Oversight Report

DEFENSE CONTRACT AUDIT AGENCY AUDITS OF INDIRECT COSTS AT MAJOR CONTRACTORS

Report Number PO 98-6-016 August 6, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CAS	Cost Accounting Standard
CO	Contracting Officer
DCAA	Defense Contract Audit Agency
DCAM	Defense Contract Audit Manual
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
GAS	Government Auditing Standards
ICAPS	Internal Control Audit Planning Summary
MAAR	Mandatory Annual Audit Requirements
MRD	Memorandum for Regional Directors
ODC	Other Direct Costs
SAS	Statements on Auditing Standards
U.S.C.	United States Code

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August 6, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation Report on Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors (Report No. PO 98-6-016)

We are providing this final evaluation report for review and comment. We considered management comments on a draft in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, we revised Recommendations B.1 and C.1. We request that you provide comments on the final report by October 6, 1998.

We appreciate the courtesies extended to the staff throughout the evaluation. Questions should be directed to Mr. Wayne C. Berry at (703) 604-8789 or Ms. Diane H. Stetler at (703) 604-8737. Please refer to Appendix D for the distribution of the report. The evaluation team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report. No. 98-6-016 **August 6, 1998**
(Project No. 7OC-9012)

Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors

Executive Summary

Introduction. The Federal Acquisition Regulation requires a contractor to submit to the contracting officer a final indirect cost rate proposal reflecting actual cost history for the year. The Defense Contract Audit Agency is required to audit the contractor's incurred cost submission and to issue an advisory report. In addition, Title 10, United States Code, Section 2324, "Allowable Costs Under Defense Contracts"; Title 41, United States Code, Section 256, "Allowability of Costs"; and Cost Accounting Standard 405, "Accounting for Unallowable Costs," require the contractor to properly identify and segregate expressly unallowable costs. Both Federal statutes permit the contracting officer to assess a penalty when the contractor includes expressly unallowable costs or other costs previously determined to be unallowable in the incurred cost submission. (see Appendix C). Therefore, an important purpose of the audit is to identify and report claimed costs that the auditor believes are unallowable under the Federal Acquisition Regulation, advance agreements, and specific contract clauses or are unallowable subject to penalties. In FY 1996, the Defense Contract Audit Agency spent about 1.5 million hours (about 1,000 staff years) auditing about $66 billion in direct and indirect incurred costs at major contractors. A major contractor is one with $70 million or more in annual reimbursable contract costs.

Evaluation Objectives. The primary evaluation objective was to determine the adequacy of the Defense Contract Audit Agency audit coverage of indirect cost claims at major contractors. We evaluated whether the Defense Contract Audit Agency performed a proper assessment in selecting cost accounts to audit and performed proper transaction testing to determine the allowability, allocability, and reasonableness of costs.

Evaluation Results. The Defense Contract Audit Agency has established a systematic approach to auditing indirect costs that includes assessing audit risk, auditing the contractor's internal control system, performing mandatory annual audit procedures, and using additional audit guidance for selecting and reviewing specific costs. However, the Defense Contract Audit Agency did not always perform sufficient transaction testing in conjunction with the internal control system review. In addition, under current guidance, those reviews can be performed less frequently than every 3 years. Therefore, the internal control review results that the Defense Contract Audit Agency relies on to assess audit risk may be outdated and inaccurate. (Finding A).

The Defense Contract Audit Agency audits of indirect costs for allowability, allocability, and reasonableness often did not provide sufficient in-depth analysis to conclude that the costs were acceptable for reimbursement. The audit procedures used for selecting or sampling transactions for review were frequently not the most effective

means to review indirect costs. Consequently, DoD may be paying contractors for costs that should not or need not be reimbursed, thereby increasing the overall cost for DoD programs (Finding B).

The Defense Contract Audit Agency sometimes did not properly recognize or recommend disallowance of the costs that Federal statutes and regulations define as expressly unallowable for reimbursement under Government contracts. In addition, the Defense Contract Audit Agency sometimes did not properly identify and report that expressly unallowable costs were subject to the penalty provisions of Federal statutes. Consequently, the Government has paid and may continue to pay contractors for costs prohibited from cost reimbursement by Federal statutes and regulations (Finding C).

Summary of Recommendations. We recommend that the Director, Defense Contract Audit Agency, issue revised guidance on performing and completing audits of internal control systems for charging indirect costs, establishing more stringent reliability parameters for statistical sampling applications, determining when to use judgmental sampling to review claimed costs, implementing an auditing standard revision on due professional care and professional skepticism, identifying and reporting unallowable costs subject to penalties, and recommending assessment of penalties.

Management Comments. The Defense Contract Audit Agency nonconcurred with our finding and recommendation on revising its implementation approach for performing internal control system reviews of indirect costs. However, management did agree that the internal control system review of indirect costs should be completed by the end of FY 1998 for all major contractor entities. The Defense Contract Audit Agency nonconcurred with establishing specific reliability goals for statistical sampling applications, but offered an alternative solution. Management also nonconcurred with revising its audit guidance on judgmental sampling, due professional care and professional skepticism, and identification of unallowable costs subject to penalties. The Defense Contract Audit Agency did agree to revise its guidance on reporting unallowable costs subject to penalties. See Part I for a complete discussion of management comments and Part III for the complete text of those comments.

Evaluation Response. We consider the management response on our recommendation on revising its implementation approach for performing internal control system reviews of indirect costs to be nonresponsive. Subsequent actions taken by management to implement the agreed-to recommendation on completion of all internal control system reviews of indirect costs by the end of FY 1998 are considered responsive. The alternative solution offered on reliability goals for statistical sampling is acceptable and we have revised our report (Finding B) and draft recommendation accordingly. However, the management response on revising guidance on use of judgmental sampling is nonresponsive. We also reviewed audit guidance subsequently issued by the Defense Contract Audit Agency, and determined that they were fully responsive to our recommendation to issue audit guidance incorporating the revised auditing standard language on due professional care and professional skepticism. Additionally, we revised our recommendation to clarify audit guidance on when unallowable costs are subject to the penalty as part of existing guidance on the cost versus as a separate section in the audit manual. We request that the Director, Defense Contract Audit Agency, provide comments on our revised recommendation, and reconsider the response on the two recommendations to which they nonconcurred. Written comments should be provided on the final report by October 6, 1998.

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Part I - Evaluation Results

Evaluation Background

The Federal Acquisition Regulation (FAR) requires a contractor to submit to the contracting officer (CO) a final indirect cost rate proposal reflecting actual cost history for the year. The Defense Contract Audit Agency (DCAA) is required to audit the contractor's incurred cost submission and to issue an advisory report. The principle audit objective is to determine that the costs claimed by the contractor are allowable, allocable, and reasonable for reimbursement under Government contracts. The DCAA audits the incurred cost submission by using the results of overall system reviews, risk assessments, certain mandatory annual audit requirements (MAAR), and selective transaction testing. An important purpose of the audit report is to identify and describe any claimed costs that the auditor believes are unallowable under the FAR, advance agreements, or specific contract clauses.

The FAR Subpart 31.2 contains the cost principles and procedures applicable to contracts with commercial organizations, such as Defense contractors. The cost principles and procedures are incorporated by reference in contracts and are used as the basis for determining which costs are reimbursable. The FAR 31.204 states that costs shall be allowed to the extent that they are reasonable, allocable, and allowable under FAR 31.205. Costs not covered by FAR 31.205 are not to be assumed to be either allowable or unallowable. Expressly unallowable costs are also described in Title 10, United States Code, Section 2324 (10 U.S.C. 2324), "Allowable Costs Under Defense Contracts" (see Appendix C).

The contractor is required by the FAR, and Cost Accounting Standard (CAS) 405, "Accounting for Unallowable Costs," to properly identify and segregate expressly unallowable and directly associated costs. The statutory provisions in 10 U.S.C. 2324 and Title 41, United States Code, Section 256 (41 U.S.C. 256), "Allowability of Costs" (the Federal statutes) (Appendix C), require contractors to comply with the regulatory requirement to segregate expressly unallowable costs. Under the Federal statutes, as implemented by FAR and the Defense Federal Acquisition Regulation Supplement (DFARS), the CO may impose a penalty when the contractor includes expressly unallowable costs in the incurred cost submission. A level-one penalty is assessed when the contractor includes in its incurred cost submission a cost that is considered expressly unallowable under FAR or DFARS. The level-one penalty is equal to the amount of the disallowed cost allocated to covered contracts plus interest. A level-two penalty is applicable when the contractor claims a cost that has been determined to be unallowable prior to the submission of the incurred cost proposal. This category includes costs such as those mutually agreed to be unallowable or previously determined by the CO in writing to be unallowable. The level-two penalty is equal to double that of the disallowed cost allocated to covered contracts.

The Federal statutes also provide three circumstances in which the CO should waive the applicable penalty. The CO should waive the penalty if the contractor withdraws the proposal before the formal initiation of an audit and then resubmits a revised proposal not containing the cost. A waiver is also provided when the amount of the unallowable cost subject to the penalty is insignificant.

The FAR 42.709 defines insignificant as when the cost impact of the unallowable cost is $10,000 or less. The third circumstance has two criteria. The contractor must satisfy the CO that it has established appropriate policies and procedures, including an internal control and review system, that should preclude unallowable costs subject to penalties from being claimed and that the unallowable cost subject to the penalty was inadvertently included in the proposal.

In FY 1996, the DCAA spent about 1.5 million hours (about 1,000 staff years) auditing about $66 billion in direct and indirect incurred costs at major contractors. A major contractor is one with $70 million or more in auditable dollars yearly. Of the 1,000 staff years, roughly 400 were spent on indirect cost audits. For final overhead audit reports issued in FY 1996, the DCAA questioned about $842 million in direct and indirect costs. Therefore, DCAA questioned less than 1 percent of the dollars reviewed. Current management information reports available from DCAA do not separate dollars examined or costs questioned between direct and indirect costs. However, past experience indicates that the majority of costs questioned is indirect costs. The DCAA estimated that 1,454 staff years would be spent auditing $93.8 billion of direct and indirect incurred costs in FY 1997 and that in FY 1998, 1,323 staff years would be used to review $90.4 billion.

Evaluation Objectives

The primary evaluation objective was to determine the adequacy of DCAA audits of indirect cost claims at major contractors. We evaluated whether DCAA performed a proper assessment in selecting cost accounts to be audited and performed sufficient transaction testing to determine the allowability, allocability, and reasonableness of the costs. We did not attempt to quantify the monetary effects of audit inadequacies. We will assess the interaction between DCAA and the cognizant administrative COs and their use of DCAA audit reports in a separate evaluation. See Appendix A for the evaluation process and Appendix B for a summary of prior coverage related to the evaluation objectives.

Finding A. Internal Control System Review and Audit Risk Assessment

The DCAA process for assessing and documenting audit risk by using internal control system review results had not been fully implemented as of the completion dates of the incurred cost audits we reviewed. If properly implemented, the internal control system review for charging indirect costs should provide a reasonable basis for assessing the audit risk associated with those costs. Proper implementation includes transaction testing to verify that the contractor is complying with the appropriate policies and procedures. However, the auditors seldom performed sufficient transaction testing during the internal control system review to make this determination. In addition, four of eight offices had not completed the initial internal control system review for five of the nine contractor entities we reviewed. Because the internal control system review provides the basis for planning the yearly incurred indirect cost audit, proper implementation also requires that it be performed at least every 3 years, if not earlier. Without the performance of an adequate internal control system review, the DCAA cannot accurately assess the audit risk associated with incurred indirect costs; properly plan the incurred cost audit of indirect costs; and determine the nature, timing, and extent of transaction testing needed for the individual indirect cost accounts.

Incurred Cost Audit Process

The DCAA auditor's primary objective is to examine the contractor's incurred cost submission and to express an opinion on whether the incurred costs are reasonable, allowable, and allocable. Incurred cost audits are usually performed on a contractor-wide basis covering all business activities and contracts to address the adequacy of management and financial systems and controls. The DCAA system approach to auditing is supplemented by transaction testing and other substantive procedures, such as comparative analyses, as required by the MAARs (Finding B). For major contractors, DCAA audits of relevant accounting and management systems are performed on a cyclical basis and form the foundation for the audit risk assessment. The risk assessment, in turn, should help determine the nature and extent of the transaction testing necessary on individual incurred cost audit assignments and for individual cost accounts.

Internal Control System Audit and Risk Assessment

The Government Auditing Standards (GAS) require auditors to obtain a sufficient understanding of the contractor internal control structure as a basis for assessing risk. The auditor uses this assessment of control risk to properly plan the audit and to determine the nature, timing, and extent of testing needed.

Internal Control System Review Process. In FY 1995, DCAA instituted a new process for assessing and documenting the control risk for major contractors. The DCAA determined that 10 common accounting and management systems exist in the contract audit environment. The 10 systems selected for the standard internal control reviews included: Environment and Overall Accounting Controls, General Electronic Data Processing System, Budget and Planning System, Purchasing System, Material System, Compensation System, Labor System, Indirect and Other Direct Costs (ODC) System, Billing System, and Estimating System. The DCAA established standard control objectives and associated audit procedures for each system. The internal control system guidance for charging indirect costs and ODCs requires that to be considered adequate, a contractor system should have certain attributes.

o Contractor compliance reviews should provide reasonable assurance that the policies and procedures relating to indirect costs and ODC submissions are established, currently in practice, understood, and effectively implemented by contractor employees.

o Policies and procedures should be established and maintained to charge and allocate, directly or indirectly, allowable costs in billing, claims, or proposals applicable to Government contracts in accordance with FAR 31.2 and CAS.

o Policies and procedures should ensure that indirect costs and ODCs, including directly associated costs, are properly classified as allowable or unallowable in accordance with FAR and contract terms and that unallowable costs are identified and excluded from proposals, billings, and claims submitted to the Government.

o Policies and procedures should ensure that indirect costs and ODCs are properly charged and allocated to cost objectives in accordance with the FAR and CAS.

