Audit Report

INDEPENDENT REVIEW OF THE DEFENSE FINANCE AND ACCOUNTING SERVICE COST COMPARISON STUDY OF CIVILIAN PAY FUNCTION

Report No. D-2001-173 August 14, 2001

Office of the Inspector General
Department of Defense

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Acronyms

DFAS	Defense Finance and Accounting Service
FTE	Full-Time Equivalent
MEO	Most Efficient Organization
OMB	Office of Management and Budget
PWS	Performance Work Statement

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

August 14, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Independent Review of the Defense Finance and Accounting Service Cost Comparison Study of Civilian Pay Function (Report No. D-2001-173)

We are providing this report for your information and use. This report is one in a series on Defense agencies' performance of commercial activities. We conducted the independent review in response to a request from the Defense Finance and Accounting Service. No written response to this report was required, and none was received. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Garold E. Stephenson at (703) 604-9332 (DSN 664-9332) (gstephenson@dodig.osd.mil) or Mr. Kent E. Shaw at (703) 604-9228 (DSN 664-9228) (kshaw@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

Thomas F. Gimble

Thomas F. Gimble
Acting
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2001-173 **August 14, 2001**
(Project No. D2000CH-0076.004)

Independent Review of the Defense Finance and Accounting Service Cost Comparison Study of Civilian Pay Function

Executive Summary

Introduction. We performed the independent review at the request of the Defense Finance and Accounting Service. An independent review is required for each cost comparison study conducted in accordance with Office of Management and Budget Circular No. A-76. The Defense Finance and Accounting Service provides financial and accounting services for DoD components and other Federal agencies. The Defense Finance and Accounting Service announced the A-76 cost comparison study of the civilian pay function in December 1997. At that time, 510.6 full-time equivalent personnel performed the services included in the study. The Defense Finance and Accounting Service, most efficient organization, included staffing of 399 full-time equivalent personnel during the first performance period, with staffing decreases to 298 full-time equivalent personnel in performance period nine. The total estimated cost for the most efficient organization proposal over the 9-year performance period was $250.0 million. The Defense Finance and Accounting Service received no private sector or interservice support agreement proposals to perform the civilian pay function. On June 25, 2001, the Under Secretary of Defense (Comptroller) announced that the MEO would not be implemented and that an expanded review would be initiated to evaluate alternatives and seek additional efficiencies in the end-to-end process for delivering civilian personnel and pay services.

Objectives. The overall objective was to evaluate the reasonableness of the Defense Finance and Accounting Service in-house cost estimate for performing the civilian pay function. Specific objectives of the independent review were to determine whether:

- data in the management plan reasonably established the Government's ability to perform work requirements in the performance work statement with resources provided by the most efficient organization, and

- the Government cost estimates are fully justified and calculated in accordance with procedures described in part II of the Office of Management and Budget Circular No. A-76 Supplemental Handbook and the DoD A-76 Costing Manual.

The independent review is a management control procedure for ensuring the credibility of the most efficient organization; the reliability and accuracy of the amounts presented on the cost comparison form; and the credibility, impartiality, and fairness of the A-76 process. Because this was an independent review under A-76 rules, we did not review the management control program.

Results. The independent review of the Defense Finance and Accounting Service competitive sourcing study of the civilian pay function concluded that:

- the management plan reasonably established the Government's ability to perform work requirements of the performance work statement within resources provided by the most efficient organization, and

- the Government cost estimates entered on the cost comparison form were fully justified and calculated in accordance with procedures described in part II of the Office of Management and Budget Circular No. A-76 Revised Supplemental Handbook and the DoD A-76 Costing Manual.

The independent review identified the need for changes to the management plan and the Government cost estimates. We discussed the needed changes with Defense Finance and Accounting Service management and they made the changes prior to the completion of the independent review. See the Finding section for a discussion of the independent review.

Summary of Recommendations. Because the Defense Finance and Accounting Service changed the management plan and the cost estimates prior to completion of the independent review, we made no recommendations in this report.

