Policy and Oversight

Contract Audit Directorate

Defense Hotline Allegations Concerning
Contract Audit Recommendations

Report Number PO 97-056 September 29, 1997

Office of the Inspector General
Department of Defense

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Acronyms

ACO	Administrative Contracting Officer
CAS	Cost Accounting Standards
CAM	Contract Audit Manual
DCAA	Defense Contract Audit Agency
DFARS	Defense Federal Acquisition Regulation Supplement
FAO	Field Audit Office
FAR	Federal Acquisition Regulation
NAPS	Navy Acquisition Procedures Supplement
NAVSEA	Naval Sea Systems Command
NNS	Newport News Shipbuilding and Dry Dock Company
RAM	Regional Audit Manager
SUPSHIP	Supervisor of Shipbuilding, Conversion, and Repair

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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September 30, 1997

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation Report on Defense Hotline Allegations Concerning Contract Audit Recommendations (Report No. PO 97-056)

We are providing this evaluation report for review and comment. We conducted the evaluation in response to a complaint made to the Defense Hotline. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Navy fully concurred with our findings and recommendations and left no unresolved issues. Therefore, no additional comments are required from the Navy. The Defense Contract Audit Agency comments, however, were partially responsive. We request that the Defense Contract Audit Agency provide additional comments on Recommendation C. in response to the final report by December 1, 1997.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation should be directed to Mr. Maurice Nestor, Evaluation Program Director, at (703) 604-8789 (DSN 664-8789) or Ms. Suzanne J. Servis, Project Manager, at (703) 604-8745 (DSN 664-8745). See Appendix D for the report distribution.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

Office of the Inspector General, DoD

Report No. PO 97-056 **September 30, 1997**
(Project No. 6OC-8020)

Defense Hotline Allegations Concerning Contract Audit Recommendations

Executive Summary

Introduction. We performed this evaluation as a result of a Defense Hotline complaint. Allegedly, the contract administration staff at the Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) facility at Newport News, Virginia, did not support Defense Contract Audit Agency audit recommendations and delayed the resolution of related audit issues, which resulted in significant harm to the Government's interests. The Hotline complaint alleged that 14 issues with cost impacts to the Government of $94.6 million (including interest of $16.1 million) were handled improperly by the SUPSHIP. Also, Defense Contract Audit Agency management officials allegedly declined to act when these conditions were brought to their attention.

Evaluation Objectives. The overall evaluation objective was to determine the validity of the two Hotline allegations. Specifically, we reviewed actions the Administrative Contracting Officer at the SUPSHIP Newport News took on contract audit recommendations and the actions Defense Contract Audit Agency management officials took in pursuing reports of unsatisfactory conditions.

Evaluation Results. We substantiated both Hotline allegations. The Administrative Contracting Officer did not promptly settle and did not support audit recommendations the Defense Contract Audit Agency made on the 14 issues cited in the Hotline complaint. Also, Defense Contract Audit Agency management failed to properly address the unsatisfactory conditions reported by its field audit staff at the SUPSHIP Newport News. We also found additional conditions requiring corrective action by both the Naval Sea Systems Command and the Defense Contract Audit Agency.

o The SUPSHIP Administrative Contracting Officer did not follow Federal Acquisition Regulation and Navy procedures for negotiation and settlement of contract audit recommendations. Therefore, we could not determine whether the Administrative Contracting Officer had negotiated fair and reasonable settlements for contract audit issues with questioned costs of $44.5 million. Also, the Administrative Contracting Officer did not conduct adequate analyses to determine whether interest was due the Government on audit-questioned costs paid to the contractor.

o The SUPSHIP Administrative Contracting Officer did not follow Federal Acquisition Regulation requirements for administering Cost Accounting Standards. Therefore, the Government paid increased costs because the Administrative Contracting Officer did not require the contractor to correct noncompliances within the period

required by the Regulation. Also, the Administrative Contracting Officer did not execute contract price adjustments when the contractor was in noncompliance with Cost Accounting Standards, allowing the contractor to earn additional profit on fixed-price incentive contracts.

o The Defense Contract Audit Agency lacks adequate management controls to ensure that unsatisfactory conditions encountered by its Field Audit Offices are resolved in a timely manner.

Summary of Recommendations. We recommend that the Commander, Naval Sea Systems Command, establish a council of management officials to facilitate business decisions at the SUPSHIP. We also recommend that he direct the SUPSHIP staff to follow pertinent acquisition regulations and obtain training in their proper use; that the SUPSHIP require Newport News Shipbuilding to strengthen its controls for ensuring that unallowable costs are not charged to the Government; and that the SUPSHIP determine whether it overpaid Newport News Shipbuilding as a result of Cost Accounting Standards noncompliances and assess interest accordingly. We also recommend that the Director, Defense Contract Audit Agency, revise the Contract Audit Manual to strengthen and clarify procedures for addressing unsatisfactory conditions involving Government operations.

Management Comments. The Assistant Secretary of the Navy for Research, Development and Acquisition concurred with the findings and recommendations and initiated corrective action on all eight recommendations directed to the Navy. The Navy has completed corrective action on two of the recommendations. The Naval Sea Systems Command has also incorporated lessons learned from this review into its procurement management review process for all SUPSHIP locations.

The Defense Contract Audit Agency generally nonconcurred with recommendations to revise its Contract Audit Manual to clarify and expand procedures for processing reports of unsatisfactory conditions submitted by Field Audit Office employees. The report contains a discussion of the management comments in Part I and the full texts of management comments in Part III.

Evaluation Response. The Navy comments were fully responsive to the report recommendations. Moreover, the Navy was cooperative and responsive during the evaluation and independently analyzed conditions at the SUPSHIP facility at Newport News. The Naval Sea Systems Command acted promptly to address conditions at that location.

The Defense Contract Audit Agency comments were partially responsive. Although it provided some details for processing reports of unsatisfactory conditions, the agency should develop and comply with a comprehensive, reasonable process for ensuring that the reports are considered seriously and addressed appropriately and that decisions are documented. We ask that the Director, Defense Contract Audit Agency, outline such a process in additional comments on the final report and provide an implementation date. The additional comments should be submitted by December 1, 1997.

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Part I - Evaluation Results

Evaluation Background

We conducted this evaluation in response to a Defense Hotline complaint. The complainant alleged that the Administrative Contracting Officer (ACO) at the Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) facility at Newport News, Virginia, delayed action on and did not support contract audit recommendations the Defense Contract Audit Agency (DCAA) made on accounting and financial operations of the Newport News Shipbuilding and Dry Dock Company (NNS). The complainant also alleged that the Resident Auditor at the Eastern Region Resident Office at NNS did not take appropriate action when these conditions were reported to him. The DCAA audit recommendations cited in the Hotline complaint were in audit reports issued to the SUPSHIP for resolution and disposition and covered 14 contract audit issues. One of the issues was the subject of a Hotline allegation previously resolved by the Office of the Inspector General, DoD; another was assigned to a location other than the SUPSHIP and, therefore, was not included in this review. To determine whether the Hotline allegations were substantiated, we evaluated the actions the ACO took on the remaining 12 issues and the actions the DCAA Resident Auditor and regional office management took on the unsatisfactory conditions reported at the SUPSHIP. The complainant alleged 10 of the 12 issues involved $78.5 million in questioned costs, plus applicable interest of $16.1 million. The actual dollar amounts for these issues have changed slightly because of more recent audit work by DCAA.

Evaluation Objectives

The overall evaluation objective was to determine the validity of the Hotline allegations. Specifically, we reviewed actions the ACO at the SUPSHIP Newport News took on contract audit recommendations and that DCAA management officials took in declining to pursue reports of unsatisfactory conditions. See Appendix A for details on our evaluation process and on prior reviews.

Finding A. Disposition of Contract Audit Recommendations by the Supervisor of Shipbuilding, Conversion, and Repair at Newport News

The ACO at the SUPSHIP took an average of 24.8 months to disposition the nine closed contract audit issues we reviewed. Also, the SUPSHIP sustained only 38.5 percent of the audit questioned costs for the nine closed issues, which was considerably less than the performance measure of 60 percent sustention other DoD acquisition and contract administration organizations have experienced. Further, the ACO did not follow Federal Acquisition Regulation (FAR) and Navy requirements for documenting prenegotiation objectives and the results of negotiations for contract audit issues, including the rationale for significant variations from audit recommendations. The ACO also did not pursue potential monetary recoveries or interest related to Cost Accounting Standards (CAS) noncompliances by the contractor. As a result, the Government had no assurance that $44.5 million in negotiated settlements was fair and reasonable.

Timeliness of Settling Contract Audit Issues

The Hotline complaint alleged that the ACO at the SUPSHIP delayed the resolution of audit issues, resulting in significant harm to the Government's interests. Evaluation of nine closed contract audit issues supported this allegation. The SUPSHIP ACO took an average of 24.8 months to settle the nine issues, which had monetary impacts of $44.5 million to the Government. This length of time significantly exceeded the 12-month disposition standard in DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports." A tenth issue with a CAS cost impact of $32.7 million was still open, as was a segment of one of the nine issues with questioned costs of $1.4 million. As a result, since January 1, 1986, the date the oldest CAS noncompliance began, the NNS had the use of potentially unallowable costs totaling $78.5 million that may have been overpaid by the Government (see Finding B). The DCAA calculated interest of $16.1 million on two of these issues, with potential interest due on 9 of the 10 issues in the allegations that had monetary impacts to the Government.

Delays in settling these contract audit issues have been harmful to the Government because potential overpayments remain in the hands of the contractor until the ACO decides the issues, determines and recovers overpayments, and assesses and collects interest on overpaid amounts. Although nine of the issues had been settled, the ACO had not yet determined whether increased costs due to the CAS noncompliances should be recovered. Therefore, potential overpayments were still in the hands of the contractor. The ACO needs to promptly determine whether increased costs were paid to NNS. Also, contractor accounting practices that were noncompliant with the CAS remained uncorrected longer than necessary because the ACO delayed settlement of CAS noncompliance issues. The harm caused by these delays will be compounded if the ACO does not collect interest on the overpayments, providing NNS with interest-free loans for being in noncompliance with CAS or for incurring questionable costs. According to the SUPSHIP, NNS insisted on settling several audit issues by December 1996, when Tenneco, Inc., the parent company of NNS, reorganized NNS as a stand-alone entity.