Contractor Compliance with Policies and Procedures. The DCAA guidance, Defense Contract Audit Manual, chapter 5, section 1000 (DCAM 5-1000), and the standard audit program do not provide specifically for transaction testing to be performed during the audit of the internal control system for charging indirect costs. The audit program for this internal control system generally calls for the review of contractor policies and procedures and not for the verification of proper implementation. Of the four internal control system audits we reviewed, one did not include any transaction testing and the other three included limited compliance testing, generally of only one specific item. All four reviews relied on findings from other DCAA audits such as the prior years' incurred cost audits or the CAS 405 reviews. The contractor's internal control system for charging indirect costs cannot be adequately reviewed in this manner. Generally, the DCAA incurred cost audits look only at a small percentage of the indirect accounts. The DCAA may not use transaction testing to review certain indirect cost accounts for several years. A more comprehensive and productive approach would be to design a sampling plan that includes a sample that covers all the indirect cost accounts for 1 year and to thoroughly analyze the transactions selected. Using that approach, DCAA would have an accurate picture of the effectiveness of the contractor's indirect cost charging system. The DCAA would still have to determine whether any

sensitive accounts needed to be reviewed for that contractor's fiscal year submission. If no deficiencies were found, DCAA could limit the amount of transaction testing needed for reviewing the individual indirect cost accounts for the next 2 contractor fiscal years, assuming a constant accounting environment. Additional transaction testing would be required if the contractor changes its accounting system; a significant variation was discovered during the indirect cost account comparative analysis; or the DCAA identified an audit lead relating to a sensitive account, such as relocation or reorganization and restructuring costs.

Risk Assessment. The internal control system audit process included an overall risk assessment form called the Internal Control Audit Planning Summary (ICAPS) for each system. When properly completed, the ICAPS documents the control risk and overall assessment of that contractor system. In the Memorandum for Regional Directors No. 94-PFD-088(R), May 24, 1994, DCAA issued draft audit programs, internal control matrixes, and initial implementing guidance to its field audit offices. The original implementing guidance required that a contractor's system be initially rated low risk unless prior reported deficiencies existed. The general plan was to stagger implementation of all the ICAPS audits over a 3-year period. Each audit office was to determine which systems were the highest risk and to perform those reviews first.

The audit guidance in DCAM 5-103a requires that relevant accounting or management systems having a significant effect on Government contract costs be reviewed on a cyclical basis, every 2 to 4 years, based on a documented risk assessment. The guidance allows for a less frequent review if past experience and current audit risk is considered low. Conversely, if the system is changed, a review of the change is given a higher priority to determine whether reliance on the system may be continued.

As explained earlier, the internal control audit is the foundation for the auditor's control and inherent risk assessments as documented on the ICAPS form. The ICAPS is the basis for planning the audit and for determining the amount and nature of transaction testing. We believe that on average, a complete internal control system audit should be done at least every 3 years. Even though the contractor is required by Federal regulations to notify the Government when significant changes occur to any system, many times the contractor does not. The auditor is not aware of the change unless it is accidentally discovered when performing other reviews. Therefore, the auditor should not delay performance of the review longer than 3 years based on a low-risk assessment.

Completion of Internal Control System Audits. At the time of our evaluation, four of the eight audit offices visited had not yet completed the internal control system audit for charging indirect costs for five of the nine contractor entities reviewed. Only two audit offices rated any contractor control objectives other than low risk for the initial FY 1995 ICAPS. In those cases, the audit office assigned a moderate risk rating to one or two control objectives. In general, all nine overall ratings indicated that the system was adequate. For FY 1997, the audit offices rated all control objectives low risk for the ICAPS on all nine contractor entities.

The ICAPS assessment for indirect costs is the basis for all work planned and performed in an indirect cost audit. Therefore, the audit should have been

performed within the 3-year implementation period. The initial internal control system audit should be completed by the end of FY 1998 for all major contractors.

Summary

The GAS requires the auditor to obtain a sufficient understanding of the contractor internal control structure as a basis for assessing risk. The auditor is to use this assessment of control risk to properly plan the audit and to determine the nature, timing, and extent of testing needed. The current method of performing the internal control system review for charging indirect costs will not provide the auditor sufficient information about the system to properly assess the risk associated with it. Therefore, the present method for planning the audit, selecting the individual indirect cost accounts to be reviewed, and determining the amount of transaction testing needed to review the selected indirect costs will not achieve the objective of being the basis for determining the scope (nature, timing, and extent) of audit work to be performed on incurred indirect cost audits. By adjusting the approach to performing internal control audits for charging indirect costs, DCAA will be able to more accurately assess the audit risk and, therefore, perform more effective incurred cost audits of indirect costs.

Recommendations, Management Comments, and Evaluation Response

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

1. Require the performance of a comprehensive audit using a sampling plan that covers the universe of transactions charged to indirect cost accounts every 3 years as part of the internal control system audit for indirect costs at major contractors.

DCAA Comment. DCAA nonconcurred by citing several Government Auditing Standards (GAS) to support its position that its auditors can and should rely on other forms of audit evidence to test contractors' indirect cost system internal controls. Specifically, DCAA considers these forms of evidence to include: other completed and in-process internal control system reviews; incurred cost audits, contractor internal audits, and contractor's screening process for unallowable indirect costs; comparative analysis between and within key contractor accounts; and CAS 405 reviews. In addition, DCAA does not agree that our findings indicate the need for an all inclusive sample of the indirect cost accounts every 3 years. DCAA stated that this approach is not more comprehensive and productive than the current approach. DCAA stated that because its auditors rely on multiple sources of audit evidence in forming opinions, a comprehensive sample to test the indirect cost accounts would duplicate some of the testing and evidence that DCAA already relies on.

Evaluation Response. We believe that our recommended approach will produce a more comprehensive, timely, and accurate risk assessment than the current method DCAA uses to implement its risk assessment procedures. Our recommendation does not necessitate the scrapping of the current DCAA audit approach to risk assessment for auditing incurred indirect costs. The multiple sources of evidence that DCAA currently relies on in forming their opinions are generally not timely. For instance, the internal control system review for indirect costs and ODCs is performed on the contractor's system as it exists in the present. At the four contractor locations where the DCAA auditors performed an initial internal control review, the auditors used results from prior incurred costs audits that averaged about two years older than the year under review. Currently, this time period variance is an inherent part of how DCAA performs its incurred indirect cost audits. Until DCAA audits indirect costs on a real-time basis or is ready to audit a contractor's submission on receipt, which should be 180 days after year-end, this timing issue will exist.

Another evidence source used by DCAA is the most current CAS 405 review. Generally, a CAS 405 compliance review is performed every 3 years. DCAA may issue CAS 405 noncompliance reports at other times based on deficiencies identified during other audits. The current CAS 405 standard audit program does not require any compliance testing. At the eight offices we reviewed, one CAS 405 review was performed in 1990; one in 1994; four in 1995; and only one in 1996. In one case, the transaction testing for the CAS 405 review was performed during the 1995 incurred cost audit; therefore, the internal control review performed by this office relied solely on transaction testing performed during the 1995 audit. In addition, most of the other forms of evidence cited by DCAA do not include compliance testing to provide sufficient evidence that the controls are effective as required by GAS 4.31b. DCAA generally performs transaction testing to determine if claimed costs are allowable, allocable, and reasonable. This approach differs from compliance testing or tests of controls. DCAA does not select transactions and trace them through the contractor's internal control system to determine if all the polices and procedures were followed. While the final conclusion may be the same, that costs are allowable or unallowable, the process differs significantly. Most contractor internal reviews of the incurred cost screening process also do not include compliance testing. The difference in approach is apparent because neither group of auditors generally points out the reason why the contractor claimed unallowable costs. Without knowing the cause, neither group of auditors can recommend revisions to the system to correct the deficiency. Correcting system deficiencies is an important goal when using the internal control system approach in auditing. We also disagree that the comparative analysis of amounts is an acceptable form of evidence for an internal control system review. We did not see this particular audit step, which is generally performed during the early stages of an incurred cost audit, being referenced in any internal control system audit or in any ICAPS risk assessment.

DCAA cannot obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed as required by GAS 4.21 as the ICAPS is currently implemented. Not all the indirect cost accounts are considered in their review to determine if the contractor is complying with its policies and procedures for removing unallowable costs. Only the accounts that the audit office determines are high risk or that the audit office has an audit lead on are reviewed. We believe that a proper method of reviewing a contractor's system of internal controls is to test

all applicable accounts. By sampling the accounts DCAA can achieve this goal. Our recommendation only suggests this approach be used for an initial review to establish a proper basis for DCAA risk rating. The first properly performed internal control review could then act as a foundation for future reviews.

In addition, DCAA only requires consideration of performing these followup reviews every 3 to 4 years. Most outside accounting firms perform an assessment of a firm's internal control system every year that a financial audit is performed. DCAA audit procedures do not require an actual system review be performed or updated, only the risk assessment needs to be updated based on other work. The guidance requires that when part or all of a contractor's system undergoes significant changes, that that part of the system should be reviewed.

Our recommendation focuses on DCAA providing a sound basis for its current risk assessment of a contractor's indirect cost system that will later provide a proper foundation for future risk assessments. For DCAA to comply with auditing standards, DCAA needs to provide a sound foundation for its risk assessment. We ask that DCAA reconsider our recommendation and provide additional comments in the response to our final report.

2. Direct audit offices cognizant of all major contractor locations to complete the initial audit of the internal control system for the Indirect and Other Direct Costs by the end of FY 1998, if not done in FYs 1996 or 1997.

DCAA Comment. The DCAA concurred and agreed to issue a memorandum notifying the regional directors.

Evaluation Response. DCAA concurred with our recommendation, and issued a March 31, 1998, Memorandum for Regional Directors (MRD) requesting the status of all the initial ICAPS reviews be reported to Headquarters by May 15, 1998. We reviewed the information provided by the regions and determined that the number of initial internal control system reviews of indirect costs that should have been completed by the end of FY 1998 but are not planned to be done until FY 1999 is small. Therefore, we consider the actions already taken by DCAA as satisfing the intent of the recommendation.

Finding B. Audit Procedures and Analysis of Indirect Costs

The DCAA has established a systematic approach to auditing indirect costs to include assessing audit risks, auditing the internal control systems, performing MAARs, and using additional audit guidance for selecting and reviewing specific costs. If properly implemented, that framework for performing incurred cost audits should provide adequate audit coverage. Often, however, DCAA audits of indirect costs for allowability, allocability, and reasonableness did not provide sufficient in-depth analyses to conclude that the costs were acceptable for reimbursement. Specifically, the audit procedures DCAA used for selecting and sampling transactions for review were not the most effective means to review indirect costs. In many cases, the auditors did not properly perform transaction testing because of inadequate analyses and poorly formed conclusions. Even though DCAA reported unallowable indirect costs for the contractor years we reviewed, DoD cannot be assured that all significant unallowable costs were identified and reported. Therefore, DoD may be paying contractors for costs that should not be reimbursed.

Mandatory Annual Audit Requirements

The MAARs are the basic audit criteria and procedures that must be performed to comply with GAS in the incurred cost contract audit environment. Individual audit assignments are established for the completion of most MAARs. The MAARs vary greatly in purpose, type of transaction under review, and time frame of accomplishment. The DCAA has established 20 MAARs, which are classified as permanent file updates, reconciliations, transaction tests, or special purpose. Permanent file updates are accomplished on a continuous basis as audits are performed and are not necessarily associated with a single contractor fiscal year or only with incurred cost audits. Reconciliations are a preliminary step in the audit of incurred costs and are a type of substantive testing. Transaction tests are audits of historical costs that can be performed prior to the year-end, depending on the situation. Special-purpose MAARs may involve substantive testing and usually must be partially performed on a current basis. All MAARs must be performed at all major contractors except when a particular MAAR will not fulfill a useful current or future need or when the contractor has no costs claimed in one or more cost elements related to that MAAR. The extent of the audit work performed to complete each MAAR is adjusted based on the audit risk assessment.

The MAARs provide the framework for incurred cost audit management. Specifically, MAARs 15, 16, 17, and 20 deal with the audit of the indirect cost accounts. MAARs 18 and 19 deal with the indirect allocation bases and the actual indirect rate computations. Of particular interest to our evaluation was how the audit office completed MAARs 15 and 16. MAAR 15, "Indirect Cost Comparison with Prior Years and Budgets," requires the auditor to review the current year indirect cost accounts and the prior year costs and budgetary

estimates. The purpose is to identify changes in cost accounting practices, reclassifications of costs, and areas with substantial increases or decreases in costs incurred that require further audit analysis or explanation. MAAR 16, "Indirect Account Analysis," requires a review of selected indirect cost accounts or transactions, such as sensitive accounts, new accounts, accounts with large variances, etc. The purpose is to obtain sufficient evidence to support an opinion on the allowability, allocability, and reasonableness of the costs.

Audit Sampling Procedures

The overall incurred cost audit is generally composed of numerous individual audit assignments. Individual indirect cost accounts, such as employee morale and welfare or business conferences and meetings, may be reviewed in separate audit assignments by performing transaction testing. Five of the eight audit offices used statistical sampling techniques to select specific transactions or items for review for at least one individual cost account. In addition, many of the contractors' internal screening processes for unallowable costs used some form of statistical sampling that had been coordinated with DCAA. Two of the five audit offices identified transactions through the use of statistical sampling that, when analyzed, produced questioned costs. Two offices used parameters to establish the sampling plan that were unacceptable. When DCAA auditors identified questioned costs, the auditors could not project the questioned costs to the rest of the universe because most of the questioned costs either were in the high-dollar stratum, for which the auditors performed a 100-percent review, or were considered insignificant. In addition, at four locations, auditors used an inappropriate sampling technique that did not select the best transactions for review.

