviewed by DCAA result in contracts.

FURTHER INFORMATION ON AUTHORITY
OF DCAA AND ITS RELATIONSHIP WITH GAO

AUTHORITY

The directive establishing the Defense Contract Audit Agency (DCAA) specifically delegated to its Director authority to have free and unrestricted access to and direct communication with all elements of the Department of Defense and other executive departments and agencies as necessary. Further, the Director was delegated authority to obtain such information from any component of the Department of Defense as might be necessary for the performance of DCAA functions.

Within certain boundaries, the Director is free to prescribe the scope of a contract audit. The Armed Services Procurement Regulation provides that the contracting officer establish the due date for receipt of the auditor's report and, in so doing, allow as much time as possible for the audit work. The auditor may request additional time if he feels the time allowed is inadequate; however, the granting of additional time is at the discretion of the contracting officer. The Armed Services Procurement Regulation also provides that, within the time available, the overall scope and depth of the audit review be determined by and be the full responsibility of the contract auditor, although the auditor is required to include in his audit report any particular areas identified by the contracting officer for special emphasis.

DCM is not responsible for selecting contractors' proposals to be audited and for deciding when such audits may be waived. It is required by regulation to audit all cost-reimbursement-type contracts. With respect to establishing initial prices and final prices of negotiated contracts, the Armed Services Procurement Regulation provides that contracting officers request an audit review by the contract audit activity prior to negotiation of a contract or modification resulting from a proposal in excess of \$100,000 where the price will be based on cost or pricing data submitted by the contractor. Audits may also be requested on proposals for lesser amounts where a valid need exists.

A decision to waive an audit on proposals exceeding \$100,000 for which cost or pricing data are required can be made by the contracting officer. According to the Armed Services Procurement

Regulation, this decision may be made whenever it is clear that information already available is adequate for the proposed procurement. The only requirement for waivers is that the contracting officer document the contract file to explain the reason for waiving an audit. DCAA is not required to concur in such waivers.

The DCAA audit report is advisory to the contracting officer. The Armed Services Procurement Regulation points out that, occasionally, differences of opinion will exist not only on the reasonableness of cost projections but also on the accounting techniques on which they are based. In addition, it is normally not possible to negotiate a pricing result which is in strict accord with the opinions of all specialists evaluating the proposal or even with the Government's pricing objective. Reasonable compromises are normally necessary. The regulation states that the contracting officer is responsible for the exercise of the requisite judgments and is solely responsible for the final pricing decisions. It further provides that, when the contracting officer does not adopt auditors' or other specialists' recommendations that have particular significance on the contract price, appropriate comments should be included in the record of negotiation.

RELATIONSHIPS BETWEEN DCAA AND THE GENERAL ACCOUNTING OFFICE

A discussion of the relationships between DCAA and the General Accounting Office (GAO) and a comparison of authority and responsibilities of the two organizations follow.

The GAO, in order to perform its independent review function as part of the legislative arm of the Government, has been provided certain broad authorities by law for access to contractors' records, which are listed below.

Budget and Accounting Act, 1921 (31 U.S.C. 53)

Budget and Accounting Procedures Act of 1950 (31 U.S.C. 67)

and more specifically under the provisions of the:

Armed Services Procurement Act (10 U.S.C. 2313(b))

Federal Property and Administrative Services Act (41 U.S.C. 254(c))

Atomic Energy Act (42 U.S.C. 2206)

Authority to examine contractors' records is also contained in the Anti-Kickback Act (41 U.S.C. 53).

The Armed Services Procurement Act, the Federal Property and Administrative Services Act, and the Atomic Energy Act require that contracts negotiated without formal advertising include a clause to the effect that the Comptroller General of the United States and his representatives are entitled, until the expiration of 3 years after the date of final payment, to examine books, documents, papers, and records of the contractor, or any subcontractors, that directly pertain to and involve transactions relating to the contracts or subcontracts.

This broad authority gives GAO an opportunity to examine all records that may have a bearing on the negotiation of contract prices and other aspects of contract administration, such as quality control, adherence to agreed upon make-or-buy programs, compliance with contractual reporting requirements, care and maintenance of Government-owned property, compliance with patent and technical data provisions of the contract, accuracy of price adjustments under incentive and escalation clauses, and contract administration and performance in general.

Although DCAA is authorized to review contractors' administration and performance under cost-reimbursement-type contracts in broad area, as is GAO, it is not authorized to examine records and documents needed to conduct similar types of reviews relating to negotiated firm fixed-price and fixed-price-with-escalation contracts.

One of the basic roles of GAO is that of an independent auditor whose primary purpose is to examine into the adequacy and effectiveness of the system of management and internal control, including internal audit, which the head of each Federal agency is required to maintain over the activities for which he is responsible. The scope of this responsibility extends to activities conducted under contract as well as to those which the Government agency itself conducts.

So that the basic difference in responsibility between the audit personnel of executive agencies and of GAO may be recognized and the unnecessary duplication of effort avoided, Section 117(a) of the Budget and Accounting Procedures Act of 1950 requires that,

in the determination of the auditing procedures to be followed and the extent of his examinations, the Comptroller General give due regard to the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices of the Federal agencies.

The role of DCAA differs from that of GAO in that the Agency performs primarily an advisory service in which it acts as part of a team of technical advisors to the contracting officer. Therefore, the Agency plays an operational role and its activity cannot be said to have the attributes of an internal audit function. The audits performed by the DCAA are confined to contractor activity while GAO audits cover the broader field of both contractor activity and Government agency activity.