Support for DCAA Audit Recommendations

The SUPSHIP ACO sustained 38.5 percent of the audit questioned costs for the nine closed issues in the Defense Hotline allegations. A prior Inspector General, DoD, review (see Appendix A) found that a sustention rate of approximately 60 percent was experienced by DoD acquisition and contract administration organizations. Although this is a general measure, and analysis of the data in any instance may reveal conditions that invalidate comparison to this benchmark, sustention well below 60 percent demands analysis to determine whether problem areas require corrective action. At the SUPSHIP, the reasons for nonsustention of questioned costs were not documented, which called into question whether fair and reasonable settlements were negotiated on contract audit recommendations. In particular, we found no basis for ACO decisions on at least three issues.

o **SEAWOLF Product Expense Costs.** DCAA stated in audit report 1721-95C19200004-001, September 18, 1995, that NNS was in noncompliance with CAS 418, Allocation of Direct and Indirect Costs. From 1989 through 1993, NNS established seven indirect product expense job orders that benefited only SEAWOLF submarine design or preconstruction projects, but improperly allocated the costs to 688 class submarine and aircraft carrier construction contracts. A SEAWOLF construction contract was never awarded to NNS. The ACO sustained only $1,072,466 (20.0 percent) of the $5,000,926 questioned by DCAA and did not document the basis for his position.

o **Penalties on Unallowable Costs.** The SUPSHIP ACO waived penalties of $7,815,742 that DCAA recommended he assess on unallowable costs included by NNS in its 1989 and 1990 incurred costs submissions. The ACO waived the penalty assessments even though DCAA audit report 1721-95C15500001-001, issued before the 1989/1990 overhead settlement, found that NNS had inadequate policies and procedures for identifying and excluding unallowable costs from its incurred cost submission. The purpose of these types of penalties is to ensure that unallowable costs are excluded from contractors' incurred cost submissions and that contractors maintain adequate controls to ensure that such costs are not claimed. We found no basis to waive the penalties when DCAA has found a contractor's accounting system inadequate to protect the Government from unallowable charges.

o **Bid and Proposal Costs.** The SUPSHIP sustained only $672,826 of $2,917,036 that DCAA stated in audit report 1721-94C19200-003, August 3, 1995, were Bid and Proposal costs mischarged to a Marketing Activities job order. Since NNS exceeded the allowable ceiling amounts for Independent Research and Development and Bid and Proposal costs for 1990, 1991, and 1992, the proper classification of these costs as Bid and Proposal costs should have resulted in an ACO decision that all the questioned costs were unallowable.

The delays in settling contract audit issues, the lack of documentation to support nonsustention of questioned costs, and other procedural deficiencies were not in the best interests of the Government and were not in accordance with basic acquisition principles.

Preparing for and Documenting the Results of Negotiations

The purpose of prenegotiation documentation is to establish all significant details of a contract negotiation plan and the strategy the contracting activity proposes to follow in the negotiation. The documentation should show how the negotiator developed his/her position, taking into account recommended positions in field pricing, technical, and audit reports and should demonstrate that the negotiator is adequately prepared to negotiate. Postnegotiation documentation should demonstrate that the business/pricing agreement reached was fair and reasonable and complete the historical record for the action planned in the prenegotiation documentation.

FAR and Defense Federal Acquisition Regulation Supplement Documentation Requirements. The FAR 15.807, "Prenegotiation

Objectives," and 15.808, "Price Negotiation Memorandum," establish requirements for documenting the objectives and results of price negotiations. In addition, the Defense Federal Acquisition Regulation Supplement (DFARS) 215.807, "Prenegotiation Objectives," states that "prenegotiation objectives, including objectives related to disposition of findings and recommendations contained in preaward and postaward contract audit and other advisory reports, shall be documented and reviewed in accordance with Departmental procedures."

Navy Business Clearance Requirements. For the Navy, Departmental procedures are in the Navy Acquisition Procedures Supplement (NAPS) 5201.690-8, "Special Business Clearance Requirements," which requires the ACO to prepare a business clearance memorandum for all determinations of CAS compliance or noncompliance and before negotiation of net CAS cost impacts of $1 million or more. The Naval Sea Systems Contracting Manual, July 1993, requires that CAS business clearances required by the NAPS be reviewed and approved by the Naval Sea Systems Command (NAVSEA) Contract Management Division. Business clearance approval for final indirect cost rate agreements has been delegated by NAVSEA to the SUPSHIP.

SUPSHIP Business Clearance Requirements. The SUPSHIP Newport News Instruction 4330.16G, "Contract Review of Business Clearances," establishes procedures and assigns responsibilities for formal review of prenegotiation business clearances within the SUPSHIP Newport News. The Instruction states that effective procurement disciplines are enhanced when actions involving significant dollar amounts are objectively reviewed at an administrative level organizationally above that of contracting officer. The Instruction establishes a SUPSHIP Contract Review Board and requires it to review and approve all prenegotiation business clearances when the Government's pricing objective is valued at a net of $500,000 or more and when all business clearances cited in the previous paragraph are required by NAVSEA.

Business Clearance Practices at SUPSHIP Newport News. Nine of the issues the SUPSHIP ACO had settled were subject to the NAPS, NAVSEA, or SUPSHIP review and clearance procedures because the issues involved CAS noncompliance allegations or had net monetary impacts of $500,000 or more. These issues had questioned costs or cost impacts to the Government of $44.5 million. However, the ACO at the SUPSHIP did not prepare business clearance documents for these issues nor did he prepare pre- or postnegotiation memorandums to document the objectives and results of negotiations. We discussed the business clearance requirements with SUPSHIP personnel, including the Contracts Department Director, the ACO, and the Contractor Performance Analysis Division accountant who supported the ACO in

negotiations. The ACO stated he did not believe clearances were required for issues cited in DCAA postaward audit reports or for CAS noncompliance issues unless the clearances involved voluntary accounting changes.

The NAVSEA Contract Management Branch confirmed that business clearance was required for all determinations of CAS compliance or noncompliance and for CAS noncompliance cost impacts with a net value of $1,000,000 or more. We alerted NAVSEA that the SUPSHIP was preparing to negotiate a group of CAS noncompliance and other audit issues with large amounts of questioned costs before December 1996 when Tenneco, Inc., the parent company of NNS, was planning to reorganize NNS as a separate company. The comprehensive negotiation of these issues is referred to as the "global settlement." According to NAVSEA officials, the SUPSHIP had not recently submitted any business clearances, so we suggested that NAVSEA contact the ACO at the SUPSHIP because he did not believe clearances were required. The SUPSHIP is also required to report quarterly to NAVSEA on the status of contract audit reports issued to the SUPSHIP. If these reports had been distributed to the NAVSEA Contract Management Branch, the Branch would have been aware that the SUPSHIP was working CAS noncompliance issues and could have requested business clearances from the SUPSHIP.

In early December 1996, SUPSHIP officials indicated that NNS would be reorganized as a separate entity from Tenneco, Inc., on December 10, 1996, and that negotiation of the global settlement was nearly complete. Since our October visit, the SUPSHIP contracting personnel had not contacted NAVSEA, as we had advised, to clarify business clearance requirements. The Chief of the SUPSHIP Contracts Department also informed us that the Contract Review Board had not convened since he began his tour of duty at the SUPSHIP in July 1996, and he did not know of any plans to do so. SUPSHIP Instruction 4330.16G requires that the Chief be a member of the Contract Review Board.

During our October and early December 1996 visits, we apprised the SUPSHIP staff and the Supervisor of Shipbuilding, Conversion, and Repair (the Supervisor) of the requirements for preparing business clearances, documenting the results of negotiations, and assessing interest on CAS cost impacts. On December 10, 1996, the SUPSHIP signed the global settlement agreement without complying with these requirements. On January 7, 1997, the Assistant Inspector General for Policy and Oversight, DoD, informed the Commander of NAVSEA of these findings. The Commander of NAVSEA responded on February 24, 1997, that he had directed the SUPSHIP to correct the deficiencies and directed independent assessment of conditions at the SUPSHIP. A second response on March 18, 1997, included a response from the SUPSHIP, who concurred with two of our three findings and proposed corrective actions, but

nonconcurred with our finding that the SUPSHIP had not determined whether increased costs had been paid to NNS due to CAS noncompliances assessed and interest collected accordingly.

Global Settlement of Contract Audit Issues. The SUPSHIP Contracting Officer signed on December 10, 1996, a global settlement agreement encompassing 25 issues. Six of these issues were in the Hotline complaint, with $22,778,641 questioned and $12,610,503 sustained, for a sustention rate of 55.4 percent. For these six issues, we could not determine from either the official contract files or the documentation included with the global settlement the reasons why 44.6 percent of the costs questioned by DCAA were not sustained, and we could not determine the rationale for settlement or the specific treatment of certain costs. Moreover, the settlement agreement and the disposition of each cost element had been prepared by the contractor, which gave the appearance that the ACO did not maintain his independence in the negotiation process. The Government negotiation team did not comply with the FAR or DFARS, Navy, or SUPSHIP documentation and business clearance requirements to explain the basis for the disposition of costs.

o DCAA audit report 1721-94C15500001-001, July 14, 1995, reported on provisional overhead disallowance rates NNS proposed for billing purposes for 1989 through 1995. The auditor found that the NNS proposed rates were understated and would result in significant overbilling to the Government if accepted by the ACO. The report also stated that NNS did not have adequate internal controls for identifying and excluding unallowable costs when establishing billing rates or preparing its incurred cost submission, which made the Government vulnerable to paying unallowable costs to NNS. The ACO accepted the rates, and on April 1, 1996, DCAA identified $1,989,693 overbilled by NNS for 1991 through 1995. In the December 10, 1996, global settlement, the ACO did not sustain the NNS overbillings. The agreement simply stated that "Government accepts NNS monetary position," with no further discussion. This action perpetuated the contractor's weak system of controls and left the Government at risk of paying future unallowable costs.

o DCAA audit report 1721-95C19200004-001, September 18, 1995, cited NNS for noncompliance with CAS 418 for misallocating SEAWOLF product expense costs to 688 class submarine construction and aircraft carrier construction contracts. The auditor questioned $5.0 million for 1989 through 1993. The SEAWOLF product expense issue for 1991 through 1993, with questioned costs of $2,559,832, was settled as part of the December 10, 1996, global settlement, with the Government sustaining $511,966. The settlement agreement stated that "NNS accepts a disallowance for SEAWOLF Product Expense similar to the 1989-1990 Overhead Negotiation Settlement. Cost will be disallowed via overhead disallowance rate." The ACO spreadsheet that

documented the 1989 through 1990 overhead negotiation specified a 50/50 Government/NNS split for SEAWOLF product expense costs. However, the ACO applied an 80/20 ratio to the questioned costs in the global settlement without adequate justification. Adherence to the 50-percent split would have saved the Government $1,279,916. Thus, the ACO action cost the Government $767,950 ($1,279,916 minus $511,966).