Sampling Plan Parameters. At three of the five audit offices, auditors evaluated individual cost accounts by using statistical sampling. Auditors used various confidence levels and precision levels to determine the sample sizes with the universe consisting of all transactions charged to one cost account. At two locations, auditors used confidence levels of 70 to 75 percent with precision levels of 40 to 45 percent. In other cases, the confidence levels ranged from 80 to 90 percent with precision levels of 5 to 25 percent. In general, the sample sizes ranged from 30 to 75 items, depending on the number of items to be reviewed in the cost account (universe). None of the reviews produced results that the auditor could project for additional questioned costs. Often, such small sample sizes as 30 to 60 items can produce a false negative. In other words, depending on the confidence level selected, the sample size will be small enough to almost ensure that some findings will not turn up in the sample. When an auditor misclassifies a contractor as low risk based on limited or no audit work, the confidence level is set artificially low and a relatively small sample size is selected. Consequently, the auditor may not find any or only a small amount of unallowable costs, thereby validating the contractor low-risk assessment. When using such small sample sizes, even the smallest finding should be considered relevant. Personnel at two locations told us that informal, written DCAA guidance provided during statistical sampling training allowed the auditors to use a 70-percent confidence level with a 45-percent precision level in cases of low risk. In a physical unit sampling application, precision of

plus or minus 45 percent at the 70 percent confidence level (30 percent risk) equates approximately to a 90 percent confidence level (10 percent risk) with a precision of plus or minus 70 percent. Therefore, statistical sampling applications with reliability goals of confidence levels as low as 70 percent and precision levels of 45 percent do not provide sufficient evidence as required by GAS and the informal guidance provided as part of auditor training was inappropriate.

Sampling Approach. The audit guidance in DCAM, appendix B, states that statistical sampling is usually the preferred approach in which the risk of material errors is probable and for which the universe consists of a large number of transactions of similar dollar value or consequence. That criteria did not apply to most of the DCAA audits we reviewed. Therefore, statistical sampling should not have been the preferred approach used to review the majority of the selected cost accounts.

DCAA auditors rated all reviewed contractors low risk for indirect cost charging. In accordance with MAAR 16 requirements, the auditors selected some accounts for review that were considered sensitive and, therefore, high risk. If a contractor is truly low risk and sensitive accounts have been identified, a judgment or purposeful sample of high dollars and other attributes may be more effective than a statistical sample. Also, the DCAA reviews were of individual cost accounts that were not composed of transactions of similar dollar value. Further, at three locations, the auditors did not include items under a certain dollar amount in the sample universe. Lower dollar items should not be excluded without first calculating what percent of the total dollars these items make up. DCAA chapter 4, section 603 recognizes the potential importance of this issue by requiring the auditor to consider "Other transactions . . . where the total amount may be significant in the aggregate" when selecting items to be tested and in determining the extent of the review. Even when the auditors used a stratified sampling plan covering all transactions in the account, the smaller dollar amounts reviewed were not of the same consequence as the larger ones. For some cost accounts, DCAA auditors wrote off questioned costs in the lower dollar strata as insignificant if they could not be projected.

Statistical sampling did not result in more questioned costs than nonstatistical sampling in the audits we reviewed. At two locations questioned costs came from the review of items in the high-dollar strata, which are not projected across the universe. Those high-dollar items would generally also be selected for review by a nonstatistical sample. Therefore, the time spent performing multiple statistical samples for various accounts could be more efficiently and effectively used by performing judgment or purposeful sampling. Accordingly, DCAA should revise the guidance in DCAM, chapter 4 and appendix B, to specify when judgment or purposeful sampling may be the better technique for reviewing selected cost accounts of low-risk contractors.

Dollar Unit Sampling. During an audit of severance pay, DCAA used dollar unit sampling, which focused on individual payments. That statistical sampling method was not the best choice. Because employees normally receive more than one severance payment, the same employee can be selected more than once as a sample item. Duplicate selection occurred for the audit we reviewed. Because the critical attributes being examined related more to the employee, a better review approach would have been to select individual employees, not individual payments. For example, by using either a statistical or nonstatistical

approach in which employees are selected, the auditor could review the payment total and the severance pay agreement to make sure that the terms and conditions of the agreement were correctly implemented and complied with applicable FAR clauses and company policies and procedures. Therefore, a different sampling approach, such as a randomly selected statistical sample of employees, or technique would have resulted in a more efficient, effective review of costs.

Auditor Analysis of Selected Transactions

At all eight audit offices, we identified situations where auditors did not critically analyze the transactions selected for review. Frequently, the auditor did not ask enough questions about the costs or the auditor determined that the dollar amount was insignificant and did not pursue complete answers to their inquiries about the items. For example, in some cases, the auditor statistically sampled transactions for review, but did not attempt to review other related costs that were unallowable. Also, the auditor limited the review to one or two attributes instead of reviewing all the criteria required to determine that a cost was allowable. Further, audit analysis of certain costs was hindered when some contractors did not provide DCAA enough information to properly determine whether the costs were unallowable and subject to penalties.

Auditor Analysis. In performing statistical sampling at one location, auditors considered some items insignificant when documentation could not be found to support the costs. The auditor explained that the contractor had converted the records to microfiche for that year and that problems existed with the process. The auditor knew that original documentation could be requested. However, because of the nature of the transaction and the cost to the contractor to get the original documentation, the auditor decided not to pursue the documentation and open issues. By considering an item as insignificant or by not examining it, the auditor invalidated the statistical sample.

At another location, during a review of company executive travel, an auditor initiated a 100-percent review of the costs and then adjusted the scope to review only the two most expensive trips for each executive. The working paper included information about trips that the auditor did not review. Two of the itemized expenses on the working paper were charges for house-sitting and spousal travel. The spousal travel was questioned for two executives but not for two others. When we asked why, auditors attributed lack of questioning the costs to an oversight and stated that the amount was insignificant and that questioning the costs would have no material effect on the indirect cost rates. Only one executive was shown as charging house-sitting fees. The auditor did not consider the costs because the auditor did not review the trips for which the fees were charged. Another trip, which auditors did not review, included costs not only for spousal travel, but also for attendance at a board meeting for a private university. None of those costs were questioned by the auditor.

Audit Approach. At three audit offices, auditors ignored potentially unallowable costs because the transactions had not been selected for review. In one audit, the contractor's internal audit group recognized that a difference of opinion existed between the contractor and DCAA on the allowability of the

cost of providing meals at offsite meetings and for guests to attend company events. The contractor's internal audit review segregated the amount DCAA might consider unallowable but did not include the cost in the internal audit report. The DCAA was offered access to the working papers, but did not review them to determine the cost differences. Therefore, the DCAA missed the opportunity to determine the existence of easily identifiable, potentially unallowable costs. The auditor could have removed those transactions from the statistical sample and performed a 100-percent review. At a minimum, the DCAA auditor should have determined the cost effect as calculated by the internal auditors for risk assessment purposes.

Audit Criteria. At five audit offices, auditors limited the review to one or two attributes instead of reviewing all the criteria required to determine that a cost was allowable. For example, at one contractor location, the auditor did not perform a complete analysis of legal costs associated with patents. FAR 31.205.30, "Patent costs," states that those costs are generally allowable to the extent that they are incurred as a requirement of a Government contract or are for general advice on patent matters. The auditor reviewed the costs by obtaining supporting documentation from the contractor that stated that the patent costs related to a Government contract. Relating to a Government contract does not necessarily mean that the patents were required by a Government contract. The review of patent costs for allowability hinges on two criteria: that the legal costs relate to a patent and that the patent is required by a Government contract. The auditor did not attempt to verify that the patent was required by a Government contract.

Contractor Documentation. At five audit offices, audit analysis of specific costs was hindered when contractors did not provide DCAA enough information to properly determine whether costs were unallowable and subject to penalties. Auditors initially questioned costs because of insufficient documentation. Later, the contractor provided additional documentation that the auditor used to determine the allowability of costs. Consulting costs and legal fees are particularly susceptible to deficient documentation. Generally, consulting and legal invoices alone do not provide sufficient information to enable the auditor to determine whether the cost is allowable, allocable, and reasonable. Specifically, FAR 31.205-33(f) stipulates what documentation is required to adequately support consultant costs. In some cases, the auditor concluded that the cost was allowable without all the required documentation. Auditors should question such costs unless all required documentation is provided (see Finding C).

In addition, auditors did not review the consultant's travel or other expenses to determine whether they complied with the applicable FAR clauses. In most cases, the auditor told us that either the costs were insignificant or the contractor screening process would review those costs for acceptability. Considering the sensitivity of such costs, the auditors should review the contractor screening process to verify that the costs are properly charged.

Working Paper Documentation

At seven audit offices, audit files contained working paper documentation that did not comply with GAS requirements. In general, auditors did not adequately document the specific criteria used to evaluate the selected cost items. In addition, the auditors sometimes did not explain sufficiently how they determined that a cost met all the referenced criteria.

DCAA and GAS Guidance on Working Paper Documentation. The DCAM 4-406a(2) provides that routine audit conclusions may be sufficiently documented by reference and extraction of pertinent information. The DCAM also recommends that copies of contractor financial records and documents be kept to the minimum necessary to support the information obtained and the conclusions reached. We agree with DCAA that it is unnecessary to include copies of all contractor documents examined in the audit file; however, the transactions reviewed must be adequately described along with the criteria used to review them. At times, the simplest and most efficient documentation may be copies of contractor documents if already provided. Otherwise, the auditor must be sure to fully describe all pertinent information from the contractor document.

The GAS requires that working papers "contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments." An audit conclusion that there are no questioned costs or that all costs are allowable, allocable, and reasonable is just as significant as one that identifies questioned costs. Therefore, those conclusions must be adequately explained and supported. An audit conclusion that costs are unallowable also must sufficiently explain why they are unallowable. That conclusion usually requires that additional information be provided. In general, the audit file should also contain copies of documents supporting questioned costs. Having copies readily available for reference, or to provide to others, speeds up discussions at meetings or negotiations.

Adequacy of Documentation. At seven audit offices, audit files contained working paper documentation that did not comply with GAS requirements. In general, auditors did not adequately document the specific criteria used to evaluate the selected cost items. For example, the auditor referenced a FAR clause, but did not specify the various criteria within the clause that needed to be met. Many of the FAR clauses contain multiple criteria, and to demonstrate that all applicable criteria were considered, the auditor should have separately referenced the criteria in the working papers. A complete listing of the all the criteria used, however, is not sufficient documentation. For example, at one audit office, an auditor reviewing help wanted advertising invoices documented that the costs were reviewed for allowability by referencing FAR 31.205-34, "Recruitment costs." The supporting documentation did not include sufficient details for us to determine how the auditor concluded that the various criteria in FAR 31.205-34 were not applicable and, therefore, that the costs were allowable.

In addition to basic information about the invoice such as dollar amount, vendor, and date, the working papers should have contained a brief description

of the advertised position and the project or indirect job for which the employee was needed. The evaluator needed the additional information to determine that the DCAA auditor properly concluded that the advertisement was for personnel required to perform contractual obligations under Government contracts. That requirement is the first of six criteria under FAR 31.205-34. The auditor should use the six criteria to determine whether costs are unallowable. The other criteria are:

- specific positions or classes of positions are not described;
- cost is excessive relative to the number and importance of the positions or to industry practices;
- the advertisement includes material that is not needed for recruitment purposes;
- the advertisement is designed to pirate personnel from another Government contractor; and
- the advertisement is in color.

The auditor should have documented how the review covered all of the criteria and how the auditor concluded that the costs were allowable. Adequate documentation does not mandate that copies of all reviewed documents be kept in the audit files. Sufficient documentation requires only that the working papers adequately describe what was reviewed and how the auditor determined that the costs were acceptable.

At that audit office, the documentation was so inadequate that we found it difficult to conclude that the overall incurred cost audit coverage was sufficient. Subsequently, we reviewed additional audit files and further discussed the deficiencies with the audit managers. As a result of the second review, we concluded that the audit work, in total, could be considered sufficient; however, the documentation in the audit files needed substantial improvement.

Electronic Working Papers. On May 1, 1997, the DCAA staff briefed us on their initiative to implement tailored electronic working papers. The DCAA believes that by computerizing working papers, providing a template that can be tailored to the auditor's requirements, and by changing certain standard procedures on the use of audit programs DCAA auditors will create more efficient, effective working papers that result in improved and more meaningful documentation. We generally agree; however, computerization of working papers alone will not necessarily improve documentation.

Professional Skepticism

Under GAS and American Institute of Certified Public Accountants, Statements on Auditing Standards (SAS) No. 1, "Due Care in the Performance of Work," the auditor is required to exercise due professional care. In April 1997, the American Institute of Certified Public Accountants issued SAS No. 82, "Consideration of Fraud in a Financial Statement Audit." Appendix B of SAS

No. 82 amends SAS No. 1, section 230. The amendment expands the discussion of professional care with the objective of heightening the auditor's awareness of the need for professional skepticism throughout the conduct of the audit. Specifically, professional skepticism is defined as "an attitude that includes a questioning mind and a critical assessment of audit evidence." The amendment also requires that an auditor "neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest." SAS No. 82 is effective for audits of financial statements for periods ending on or after December 15, 1997. Earlier implementation is allowed, and we encourage the DCAA to promptly issue guidance to its regional and field audit offices to explain the revised definitions. The additional guidance should help improve DCAA auditor analyses of contractor claimed costs.

Summary

Assessing a contractor as low risk for internal controls (control risk) affects the amount of transaction testing (testing of details) that needs to be performed. The low-risk rating should not significantly alter the depth of analysis or evidence required when reviewing the selected individual transactions to provide overall adequate audit coverage. The auditor's inherent risk assessment for certain cost accounts also helps determine the amount of transaction testing, not the nature of the analysis. The DCAA has increased the detection risk associated with many of its indirect cost audits by not selecting an appropriate auditing procedure, misapplying an appropriate procedure, performing incomplete analyses, or misinterpreting audit results. Increasing the detection risk increases the risk that DCAA auditors will not identify significant unallowable costs. The minimal amount of transaction testing resulting from assessing a contractor as low risk makes it critical that audits be performed with attention to due professional care and professional skepticism. By revising audit guidance on statistical and nonstatistical sampling and providing guidance on professional skepticism and critical analysis of transactions, the DCAA can improve its performance of indirect cost audits.