Management Comments. We provided a draft of this report on July 2, 2001. No written response to this report was required, and none was received. Therefore, we are publishing this report in final form.

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Background

In response to the November 1997 Defense Reform Initiative Report, the Defense Finance and Accounting Service (DFAS) announced its decision to perform an Office of Management and Budget (OMB) A-76 study on its civilian pay function in December 1997. At that time, the function included 510.6 full-time equivalent (FTE) employees from various locations in Charleston, South Carolina; Pensacola, Florida; and Denver, Colorado. DFAS developed a MEO of 399 FTE personnel during the first performance period, with staff decreases to 298 FTE personnel in performance period nine.

OMB Circular A-76 and DoD Guidance. OMB Circular No. A-76, "Performance of Commercial Activities," August 4, 1983 (revised 1999), establishes Federal policy and guidance for determining whether commercial activities should be contracted out or performed in-house. The OMB Circular No. A-76 Revised Supplemental Handbook, March 1996 (updated through transmittal memorandum 20, June 1999), provides detailed guidance on cost comparison performance studies and the costs to include in the comparison of in-house and contractor cost proposals. DoD Instruction 4100.33, "Commercial Activities Program Procedures," September 9, 1985, and DoD Directive 4100.15, "Commercial Activities Program," March 10, 1989, implements the OMB Circular No. A-76 and the Revised Supplemental Handbook.

Cost Comparison Process. The A-76 process consists of developing the performance work statement (PWS) and the management plan, submitting formal bids, and conducting the A-76 cost comparison. The management plan describes the Government's most efficient organization (MEO) and is the basis of the Government's in-house cost estimates. The process culminates in a cost comparison of the in-house estimate of Government performance of a commercial activity with the cost for contract performance of the commercial activity function, and a decision to perform the function with Government or contract employees. Experience has shown that public and private sector competitions for the performance of commercial activities result in costs avoided, usually through a reduction in personnel, whether the Government or the private sector wins the competitions. On March 13, 2001, the Deputy Under Secretary of Defense (Installations), now the Deputy Under Secretary of Defense (Environment and Installations), issued the A-76 Costing Manual. The guidance requires the use of new DoD A-76 costing software (win.COMPARE^2) for all FY 2001 Circular A-76 studies, including the DFAS study of the civilian pay function.

Independent Review. OMB Circular No. A-76 Revised Supplemental Handbook and DoD Instruction 4100.33 require that all competitive sourcing cost comparisons be reviewed and certified in writing by an impartial independent review officer organizationally independent of the commercial activity being studied and the activity preparing the cost comparison.

The independent review officer must certify that the data contained in the A-76 management plan and attendant cost estimates reasonably establish the Government's ability to perform the PWS within the resources provided by the MEO.

Defense Finance and Accounting Service. DFAS was established on January 15, 1991, to provide finance and accounting services to other DoD Components and Federal agencies under the direction, authority, and control of the Under Secretary of Defense (Comptroller). DFAS directs all finance and accounting requirements, systems, and functions for appropriated, nonappropriated, working capital, revolving, and trust fund activities, including security assistance. The civilian pay function pays about 700,000 DoD and non-DoD Federal employees.

DFAS Request for Performance of Independent Reviews. On February 13, 1998, DFAS requested that the Office of Inspector General, DoD, perform independent reviews for the following five A-76 studies:

- Defense commissary agency accounting function,
- transportation accounting function,
- depot maintenance accounting function,
- military retired and annuitant pay function, and
- civilian pay function.

In March 2000, DFAS announced that it was also conducting an A-76 cost comparison study of the security assistance accounting function. DFAS has completed the A-76 studies for the first three functions during FYs 1999 and 2000. The military retired and annuitant and the civilian pay studies will be completed in FY 2001, and the security assistance accounting study in FY 2002.

Objectives

The overall objective was to evaluate the reasonableness of the in-house cost estimate for the DFAS competitive sourcing study for civilian payroll. Specific objectives of the independent review were to determine whether:

- data in the management plan reasonably established the Government's ability to perform work requirements of the PWS within resources provided by the MEO, and
- the Government cost estimates were fully justified and calculated in accordance with procedures described in part II of the OMB Circular No. A-76 Supplemental Handbook and the DoD A-76 Costing Manual.