Distribution of Disposition Documentation. The FAR and DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," require that a copy of the price negotiation memorandum, which summarizes the results of negotiations, be forwarded to the cognizant audit office. This requirement enables DCAA to use the postnegotiation documentation for improving audit procedures and practices. Because the SUPSHIP did not document negotiations, the DCAA Resident Office at NNS was not apprised of the results of negotiations on its findings and recommendations.

Documentation for the 10 issues that were subject to DoD clearance requirements did not demonstrate that the SUPSHIP negotiators were adequately prepared for negotiations, had established negotiation objectives, had any rationale for variances from audit report recommendations, or that the settlements achieved were fair and reasonable. Moreover, the only negotiation documentation available in most cases, including the global settlement agreement, was prepared by NNS.

Increased Costs and Interest Potentially Due the Government

The FAR 30.602-2, "Noncompliance with CAS Requirements," requires that interest on CAS noncompliance cost impacts accrue from the time increased costs are paid to the contractor until the Government receives full compensation for the price adjustment. The December 1996 global settlement agreement between NNS and the SUPSHIP included four issues for which the Government sustained $10.7 million in costs questioned by DCAA auditors because of CAS noncompliances by the NNS. The SUPSHIP ACO did not recover the $10.7 million or interest on this amount because he determined that none of it had been paid to the contractor. He asserted that the provisional overhead

billing rates for 1991 through 1996 contained a Provision for Open Items* element that was withheld from each payment and that the Government withheld more money than the increased costs that resulted from the CAS noncompliances included in the global settlement. If no increased costs were paid to NNS, then no interest would be due the Government. However, in the opinion of DCAA, interest may be due on all four CAS issues.

Even if the ACO rationale that overpayments had not been made was valid, the SUPSHIP ACO could provide no evidence that he had conducted the necessary analysis to reach that conclusion regarding the $10.7 million sustained by the Government in the global settlement agreement. The $10.7 million does not include CAS cost impacts for other noncompliances, such as modular outfitting facility/land-level facility, or other disallowed costs, that might count against the Open Items element for a given year.

The SUPSHIP did not perform an ongoing year-by-year analysis of the CAS cost impacts sustained by the Government in the global settlement, all other CAS cost impacts effecting each year, and other applicable disallowances for each year to show whether or not the total of these costs for a given year exceeded the Open Items element for that year. At a minimum, the amounts that exceed the Open Items element would be considered overpayments to the contractor and should be recovered by the SUPSHIP together with applicable interest. Such an analysis, subject to audit review, would ensure that the Open Items element had not been exceeded because it was used several times in a given year to offset different groupings of cost impacts or disallowances.

If the ACO applies his rationale to CAS noncompliance issues in future negotiations, even more interest may be lost. The largest unsettled issue has a cost impact of $32.7 million, which does not include interest of $14.9 million calculated by DCAA through December 31, 1995 (interest will continue to accrue until a contract price adjustment is effected). Because the ACO is not following the CAS administration procedures, however, contract price adjustments are not being effected and interest is not being assessed.

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*The Open Items element is essentially what DCAA refers to as voluntary management reductions (Contract Audit Manual 6-604.2). These are lump-sum, unsupported estimates that do not identify the type and amount of unallowable costs not being claimed. Contractors use voluntary management reductions to reduce their risk of noncompliance when controls for separately identifying and excluding unallowable costs are weak or ineffective. They are not an acceptable alternative to an effective system of controls for identifying and excluding unallowable costs from incurred cost proposals. Contractors are required by law to identify and eliminate unallowable costs from their submissions.

SUPSHIP Adherence to Acquisition Principles

The ACO and the SUPSHIP contract administration staff exhibited persistent procedural deficiencies in the disposition of contract audit recommendations, which resulted in significant loss of monies and placed the Government at risk of paying unallowable costs. The SUPSHIP lack of adherence to basic acquisition principles for preparing for and documenting the results of negotiations and for administration of CAS, combined with an assertive stance by NNS on contract audit issues, strengthened the negotiating position of NNS to the detriment of the Government. These conditions also led to a deteriorated relationship between the SUPSHIP and DCAA that benefited NNS at the expense of the Government. The Commander of NAVSEA should establish a council of managers including the Director or Deputy Director of the DCAA Eastern Region and a NAVSEA official to improve these relationships and to ensure that business decisions involving contract audit issues are made within a reasonable time. Moreover, the DCAA Eastern Region and Headquarters management should be actively involved with the NAVSEA Headquarters to resolve the unsatisfactory conditions reported by its field office staff.

At the working level, the SUPSHIP and DCAA staffs need to present a unified presence when interacting with the contractor. The ACO should, for example, request auditor attendance when contract audit issues are to be discussed or negotiated with NNS so the auditor can explain the audit report recommendations, discuss the bases for audit determinations, and review any additional cost information the contractor may submit or any different considerations that the contractor may allege during negotiations. Auditor attendance could help the ACO to better assess the relative positions of NNS and DCAA on contract audit issues before arriving at a definitive agreement. The ACO should also work with NNS to resolve audit issues as they are found by DCAA, instead of waiting until the audit is completed, to reduce the overall audit cycle time.

Recommendations for Corrective Action

A. We recommend that the Commander, Naval Sea Systems Command:

1. Initiate action to establish a management council at Newport News composed of one official each from the Defense Contract Audit Agency, Naval Sea Systems Command, and Newport News Shipbuilding to facilitate business decisions and, in conjunction with the Administrative

Contracting Officer, resolve all outstanding contract audit recommendations. The management council should report its activities quarterly to the Commander of the Naval Sea Systems Command.

2. Direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to prepare pre- and postnegotiation business clearances on future negotiations in accordance with Navy regulations that fully document and support the decisions made by the Administrative Contracting Officer.

3. Require the Administrative Contracting Officer and his staff at the Supervisor of Shipbuilding, Conversion and Repair, Newport News, to attend training in preparing pre- and postnegotiation business clearances as well as the contract cost principles and negotiation principles and procedures.

4. Direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to disapprove use by Newport News Shipbuilding of the Open Items element in its provisional disallowance rate submissions and require that Newport News Shipbuilding implement appropriate internal controls to ensure that unallowable costs are specifically identified and eliminated from claims against the Government.

5. Direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, with the assistance of the Defense Contract Audit Agency, to determine whether Newport News Shipbuilding and Dry Dock Company owes costs or interest for amounts sustained by the Government in the December 12, 1996, global settlement agreement. This determination should include a comprehensive year-by-year analysis for 1991 through 1996 of the Cost Accounting Standards cost impacts sustained by the Government in the global settlement, all other Cost Accounting Standards cost impacts affecting each year, and all other applicable disallowances for each year. These amounts should be compared to the Open Items element for each of those years and, if overpayments occurred, the Administrative Contracting Officer should recover the overpayments and assess and collect interest. The results of the analysis, including the auditor's opinion of the analysis, should be provided to the Inspector General, DoD, along with copies of demand letters from the Supervisor of Shipbuilding, Conversion, and Repair to Newport News Shipbuilding for collection of any costs or interest due the Government.

Navy Comments. The Navy concurred with all the recommendations. It has established the management council, which is overseeing full implementation of all corrective action. The NAVSEA conducted an on-site review of business clearance procedures and has provided training to ensure future compliance with Navy regulations. The management council reviewed the disallowance rate, unallowable cost screening, and interest assessment issues with the DCAA and the contractor, and the Navy estimates completion of corrective action for these three issues by February 9, 1998. The full text of the Navy comments is in Part III.

Finding B. Administration of Cost Accounting Standards by the Supervisor of Shipbuilding, Conversion, and Repair, Newport News

For seven of the issues in the Hotline complaint, the SUPSHIP ACO did not follow FAR procedures for administration of Cost Accounting Standards that are required when the auditor has alleged CAS noncompliance. As a result, NNS was not required by the ACO to promptly correct Cost Accounting Standards noncompliances, submit adequate cost impact proposals within a reasonable time, execute contract price adjustments, or repay increased costs paid by the Government. The DCAA had estimated CAS noncompliance cost impacts of $58.7 million for the seven issues.