Management Comments on Sampling Approach and Evaluation Response

DCAA Comment. The DCAA disagreed that excluding items under a set dollar amount influences the accuracy of the statistical sampling results. The DCAA stated that in the cited cases, the auditors decided to exclude dollar amounts below a certain amount because of a low risk that there would be significant unallowable costs found in these items.

Evaluation Response. We have revised the wording relating to this section of the report. However, we disagree that an auditor should decide to exclude certain dollar items because of a belief that significant unallowable costs will not be found. Before the auditor can make that determination, the auditor must

calculate the percentage of dollars attributable to the low dollar items in the universe. If the low dollar items make up a significant percentage of the universe dollars, then they should still be included. The working papers did not document that the auditor performed this step prior to deciding to exclude the low dollar items from the sample.

Recommendations, Management Comments, and Evaluation Response

Revised Recommendation. As a result of management comments, we revised draft Recommendation B.1.

B. We recommend that the Director, Defense Contract Audit Agency:

1. Revise audit guidance and associated training on establishing appropriate reliability goals for statistical sampling to be used while performing incurred cost audits at major contractors. Revised guidance should emphasize an analytical approach to setting the appropriate reliability goals to determine the sample size needed for gathering sufficient audit evidence.

DCAA Comment. DCAA nonconcurred with our recommendation directing use of a confidence level of no less than 90 percent and a precision of no less than 10 percent. DCAA viewed the draft recommendation as an impractical requirement. DCAA stated that the audit resource requirements would prove to be overwhelming and establishment of specific precision criteria would eliminate auditor judgment from the sampling process. Finally, DCAA stated that the benefits derived from the tighter precision calculations would simply not be worth the increased cost in time and effort.

DCAA proposed an alternative solution involving the use of informal "Rules of Thumb" that now allow auditors in instances of low risk to use a 70 percent confidence level with a 45 percent precision level. DCAA stated that they intend to develop a more analytical approach for auditors to use in determining sample sizes and re-emphasize the current DCAM guidance found in appendix B on determining appropriate sample sizes.

Evaluation Response. Although the DCAA nonconcurred with our draft recommendation, their proposed alternative solution satisfies the intent of our recommendation. Therefore, we have revised our draft recommendation and accept their proposed alternative as being responsive.

2. Revise Defense Contract Audit Manual, chapter 4 and appendix B, to permit greater flexibility in the exercise of auditor judgment on the use of nonstatistical sampling for transactional testing. Revised guidance should include guidelines on using purposeful or judgment sampling to select indirect cost account transactions to be reviewed at low-risk contractors.

DCAA Comment. DCAA nonconcurred with this draft recommendation. DCAA gathered data on the types of sampling actually performed in the 10 DCAA audits covered by our evaluation and concluded that the vast majority of accounts audited were evaluated using judgmental sampling. Therefore, DCAA believes that its existing policy provides its field auditors with adequate flexibility in the use of judgmental sampling and that the auditors make use of this flexibility.

Evaluation Response. We disagree that the current DCAA guidance allows the auditor flexibility in determining how to select transactions to be tested. For instance, DCAM chapter 4, section 605a states, "Because of its many advantages, including objectivity and overall defensibility, statistical (probability) sampling will be used, if feasible, wherever an audit involves tests or selected transactions or items in order to express an opinion regarding the entire area (universe) from which the selection was made. If statistical sampling is not used in these circumstances, an explanation should be given in the working papers." Appendix B, Section 202b also states, "Statistical sampling is preferred because of its advantages including objectivity, overall defensibility, and the risk of sampling error can be measured." We believe the quoted DCAA guidance is fairly strict in requiring the auditor to use statistical sampling. The fact that the majority of the accounts were reviewed by use of judgmental sampling is because of conflicting guidance in other sections of the DCAM. For instance Appendix B, section 202 a states, ". . .Therefore, auditors will normally use either statistical or judgmental (nonstatistical) sampling in their audits. The method selected depends on which is the most cost effective means of satisfying the audit objective and supporting favorable resolution of any reported conditions." In addition, DCAM chapter 4, section 603, "Scope and Degree of Testing," provides guidelines for determining items to be selected for testing and the extent of the examination. One guideline is that all transactions of an unusual or sensitive nature should be reviewed. This can only be satisfied through judgmental sampling. The first guideline of considering all large transactions for review could be satisfied through either judgmental or stratified statistical sampling.

We still believe that additional clarifying guidance would be useful to the field auditors. By revising its existing guidance, DCAA would eliminate any confusion between the various DCAM sections and update the guidance to better reflect actual field implementation. We request DCAA reconsider its comments in responding to the final report and agree to revise current guidance to include more specific guidelines for when judgmental versus statistical sampling is appropriate.

3. Issue interim guidance immediately to the regional and field audit offices implementing the Statements on Auditing Standards No. 82, "Consideration of Fraud in a Financial Statement Audit," in particular, the guidance in the Defense Contract Audit Manual that relates to due professional care and professional skepticism. The interim guidance should address how to implement the revised auditing standard on due professional care and should be incorporated promptly into the next version of the Defense Contract Audit Manual.

DCAA Comment. DCAA nonconcurred and disagreed with the draft finding. DCAA did agree to forward the report with our findings and concerns to each

DCAA region and field audit office with direction to correct any related weaknesses in their related audits or auditor performance.

Evaluation Response. Although DCAA nonconcurred with our draft recommendation, subsequent DCAA actions are fully responsive. On March 26, 1998, DCAA Headquarters issued an MRD [reference 98-PAS-044(R)] that provided some additional information on SAS 82 revisions. Recently, DCAA issued the July 1998 version of the DCAM that included the revised audit guidance required by SAS 82.

Finding C. Recognition and Reporting of Unallowable Costs Subject to Penalties

The DCAA did not properly recognize or recommend disallowance of costs that 10 U.S.C 2324(e), 41 U.S.C. 256(e) (see Appendix C), and Federal regulations define as expressly unallowable for reimbursement under Government contracts. In addition, DCAA did not always properly identify and report that expressly unallowable costs were subject to the penalty provisions of 10 U.S.C. 2324(b) and 41 U.S.C. 256(b). Nonrecognition or nonreporting of unallowable costs subject to penalties occurred because DCAA auditors did not properly implement the existing audit guidance. Further, existing DCAA guidance is not specific on how to identify and recognize those costs. Because DCAA did not recognize or properly report on unallowable costs subject to penalty, the Government has paid and may continue to pay contractors for costs prohibited from reimbursement by Federal statutes and regulations.

Audit Guidance

Unallowable Indirect Costs. The standard DCAA incurred cost audit programs covering indirect costs require that the auditor determine the allowability, allocability, and reasonableness of the costs selected for review. Most standard audit programs do not cover specific cost items in detail; therefore, the auditor must determine which FAR or DFARS clause is applicable and develop suitable audit steps and procedures to review the costs for acceptability. For certain costs, such as employee travel and relocation, DCAM chapter 7, "Selected Areas of Cost," provides additional guidance for the auditor to consider during the review. In some cases, the applicable FAR or DFARS clause has been revised since the cost was incurred; therefore, the auditor must be certain to use the criteria and audit guidance applicable at the time the cost was incurred.

Expressly Unallowable Costs. Audit guidance on expressly unallowable costs is in DCAM chapter 6, section 6. Specifically, DCAM 6-608.3a(2) provides some examples of costs declared expressly unallowable by Federal statutes or regulations. Examples of costs include entertainment expenses, fines and penalties, contributions, interest, losses on other contracts, certain types of advertising and business meetings, and Federal income taxes. DCAM 6-608.3a(2) does not specify all costs that could be considered expressly unallowable under CAS 405, 10 U.S.C. 2324(e), 41 U.S.C. 256(e), or FAR 31.205. The DCAM includes FAR subpart 31.2 in its entirety as appendix A, section A-300; and DFARS subpart 231 as appendix A, section A-400.

Penalty for Expressly Unallowable Costs. The auditor has the responsibility to determine whether any costs claimed by the contractor in the incurred cost submission are expressly unallowable and, therefore, subject to the penalty provided for in 10 U.S.C. 2324(b) and 41 U.S.C. 256(b) as implemented by FAR 42.709. The DCAM 6-608.4d, "General Responsibilities," states that the

auditor is responsible for making recommendations concerning the appropriateness of penalties. The guidance provides for auditor assistance in the computation of the paid portion of the disallowance for purposes of interest computation. The DCAM also makes it clear that the auditor has no authority to determine whether a penalty is to be imposed, impose the penalty, or recover a penalty against subsequent vouchers. Reporting requirements are discussed in DCAM 6-608.4f(5)-(7) and 10-500.

The auditor is required to expand the audit report to specifically identify questioned costs that are subject to the level-one and -two penalties. The report exhibit note should contain enough detail to explain why the level-one penalty is being recommended. For recommendation of a level-two penalty, the report exhibit note should describe the specific prior determination or mutual agreement that shows that the contractor should have known the cost was unallowable. The main reporting objective is to provide the CO with enough information to determine which unallowable costs are subject to penalties and to allocate the penalties to the applicable contracts. A separate exhibit should be included identifying questioned costs by penalty level, amount, and percent of base subject to penalty. To compute the estimated percent of base subject to penalty or the cost impact, the auditor must obtain from the contractor a list of all contracts that contain or should contain the applicable penalty clause.

Waiver of Penalty. A reduced reporting requirement is explained in DCAM 6-608.4f(7) to be applied when the auditor identifies unallowable costs subject to penalties with a cost impact of $10,000 or less. In cases where it is obvious that the waiver applies, the auditor needs only to include information in the report to alert the CO that there are costs subject to penalties and that the cost impact is less than the $10,000 waiver threshold. The calculation supporting the auditor's conclusion that the penalty waiver applies should be documented in the working papers. The DCAM provides a sample paragraph that can be adapted to the auditor's reporting situation. The auditor is also required to coordinate with the CO before issuing the report to ensure that the report will include the information the CO needs to make a determination.

Recognizing and Reporting Unallowable Costs Subject to Penalties

Adequacy of Reporting. For 8 of the 10 audit reports reviewed, DCAA did not properly recognize or report costs that were expressly unallowable and, therefore, subject to penalties. Significant errors occurred when DCAA did not recognize or report those costs, which may have affected the ability of the CO to properly comply with Federal statutes and FAR. However, when the CO should have been able to use the audit report information to implement the requirements of the Federal statutes and FAR, we considered the reporting error minor even if the auditor did not follow existing DCAM guidance.

For example, one incurred cost audit report contained several reporting errors. Minor reporting errors included using subcontracts in the calculation of the cost effect, failing to clearly specify in the applicable notes to the report exhibits that questioned costs were expressly unallowable, and failing to identify which level

of the penalty was appropriate. The significant deficiencies included not reporting expressly unallowable costs as such, improperly reporting unallowable costs as expressly unallowable, and not reporting costs identified as expressly unallowable in the amount subject to the penalty. Specifically, the auditor did not properly identify or report certain costs that the contractor screening process identified as unallowable after the contractor had submitted the certified incurred cost submission and the DCAA audit had started. Any expressly unallowable cost found by the contractor after the start of the audit is subject to penalties. Therefore, the auditor should have determined which costs were expressly unallowable and subject to the penalties and reported those costs as such in the audit report.

That audit report identified $12,641 from the contractor internal review process as unallowable; however, the report states, "Since the dollar impact of this adjustment is insignificant, we have not included the costs as part of the penalty computations for unallowable costs." First, we do not agree that total costs of $12,641 are expressly unallowable as detailed in the report. Of the $3,150 relating to new employee referral bonuses, $750 is a duplicate payment. While we agree that the $750 is unallowable because it duplicates a payment made to another employee, we could identify no FAR clause or reference in the Federal statutes that would make this cost expressly unallowable. In addition, we disagree with the audit office's decision to exclude the costs that were expressly unallowable from the calculation of the amount subject to penalty. The auditor does not have the authority to exempt a cost from the penalty. Only the CO can make that determination. Moreover, the audit report identified roughly $680,000 of expressly unallowable costs subject to a level-one penalty. Once the audit has identified sufficient expressly unallowable costs for the cost impact to be in excess of the $10,000 waiver threshold, then all identified expressly unallowable costs must be shown as such and included in the amount subject to penalty. If the total cost impact of the expressly unallowable costs is considered insignificant, the audit report should follow the reduced reporting requirement suggested by DCAM 6-608.4f(7). To do otherwise would conflict with the requirements of the Federal statutes.

The same audit report also did not classify certain costs that were expressly unallowable as such and subject to penalty. For example, in the audit report note, advertising costs of about $1,500; excess airfare of $4,710; contributions of about $2,500; and entertainment costs of $520 were not shown as expressly unallowable, even though all those costs are clearly designated as such by 10 U.S.C. 2324(e) and FAR 31.205.

At another office, the audit report did not identify $14,400 for market fluctuation in a stock appreciation account as subject to penalties. This cost is expressly unallowable according to FAR 31.205-6(i)(3), which was in effect at the time. Although Federal statutes and FAR help auditors to determine which costs are expressly unallowable, auditors have problems in interpreting the applicable regulations. More comprehensive guidance that specifies which costs are expressly unallowable and when they are expressly unallowable would help the auditors and others who must make determinations. More comprehensive guidance would also help ensure that costs are treated more consistently by all auditors and COs.