Under its charter, DCAA is expected to maintain liaison with other components of the Department of Defense, other agencies of the executive branch, and GAO for the exchange of information and programs in the field of assigned responsibilities. Liaison with GAO for this purpose is carried on rather extensively both at headquarters and at regional office levels. DCAA receives copies of all GAO reports relating to contract matters and reviews proposed Department of Defense responses thereto. In this way, the Agency is kept informed of GAO findings and of proposed actions with respect to GAO reports.

In turn, GAO gives full consideration to the work of the audit organizations of the contracting agencies concerned. Those organizations are an integral part of the Government's administrative processes which are to be reviewed. Moreover, the scope and effectiveness of the work of agency audit organizations on contract and agency activities are important considerations in determining the scope and nature of the audit work to be performed by GAO. By reviewing and testing their work, GAO often lessens the amount of its direct audit work. GAO field personnel are instructed that, in the review of contracts negotiated on the basis of reviews and evaluations performed by agency representatives (including the auditors), they should evaluate such work. After its reliability has been tested, maximum use is made of the work of agency personnel, thus limiting the extent of further work that GAO needs to do. Because of this, the efforts of DCAA and GAO organizations are considered complementary.

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ITEM 111--CONTRACTORS' ESTIMATING SYSTEMS

Pending publication in an ASPR revision, the changes set forth below clarify and update policies concerning responsibility for reviews of contractors' estimating systems, by emphasizing the advantages of the program, reiterating the contract auditor's responsibility for establishing and conducting the review program, and establishing criteria to be considered in determining acceptability of an estimating system. This change supersedes ASPR 3-809(c)(3)(ii), 1 June 1966, deleted herein.

3-809 Contract Audit as a Pricing Aid.

(a) through (c)(2) - No change.

(3) Responsibilities for Pre-Award Surveys and Reviews: Pre-award surveys of potential contractor's competence to perform proposed contracts shall be managed and conducted **f**** matters concerning the contractor's financial competence or credit needs.

(4) Reviews of Contractors' Estimating Systems:

(i) The establishment, maintenance, and consistent use of formal cost estimating systems by contractors is to the mutual benefit of the Government and industry, particularly where a large portion of the contractor's business is defense work and there are a number of significant proposals requiring review. Procuring activities and contract administration activities are required to furnish full support to a program of encouraging major defense contractors to formalize and follow good estimating procedures. It is recognized that estimating procedures will vary among contractors, and may vary between plants or divisions of a contractor due to differences in products, size and methods of operations, production vs. research, and other factors. While formal systems do not eliminate the need for judgmental factors to be applied by contractors in developing cost proposals, they do provide a sound foundation for the systematic and orderly application of these judgment factors to specific proposals. The consistent preparation of proposals in

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accordance with an acceptable estimating system is of material benefit in assuring both the contractor and the Government that proposals are realistically and reasonably priced, that the 3-807.3 requirements for utilizing current, accurate, and complete cost and pricing data in developing the proposal are met, and that under-estimating and over-estimating of contract costs are minimized. Some of the advantages of sound estimating procedures are: a greater degree of confidence can normally be placed in the accuracy and reliability of contractors' individual pricing proposals; it expedites the negotiation process; it reduces the amount of detailed explanation of estimating processes on each individual proposal as required by the notes on DD Form **633**; and, as in the case of the well established practice regarding acceptable accounting systems, reduces the scope of reviews performed by audit and other technical and procurement personnel.

- (ii) A regular program for conducting reviews of selected contractors' estimating systems or methods shall be established and managed by the Defense Contract Audit Agency. Reviews and reports shall be accomplished as a joint contract audit and contract administration office team effort, with the contract auditor designated as its head. Reviews shall be tailored to take full advantage of the day-to-day work done as an integral part of both the contract audit and contract administration activities. The program established by the contract audit activity shall be coordinated with the appropriate contract administration activity to assure that team membership includes qualified technical specialists, and that adequate personnel resources are made available to accomplish the program. A copy of the survey report, together with a copy of the official notice of corrective action required, shall be furnished to each purchasing and contract administration office having substantial business with that contractor. Any significant deficiencies in the system not corrected by the contractor shall be referenced in Part V of subsequent Pre-Award Surveys and will be considered in subsequent proposal reviews and by the ACO and PCO in negotiating with, and in determining

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the reasonableness of prices proposed by, that contractor. Where these deficiencies continue to exist and where they have an adverse effect on prices, the problem should be brought to the attention of procurement officials at a level necessary to bring about corrective action.

- (iii) Among the matters to be considered in determining the acceptability of a contractor's estimating system are the following:
- (A) responsibilities within the contractor's organization for originating, reviewing, and approving estimates;
 - (B) procedures followed in developing estimates for each of the direct and indirect elements of cost;
 - (C) the source of data used in developing the estimates and in assuring that such data is current, complete, and accurate;
 - (D) the documentation developed and maintained by the contractor to support the estimate;
 - (E) management support of the program review including approval of the estimate, controls established to assure consistent compliance with estimating procedures, and personnel training and evaluation programs; and
 - (F) the extent of coordination and communication between the various elements of the contractor's organization responsible for the estimate.

PEN-AND-INK CHANGES: Page 301--Par. 3-101(viii) 7th line: change "(DCC-OSB)" to "(DDC-OSB)".

Page 346.3--Par. 3-606.3(b)(ii) last 3 lines: delete "(In the case of multiple deliveries ~~xxx~~ is completed.)"

--Par. 3-606.3(b)(iii) 1st line: change "or" to "on".

--Par. 3-606.3(b)(iv) clause, 1st line: change "(NOV. 1964)" to "(APR. 1966)"; and in par. (a), last line: delete last sentence "Only one payment will be made."