Processing of Alleged Cost Accounting Standards Noncompliances

The FAR 30.602, "Cost Accounting Standards Administration," describes procedures for the ACO to follow when DCAA cites a contractor for noncompliance with a Cost Accounting Standard. The CAS administration procedures establish periods within which the ACO and the contractor are to take specific actions so that noncompliances are corrected and resulting overpayments are promptly recouped by the Government. The FAR 30.602-2, "Noncompliance with CAS requirements," and the clause at 52.230-6 require that contractors follow the procedures and make specific submissions to the ACO. Key points in the CAS administration procedures include the following.

o Within 15 days of the receipt of a report of alleged noncompliance from the auditor, the ACO should make an initial finding of compliance or noncompliance and immediately notify the contractor.

o The contractor is allowed 60 days to agree or to submit reasons why the existing practices are considered to be in compliance.

o If the contractor agrees with the initial finding of noncompliance, the contractor has 60 days to submit a description of any cost accounting practice change required to correct the noncompliance and to submit the cost impact of the noncompliance.

o If the contractor disagrees with the initial finding of noncompliance, the ACO should review the reasons why the contractor considers the existing practice to be compliant and make a determination of compliance or noncompliance. If the ACO determines noncompliance, the contractor has 60 days to submit a description of the accounting practice change required to correct the noncompliance and to submit the cost impact of the noncompliance.

o If the contractor does not make the submissions required by these procedures, FAR 30.602-2 and 52.230-6 permit contractual remedies for obtaining them, including withholding a percentage of payments to the contractor and unilateral contract adjustments.

These procedures provide for timely resolution of CAS noncompliance allegations, correction of noncompliant practices, determination of the cost impacts of noncompliances, and recoupment of overpayments made by the Government because of noncompliances.

SUPSHIP Actions on Alleged Cost Accounting Standards Noncompliances. In seven cases, the ACO did not follow the FAR procedures for administration of the CAS when DCAA alleged NNS noncompliance with them. DCAA estimated that the cost impacts to the Government, either general dollar magnitude or audit of the contractor's cost impact proposals, totaled $58.7 million (excluding interest) for these cases. The ACO did not require the contractor to promptly correct the noncompliances or to submit timely and adequate cost impact proposals as required by the FAR. The ACO also did not initiate withholding payments when the contractor delayed submission of adequate cost impact proposals, although DCAA had recommended doing so on the modular outfitting facility/land-level facility and submarine material control cost issues. The ACO also did not recover increased costs paid to the contractor because of the noncompliances, execute the required contract price adjustments, or assess and collect interest on the increased costs as required by statute.

o Two CAS 418 noncompliances involving misallocation of modular outfitting facility/land-level facility costs were cited in DCAA audit reports (Audit Report Nos. 1721-92C19200004-001 and 1721-92C19200003-001), dated April 21, 1993. Although the ACO sent the audit reports to the contractor and exchanged correspondence on the issues, he did not make determinations of noncompliance and request cost impact proposals until January 27, 1995, nearly 2 years later. The contractor did not submit an adequate cost impact proposal until August 2, 1996, although DCAA first recommended in January 1995 that the ACO withhold payments until NNS submitted an adequate cost impact proposal. The DCAA audited the August 1996 proposal and verified the cost impact as $32.7 million, with an additional $14.9 million in interest through December 31, 1995. This issue is still open.

o DCAA cited another CAS 418 issue involving misallocation of material handing costs on November 28, 1994 (Audit Report No. 1721-94C19200003-001), with an estimated general dollar magnitude cost impact of $7.9 million. The ACO did not issue a determination of noncompliance or request a cost impact proposal and description of the changed cost accounting practice as required by FAR 30.602-3 and FAR 52.230-5. NNS never submitted a cost impact proposal. By agreement with the SUPSHIP, NNS was to reallocate 50 percent of the affected costs, apparently based on the DCAA general dollar magnitude estimate, in November 1996, although the rationale for this agreement was never specified. We found no evidence that a description of the accounting change that caused the noncompliance was submitted to the SUPSHIP for an ACO determination of adequacy.

o The DCAA cited NNS on September 2, 1993, for a CAS 418 noncompliance related to mischarging submarine material control costs (Audit Report No. 1721-93C19200005-001). The ACO did not issue a determination of noncompliance until April 20, 1995. Although this issue had been referred for investigation of fraudulent practices, the ACO informed NNS it was not relieved of responsibility for resolution of CAS noncompliance issues while the investigation was ongoing. The contractor did not submit an adequate cost impact proposal until August 2, 1996, nearly 3 years after the audit report was issued, even though DCAA first recommended in June 1994 that the ACO withhold payments until NNS submitted an adequate cost impact proposal.

Settlement of CAS Noncompliances as Cost Disallowances

The method used for settling CAS noncompliances and cost impacts also resulted in inequities to the Government. FAR 30.602 requires that the ACO promptly analyze the contractor's cost impact proposal and, with the assistance of the auditor, determine the cost impact and negotiate a contract price adjustment. According to 48 Code of Federal Regulations 9903.306, increased costs result when the cost paid by the Government is due to failure to comply with applicable CAS and such cost is higher than it would have been had the contractor complied with CAS. If the contractor fails to comply with CAS under fixed-price contracts, increased costs are measured by the difference between the contract price agreed to and the contract price that would have been agreed to had the contractor proposed in accordance with the cost accounting practices used during contract performance. The resulting contract price adjustment should provide for recovery of the increased costs together with interest.

The ACO obtained cost impact proposals from the contractor for only two of the seven CAS noncompliance issues in the Hotline complaint. The DCAA estimated general dollar magnitude cost impacts of $58.7 million for the seven CAS issues, but the ACO did not negotiate and execute contract price adjustments in accordance with the FAR. Instead, for four CAS issues in the global settlement, the ACO agreed that the contractor could simply transfer misallocated costs or that the costs could be disallowed through the overhead disallowance rate for the applicable contract year. If the ACO does not adjust the contract price or target cost in these affected fixed-price incentive contracts, then the disallowance below the target cost reduces the costs the contractor can charge to the contract and increases incentive profit. The following table illustrates the effect on profit earned by the contractor if a CAS cost impact of $500,000 is treated as a cost disallowance instead of a contract price adjustment.

Cost Accounting Standards Cost Impact
Cost Disallowance Versus Contract Price Adjustment

	Overhead Disallowance	Contract Price Adjustment
Share Ratio (Govt/Contr)*	70/30	70/30
Target Profit	$ 900,000	$ 900,000
Target Cost	10,000,000	10,000,000
Target Cost Reduction	-0	-500,000
Adjusted Target Cost	10,000,000	9,500,000
Actual Cost	9,500,000	9,500,000
Profit Adjustment:		
Disallowed Cost (underrun)	500,000	0
Contractor Share	x.30	x.30
Contractor Profit Share	**150,000**	**0**
Target Profit	+900,000	+900,000
Contractor Profit	**$ 1,050,000**	**$ 900,000**

*Between Government and contractor.

In this example, the contractor obtained additional profit of $150,000 following the SUPSHIP practice of treating CAS noncompliance cost impacts as disallowed costs instead of executing a contract price adjustment. The two CAS issues for which the ACO received cost impact proposals from NNS (modular

outfitting facility/land-level facility and Submarine Material Control Costs) had cost impacts to the Government of $36.8 million which, if settled as overhead disallowances without adjusting contract target costs, will increase profit for NNS.

The ACO delays in pursuing resolution of these CAS noncompliance issues and his failure to use contractual remedies, such as withholding payments to obtain adequate cost impact proposals from NNS, suggest that he either did not have knowledge of or was disregarding the CAS administration procedures and was not, therefore, using the proper remedies to protect the Government's interests.

Recommendations for Corrective Action

B. We recommend that the Commander, Naval Sea Systems Command:

1. Direct the management council established in Recommendation A.1. to ensure that the Administrative Contracting Officer promptly resolves all outstanding Cost Accounting Standards noncompliances reported by the Defense Contract Audit Agency in accordance with DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports."

2. Require the Administrative Contracting Officer and his staff at the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to take training on Cost Accounting Standards and related Federal Acquisition Regulation contractual requirements.

3. Direct the Supervisor of Shipbuilding, Conversion and Repair, Newport News, to follow the Federal Acquisition Regulation 30.602, "Administration of Cost Accounting Standards," for negotiating Cost Accounting Standards cost impacts, executing contract price adjustments, recovering overpayments, and assessing interest in all future noncompliance cases.

Navy Comments. The Navy concurred with all the recommendations and estimated that corrective action will be completed by February 9, 1998, for Recommendations B.1. and B.2. Action is completed for Recommendation B.3. On June 30, 1997, the SUPSHIP issued Instruction 4330.15, "Administration of CAS Issues." The full text of the Navy comments is in Part III.

Finding C. Defense Contract Audit Agency Reports of Unsatisfactory Conditions

The Resident Auditor at the DCAA Newport News office received two draft reports of unsatisfactory conditions that cited delays and lack of support by the SUPSHIP ACO in settling contract audit issues. After consultation with the Regional Special Programs Office and the Regional Audit Manager, DCAA managers decided not to forward the reports to the regional office for further action because they did not believe the ACO was grossly negligent or violated specific regulatory authority to the detriment of the Government. The decision not to act on the reports of unsatisfactory conditions contributed to frustration and low morale at the DCAA Newport News Resident Office and resulted in a lost opportunity to facilitate resolution of significant contract audit issues with questioned costs of $94.6 million (including interest of $16.1 million).

Resident Auditor Actions

The Hotline complainant alleged that DCAA management was not sufficiently concerned about whether the SUPSHIP ACO sustained contract audit issues because the Resident Auditor did not forward two reports of unsatisfactory conditions to higher management officials at the DCAA Eastern Region Office (referred to as the regional office). The DCAA Contract Audit Manual (CAM) 4-803 requires the Field Audit Office (FAO) to obtain prompt regional office involvement when a Government official appears to have failed to comply with regulatory requirements or is grossly negligent in fulfilling his or her responsibility, resulting in substantial harm to the Government interest. The CAM, however, does not define "prompt regional office involvement" or provide procedures for resolution of draft reports of unsatisfactory conditions. The absence of specific guidance allows action on these reports to be discretionary. As a result, unsatisfactory condition reports involving Government operations may not be acted upon or action may not be effective in improving the cited conditions.