Unallowable Costs Identified, But Not Reported. In some audits, the auditor showed unallowable costs in the working papers, but did not report the costs as

such. Those costs may or may not have been specifically identified in the working papers as expressly unallowable, but the auditor should have recognized them as such. One example is reimbursement for alcoholic beverages, which is expressly unallowable under FAR 31.205-14 (Entertainment costs) and 10 U.S.C. 2324(e). At one audit office, the auditor determined that the amount would not be enough to affect the indirect rate calculation. The auditor wrote the amount off as insignificant. This approach results in the auditor, instead of the CO, deciding to waive the applicable penalty. Only the CO has the authority to waive the penalty under the conditions provided for in the Federal statutes and regulations. Therefore, if the auditor identifies unallowable costs subject to penalties during the audit, those costs must be included in the audit report. If the total cost impact of the expressly unallowable costs is less than the $10,000 waiver threshold, then the auditor must use the minimum reporting requirements suggested in the DCAM. The auditor does not need to show the costs as questioned in the audit report body or exhibits if the dollar amount would not affect the indirect rates. However, the auditor is required to report the costs for penalty consideration. Even though the costs may not be significant, it is important to properly identify and report the costs as expressly unallowable to permit the CO the chance to officially notify the contractor that the costs are considered expressly unallowable. Thus, if the contractor improperly claims the costs again, the costs would be subject to the level-two penalty. The Government must preserve the right to impose the level-two penalty for repeat occurrences. Therefore, the DCAA must report all unallowable costs subject to penalties with no consideration given to dollar amount involved.

Contractor Documentation Provided. At four contractor locations, DCAA had difficulty determining whether a cost was unallowable or expressly unallowable and subject to penalty because of the amount and type of supporting documentation provided by the contractor. The FAR 31.201-2(d) provides that the contractor is responsible for appropriately accounting for costs and maintaining adequate supporting documentation to show that costs claimed have been incurred, are allocable to the contract, and comply with applicable regulations. This FAR clause also specifically permits the CO to disallow all or part of a claimed cost that is inadequately supported. For professional and consultant service costs, FAR 31.205-33(f) specifically states what supporting documentation is required. The contractor benefits by providing documentation only until the auditor determines that a cost is unallowable. If the contractor provides additional documentation, the auditor may decide that the cost is expressly unallowable and subject to penalties. For example, during a DCAA audit, one contractor internal review process found that $56,240 relating to a special services allocation from a contractor group entity should not have been claimed. Because the contractor agreed that the costs were unallowable, DCAA did not request documentation. The costs were for employee morale and welfare items and, therefore, could have contained costs that were expressly unallowable. Without documentation, the auditor could not make this determination. Therefore, DCAA, in effect, permitted the contractor to circumvent the intent of the Federal statutes. Adequate support for claimed costs is essential to permit the auditor and CO to fully comply with the intent of the Federal statutes. The Federal statutes should be amended to include the lack of adequate support as a basis for assessing a level one penalty. We are planning to draft a suggested revision to the Federal statutes and forward it for congressional consideration.

Penalty Waiver Applied. For one contractor location, the DCAA audit report contained inappropriate comments relating to the imposition of penalties. The audit report stated that the contractor had claimed the costs in error and, therefore, the penalty should not be applied. Although the guidance in DCAM 6-608.4d states that the auditor can make recommendations on the appropriateness of imposing penalties, Federal statutes and FAR 42.709 do not delegate that authority to the auditor. According to FAR 42.709, the auditor is responsible for recommending to the contracting officer which costs may be unallowable and subject to penalties. The FAR does not allow the auditor to recommend that a cost may be expressly unallowable but not subject to the penalty. The Federal statutes are clear that the responsibility for determining whether to impose the penalty belongs to the CO. In addition, the waiver of the penalty is allowed when the $10,000 threshold waiver is exceeded, only if two conditions are met: first, the contractor must have inadvertently claimed the costs; second, the contractor has to satisfy the CO that it has in place policies and procedures and an effective internal control system to assure that unallowable costs are not claimed. Therefore, the auditor should not make the recommendation in the incurred cost audit report. The audit report should provide factual information concerning the circumstances under which the expressly unallowable costs were claimed. Based on that information, the CO can determine whether claiming the cost was an error or not. If the CO needs more advice or information to determine whether to impose the penalty, the CO may request additional information from the auditor. The DCAM needs to be revised to clarify that the auditor may not determine or state that a penalty is not applicable because an expressly unallowable cost was claimed inadvertently.

Summary

Current Federal statutes and regulations require that in most circumstances when a contractor claims expressly unallowable costs, a penalty should be assessed. The DCAA audits are the starting point for compliance with the laws and regulations. Therefore, when DCAA does not recognize and report expressly unallowable costs, the ability of DoD to properly comply with Federal statutes and regulations is compromised. By clarifying guidance on reporting requirements and providing a specific list of expressly unallowable costs to the auditors, the DoD will improve compliance. Better compliance will help motivate contractors with adequate screening processes and internal control systems to properly maintain them while those with inadequate policies and procedures continue to improve their screening processes for elimination of unallowable costs. In turn, DoD can more effectively use its limited resources to ensure that contractors are paid only for costs that are eligible for reimbursement under Government contracts.

Recommendation, Management Comments, and Evaluation Response

Revised Recommendation. As a result of management comments, we revised draft Recommendation C.1.

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

1. Revise pertinent sections of the Defense Contract Audit Manual such as Chapter 7, "Selected Areas of Cost," where guidance is provided in auditing specific types of costs, to include a statement highlighting when the cost is considered an expressly unallowable cost subject to a level-one penalty under Title 10, United States Code, Section 2324; Title 41, United States Code, Section 256; Federal Acquisition Regulation subpart 31.205; and Defense Federal Acquisition Regulation Supplement subpart 231.205.

DCAA Comment. DCAA nonconcurred with our draft recommendation to revise DCAM, chapter 6. DCAA stated that DCAM already refers to the specific CAS and FAR sections that define and explain what are expressly unallowable costs and to further expand the coverage and examples would be an unjustified duplication of the existing FAR coverage and other audit guidance. In addition, DCAA stated that the FAR cost principles change frequently and are quite complex; therefore, implementing our draft recommendation, as well as, updating the information in other sections of DCAM, would be time-consuming and costly without a corresponding benefit.

Evaluation Response. We have considered the comments and revised our draft recommendation to address their concern about efficient and effective use of limited resources. In reviewing the example (executive compensation) that DCAA provided in their comments, we found that DCAM chapter 6, section 6-414.9c provides specific guidance to the auditor on when executive compensation is unallowable and subject to the penalty clause. Specifying when a cost is considered unallowable and subject to the penalty clause in the DCAM section that already provides guidance on that specific cost will make it easy for DCAA to update as needed. The wording of the revised recommendation also reflects our concern that DCAA auditors need clear guidance on when specific costs are unallowable and subject to the penalty clause so that consistent treatment of costs can occur. Please comment on the revised recommendation in response to our final report.

2. Revise guidance in Defense Contract Audit Manual chapter 6, section 6, to clarify that the auditor must report all unallowable costs subject to penalties identified during the audit, regardless of dollar amount.

DCAA Comment. DCAA concurred and stated that the recommended guidance will be added to the DCAM by 31 July 1998.

Evaluation Response. The DCAA planned actions are fully responsive.

3. Revise Defense Contract Audit Manual chapter 6, section 608.4d, to clarify that the auditor should make recommendations concerning the appropriateness of penalties only when the contracting officer specifically requests that assessment. The assessment of whether a penalty is appropriate should be made independent of and after the issuance of the incurred cost audit report.

DCAA Comment. DCAA concurred and agreed to revise DCAM 6-608.4d to more clearly reflect the provisions of FAR 42.709-2(b).

Evaluation Response. The DCAA planned action is considered responsive.

Part II - Additional Information

Appendix A. Evaluation Process

Scope and Methodology

We conducted this evaluation from November 1996 through April 1997. From November 1996 through March 1997, we visited eight DCAA audit offices responsible for major contractors. To accomplish our objectives, we reviewed the incurred cost audit coverage of major contractors at each DCAA audit offices visited. Our evaluation included reviewing:

- o the audit office's risk assessment of the contractor's internal control system for charging indirect costs;
- o the most recently completed incurred cost audit report and selected associated indirect cost audit assignments for the contractor entity;
- o associated audits, including CAS 405 reviews and other CAS noncompliance reviews; and
- o requirements and program plan information relating to the completion of internal control systems reviews and incurred cost audits.

Our review concentrated on identification of unallowable costs and proper recognition and reporting of unallowable costs subject to penalties.

We judgmentally selected the eight DCAA offices and reviewed nine contractor entities based on information available in the DCAA Management Information System. The criteria we used in the selection process included the most current contractor year audited, the amount of questioned costs, and the number of hours expended. We selected at least one audit office from each of the five regions. We varied the type of audit office visited by choosing both resident audit offices and suboffices of a branch office. We reviewed 10 final incurred cost audit reports and 73 audit assignments. Information on specific audit offices visited and audit reports and audit assignments reviewed is available on request.

DoD-wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to the GPRA, the DoD has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

- o **Objective:** Fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Acquisition Functional Area. Objective:** Fostering Partnerships. **Goal:** With no top-line budget change, achieve annual defense procurement of at least $54 billion toward a goal of $60 billion in 2001. **(ACQ-2.1)**

- **Acquisition Functional Area. Objective:** Internal Reinvention. **Goal:** Minimize cost growth in major defense acquisition programs at no greater than 1 percent annually. **(ACQ-3.4)**

General Accounting Office High Risk Area. The General Accounting Office has identified several high risk areas in the DoD. This report provides coverage of the Defense Contract Management high risk area.

Contacts During the Evaluation. We visited or contacted individuals and organizations within the DoD. Further details are available on request.

Appendix B. Summary of Prior Coverage

During the last 5 years, the Assistant Inspector General for Audit Policy and Oversight, Office of Inspector General, DoD, issued three reports on topics pertinent to issues in our evaluation.

Report No. 95-009, "Report on the Oversight Review of the Defense Contract Audit Agency Evaluations of Contractor Compensation Systems," was issued July 3, 1995. Of 21 audits of contractor compensation systems, 18 were inadequate. Auditors did not report $700,000 in unreasonable executive compensation because offsets were allowed without justification, inadequate audit steps were performed, and proper fringe benefits rates were not applied to unreasonable compensation costs. Also, the DCAA and Defense Logistics Agency used different methods for offsetting compensation between labor grades.

The Director, DCAA, agreed with our recommendations to:

o review compensation system reviews where unreasonable executive compensation was offset and determine whether supplemental reports should be issued;

o require the Assistant Director for Operations and the Regional Directors to monitor the performance of compensation system reviews;

o develop a self-study course on compensation system reviews and require the auditors to complete the course prior to starting a compensation system review; and

o include more specific guidance for performing compensation system reviews in the DCAM.

Report No. 95-001, "Oversight Review of the Defense Contract Audit Agency Reporting of Cost Questioned Subject To Penalties," was issued October 18, 1994. Of 72 incurred cost audits, 27 did not adequately justify recommending penalty assessments and 61 did not comment on the adequacy of the contractor screening process for identifying unallowable costs. In addition, none of the 13 reports recommending a second-level penalty assessment were referred for investigation. The report recommended that audit guidance require the report to indicate a level-one or level-two penalty, to adequately explain the basis of the disallowance, and to include comments on the contractor failure to adequately screen the submission for expressly unallowable costs. The report also recommended guidance on submitting a fraud referral based on a level-one or -two assessment.

The Director, DCAA, agreed with or provided acceptable alternatives to the recommendations.

Report No. 92-008, "Report on Oversight Review of the Adequacy of the Defense Contract Audit Agency Coverage of Internal Controls At Major Contractors," was issued June 29, 1992. The accuracy of the Internal Control Questionnaire needed to be improved as a result of incorrectly answered

questions and answers that were inadequately supported by referenced working papers. The questionnaires were generally completed by inexperienced auditors, and supervisors generally did not review them to ensure accuracy. The report recommended that DCAA ensure that supervisors closely monitor subordinates' work, improve integration of the Internal Control Questionnaire with the vulnerability assessment procedures, and change the Internal Control Questionnaire to enhance the accuracy and effectiveness of the audit planning process. Improved integration of the Internal Control Questionnaire and the vulnerability assessment procedures will highlight identified control weaknesses and risks to facilitate proper planning and audit coverage. The report also recommended that DCAA issue guidance to better focus reporting on internal control weaknesses to prevent recurring questionable costs.

The DCAA concurred with all the recommendations and took action to correct the deficiencies.

Appendix C. Federal Statutes on Allowable Costs

UNITED STATES CODE ANNOTATED
TITLE 10. ARMED FORCES
SUBTITLE A--GENERAL MILITARY LAW
PART IV--SERVICE SUPPLY, AND PROCUREMENT
CHAPTER 137--PROCUREMENT GENERALLY

Section 2324. Allowable costs under defense contracts[1]

(a) Indirect cost that violates a FAR cost principle.--The head of an agency shall require that a covered contract provide that if the contractor submits to the agency a proposal for settlement of indirect costs incurred by the contractor for any period after such costs have been accrued and if that proposal includes the submission of a cost which is unallowable because the cost violates a cost principle in the Federal Acquisition Regulation or applicable agency supplement to the Federal Acquisition Regulation, the cost shall be disallowed.

(b) Penalty for violation of cost principle.--(1) If the head of the agency determines that a cost submitted by a contractor in its proposal for settlement is expressly unallowable under a cost principle referred to in subsection (a) that defines the allowability of specific selected costs, the head of the agency shall assess a penalty against the contractor in an amount equal to--

(A) the amount of the disallowed cost allocated to covered contracts for which a proposal for settlement of indirect costs has been submitted; plus

(B) interest (to be computed based on provisions in the Federal Acquisition Regulation) to compensate the United States for the use of any funds which a contractor has been paid in excess of the amount to which the contractor was entitled.

(2) If the head of the agency determines that a proposal for settlement of indirect costs submitted by a contractor includes a cost determined to be unallowable in the case of such contractor before the submission of such proposal, the head of the agency shall assess a penalty against the contractor, in an amount equal to two times the amount of the disallowed cost allocated to covered contracts for which a proposal for settlement of indirect costs has been submitted.