The independent review is a required management control procedure for ensuring the credibility of the MEO; reliability and accuracy of the amounts presented on the cost comparison form; and the credibility, impartiality, and fairness of the A-76 process. See Appendix A for discussion of the audit scope and methodology.

Results of Independent Review

The independent review concluded that the management plan reasonably established the Government's ability to perform work requirements of the PWS within the resources provided by the MEO. The independent review also concluded that costs entered on the cost comparison form were justified and calculated in accordance within procedures described in part II of the OMB Circular No. A-76 Revised Supplemental Handbook. The independent review identified several necessary changes for the management plan and the in-house cost estimate, which were discussed, agreed upon, and completed by DFAS.

Amendments to the PWS

The PWS document describes the technical, functional, and performance characteristics of the work to be performed, including the location, quality, and timeliness of work units. The PWS must be sufficiently comprehensive to ensure that in-house or contractor performance satisfies Government requirements and enables a comparison of Government cost estimates and contractor proposals. The PWS for civilian pay requires a service provider to provide payroll services to about 700,000 DoD and non-DoD civilian pay recipients. These services encompassed management of new and existing accounts, performance of customer service operations, pay operations, electronic data exchanges within financial institutions and other Federal organizations, generation and distribution of reports, and infrastructure support services. DFAS projects that civilian pay accounts may decline about four percent over the next 5 years, beginning in FY 2001. The PWS that DFAS included in solicitation MDA220-00-R-6000, dated November 3, 2000, was the basis for the MEO and in-house cost estimate for the civilian pay function.

DFAS issued five amendments to the solicitation that remedied the deficiencies in the PWS and accompanying technical exhibits.

- Amendment 1, dated December 19, 2000, provided responses to vendor questions regarding the draft PWS, offered data regarding authorized staffing and budget, and provided additional information regarding oral proposals contained in paragraph L-4(a).

- Amendment 2, dated January 26, 2001, extended the proposal closing date from February 9, 2001, to April 25, 2001.

- Amendment 3, dated March 9, 2001, incorporated changes to the workload estimates and statistical data in attachment J.6-2, and provided staffing and budget information for the civilian pay function.

- Amendment 4, dated March 16, 2001, made the bidder responsible for all postage expenses with the exception of the annual tax reporting information (IRS Form W-2). The amendment also clarified issues regarding Government-furnished equipment, facilities, and equipment,

and provided staffing data for Charleston, South Carolina; Denver, Colorado; and Pensacola, Florida; and the technical services organization.

- Amendment 5, dated April 20, 2001, informed bidders that the Government would use win.COMPARE[2] to prepare the in-house cost estimate and to perform the cost comparison between the MEO and the best contractor proposal.

Reasonableness of Management Plan and MEO

The management plan is an analytical evaluation of an organization to determine the most economical method to accomplish the job. The management plan identifies essential functions and establishes performance factors, organization structure, staffing requirements, and operating procedures for the MEO. A MEO must be prepared for all competitive sourcing studies where the activity is performed by more than 10 FTE personnel. A goal in creating the MEO is to develop the best possible organization to accomplish the workload required in the PWS within as little resource consumption as possible and without sacrificing the quality level of products or services.

The DFAS management plan and MEO dated March 19, 2001, consolidated the civilian payroll service functions performed at Denver, Colorado; Charleston, South Carolina; and Pensacola, Florida, into a single division at Pensacola. The MEO included 399 FTEs at the beginning of the first performance period, with a decline in staffing to 298 FTEs in performance period 9. On March 16, 2001, the Director, Military and Civilian Pay Operations, DFAS-Kansas City, Missouri, certified the MEO as the most efficient and cost effective organization fully capable of performing the scope of work and the tasks required by the PWS.