The Resident Auditor received the draft reports of unsatisfactory conditions in August and December of 1995. The Regional Director disclosed that, after

consultation between the Resident Auditor and the Regional Audit Manager (RAM), DCAA managers decided not to forward the reports of unsatisfactory conditions to the regional office because they concluded the ACO was not grossly negligent nor had he violated specific regulatory authority that resulted in substantial harm to the Government. We disagree that there was full adherence to FAR and DoD requirements as discussed in Findings A and B, which describe inordinate delays in negotiation and lack of adherence to basic acquisition requirements and regulations with harmful impact to the Government. Records maintained by the regional office, including Weekly Significant Activity Reports, meeting notes, and correspondence from the FAO, show that the Resident Auditor at Newport News was aware of these problems, pursued resolution of open issues at the SUPSHIP, and attempted to gain more support from the ACO for contract audit recommendations. In this effort, the Resident Auditor held monthly meetings with the SUPSHIP from 1993 through 1995 to discuss outstanding issues; submitted DCAA forms 2000, Suspected Irregular Conduct for three of the Hotline issues; and redoubled efforts to resolve outstanding audit issues before the establishment of NNS as an entity separate from Tenneco. The Resident Auditor also raised significant issues to the regional office, although most were not those in the Hotline allegations. Some of these issues included the following.

o **Impending Reorganization of NNS.** Tenneco, Inc., parent company of NNS, was planning to relinquish control of NNS in December 1996 and to reorganize it as an independent entity. This reorganization was an overriding concern throughout 1996 at both the SUPSHIP and DCAA offices and prompted DCAA regional office involvement, including the Deputy Regional Director, in trying to analyze the financial impact of the reorganization on NNS and to settle outstanding audit issues before the reorganization took effect.

o **Cash Flow Analysis and Financial Capability of NNS.** The Resident Auditor considered the financial status of NNS a major concern to which the Navy had been minimally responsive. The FAO fully supported the SUPSHIP and NAVSEA efforts to obtain financial capability data. Concerns about financial capability analysis continue at the FAO.

o **CVN 76 Defective Pricing.** This audit issue was in the Hotline allegations, but was not covered by this evaluation because the SUPSHIP was not responsible for its resolution. The Weekly Reports show extensive coordination by FAO and regional office personnel with the DCAA Procurement Liaison Auditor and Procuring Contracting Officer at NAVSEA.

o **Management Council Initiative.** The Weekly Reports refer to visits by the Regional Director, the RAM, and the Resident Auditor with the Supervisor and the President of NNS. The Weekly Reports refer to initiation in August 1996 of a management council composed of these officials to increase

contact for DCAA, SUPSHIP, and NNS senior management, so that long-standing issues could be resolved more quickly. The Weekly Reports also indicate that the Supervisor planned to follow up on this initiative. Nonetheless, the regional office and the Supervisor did not follow through on this initiative, which could be a key element in improving relationships at Newport News and in facilitating better business decisions.

Regional Office Involvement

The Regional Director provided us a listing of activities at the Newport News FAO during the period covered by the Hotline referral (see Appendix C) in which he stated "we have not been satisfied with the timeliness or the outcomes of settlement," and listed numerous attempts over an extended period to resolve issues at the SUPSHIP. We agree that the FAO and the regional management attempted to resolve the outstanding audit findings issued to the SUPSHIP. However, the large number of issues, their dollar magnitude, and the fact that the issues remained unresolved for an extended period (from 1991 through 1996) is clear evidence that additional action by DCAA senior leadership would have been in the best interest of the Government.

The conditions at the SUPSHIP did not improve despite the FAO and regional office efforts and were exacerbated by delays and lack of cooperation by the contractor. The CAM requires headquarters involvement if exhaustive efforts by the FAO and regional office fail to improve conditions. The Regional Director should have elevated the matter to DCAA headquarters, if not based on the FAO unsatisfactory condition report, then as soon as he learned about the Tenneco plan to reorganize NNS as a separate entity. The impending reorganization heightened the matter and made it urgent to focus high-level attention on resolving outstanding audit issues. Clearly, attention from the highest management levels was needed to correct the unsatisfactory conditions at the SUPSHIP Newport News.

Auditor Independence

The DCAA was established as an independent agency, separate from the procurement function, to ensure that its audits were free from bias in the award and administration of DoD contracts. As an independent agency and particularly considering its responsibility as an audit agency, DCAA regional management should have recognized its responsibility to elevate the SUPSHIP inaction on DCAA audit findings to headquarters and should have sought higher

level assistance to protect the Government's interest. SUPSHIP prenegotiation documents supported the Hotline allegation that DCAA regional managers were not sufficiently concerned about the sustention of contract audit recommendations. The region did not elevate the matter to DCAA headquarters when the conditions did not improve. The DCAA CAM guidance advises that unsatisfactory condition reports are to be submitted to headquarters only after all efforts have been exhausted. The guidance and its application is ineffective and serves only to discourage submission of unsatisfactory condition reports to headquarters. In response to an Office of the Inspector General, DoD, inquiry in July 1996, DCAA headquarters indicated it had not received a single unsatisfactory condition report in response to or in compliance with its CAM 4-803 guidance during the last 5 years. Moreover, the lack of specific procedures and the lack of requirements to document actions on these reports does not provide adequate management controls to ensure that the unsatisfactory conditions are validated and that corrective action is initiated.

Management Comments on the Finding and Evaluation Response

The DCAA commented extensively on the report findings and conclusions. The full text of the response is included in Part III.

DCAA Comments. The evaluation report clearly acknowledges that the SUPSHIP and DCAA worked together to resolve many of the outstanding contract audit issues and that both the FAO and the regional office followed the DCAA procedures for resolution of differences with procurement personnel. Despite these efforts, the report recommends that these procedures be revised. Also, the report should recognize that DCAA policy allows for the "safety valve" of the Defense Hotline and that DCAA personnel who believe management has failed to act upon their allegations are free to express their concerns through the Hotline. Further, DCAA management officials addressed the issues in two proposed reports of unsatisfactory conditions, one of which involved a terminated pension plan issue. The Resident Auditor forwarded the proposed report to the regional office, but was informed by the Regional Special Programs Office that the proposed report did not evidence a reportable unsatisfactory condition. Therefore, the report was not forwarded to DCAA headquarters.

Evaluation Response. We saw evidence during the evaluation that the SUPSHIP and DCAA worked to resolve outstanding contract audit issues. However, their efforts were ineffective. Finding A describes the deteriorating working relationship between the SUPSHIP and DCAA, which the contractor

exploited to strengthen its negotiating position with the Government. The poor working relationships among NNS, the SUPSHIP, and DCAA was the reason we recommended establishment of a council of senior managers to raise the level of the discussions between the parties and to remove obstacles that delayed decisions on contract audit issues at the SUPSHIP.

Relative to the DCAA assertion that the FAO and the regional office followed DCAA procedures for resolution of differences with procurement personnel, Finding C discusses the lack of specific procedures in the CAM guidance when the FAO encounters unsatisfactory conditions involving Government operations. Recommendations C.1, C.2., and C.3. address this deficiency and recommend the formulation of specific guidance for processing and documenting actions and reporting on unsatisfactory conditions. Further, DCAA policy does not discuss use of the Defense Hotline for reporting unsatisfactory conditions. We do not agree that the Defense Hotline should be routinely used to elevate issues in lieu of elevating them through the chain of command, except as provided for in CAM 4-702.4, "Procedures for Referring Suspicions," on actions to take when the auditor encounters a reasonable suspicion of fraud, corruption, or unlawful activity.

DCAA comments assume that one of the two draft reports of unsatisfactory conditions addressed in our report involved a terminated pension plan. There were three draft reports of unsatisfactory conditions submitted to the Resident Auditor at Newport News. The first involved a terminated pension plan and was settled by the ACO in December 1994 and was not an issue in the Hotline allegations covered by this evaluation. The two draft reports of unsatisfactory conditions included in the Hotline allegations and addressed in this evaluation report were submitted to the Resident Auditor in August and December 1995, respectively. Neither was submitted to the regional office, nor were the reports issued by the regional office to DCAA headquarters. Until the region issues the reports to DCAA headquarters, an unsatisfactory condition report does not exist under the DCAA CAM 4-702.4 procedures. Both of the reports included the 14 issues listed in Appendix B.

In summary, the DCAA procedures do not provide for adequate management control when FAO employees report unsatisfactory conditions encountered during audit reviews. Such control, at a minimum, must require formal reporting of unsatisfactory conditions to regional offices so that the reports and their resolution are a matter of record.

Recommendations, Management Comments, and Evaluation Response

C. We recommend that the Director, Defense Contract Audit Agency, revise the Contract Audit Manual to:

1. Make it mandatory for Field Audit Offices to submit all unsatisfactory condition reports to the regional office for its review and disposition.

DCAA Comments. The DCAA nonconcurred, stating that employee submissions of draft unsatisfactory condition reports, similar to Denial of Access to Records reports, should be internally reviewed at the FAOs to ensure that:

- o they are based on sufficient evidential matter,
- o an attempt has been made to resolve the issues locally,
- o the instances of alleged noncompliance with specific regulatory requirements or gross negligence are fully documented, and
- o there is a common understanding of the purpose, approach, and probable results of such actions.

Evaluation Response: The DCAA comments were not responsive to the recommendation. We agree that draft reports of unsatisfactory conditions encountered by auditors should undergo review at the FAO to ensure that they are accurate, complete, and meet general criteria for sufficiency. After review, however, the reports should be issued to the regional office for review and disposition to provide an appropriate level of management control on the reporting and resolution of these conditions. We request that the DCAA reconsider its position in the response to the final report.

C.2. Include procedures for processing and documenting actions taken on reports of unsatisfactory conditions.

DCAA Comment. The DCAA concurred and agreed to modify the July 1998 CAM section 4-803 to clarify the points made in response to Recommendation C.1.

Evaluation Response. Although the DCAA concurred, its comments were only partially responsive to the intent of the recommendation. The CAM should specify complete procedures with adequate management controls for handling reports of unsatisfactory conditions, not just the elements of the initial FAO

review. The procedures should, at a minimum, specify the organizational level responsible for resolution of the reports, how their status will be tracked, and how the disposition will be documented. We request that the DCAA reconsider its comments in response to the final report and provide comprehensive procedures and their implementation date for handling reports of unsatisfactory conditions.