(c) Waiver of penalty.--The Federal Acquisition Regulation shall provide for a penalty under subsection (b) to be waived in the case of a contractor's proposal for settlement of indirect costs when--

(1) the contractor withdraws the proposal before the formal initiation of an audit of the proposal by the Federal Government and resubmits a revised proposal;

[1] Current through Public Law 105-15, approved 5-15-97

(2) the amount of unallowable costs subject to the penalty is insignificant; or

(3) the contractor demonstrates, to the contracting officer's satisfaction, that--

(A) it has established appropriate policies and personnel training and an internal control and review system that provide assurances that unallowable costs subject to penalties are precluded from being included in the contractor's proposal for settlement of indirect costs; and

(B) the unallowable costs subject to the penalty were inadvertently incorporated into the proposal.

(d) Applicability of contract disputes procedure to disallowance of cost and assessment of penalty.--An action of the head of an agency under subsection (a) or (b)--

(1) shall be considered a final decision for the purposes of section 6 of the Contract Disputes Act of 1978 (41 U.S.C. 605); and

(2) is appealable in the manner provided in section 7 of such Act (41 U.S.C. 606).

(e) Specific costs not allowable.--(1) The following costs are not allowable under a covered contract:

(A) Costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities).

(B) Costs incurred to influence (directly or indirectly) legislative action on any matter pending before Congress, a State legislature, or a legislative body of a political subdivision of a State.

(C) Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the United States where the contractor is found liable or has pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).

(D) Payments of fines and penalties resulting from violations of, failure to comply with, Federal, State, local, or foreign laws and regulations, except when incurred as a result of compliance with specific terms and conditions of the contract or specific written instructions from the contracting officer authorizing in advance such payments in accordance with applicable provisions of the Federal Acquisition Regulation.

(E) Costs of membership in any social, dining, or country club or organization.

(F) Costs of alcoholic beverages.

(G) Contributions or donations, regardless of the recipient.

(H) Costs of advertising designed to promote the contractor or its products.

(I) Costs of promotional items and memorabilia, including models, gifts, and souvenirs.

(J) Costs for travel by commercial aircraft which exceed the amount of the standard commercial fare.

(K) Costs incurred in making any payment (commonly known as a "golden parachute payment") which is--

(i) in an amount in excess of the normal severance pay paid by the contractor to an employee upon termination of employment; and

(ii) is paid to the employee contingent upon, and following, a change in management control over, or ownership of, the contractor or a substantial portion of the contractor's assets.

(L) Costs of commercial insurance that protects against the costs of the contractor for correction of the contractor's own defects in materials or workmanship.

(M) Costs of severance pay paid by the contractor to foreign nationals employed by the contractor under a service contract performed outside the Untied States, to the extent that the amount of severance pay paid in any case exceeds the amount paid in the industry involved under the customary or prevailing practice for firms in that industry providing similar services in the United States, as determined under the Federal Acquisition Regulation.

(N) Costs of severance pay paid by the contractor to a foreign national employed by the contractor under a service contract performed in a foreign country if the termination of the employment of the foreign national is the result of the closing of, or the curtailment of activities at, a United States military facility in that country at the request of the government of that country.

(O) Costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States or a State, to the extent provided in subsection (k).

(2)(A) The Secretary of Defense may provide in a military banking contract that the provisions of paragraphs (1)(M) and (1)(N) shall not apply to costs incurred under the contract by the contractor for payment of mandated foreign national severance pay. The Secretary may include such a provision in a military banking contract only if the Secretary determines, with respect to that contract, that the contractor has taken (or has established plans to take) appropriate actions within the contractor's control to minimize the amount and number of incidents of the payment of severance pay by the contractor to employees under the contract who are foreign nationals.

(B) In subparagraph (A):

(i) The term "military banking contract" means a contract between the Secretary and a financial institution under which the financial institution operates a military banking facility outside the United States for use by members of the armed forces stationed or deployed outside the United States and other authorized personnel.

(ii) The term "mandated foreign national severance pay" means severance pay paid by a contractor to a foreign national employee the payment of which by the payment of which by the contractor is required in order to comply with a law that is generally applicable to a significant number of businesses in the country in which the foreign national receiving the payment performed services under the contract.

(C) Subparagraph (A) does not apply to a contract with a financial institution that is owned or controlled by citizens or nationals of a foreign country, as determined by the Secretary of Defense. Such a determination shall be made in accordance with the criteria set out in paragraph (1) of section 4(g) of the Buy American Act (41 U.S.C. 10b-1) and the policy guidance referred to in paragraph (2)(A) of that section.

(3)(A) Pursuant to the Federal Acquisition Regulation and subject to the availability of appropriations, the head of an agency awarding a covered contract (other than a contract to which paragraph (2) applies) may waive the application of the provisions of paragraphs (1)(M) and (1)(N) to that contract if the head of the agency determines that--

(i) the application of such provisions to the contract would adversely affect the continuation of a program, project, or activity that provides significant support services for members of the armed forces stationed or deployed outside the United States;

(ii) the contractor has taken (or has established plans to take) appropriate actions within the contractor's control to minimize the amount and number of incidents of the payment of severance pay by the contractor to employees under the contract who are foreign nationals; and

(iii) the payment of severance pay is necessary in order to comply with a law that is generally applicable to a significant number of businesses in the country in which the foreign national receiving the payment performed services under the contract or is necessary to comply with a collective bargaining agreement.

(B) The head of an agency shall include in the solicitation for a covered contract a statement indicating--

(i) that a waiver has been granted under subparagraph (A) for the contract; or

(ii) whether the head of the agency will consider granting such a waiver, and, if the agency head will consider granting a waiver, the criteria to be used in granting the waiver.

(C) The head of an agency shall make the final determination regarding whether to grant a waiver under subparagraph (A) with respect to a covered contract before award of the contract.

(4) The provisions of the Federal Acquisition Regulation implementing this section may establish appropriate definitions, exclusions, limitations, and qualifications.

(f) Required regulations.--(1) The Federal Acquisition Regulation shall contain provisions on the allowability of contractor costs. Such provisions shall define in detail and in specific terms those costs which are unallowable, in whole or in part, under covered contracts. The regulations shall, at a minimum, clarify the cost principles applicable to contractor costs of the following:

(A) Air shows.

(B) Membership in civic, community, and professional organizations.

(C) Recruitment.

(D) Employee morale and welfare.

(E) Actions to influence (directly and indirectly) executive branch action on regulatory and contract matters (other than costs incurred in regard to contract proposals pursuant to solicited or unsolicited bids).

(F) Community relations.

(G) Dining facilities.

(H) Professional and consulting services, including legal services.

(I) Compensation.

(J) Selling and marketing.

(K) Travel.

(L) Public relations.

(M) Hotel and meal expenses.

(N) Expense of corporate aircraft.

(O) Company-furnished automobiles.

(P) Advertising.

(Q) Conventions.

(2) The Federal Acquisition Regulation shall require that a contracting officer not resolve any questioned costs until he has obtained--

(A) adequate documentation with respect to such costs; and

(B) the opinion of the contract auditor on the allowability of such costs.

(3) The Federal Acquisition Regulation shall provide that, to the maximum extent practicable, the contract auditor be present at any negotiation or meeting with the contractor regarding a determination of the allowability of indirect costs of the contractor.

(4) The Federal Acquisition Regulation shall require that all categories of costs designated in the report of the contract auditor as questioned with respect to a proposal for settlement be resolved in such a manner that the amount of the individual questioned costs that are paid will be reflected in the settlement.

(g) Applicability of regulations to subcontractors.--The regulations referred to in subsections (e) and (f)(1) shall require prime contractors of a covered contract, to the maximum extent practicable, to apply the provisions of such regulations to all subcontractors of the covered contract.

(h) Contractor certification required.--(1) A proposal for settlement of indirect costs applicable to a covered contract shall include a certification by an official of the contractor that, to the best of the certifying official's knowledge and belief, all indirect costs included in the proposal are allowable. Any such certification shall be in a form prescribed in the Federal Acquisition Regulation.

(2) The head of the agency or the Secretary of the military department concerned may, in an exceptional case, waive the requirement for certification under paragraph (1) in the case of any contract if the head of the agency or the Secretary--

(A) determines in such case that it would be in the interest of the United States to waive such certification; and

(B) states in writing the reasons for that determination and makes such determination available to the public.

(i) Penalties for submission of cost known as not allowable.--The submission to an agency of a proposal for settlement of costs for any period after such costs have been accrued that includes a cost that is expressly specified by statute or regulation as being unallowable, with the knowledge that such cost is unallowable, shall be subject to the provisions of section 287 of title 18 and section 3729 of title 31.

(j) Contractor to have burden of proof.--In a proceeding before the Armed Services Board of Contract Appeals, the United States Court of Federal Claims, or any other Federal court in which the reasonableness of indirect costs for which a contractor seeks reimbursement from the Department of Defense is in issue, the burden of proof shall be upon the contractor to establish that those costs are reasonable.

(k) Proceeding costs not allowable.--(1) Except as otherwise provided in this subsection, costs incurred by a contractor in connection with any criminal, civil,

or administrative proceeding commenced by the United States or a State are not allowable as reimbursable costs under a covered contract if the proceeding (A) relates to a violation of, or failure to comply with, a Federal or State statute or regulation, and (B) results in disposition described in paragraph (2).

(2) A disposition referred to in paragraph (1)(B) is any of the following:

(A) In the case of a criminal proceeding, a conviction (including a conviction pursuant to a plea of nolo contendere) by reason of the violation or failure referred to in paragraph (1).

(B) In the case of a civil or administrative proceeding involving an allegation of fraud or similar misconduct, a determination of contractor liability on the basis of the violation or failure referred to in paragraph (1).

(C) In case of any civil or administrative proceeding, the imposition of a monetary penalty by reason of violation or failure referred to in paragraph(1).

(D) A final decision--

(i) to debar or suspend the contractor;

(ii) to rescind or void the contract; or

(iii) to terminate the contract for default;

by reason of the violation or failure referred to in paragraph (1).

(E) A disposition of the proceeding by consent or compromise if such action could have resulted in a disposition described in subparagraph (A), (B), (C), or (D).

(3) In the case of the proceeding referred to in paragraph (1) that is commenced by the United States and is resolved by consent or compromise pursuant to an agreement entered into by a contractor and the United States, the costs incurred by the contractor in connection with such proceeding that are otherwise not allowable as reimbursable costs under such paragraph may be allowed to the extent specifically provided in such agreement.

(4) In the case of a proceeding referred to in paragraph (1) that is commenced by a State, the head of the agency or Secretary of the military department concerned that awarded the covered contract involved in the proceeding may allow the costs incurred by the contractor in connection with such proceeding as reimbursable costs if the agency head or Secretary determines, in accordance with the Federal Acquisition Regulation, that the costs were incurred as a result of (A) a specific term or condition of the contract, or (B) specific written instructions of the agency or military department.

(5)(A) Except as provided in subparagraph (C), cost incurred by a contractor in connection with a criminal, civil, or administrative proceeding commenced by the United States or a State in connection with a covered contract may be allowed as reimbursable costs under the contract if such costs

are not disallowable under paragraph (1), but only to the extent provided in subparagraph (B).

(B)(i) The amount of the costs allowable under subparagraph (A) in any case may not exceed the amount equal to 80 percent of the amount of the costs incurred, to the extent that such costs are determined to be otherwise allowable and allocable under the Federal Acquisition Regulation.

(ii) Regulations issued for the purpose of clause (i) shall provide for appropriate consideration of the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions involving the United States as a party, and such other factors as may be appropriate.

(C) In the case of a proceeding referred to in subparagraph (A), contractor costs otherwise allowable as reimbursable costs under this paragraph are not allowable if (i) such proceeding involves the same contractor misconduct alleged as the basis of another criminal, civil, or administrative proceeding, and (ii) the costs of such other proceeding are not allowable under paragraph (1).

(6) In this subsection:

(A) The term "proceeding" includes an investigation.

(B) The term "costs", with respect to a proceeding--

(i) means all costs incurred by a contractor, whether before or after the commencement of any such proceeding; and

(ii) includes--

(I) administrative and clerical expenses;

(II) the cost of legal services, including legal services performed by an employee of the contractor;

(III) the cost of the services of accountants and consultants retained by the contractor; and

(IV) the pay of directors, officers, and employees of the contractor for time devoted by such directors, officers and employees to such proceeding..

(C) The term "penalty" does not include restitution, reimbursement, or compensatory damages.

(1) Definitions.--In this section:

(1)(A) The term "covered contract" means a contract for an amount in excess of $500,000 that is entered into by the head of an agency, except that such term does not include a fixed-price contract without cost incentives or any firm fixed-price contract for the purchase of commercial items.

(B) Effective on October 1 of each year that is divisible by five, the amount set forth in subparagraph (A) shall be adjusted to the equivalent amount in constant fiscal year 1994 dollars. An amount, as so adjusted, that is not evenly divisible by $50,000 shall be rounded to the nearest multiple of $50,000. In the case of an amount that is evenly divisible by $25,000 but is not evenly divisible by $50,000, the amount shall be rounded to the next higher multiple of $50,000.

(2) The term "head of the agency" or "agency head" does not include the Secretary of a military department.

(3) The term "agency" means the Department of Defense, the Coast Guard, and the National Aeronautics and Space Administration.

UNITED STATES CODE ANNOTATED
TITLE 41. PUBLIC CONTRACTS
CHAPTER 4--PROCUREMENT PROCEDURES
SUBCHAPTER IV--PROCUREMENT PROVISIONS

Section 256. Allowable costs[1]

(a) Indirect cost that violates a FAR cost principle

An executive agency shall require that a covered contract provide that if the contractor submits to the executive agency a proposal for settlement of indirect costs incurred by the contractor for any period after such costs have been accrued and if that proposal includes the submission of a cost which is unallowable because the cost violates a cost principle in the Federal Acquisition Regulation (referred to in section 421(c)(1) of this title) or an executive agency supplement to the Federal Acquisition Regulation, the cost shall be disallowed.