We examined the supporting documentation and analysis for the management plan to determine whether it reasonably established the ability of the MEO to perform the requirements of the PWS. We suggested changes to the plan. On April 18, 2001, DFAS revised the management plan to:

- show that the work performed in Denver, Colorado; and Charleston, South Carolina; would be moved to Pensacola, Florida;

- explain the basis for the overtime required by the MEO;

- identify the members of the MEO functional working group and detail their respective experience and authority; and

- provide justification for the two contract manpower equivalent positions supporting the imaging support contract under the MEO subcontracts.

After the changes, we concluded that the DFAS management plan reasonably established the Government's ability to perform work requirements of the PWS within the resources provided by the MEO.

Adequacy of Government Cost Estimates

The initial in-house cost estimate of $267,747,093 required the following adjustments.

Inflation of Personnel Costs. Line 1 of the in-house cost estimate, "personnel costs," included positions that were miscoded as not subjected to an economic price adjustment, when they were subjected to economic price adjustments. Therefore, these costs were improperly inflated. Most of the positions were in the nonprofessional series, and therefore, subjected to the economic price adjustment clause in accordance with title 29, Code of Federal Regulations, part 541. Positions that are subject to economic price adjustments are only inflated to and through the end of the first performance period. As a result of this correction, line 1, "personnel costs" decreased by $13,229,417; line 3, "other specifically attributable costs," decreased by $92,606; and line 4, "overhead" decreased by $1,587,531.

Subcontract Costs. The MEO subcontract costs under line 3, "government-directed AIS maintenance," was estimated at the annual amount for the 6-month transition period rather than prorated. When this error was corrected, it reduced the MEO line 3, subcontract costs by $3,320,366.

Postage Expense. The line 3, "other costs," category included an incorrect postage rate. The rate of $0.275 that DFAS used did not reflect the rate established by the United States Postal Service Ratefold Notice 123, January 7, 2001. The ratefold notice increased the cost to $0.278 for basic automated first class letter-size postage not weighing over one ounce. The postage rate change plus associated inflation increased line 3 costs by $522,347.

Revision of In-house Cost Estimate. DFAS presented a revised 9-year cost estimate of $250,039,522 on April 20, 2001, that corrected the costing errors. We concluded that the costs entered on the revised cost comparison form were fully justified and calculated in accordance with procedures described in part II of the OMB Circular No. A-76 Revised Supplemental Handbook and the DoD A-76 Costing Manual. The Director, Contract Management Directorate, Office of the Assistant Inspector General for Auditing, signed the independent review certification on April 20, 2001.

Outsourcing Study Decision

On June 25, 2001, the Under Secretary of Defense (Comptroller) directed that DFAS not implement the MEO and continue civilian pay operations at the current DFAS locations (Pensacola, Florida; Charleston, South Carolina; and Denver, Colorado). Additionally, the Comptroller requested that DFAS initiate an expanded review to evaluate alternatives and seek additional efficiencies in the end-to-end process for delivering civilian personnel and pay services. A copy of the Under Secretary's memorandum to DFAS is at Appendix B. On June 28, 2001, the DFAS issued amendment 6 to the solicitation, which canceled the procurement.

Appendix A. Audit Process

Scope and Methodology

The independent review evaluated the DFAS PWS, management plan, and MEO, in-house cost estimate, and other supporting documentation to determine whether DFAS:

- followed Federal and DoD guidance for preparing cost comparison competitions, and
- had adequate documentation to support the in-house cost estimate and its supporting plans.

We traced staffing in the MEO to the PWS requirements and examined the supporting documentation and analysis for reasonableness, clarity, and accuracy. We verified that costs on the cost comparison form were consistent with the workload in the PWS and the resources in the management study. We traced cost estimates to source documentation to ensure that the most significant cost elements were adequately supported. The review was limited to costs that could be estimated prior to bid opening and did not include contractor or inter-service support agreement price, or deduction for Federal income taxes (cost comparison form lines 9, 14 and 15) since DFAS received no private sector or inter-service support agreement proposals.

Limitations to Scope. We did not review the management control program because the scope of the audit was limited to the independent review of the Government's management plan proposal.