C.3. Require that regional offices inform the Defense Contract Audit Agency Headquarters of the status of all reports of unsatisfactory conditions and their resolution.

DCAA Comment. The DCAA did not concur. It believes that, while the regional office should continue to monitor the status of the unsatisfactory condition report once it has been forwarded to headquarters, the initial decision to forward a report to headquarters should rest with regional management. DCAA will revise its procedures to clarify that once an unsatisfactory condition report is forwarded to the regional office, it should keep the FAO informed of the status of the report until it is resolved and should document the decisionmaking process on a real-time basis.

Evaluation Response. Although the DCAA did not concur with the recommendation, we consider its comments partially responsive. The intent of the recommendation was to establish management control for reports of unsatisfactory conditions so that they are validated and corrective action is taken as necessary. The recommendation is premised on changing the DCAA procedure to require that the FAO formally issue unsatisfactory condition reports to regional offices for review and disposition as set forth in Recommendation C.1. The reports need not be issued to DCAA headquarters unless the regional office believes it is necessary to obtain headquarters assistance in resolving the condition. We agree with DCAA that the regional office should inform the FAO of the status of the report until it is resolved and should document the actions taken. The regional office, however, should inform headquarters of the status of all reports received from the FAOs until they are resolved. We request that the DCAA reconsider its position in the response to the final report.

Part II - Additional Information

Appendix A. Scope and Methodology

Scope and Methodology

We visited the SUPSHIP Newport News on three occasions to review contract files pertaining to 12 of the contract audit issues in the Hotline complaint for which the SUPSHIP had responsibility. We also conducted extensive discussions with SUPSHIP contract administration officials and DCAA auditors and met with the Supervisor at Newport News and the DCAA Resident Auditor at the Newport News Resident Office. We contacted NAVSEA contract management officials and DCAA Eastern Region officials.

We performed this evaluation from October 1996 through January 1997. We visited or contacted individuals and organizations within DoD. Details are available on request.

Prior Audits and Other Reviews

Inspector General, DoD, Report No. AFU91-1, "Nonsustention of Costs Questioned in Postaward Contract Audit Reports," October 11, 1990, included a systematic, historical review of dispositioned audit reports to better understand why DoD contracting officers did not sustain audit-questioned costs. The study used a statistical sample of 326 audit reports from a universe of 6,866 reports closed over 2 years. The report concluded that a sustention rate of 60.6 percent overall and 57 percent for CAS audit reports were reasonable benchmarks for indicating that DoD contracting and contract management activities were making adequate use of audit advice.

Appendix B. Defense Hotline Allegation Issues

DCAA Report Date	Issue	Cost Impact (in millions)
June 1991	Residual Material from Change Orders	$ 1.9
April 21, 1993	Misallocation of Modular Outfitting Facility and Land Level Facility Patio Costs, CAS 418 Noncompliance	32.7
July 23, 1993	CVN 74/75 Defective Pricing[1]	
September 2, 1993	Misallocation of Submarine Material Control Costs, CAS 402 and 418 Noncompliance	5.5
February 15, 1994	Billing of 1992 State Taxes	4.7
June 20, 1994	Failure to Notify the ACO of Cost Accounting Changes	0.0
July 26, 1994	Provisional Billing Rates and Overhead Submissions	2.0
November 28, 1994	Misallocation of Material Handling Costs, CAS 418 Noncompliance	7.9
February 6, 1995	Terminated Pension Plan	6.7
Spring 1995	Penalties on Unallowable Costs (1989-91)	9.2
March 21, 1995	Navy Alert to NNS of a DCAA Fraud Referral	0.0
May 26, 1995	Vevey Equipment, CAS 409 and 414 Noncompliance[2]	
August 3, 1995	Mischarging of Bid and Proposal Costs, CAS 420 Noncompliance	2.9
September 18, 1995	Mischarging of SEAWOLF Submarine Construction Preparation Costs	5.0
	Total	**$78.5**

[1] Previously reviewed by the Office of the Inspector General, DoD, and closed on November 6, 1995.

[2] Action office was Naval Sea Systems Command.

Appendix C. Description of Actions Taken by the Defense Contract Audit Agency

EASTERN REGION
DEFENSE CONTRACT AUDIT AGENCY
2400 LAKE PARK DRIVE SUITE 300
SMYRNA GA 30080-7644

IN REPLY REFER TO

0 2 MAY 1997

DRD-1 710.1

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE, ARLINGTON, VA 22202-2884

ATTENTION: Ms. Suzanne Servis

SUBJECT: Project No. 60C-8-020 – Additional Clarification

The following comments are offered relative to your inquiry of 7 April 1997. In a subsequent telephone conversation with DCAA Headquarters (PP) on 21 April, Mr. Maurice Nestor of your office refined the general areas of interest. Our response addresses those areas.

Was the Region previously aware of the allegations of conditions cited in the Hotline? If so, how and when did the Region become aware of the allegations or conditions? What documents evidence this awareness? If the Region was aware, did it take any actions, and if so what actions were taken or are in process? What documents support these actions?

Historically, resolution of audit issues and exceptions at NNS has been difficult. In many cases, we have not been satisfied with the timeliness or the outcomes of settlement. Although we have not seen the Hotline inquiry, we believe that to be the crux of it.

We have been persistent in pursuing resolution of open issues. On a continuing basis, local FAO management meets with SUPSHIP staff and, on occasion, Regional management has participated. Local management has not been hesitant to use any appropriate means to ensure that government interests are protected.

For example, in December 1994, NNS SUPSHIP settled an issue dealing with reversionary credits from termination of a salaried pension plan for substantially less than the audit position. The FAO manager notified the Regional office on 19 January 1995 of his intent to issue an unsatisfactory condition report (Enclosure 1) and forwarded the report to the Region on 6 February 1995 (Enclosure 2). It was mutually concluded by subsequent fact-finding with the Regional Special Programs Office that there was insufficient basis to issue the report, however, the incident evidences the FAO's inclination to make the tough calls.

Later in 1995, another unsatisfactory condition report was proposed by two auditors within the FAO. The determination not to forward the reports to the Region or Headquarters was made by the FAO Manager, in consultation with the Regional Audit Manager. Feedback was given to the individuals proposing the action regarding the reasons (no record).

DRD-1 710.1 0 2 MAY 1997
SUBJECT: Project No. 60C-8-020 – Additional Clarification

While management didn't agree with certain settlement outcomes, they did not conclude (nor did anyone since) that the contracting officer was either grossly negligent or that he violated specific regulatory authority. Relative to the issues not settled in a timely manner, the Contract Audit Follow-up system is in place to apprise higher-level acquisition officials of progress in resolving significant business issues. Concurrently, resolution was aggressively pursued on a regular basis at the local level.

Monthly meetings were held with SUPSHIP during the period 1993-1995. Outstanding issues were frequently the topics of discussion. At the Navy's request, we continued to provide them with updated information (both formally and informally) regarding those issues. Each time, we were hopeful that settlement was forthcoming.

When appropriate, the FAO also submitted DCAA Forms 2000, Suspected Irregular Conduct. One was submitted regarding Seawolf submarine construction preparation costs, another was submitted on the pricing of the CVN-76, and a third on submarine material control (Enclosure 3). Others have been considered, but not initiated.

Early in 1996, when we learned of NNS impending spin-off from its parent company Tenneco, Inc., we redoubled our efforts to resolve outstanding issues. Considerable communication with Navy (both oral and written) highlighted the importance of settlement prior to the spin-off. Copies of various correspondence and meeting notes are provided (Enclosure 4).

Over the years, all parties (DCAA Region, DCAA Headquarters, NAVSEA, and the DoDIG) have been aware of problems related to this contractor. You have conducted other reviews during which management and the audit staff have discussed their frustrations relative to the timeliness and outcomes of contract administration issues. As evident from the above actions, we have been vigilant in protecting government interests and we will continue to fulfill our role to provide the best audit and financial advisory services possible.

2.R Richard R. Buhre
Regional Director

Enclosures (4)
1. Weekly Significant Activity Report
2. Proposed Unsatisfactory Condition Report
3. DCAA Forms 2000
4. Selected Correspondence and Meeting Notes

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Director, Defense Logistics Studies Information Center
Under Secretary of Defense (Comptroller)
Assistant Secretary of Defense (Public Affairs)
Director, Defense Procurement

Department of the Army

Assistant Secretary of the Army (Research, Development, and Acquisition)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Assistant Secretary of the Navy (Research, Development, and Acquisition)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Acquisition)
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
  Commander, Defense Contract Management Command

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office

Chairman and ranking minority member of each of the following congressional committees or subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Department of the Navy Comments

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(Research, Development and Acquisition)
WASHINGTON, D.C. 20350-1000

SEP 11 1997

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DOD DRAFT REPORT ON EVALUATION OF DEFENSE HOTLINE ALLEGATIONS CONCERNING CONTRACT AUDIT RECOMMENDATIONS PROJECT NO. 60C-8020

Ref: (a) DODIG Memorandum of June 11, 1997

Encl: (1) Department of the Navy Comments

We have reviewed the findings and recommendations provided by reference (a) and concur with them. As noted in enclosure (1), corrective action is nearly complete. The lessons learned from this review will be incorporated into NAVSEA's Procurement Management Review process for all SUPSHIPs.

M. P. SULLIVAN
RADM, SC, USN
Principal Deputy

Copy to:
NAVINSGEN
ASN RDA
FMO-31
COMNAVSEA
NAVSEA (SEA 02)
NAVSEA (SEA 07)
NAVSEA (SEA 00N3)
SUPSHIP NNS

DEPARTMENT OF THE NAVY RESPONSE TO
DODIG DRAFT REPORT ON DEFENSE HOTLINE ALLEGATIONS CONCERNING
CONTRACT AUDIT RECOMMENDATIONS
(Project No. 60C-8020)

1. Recommendation A.1: **We recommend that the Commander, Naval Sea Systems Command initiate action to establish a management council at Newport News composed of one official each from the Defense Contract Audit Agency, Naval Sea Systems Command, and Newport News Shipbuilding to facilitate business decisions and, in conjunction with the Administrative Contracting Officer, resolve all outstanding contract audit recommendations. The management council should report its activities quarterly to the Commander of the Naval Sea Systems Command.**

MANAGEMENT RESPONSE: Concur. The Management Council has been established and is overseeing full implementation of all corrective action. Action is complete. However, the Management Council will continue to oversee completion of all corrective action.