(b) Penalty for violation of cost principle

(1) If the executive agency determines that a cost submitted by a contractor in its proposal for settlement is expressly unallowable under a cost principle referred to in subsection (a) of this section that defines the allowability of specific selected costs, the executive agency shall assess a penalty against the contractor in an amount equal to--

(A) the amount of the disallowed cost allocated to covered contracts for which a proposal for settlement of indirect costs has been submitted; plus

(B) interest (to be computed based on provisions in the Federal Acquisition Regulation) to compensate the United States for the use of any funds which a contractor has been paid in excess of the amount to which the contractor was entitled.

(2) If the executive agency determines that a proposal for settlement of indirect costs submitted by a contractor includes a cost determined to be unallowable in the case of such contractor before the submission of such proposal, the executive agency shall assess a penalty against the contractor in an amount equal to two times the amount of the disallowed cost allocated to covered contracts for which a proposal for settlement of indirect costs has been submitted.

(c) Waiver of penalty

The Federal Acquisition Regulation shall provide for a penalty under subsection (b) of this section to be waived in the case of a contractor's proposal for settlement of indirect costs when--

[1] Current through Public Law 105-15, approved 5-15-97

(1) the contractor withdraws the proposal before the formal initiation of an audit of the proposal by the Federal Government and resubmits a revised proposal;

(2) the amount of unallowable costs subject to the penalty is insignificant; or

(3) the contractor demonstrates, to the contracting officer's satisfaction, that--

(A) it has established appropriate policies and personnel training and an internal control and review system that provide assurances that unallowable costs subject to penalties are precluded from being included in the contractor's proposal for settlement of indirect costs; and

(B) the unallowable costs subject to the penalty were inadvertently incorporated into the proposal.

(d) Applicability of contract disputes procedure to disallowance of cost and assessment of penalty

An action of an executive agency under subsection (a) or (b) of this section--

(1) shall be considered a final decision for the purposes of section 605 of this title; and

(2) is appealable in the manner provided in section 606 of this title.

(e) Specific costs not allowable

(1) The following costs are not allowable under a covered contract:

(A) Costs of entertainment, including amusement, diversion, and social activities, and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities).

(B) Costs incurred to influence (directly or indirectly) legislative action on any matter pending before Congress, a State legislature, or a legislative body of a political subdivision of a State.

(C) Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the Unites States where the contractor is found liable or had pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).

(D) Payments of fines and penalties resulting from violations of, or failure to comply with, Federal, State, local, or foreign laws and regulations, except when incurred as a result of compliance with specific terms and conditions of the contract or specific written instructions from the contracting officer authorizing in advance such payments in accordance with applicable provisions of the Federal Acquisition Regulation.

(E) Costs of membership in any social, dining, or country club or organization.

(F) Costs of alcoholic beverages.

(G) Contributions or donations, regardless of the recipient.

(H) Costs of advertising designed to promote the contractor or its products.

(I) Costs of promotional items and memorabilia, including models, gifts, and souvenirs.

(J) Costs of travel by commercial aircraft which exceed the amount of the standard commercial fare.

(K) Costs incurred in making any payment (commonly known as "golden parachute payment") which is--

(i) in an amount in excess of the normal severance pay paid by the contractor to an employee upon termination of employment; and

(ii) is paid to the employee contingent upon, and following, a change in management control over, or ownership of, the contractor or a substantial portion of the contractor's assets.

(L) Costs of commercial insurance that protects against the costs of the contractor for correction of the contractor's own defects in materials or workmanship.

(M) Costs of severance pay paid by the contractor to foreign nationals employed by the contractor under a service contract performed outside the United States, to the extent that the amount of severance pay paid in any case exceeds the amount paid in the industry involved under the customary or prevailing practice for firms in that industry providing similar services in the United States, as determined under the Federal Acquisition Regulation.

(N) Costs of severance pay paid by the contractor to a foreign national employed by the contractor under a service contract performed in a foreign country if the termination of the employment of the foreign national is the result of the closing of, or the curtailment of activities at, a United States facility in that country at the request of the government of that country.

(O) Costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States or a State, to the extent provided in subsection (k) of this section.

(2)(A) Pursuant to the Federal Acquisition Regulation and subject to the availability of appropriations, an executive agency, in awarding a covered contract, may waive the application of the provisions of paragraphs (1)(M) and (1)(N) to that contract if the executive agency determines that--

(i) the application of such provisions to the contract would adversely affect the continuation of a program, project, or activity that

provides significant support services for employees of the executive agency posted outside the United States;

(ii) the contractor has taken (or has established plans to take) appropriate actions within the contractor's control to minimize the amount and number of incidents of the payment of severance pay by the contractor to employees under the contract who are foreign nationals; and

(iii) the payment of severance pay is necessary in order to comply with a law that is generally applicable to a significant number of businesses in the country in which the foreign national receiving the payment performed services under the contract or is necessary to comply with a collective bargaining agreement.

(B) An executive agency shall include in the solicitation for a covered contract a statement indicating--

(i) that a waiver has been granted under subparagraph (A) for the contract; or

(ii) whether the executive agency will consider granting such a waiver, and, if the executive agency will consider granting a waiver, the criteria to be used in granting the waiver.

(C) An executive agency shall make the final determination regarding whether to grant a waiver under subparagraph (A) with respect to a covered contract before award of the contract.

(3) The provisions of the Federal Acquisition Regulation implementing this section may establish appropriate definitions, exclusions, limitations, and qualifications. Any submission by a contractor of costs which are incurred by the contractor and which are claimed to be allowed under Department of Energy management and operating contracts shall be considered a "proposal for settlement of indirect costs incurred by the contractor for any period after such costs have been accrued", as used in this section.

(f) Required regulations

(1) The Federal Acquisition Regulation shall contain provisions on the allowability of contractor costs. Such provisions shall define in detail and in specific terms those costs which are unallowable, in whole or in part, under covered contracts. The regulations shall, at a minimum, clarify the cost principles applicable to contractor costs of the following:

(A) Air shows.

(B) Membership in civic, community, and professional organizations.

(C) Recruitment.

(D) Employee morale and welfare.

(E) Actions to influence (directly or indirectly) executive branch action on regulatory and contract matters (other than costs incurred in regard to contract proposals pursuant to solicited or unsolicited bids).

(F) Community relations.

(G) Dining facilities.

(H) Professional and consulting services, including legal services.

(I) Compensation.

(J) Selling and marketing.

(K) Travel.

(L) Public relations.

(M) Hotel and meal expenses.

(N) Expense of corporate aircraft.

(O) Company-furnished automobiles.

(P) Advertising.

(Q) Conventions.

(2) The Federal Acquisition Regulation shall require that a contracting officer not resolve any questioned cost until the contracting officer has obtained--

(A) adequate documentation with respect to such costs; and

(B) the opinion of the contract auditor on the allowability of such costs.

(3) The Federal Acquisition Regulation shall provide that, to the maximum extent practicable, a contract auditor be present at any negotiation or meeting with contractor regarding a determination of the allowability of indirect costs of the contractor.

(4) The Federal Acquisition Regulation shall require that all categories of cost designated in the report of a contract auditor as questioned with respect to a proposal for settlement be resolved in such a manner that the amount of the individual questioned costs that are paid will be reflected in the settlement.

(g) Applicability of regulations to subcontractors

The regulations referred to in subsections (e) and (f)(1) of this section shall require prime contractors of a covered contract, to the maximum extent practicable, to apply the provisions of such regulations to all subcontractors of the covered contract.

(h) Contractor certification required

(1) A proposal for settlement of indirect costs applicable to a covered contract shall include a certification by an official of the contractor that, to the best of the certifying official's knowledge and belief, all indirect costs included in the proposal are allowable. Any such certification shall be in a form prescribed in the Federal Acquisition Regulation.

(2) An executive agency may, in an exceptional case, waive the requirement for certification under paragraph (1) in the case of any contract if the agency--

(A) determines in such case that it would be in the interest of the United States to waive such certification; and

(B) states in writing the reasons for that determination and makes such determination available to the public.

(i) Penalties for submission of cost known as not allowable

The submission to an executive agency of a proposal for settlement of costs for any period after such costs have been accrued that includes a cost that is expressly specified by statute or regulation as being unallowable, with the knowledge that such cost is unallowable, shall be subject to the provisions of section 287 of Title 18 and section 3729 of Title 31.

(j) Contractor to have burden of proof

In a proceeding before a board of contract appeals, the United States Court of Federal Claims, or any other Federal court in which the reasonableness of indirect costs for which a contractor seeks reimbursement from the United States is in issue, the burden of proof shall be upon the contractor to establish that those costs are reasonable.

(k) Proceeding costs not allowable

(1) Except as otherwise provided in this subsection, costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States or a State are not allowable as reimbursable costs under a covered contract if the proceeding (A) relates to a violation of, or failure to comply with, a Federal or State statute or regulation, and (B) results in a disposition described in paragraph (2).

(2) A disposition referred to in paragraph (1)(B) is any of following:

(A) In the case of a criminal proceeding, a conviction (including a conviction pursuant to a plea of nolo contendere) by reason of the violation or failure referred to in paragraph (1).

(B) In the case of a civil or administrative proceeding involving an allegation of fraud or similar misconduct, a determination of contractor liability on the basis of the violation or failure referred to in paragraph (1).

(C) In the case of any civil or administrative proceeding, the imposition of a monetary penalty by reason of the violation or failure referred to in paragraph (1).

(D) A final decision--

(I) to debar or suspend the contractor,

(ii) to rescind or void the contract, or

(iii) to terminate the contract for default,

by reason of the violation or failure referred to in paragraph (1).

(E) A disposition of the proceeding by consent or compromise if such action could have resulted in a disposition described in subparagraph (A), (B), (C), or (D).

(3) In the case of a proceeding referred to in paragraph (1) that is commenced by the United States and is resolved by consent or compromise pursuant to an agreement entered into by a contractor and the United States, the costs incurred by the contractor in connection with such proceeding that are otherwise not allowable as reimbursable costs under such paragraph may be allowed to the extent specifically provided in such agreement.

(4) In the case of a proceeding referred to in paragraph (1) that is commenced by a State, the executive agency that awarded the covered contract involved in the proceeding may allow the costs incurred by the contractor in connection with such proceeding as reimbursable costs if the executive agency determines, in accordance with the Federal Acquisition Regulation, that the costs were incurred as a result of (A) a specific term or condition of the contract, or (B) specific written instructions of the executive agency.

(5)(A) Except as provided in subparagraph (C), costs incurred by a contractor in connection with a criminal, civil, or administrative proceeding commenced by the United States or a State in connection with a covered contract may be allowed as reimbursable costs under the contract if such costs are not disallowable under paragraph (1), but only to the extent provided in subparagraph (B).

(B)(i) The amount of the costs allowable under subparagraph (A) in any case may not exceed the amount equal to 80 percent of the amount of the costs incurred, to the extent that such costs are determined to be otherwise allowable and allocable under the Federal Acquisition Regulation.

(ii) Regulations issued for the purpose of clause (i) shall provide for appropriate consideration of the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions involving the United States as a party, and such other factors as may be appropriate.

(C) In the case of a proceeding referred to in subparagraph (A), contractor costs otherwise allowable as reimbursable costs under this paragraph are not allowable if (i) such proceeding involve the same contractor misconduct

alleged as the basis of another criminal, civil, or administrative proceeding, and (ii) the costs of such other proceeding are not allowable under paragraph (1).

(6) In this subsection:

(A) The term "proceeding" includes an investigation.

(B) The term "costs", with respect to a proceeding--

(i) means all costs incurred by a contractor, whether before or after the commencement of any such proceeding; and

(ii) includes--

(I) administrative and clerical expenses;

(II) the cost of legal services, including legal services performed by an employee of the contractor;

(III) the cost of the services of accountants and consultants retained by the contractor; and

(IV) the pay of directors, officers, and employees of the contractor for time devoted by such directors, officers, and employees to such proceeding.

(C) The term "penalty" does not include restitution, reimbursement, or compensatory damages.

(l) "Covered contract" defined

(1) In this section, the term "covered contract" means a contract for an amount in excess of $500,000 that is entered into by an executive agency, except that such term does not include a fixed-price contract without cost incentives or any firm, fixed price contract for the purchase of commercial items.

(2) Effective on October 1 of each year that is divisible by five, the amount set forth in paragraph (1) shall be adjusted to the equivalent amount in constant fiscal year 1994 dollars. An amount, as so adjusted, that is not evenly divisible by $50,000 shall be rounded to the nearest multiple of $50,000. In the case of an amount that is evenly divisible by $25,000 but is not evenly divisible by $50,000, the amount shall be rounded to the next higher multiple of $50,000.

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Assistant Secretary of Defense (Public Affairs)
Director, Defense Procurement

Other Defense Organizations

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

Non-Defense Federal Organizations and Individuals

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

Chairman and ranking minority member of each of the following congressional committees and 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

Defense Contract Audit Agency Comments

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

IN REPLY REFER TO

PIC 225 [IG 70C-9012] 4 November 1997

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

SUBJECT: Response to Draft DoDIG Report on Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors (Project No. 70C-9012)

Our response to the subject report recommendations and to selected statements in the report follow:

Recommendation A.1

We recommend that the Director, Defense Contract Audit Agency require the performance of a comprehensive audit using a sampling plan that covers the universe of transactions charged to indirect cost accounts every 3 years as part of the internal control system audit of indirect costs at major contractors.

DCAA Response: **Nonconcur.** On page 4 of the draft report you state:

If properly implemented, the internal control system review for charging indirect costs should provide a reasonable basis for assessing the audit risk associated with those costs.

We agree that DCAA's existing approach for reviewing contractor indirect cost system internal controls should be properly implemented, and that if properly implemented, it will provide a reasonable basis for assessing audit risk. We also agree that our FAOs cognizant of major contractor locations should have current audits of the contractors' indirect cost system internal controls completed by the end of FY 1998 (Recommendation A.2)

We do not agree, however, with the report's conclusion that our FAOs must perform additional transaction testing to test the contractor's indirect cost system internal controls. The draft report's conclusion is presented on pages 5 through 7 and restated in part below:

*Original management comments were marked "For Official Use Only." On March 25, 1998, DCAA agreed to the removal of the "For Official Use Only" marking from this response to the draft report in order to include it in our final report.