DoD-Wide Corporate Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measure:

> **FY 2001 DoD Corporate Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the revolution in Military affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-2) FY 2001 Subordinate Performance Goal 2.3:** Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing business practice reforms. **(00-DoD-2.3) FY 2001 Performance Measure 2.3.3:** Public/Private Sector Competitions.

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 Financial Management and Defense Infrastructure high-risk areas.

Use of Computer-Processed Data. The independent review relied on computer-processed cost comparison data calculated by the win.COMPARE^2 software program. This Air Force-developed program was released on March 13, 2001, for mandatory use on all FY 2001 and later OMB A-76 cost comparison studies. The Inspector General, DoD, performed a reliability assessment of win.COMPARE^2 and published its report D-2001-127 "Data Reliability Assessment Review of win.COMPARE^2 Software," on May 23, 2001. The report concluded that general and application controls over the software were adequate. It was determined, through software testing, that computations and reports generated by win.COMPARE^2 were sufficiently reliable, accurate, and in accordance with the OMB Circular No. A-76 Revised Supplemental Handbook and the DoD A-76 Costing Manual. Nothing came to our attention in this independent review that caused us to doubt the reliability of the computer-processed data.

Use of Technical Assistance. We did not use technical assistance in the performance of the independent review.

Audit Type, Dates, and Standards. Except as noted, we performed this financial related audit from March 19, 2001, through April 20, 2001, in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. We did our work in accordance with generally accepted Government auditing standards except that we were unable to obtain an opinion on our system of quality control. The most recent external quality control review was withdrawn on March 15, 2001, and we will undergo a new review. Because this was an independent review which followed procedures under OMB Circular No. A-76, we:

- did not follow-up on findings and recommendations from previous audits;
- did not test for fraud, illegal acts or compliance with directives other than OMB A-76 and implementing DoD guidance;
- did not examine the management control program although we did verify that MEO staff had the required independence and had no conflicts of interest; and
- limited report distribution to the DFAS and Office of the Secretary of Defense components having oversight responsibilities for the OMB A-76 Program.

Contacts During the Audit. We interviewed DFAS and contractor personnel that participated in the preparation or support for the competitive sourcing study. Further details are available upon request.

Prior Coverage. No prior coverage has been conducted on the subject during the last 5 years.

Appendix B. Under Secretary of Defense (Comptroller) Direction on Civilian Pay Function Evaluation

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON DC 20301-1100

COMPTROLLER

JUN 25 2001

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Delivery of Civilian Personnel and Pay Services

Central to the Department's management reform is the desire to evaluate business processes to identify efficiencies and garner economies in defense support operations. With the completion of the A-76 study of civilian pay operations, I believe that we need to expand our view and undertake a more comprehensive analysis of civilian personnel and pay functions. I believe that we can build on the work that was accomplished during the A-76 process to improve our financial management while leveraging process changes for the Department. We must continue to implement those improvements that reduce the cost of support operations.

I request that you initiate an expanded review that evaluates alternatives and seeks additional efficiencies in the end-to-end process for delivering civilian personnel and pay services. Consultation and collaboration with the personnel community should be pursued to determine best practices and the optimal approach for management of these services. In the interim, you should continue civilian pay operations at the three current DFAS locations while implementing appropriate business process changes that would minimize the cost or enhance the efficiency of current operations at these locations.

Dov S. Zakheim

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
- Deputy Under Secretary of Defense (Installations and Environment)

Under Secretary of Defense (Comptroller)
- Deputy Chief Financial Officer
- Deputy Comptroller (Program/Budget)

Other Defense Organizations

Director, Defense Finance and Accounting Service
- Director, Defense Finance and Accounting Service-Cleveland Center
  - Director, Defense Finance and Accounting Service-Charleston Operating Location
  - Director, Defense Finance and Accounting Service-Pensacola Operating Location
- Director, Defense Finance and Accounting Service-Denver Center

Audit Team Members

The Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

Richard B. Jolliffe
Garold E. Stephenson
Kent E. Shaw
Lawrence N. Heller
Catherine A. Annulis
Stephanie N. Lay