2. Recommendation A.2: **We recommend that the Commander, Naval Sea Systems Command direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to prepare pre- and postnegotiation business clearances on future negotiations in accordance with Navy regulations that fully document and support the decisions made by the Administrative Contracting Officer.**

MANAGEMENT RESPONSE: Concur. An on-site review of business clearance procedures has been conducted by NAVSEA. Training was provided to ensure future compliance with Navy regulations. Action is complete.

3. Recommendation A.3: We recommend that the Commander, Naval Sea Systems Command require the Administrative Contracting Officer and his staff at the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to attend training in preparing pre- and postnegotiation business clearances as well as the contract cost principles and negotiation principles and procedures.

MANAGEMENT RESPONSE: Concur. Initial training was provided during an on-site review. Additional formal training has been scheduled. Estimated completion date is 9 February 1998.

4. Recommendation A.4: We recommend that the Commander, Naval Sea Systems Command direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to disapprove use by Newport News Shipbuilding of the Open Items element in its provisional disallowance rate submissions and require that Newport News Shipbuilding implement appropriate internal controls to ensure unallowable costs are specifically identified and eliminated from claims against the Government.

MANAGEMENT RESPONSE: Concur. The Management Council has reviewed this issue with NNS and DCAA and will oversee the completion of the corrective action. Estimated completion date is 9 February 1998.

5. Recommendation A.5: We recommend that the Commander, Naval Sea Systems Command direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, with the assistance of the Defense Contract Audit Agency, to determine whether Newport News Shipbuilding and Dry Dock Company owes costs or interest for amounts sustained by the Government in the December 12, 1996 global settlement agreement. This determination should include a comprehensive year-by-year analysis for 1991 through 1996 of the Cost Accounting Standards cost impacts sustained by the Government in the global settlement, all other Cost Accounting Standards cost impacts affecting each year, and all other applicable disallowances for each year. These amounts should be compared to the Open Items element for each of those years and, if overpayments occurred, the Administrative Contracting Officer should recover the overpayments and assess and collect interest. The results of the analysis, including the auditor's opinion of the analysis, should be provided to the Inspector General along with copies of demand letters from the Supervisor of Shipbuilding, Conversion, and Repair, to Newport News

Shipbuilding for collection of any costs or interest due the Government.

MANAGEMENT RESPONSE: Concur. The Management Council has reviewed this issue with NNS and DCAA and will oversee the completion of the corrective action. Estimated completion date is 9 February 1998.

6. **Recommendation B.1: We recommend the Commander, Naval Sea Systems Command direct the management council established in Recommendation A.1. to ensure that the Administrative Contracting Officer promptly resolves all outstanding Cost Accounting Standards noncompliances reported by the Defense Contract Audit Agency in accordance with DOD Directive 7640.2, "Policy for Followup on Contract Audit Reports."**

MANAGEMENT RESPONSE: Concur. The Management Council has reviewed this issue with NNS and DCAA and will oversee the completion of the corrective action. Estimated completion date is 9 February 1998.

7. **Recommendation B.2: We recommend the Commander, Naval Sea Systems Command require the Administrative Contracting Officer and his staff at the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to take training on Cost Accounting Standards and related Federal Acquisition Regulation contractual requirements.**

MANAGEMENT RESPONSE: Concur. Initial training was provided during an on-site review. Additional formal training has been scheduled. Estimated completion date is 9 February 1998.

8. **Recommendation B.3: We recommend the Commander, Naval Sea Systems Command direct the Supervisor of Shipbuilding, Conversion, and Repair, Newport News, to follow the Federal Acquisition Regulation 30.602, "Administration of Cost Accounting Standards," for negotiating Cost Accounting Standards cost impacts, executing contract price adjustments, recovering overpayments, and assessing interest in all future noncompliance cases.**

MANAGEMENT RESPONSE: Concur. SUPSHIP has developed and implemented SUPSHIPNNINST 4330.15, "Administration of CAS Issues," of 30 June 1997. Action is complete. Please see Attachment (a).

Defense Contract Audit Agency Comments

DEFENSE CONTRACT AUDIT AGENCY
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FORT BELVOIR, VA 22060-6219

PAS 7-225.4

8 August 1997

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND OVERSIGHT

SUBJECT: Draft Evaluation Report, *Defense Hotline Allegations Concerning Contract Audit Recommendations* (Project No. 6OC-3020)

This responds to the subject draft evaluation report dated 11 June 1997. Allegations were made to the Defense Hotline regarding (1) the purported failure of the contract administration staff at the SUPSHIPS facility at Newport News, VA to support DCAA audit recommendations and to timely resolve related audit issues, and (2) the purported failure of DCAA managers to report this matter to Headquarters for resolution. The subject report clearly acknowledges that SUPSHIPS and DCAA have worked together to resolve many of the outstanding issues and that both DCAA's Newport News Shipbuilding (NNS) resident office and the Eastern regional office have followed Agency procedures for resolution of differences with procurement personnel. Nevertheless, the report recommends that these procedures be revised.

The IG's comments seem to stem primarily from a difference of opinion on matters of judgment regarding:

- the supposed impropriety of the contracting officer's actions, and
- the supposed insufficiency of the FAO and regional responses.

While the IG is free to express a difference of opinion on a matter of judgment, this alone does not warrant any change in policy or procedure. The report should recognize that DCAA's policy also allows for the "safety valve" of the DoD Hotline. Personnel who believe management has improperly failed to act upon their allegations are free to express their concerns through the Hotline. However, the fact that concerns have been expressed does not, without corroborating evidence, mean that DCAA did not follow established policy or that DCAA's policy is in error.

Our detailed responses to the subject report are enclosed. Inquiries should be directed to Linda Willard, Chief, Auditing Standards Division, at (703) 767-3274.

Robert DiMucci

For Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosure

DCAA COMMENTS ON DODIG DRAFT REPORT
DEFENSE HOTLINE ALLEGATIONS CONCERNING CONTRACT AUDIT RECOMMENDATIONS
11 JUNE 1997
(PROJECT NO. 60C-8020)

1. **DODIG STATEMENT:** (*Executive Summary, Evaluation Results*)

Defense Contract Audit Agency management failed to properly address the unsatisfactory conditions reported by its field audit office staff at the SUPSHIP Newport News.

DCAA COMMENT:

We do not agree that DCAA management officials failed to properly address the issues contained in the two proposed unsatisfactory condition reports. With regard to the report on the terminated pension plan, the FAO Manager notified the Regional Audit Manager (RAM) in January 1995 of his intent to issue an unsatisfactory condition report which was forwarded to the Regional Office on 6 February 1995. The RAM requested advice from the Regional Special Programs Office on whether or not the situation constituted a reportable unsatisfactory condition. The RAM was advised by the RSPO that the issues were not as clear-cut as portrayed by the author. There was a conscious decision by DCAA management, based on the facts available at the time, that the draft report did not evidence a reportable unsatisfactory condition; therefore, it was not forwarded to Headquarters.

The FAO Manager, after telephone consultation with the RAM, made a judgment decision not to issue a second unsatisfactory condition report that was proposed (on disposition of audit recommendations). His decision was based on the fact that the report did not appear to meet the CAM requirements. The report basically voiced two concerns--one, the length of time taken to resolve audit issues and, two, the merits of certain resolution decisions.

As for the timeliness issue, the draft unsatisfactory conditions report primarily cited the FAR requirement to make initial determinations regarding noncompliance within 15 days. We would certainly agree that the time taken by the ACO at NNS to make those determinations significantly exceeded the
15-day requirement. However, this situation is not unusual, particularly when dealing with complex issues. The FAO Manager did not view this as a violation of a specific regulatory requirement in the context of an unsatisfactory condition.

Regarding the merits of certain dispositioned audit findings, the fact that we might not agree with a particular decision made by the ACO does not constitute a reportable condition in accordance with CAM 4-803.2(b). The contracting officer appeared to be operating within the scope and authority of his warrant.

Enclosure

We take strong exception to the implication that DCAA management did not act prudently or aggressively. Although the unsatisfactory condition reports were not forwarded to Headquarters, the field audit office continued to work on the timeliness and resolution issues. The DoDIG draft report acknowledges under *Finding C, Resident Auditor Actions*, that "*the Resident Auditor held monthly meetings with the SUPSHIP from 1993 to 1995 to discuss outstanding issues; submitted DCAA Forms 2000, Suspected Irregular Conduct, for three of the Hotline issues; and redoubled efforts to resolve outstanding issues before the establishment of NNS as an entity separate from Tenneco...*" All of this was done in conjunction and coordination with Regional management.

The overall conclusion that DCAA management failed to properly address the conditions reported by the field audit office staff does not reconcile with the facts presented under *Finding C, Regional Involvement*, that "*regional management diligently pursued resolution of the outstanding audit findings issued to the SUPSHIP.*" The draft DoDIG report intimates that simple issuance of an unsatisfactory condition report would have immediately resolved all open issues. The primary purpose of such a report is to alert top management of the situation, enabling inter-organizational coordination at the highest levels. Actions taken by the Regional Director already accomplished this with likely the same result.

2. **DODIG STATEMENT**: (*Executive Summary, Summary of Recommendations*)

We also recommend that the Director, Defense Contract Audit Agency, revise its Contract Audit Manual to strengthen and clarify procedures for addressing unsatisfactory conditions involving government officials.

DCAA COMMENT:

CAM 4-803.2b states:

> FAOs should report situations where it appears that any government official has failed to comply with specific regulatory requirements or is grossly negligent in fulfilling his or her responsibility, resulting in serious harm to the government interest. In reporting such situations, FAOs should note whether the situation and/or issues in question have been appropriately elevated through the involved government official's own management channels (see 3-204.3).