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> ... *Of the four internal control system audits we reviewed, one did not include any transaction testing and the other three included limited compliance testing, generally of only one specific item. All four reviews relied on findings from other DCAA audits such as the prior years' incurred cost audits or the CAS 405 reviews. The contractor's internal control system for charging indirect costs cannot be adequately reviewed in this manner.* ...[Draft IG Report, p.6]

Revised Page No. 5

DCAA believes that its auditors can and should rely on other forms of audit evidence to test contractors' indirect cost system internal controls. Examples of these other forms of evidence include: (i) other completed and in-process ICAPS reviews; (ii) the results of past years' incurred cost audits and contractor internal audits, particularly as they relate to the screening of unallowable costs; (iii) comparative analysis of the amounts between and within key contractor accounts; and (iv) the results of CAS 405 audits. In support of our position, we have restated below the key sections from the applicable auditing standards that form the basis for DCAA's policy in the area (**emphasis added**).

> 4.21 Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed. [GAGAS §4.21]
>
> 4.30 Auditors should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. To meet that requirement auditors should have an understanding of internal controls relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider the factors that affect the risk of material misstatement, and design substantive tests. ...(GAGAS § 4.30)
>
> 4.31 When auditors assess control risk below the maximum for a given financial statement assertion, they reduce their need for evidence from substantive tests of that assertion. Auditors are not required to assess control risk below the maximum, but the likelihood that they will find it efficient and effective to do so increases with the size of the entities they audit and the complexity of their operations. Auditors should do the following when assessing control risk below the maximum:
>
> **a.** identify internal controls that are relevant to a specific financial statement assertion;
>
> **b.** perform tests that provide sufficient evidence that those controls are effective; and

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c. document the tests of controls. [GAGAS §4.31]

4.32 Auditors should remember the following when planning and performing tests of controls:

a. The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.

b. **Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.**

c. Inquiries alone generally will not support an assessment that control risk is below the maximum.

d. Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.

e. **Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and the extent of significant changes in policies, procedures, and personnel since they last performed those tests.** [GAGAS §4.32]

Evidential matter to Support the Assessed Level of Control Risk

.64 When the auditor assesses control risk at below the maximum level, he or she should obtain sufficient evidential matter to support that assessed level. **The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment.** Evidential matter varies substantially in the assurance it provides to the auditor as he or she develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads, all bear on the degree of assurance evidential matter provides. [Codification of Auditing Standards AU §.64]

.65 These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. **The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a control that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.** [Codification of Auditing Standards AU §.64]

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In addition to the preceding arguments, we do not believe that the IG findings are of such a magnitude to warrant scrapping DCAA's current audit approach (which the IG admits will work if properly implemented) in favor of this new approach. We also do not believe that the IG's recommended approach is inherently more comprehensive and productive than DCAA's current approach. In fact, because DCAA auditors rely on multiple sources of audit evidence in forming their opinions, we believe that a comprehensive three year sample to test the indirect cost accounts would be highly duplicative of some of the testing and evidence on which DCAA already relies.

Recommendation A.2

We recommend that the Director, Defense Contract Audit Agency direct audit offices cognizant of all major contractor locations to complete the initial audit of the internal control system for the Indirect and Other Direct Costs by the end of FY 1998, if not done in FYs 1996 or 1997.

DCAA Response: **Concur.** A memorandum notifying our regional directors of this requirement will be issued by 26 November 1997.

Recommendation B.1

We recommend that the Director, Defense Contract Audit Agency direct the use of a minimum confidence level of 90 percent with a precision of no less than 10 percent when performing a statistical sample.

Revised
Page No. 18

DCAA Response: **Nonconcur**. The IG recommendation, in our opinion, is an impractical requirement. First, audit resource requirements would prove to be overwhelming. Second, establishment of specific precision criteria takes away much needed auditor judgment from the sampling process. Finally, the benefits derived from the tighter precision calculations are simply not worth the increased cost in time and effort.

Sample sizes would be huge. History has shown that common DCAA sample sizes, ranging from 40 to 60 transactions, will at best, achieve a precision ratio of 25 percent at a 70 percent confidence level. Under the IG's recommendation, these samples would have to be sixteen times their current size, thus ranging from 640 to 960 transactions. This is so because, as a rough rule, a halving of the precision amount requires a quadrupling of sample size. By extension, quartering the precision amount (to achieve a precision ratio of 10 percent at 90 percent confidence) would require a multiple of sixteen.

There is no doubt that better precision is theoretically desirable, but as shown above, achieving it is expensive. What exactly are the benefits associated with tighter precision? If the

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Government recovers an amount equal to the point estimate of the misstatements in a cost submission, the associated precision depicts an overstatement amount that ***might still exist*** after the recovery. Precision improvement does not mean that the Government will recover more questionable costs (nor did the IG evaluation find any additional questioned cost in the transactions it reviewed). Instead, it simply means that the Government would be more sure (but still not totally sure) that the unrecovered, misstated amounts are within materiality limits. It seems clear that one should focus on the materiality of this amount in judging the adequacy of an audit sample's precision.

It is our contention that the auditor performing the sample is in the best position to determine what a reasonable sample size should be. In making this determination, the auditor must take into consideration materiality and the acceptable risk of an undetected cost misstatement. For example, if halving the precision in a particular statistical sample from $100,000 to $50,000 means looking at an additional 500 items (from an initial sample of 50), it should be the auditor's judgment as to whether the increased cost in reviewing the additional items is worth the improvement in precision. It is our belief that implementation of a specific precision criteria ignores considerations for materiality and will lead to an inefficient use of audit resources.

The IG's evaluation did disclose the use of informal *Rules of Thumb*. These informal guidelines allow auditors (in instances of low risk) to use a 70 percent confidence level with a 45 percent precision level. We agree that the use of these informal guidelines is inappropriate. As an alternative to the recommendation, we intend to:

1. develop a more analytical approach for auditors to use in determining sample sizes,

2. re-emphasize the current CAM guidance found in Appendix B related to determining appropriate sample sizes, and

3. continue with our evaluation of the data recently gathered on the types of sampling performed in the DCAA audits covered by your evaluation to determine if other policy clarifications are warranted. (This data has been made available to your reviewers.)

Recommendation B.2

We recommend that the Director, Defense Contract Audit Agency revise Defense Contract Audit Manual, chapter 4 and appendix B, to permit greater flexibility in the exercise of auditor judgment on the use of nonstatistical sampling for transactional testing. Revised guidance should include guidelines on using purposeful or judgmental sampling to select indirect cost account transactions to be reviewed at low-risk contractors.

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DCAA Response: **Nonconcur.** Page 10 of the draft report states: Page No. 11

> *Most audit offices used statistical sampling techniques to select specific transactions or items for review by individual cost account.*

We gathered data on the types of sampling actually performed in the 10 DCAA audits covered by your evaluation. This data shows that a total of 124 accounts were reviewed in the DCAA audits, and that 26 of these accounts (21%) were reviewed using statistical sampling, 93 accounts (75%) were reviewed using judgmental sampling, and the remaining 5 accounts (4%) were reviewed using a combination of both types of sampling. Based on this data, we cannot concur with the implication of your basic statement above, nor can we concur with the resulting recommendation. While "most audit offices" may have "used statistical sampling techniques," the vast majority of accounts audited were evaluated using judgmental sampling. We believe that DCAA's existing policy provides its field auditors with adequate flexibility in the use of judgmental sampling and that DCAA's auditors are currently making broad use of this flexibility.

Recommendation B.3

> *We recommend that the Director, Defense Contract Audit Agency issue interim guidance immediately to the regional and field audit offices implementing the Statements on Auditing Standards No. 82, "Consideration of Fraud on a Financial Statement Audit," in particular, the guidance in the Defense Contract Audit Manual, appendix B, that relates to due professional care and professional skepticism. The interim guidance should address how to implement the revised auditing standard on due professional care and should be incorporated promptly into the next version of the Defense Contract Audit Manual.*

DCAA Response: **Nonconcur.** Under the paragraph "Auditor Analysis of Selected Transactions" (page 12), the draft report states that: Page No. 13

> *In numerous instances, the auditor did not critically analyze the transactions selected for review. Frequently, the auditor did not ask enough questions about the costs or determined that the dollar amount was insignificant and did not pursue complete answers to their inquiries about the items. ....*

In the following paragraphs, the report discloses three specific instances of the above generally-cited deficiencies, and we do not question that the IG evaluators encountered other similar instances. However, we do not concur with many of the IG citings, as noted in the specific comments provided to the IG evaluators in response to the evaluators' notes. Furthermore, in the ten audits covered in the IG evaluation, there were specific DCAA working papers supporting approximately 4000 individual transactions reviewed

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for the 124 separate accounts. Given the volume of specific transactions reviewed, we do not believe the IG has sufficiently documented a general deficiency such that a prudent person would reach the same broad-based conclusion drawn by the IG, i.e., that the occasional errors in analysis result from a general Agency-wide lack of professional care and skepticism.

Notwithstanding our response above, we will forward this report with your findings and concerns to each DCAA region and field audit office, along with our direction to correct any related weaknesses that they may have in their respective incurred cost audit programs and procedures, or in the performance of individual auditors.

Recommendation C.1

Revised Page 26

We recommend that the Director, Defense Contract Audit Agency revise the Defense Contract Audit Manual chapter 6, section 6-608.3(a)(2) to include:

a. All expressly unallowable costs subject to a level-one penalty under Title 10, United States Code, Section 2324; Title 41, United States Code, Section 256; Federal Acquisition Regulation subpart 31.205; and Defense Federal Acquisition Regulation Supplement subpart 231.205.

b. Additional information specifying when certain costs that may or may not be expressly unallowable would or would not be considered expressly unallowable.

DCAA Response: **Nonconcur.** Chapter 6, section 6-608.3(a)(2) of DCAA's CAM already refers to the CAS and FAR sections that specifically define, describe, and exemplify what are expressly unallowable costs. To further expand the coverage and examples in CAM section 6-608.3, in our opinion, would be an unjustified duplication of the existing FAR coverage (and in some cases, CAM coverage). As you know, the FAR cost principles are frequently changed, and some are quite complex (e.g., 31.205-6 on unallowable executive compensation). To mirror them in summary fashion and keep them up to date in CAM 6-608.3(a)(2), as well as in other sections of CAM (e.g., 6-414.8 for executive compensation), would represent a substantial effort and cost to DCAA, without an offsetting pay-back, in our opinion.

Recommendation C.2

We recommend that the Director, Defense Contract Audit Agency revise guidance in Defense Contract Audit Manual chapter 6, section 6, to clarify that the auditor must report all unallowable costs subject to penalties identified during the audit, regardless of dollar amount.

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DCAA Response: **Concur.** We will add the recommended guidance to CAM by 31 July 1998.

Recommendation C.3

We recommend that the Director, Defense Contract Audit Agency revise Defense Contract Audit Manual chapter 6, section 608.4d, to clarify that the auditor should make recommendations concerning the appropriateness of penalties only when the contracting officer specifically requests that assessment. The assessment of whether a penalty is appropriate should be made independent of and after the issuance of the incurred cost audit report.

(2) DCAA Response: **Concur.** DCAA's policy, as stated in CAM 6-608.4d, will be revised to more clearly reflect the provisions of FAR 42.709-2(b) that require our auditors to make recommendations to the contracting officer on which costs may be unallowable and subject to the penalties and provide rationale and supporting documentation for the recommendations.

ADDITIONAL COMMENTS

Our comments addressing selected statements in the narrative of your draft report follow:

IG Statement on Page 3

In FY 1996, the DCAA spent about 1.5 million hours (about 1,000 staff years) auditing about $66 billion in direct and indirect incurred costs at major contractors. A major contractor has $70 million or more in auditable dollars yearly. Of the 1,000 staff years, roughly 400 were spent on indirect cost audits. For final overhead audit reports issued in FY 1996, the DCAA questioned about $596 million in both direct and indirect costs. Therefore, DCAA questioned less than 1 percent of the dollars reviewed. Current management information reports available from DCAA do not separate dollars examined or costs questioned between direct and indirect costs. However, past experience indicates that the majority of costs questioned is indirect costs. The DCAA estimated that 1,631 staff years would be spent auditing $87.1 billion of direct and indirect incurred costs in FY 1997 and that in FY 1998, 1,608 staff years would be used to review $86.9 billion.

DCAA Comments: The direct and indirect costs questioned associated with DCAA's incurred costs/final overhead audits was $842.4 million for FY 1996 (vs. the $596 million above). The figures below are also more accurate/current than the corresponding amounts above.

Revised Wording and Page No.3

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FY	DOLLARS EXAMINED	STAFF YEARS SPENT/PROJECTED
1996	$ 66.0 Billion	1,000
1997	$ 93.8 Billion	1,454
1998	$ 90.4 Billion	1,323

Revised Wording and Page No. 12

IG Statement on Page 11

... Further, in some cases, the auditors did not consider reviewing items under a certain dollar amount, which also affected the accuracy of the statistical sampling results.

DCAA Comments: We disagree that excluding items under a certain dollar amount affects the accuracy of the statistical sampling results. As long as the statistical sampling plan is defined up front and the plan generates a universe, the results of that statistical sample are valid for the universe selected. The decision to include or exclude certain strata from a sampling plan should be based on risk assessment and application of the auditor's professional judgment. In the cases cited by the IG, the auditors made the decision to exclude small dollar items from the universe because there was a low risk that there would be significant unallowable costs in the low dollar strata.

Questions regarding this memorandum should be directed to Mr. Robert Keri, Program Manager, Incurred Cost Division, at (703) 767-2250.

Robert DiMucci
FOR Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

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Evaluation Team Members

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

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