While the referenced section (3-200) contains adequate guidance on the format, content and timing of escalating issues to the regional office and, if necessary, to Headquarters, the section specifically deals with RFP and contract provisions which may adversely affect government operations. Guidance could be incorporated in 4-803.2b which specifies the documentation necessary to initiate FAO reporting to regional management of possible malfeasance on the part of procurement personnel. However, we do not concur that proposed unsatisfactory condition reports should be automatically forwarded to Headquarters and tracked. As is the case with Denial of Access to Records (DCAAI 7640.17), such reports should be subject to an internal review and evaluation process.

3. **DODIG STATEMENT**: (*Finding A. Recommendations for Corrective Action*)

We recommend that the Commander, Naval Sea Systems Command: 1. Initiate action to establish a management council at Newport News composed of one official each from the Defense Contract Audit Agency, Naval Sea Systems Command, and Newport News Shipbuilding to facilitate business decisions and, in conjunction with the Administrative Contracting Officer, resolve all outstanding contract audit recommendations.

DCAA COMMENT:

We are fully supportive of a management council at NNS. In fact, for some time Regional management (RD, RAM, and FAO Manager) have actively encouraged such a forum for the purpose of discussing, coordinating, and resolving issues involving the efficiency and effectiveness of contractor operations. The Regional Director has met with the SUPSHIP NNS and Newport News officials, including the company President, on a number of occasions in this regard. As acknowledged by DoDIG, however, DCAA does not have the lead role in this effort.

We are concerned that the thrust of the recommendation appears to go beyond the customary role of a management council. *Finding B., Recommendations for Corrective Action* states, "*We recommend the Commander, Naval Sea Systems Command: 1. Direct the management council . . . to ensure that the Administrative Contracting Officer promptly resolves all outstanding Cost Accounting noncompliances reported by the Defense Contract Audit Agency in accordance with DoD Directive 7640.2, Policy for Follow-up on Contract Audit Reports.*" Although it can ensure proper support for the process, a management council is not empowered to circumvent existing mechanisms established under Public Law or regulation to settle issues such as CAS.

4. **DODIG STATEMENT**: (*Finding C. Introduction*)

After consultation with the Regional Special Programs Office and the Regional Audit Manager, it was decided not to forward the reports to the Regional Office for further action because they did not believe the ACO was grossly negligent or violated specific regulatory authority to the detriment of the government. The decision not to act on the reports of unsatisfactory conditions contributed to frustration and low morale at the DCAA Newport News Resident Office and resulted in a lost opportunity to facilitate resolution of significant contract audit issues . . . .

DCAA COMMENT:

We disagree with the statement that there was a *decision not to act*. Decisions not to send the reports to Headquarters were judgments based on the facts known at the time. One unsatisfactory condition report on a terminated salary plan was, in fact, forwarded to the Regional Office on 6 February 1995, by the Resident Auditor. It was mutually concluded by subsequent fact-finding with the Regional Special Programs Office that the issue was not as clear-cut as portrayed in the report--there was insufficient basis to forward the report to Headquarters.

DCAA has a well-defined policy for the reporting of unsatisfactory conditions, which was followed in this instance. The two criteria to submit unsatisfactory condition reports are gross negligence and violation of specific regulatory authority. No one has yet concluded a finding of gross negligence, and failure to meet the 15-day time limit for making an initial determination relative to reported noncompliance was not considered a specific violation in the context of an unsatisfactory condition. DCAA management was not aware of the other reported violations of internal policies or practices such as business clearance documentation.

We do not agree that there was a lost opportunity to resolve contract cost issues. The FAO and Regional Office continued to work on the issues and most of the issues have been negotiated. Ultimately, the issues were elevated to the highest levels of NAVSEA. We believe the outcomes would have been substantially the same whether or not unsatisfactory condition reports were issued.

5. **DODIG STATEMENT:** (*Finding C. Resident Auditor Actions*)

The DCAA Contract Audit Manual (CAM) 4-803 requires the Field Audit Office (FAO) to obtain prompt Regional Office involvement when a government official appears to have failed to comply with regulatory requirements or is grossly negligent in fulfilling his or her responsibility, resulting in substantial harm to the government interest. The CAM, however, does not define "prompt Regional Office involvement" or provide procedures for resolution of draft reports of unsatisfactory conditions. The absence of specific guidance allows action on these reports to be discretionary. As a result, unsatisfactory condition reports involving government operations have little chance of improving the cited conditions because of the importance DCAA places on customer relations in the current government environment.

DCAA COMMENT:

Clearly, issues are intended to be resolved at the local level to the maximum extent practicable. This process was ongoing at the time the audit staff submitted the unsatisfactory condition reports, and continued afterward. Arbitrary proliferation of such reports certainly would not improve prospects for resolution; however, we would not hesitate to issue one where we believed it was necessary or would serve a constructive purpose. Contract administration oversight is not the responsibility of DCAA; the Contract Audit Follow-up System was created to facilitate timely issue resolution.

6. **DODIG STATEMENT:** (*Finding C. Resident Auditor Actions, Management Council Initiative*)

Nonetheless, the Regional Office and the Supervisor of Shipbuilding failed to follow through on this [the management council] initiative, which could be a key element in improving relationships at Newport News and facilitating better business decisions.

DCAA COMMENT:

We disagree that the Regional Office failed to follow through on the management council initiative. The Regional Director met with SUPSHIP NNS and contractor officials, including the President of NNS, on a number of occasions in an ongoing effort to encourage establishment of a management council. In a meeting on 21 May 1996, the Regional Director was finally informed by SUPSHIP NNS that, in his opinion, the contractor was not ready to participate in a management council. As previously acknowledged by DoDIG, DCAA does not have the lead role in this regard.

7. **DODIG STATEMENT:** (*Finding C. Regional Involvement*)

In the absence of any documentation, DCAA regional management appears to have discouraged the Resident Auditor from submitting the draft unsatisfactory condition reports to the Regional Office, even though they were aware of the conditions at the SUPSHIP.

DCAA COMMENT:

We disagree. The conclusion is without support and is certainly not the perception of the FAO Resident Auditor. In fact, one of the two draft reports was forwarded to the Regional Office for review. After further fact-finding, there was a joint decision not to pursue that avenue.

8. **DODIG STATEMENT:** (*Finding C. Regional Involvement*)

The Regional Director should have elevated the matter to DCAA Headquarters, if not based on the FAO unsatisfactory condition report, then as soon as he learned about the Tenneco plan to reorganize NNS as a separate entity. The impending reorganization heightened the matter and made it urgent to focus high-level attention on resolving outstanding audit issues. Clearly, attention from the very highest management levels was needed to correct the unsatisfactory conditions at the SUPSHIP Newport News.

DCAA COMMENT:

Contrary to the finding, the Regional Director did keep DCAA Headquarters apprised of the situation on an ongoing basis via the weekly significant activity reporting process and through other contacts. In early FY 1996, the FAO was advised that Tenneco planned to spin-off NNS as a separate company. FAO and Regional management quickly recognized the importance of the situation and redoubled efforts to resolve outstanding issues. A number of meetings were held with the SUPSHIP to discuss the need to resolve the outstanding issues in order to avoid adverse financial impacts that might result if the issues were settled after the spin-off. Based on difficulties in obtaining data from the contractor to perform a financial condition review and slow progress in the resolution process, we initiated a meeting at NAVSEA to obtain its assistance.

The meeting at NAVSEA included the Regional Audit Manager, DCAA Headquarters Legal Counsel, Headquarters Procurement Liaison Auditor, NNS Resident Auditor, and a Supervisory Auditor. In the meeting, we presented two primary areas for discussion. First, we requested the Navy's help to obtain financial data from the contractor in order to conduct the financial capability review. Second, we advised the Navy of the importance of resolving all of the

outstanding issues prior to the spin-off. As a result of the meeting, NAVSEA agreed to issue a letter to NNS requesting NNS' ". . . full cooperation and commitment in providing the necessary financial information and settling the contract issues as quickly as possible." The letter was signed by VADM George R. Sterner, Commander, Naval Sea Systems Command, and included a list of the old outstanding audit issues amounting to $169.5 million. DCAA's management actions were responsible for advising the highest levels of the Navy's management structure on the dollar magnitude and number of old issues at NNS.

9. DODIG STATEMENT: *(Finding C. Recommendations for Corrective Action) We recommend the Director, Defense Contract Audit Agency, revise the Contract Audit Manual to:*

1. Make it mandatory for the Field Audit Office to submit all unsatisfactory condition reports to the regional office for their review and disposition.

DCAA COMMENT:

Nonconcur. We believe that draft unsatisfactory condition reports submitted by employees, similar to Denial of Access to Records reports, should be internally reviewed at the field audit office to ensure that:

- they are based on sufficient evidential matter,
- an attempt has been made to resolve the issue(s) locally,
- the instances of alleged noncompliance with specific regulatory requirements or gross negligence are fully documented, and
- there is a common understanding of the purpose, approach, and probable results of such actions.

2. Include procedures for processing and documenting actions taken on reports of unsatisfactory conditions.

DCAA COMMENT:

Concur. We will modify the July 1998 CAM Section 4-803 to clarify the points made in our response to Recommendation 1.

3. Require that regional offices inform the Defense Contract Audit Agency Headquarters of the status of all reports of unsatisfactory conditions and their resolution.

DCAA COMMENT:

Nonconcur. While the Regional Office should continue to status the unsatisfactory condition once a report is forwarded to Headquarters, the initial decision to forward a report to Headquarters should rest with regional management. We will revise DCAA procedures to make it clear that once an unsatisfactory condition report is forwarded to the Regional Office, that office should keep the FAO informed of the status the situation until it is resolved, and should document the decision-making process on a real-time basis.

Evaluation Team Members

This report was prepared by the Contract Audit Directorate, Office of the Assistant Inspector General for Policy and Oversight, DoD.

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