Oversight Report

DEFENSE CONTRACT AUDIT AGENCY
AUDITS OF CONTRACTOR COMPLIANCE WITH
COST ACCOUNTING STANDARDS

Report No. PO 99-6-001 January 11, 1999

Office of the Inspector General
Department of Defense

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Acronyms

ACO	Administrative Contracting Officer
CAM	Contract Audit Manual
CAS	Cost Accounting Standards
CO	Contracting Officer
DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
FAO	Field Audit Office
FMIS	Field Audit Office Management Information System
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAS	Government Auditing Standards
ICAPS	Internal Control Audit Planning Summary
MAAR	Mandatory Annual Audit Requirements
OWD	Operations Workload Analysis Division

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

January 11, 1999

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation of Defense Contract Audit Agency Audits of Contractor Compliance with Cost Accounting Standards (Report No. PO 99-6-001)

We are providing this report for your information and use We considered management comments on a draft of this report when preparing the final report

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the evaluation staff Questions on the evaluation should be directed to Ms. Barbara Smolenyak at (703) 604-8760 (DSN 664-8760) or Ms. Madelaine E. Fusfield at (703) 604-8739 (DSN 664-8739). See Appendix C for the report distribution. The evaluation team members are listed inside the back cover

Robert J Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. PO 99-6-001 **January 11 1999**
(Project No. 70C-9047)

Defense Contract Audit Agency Audits of Contractor Compliance with Cost Accounting Standards

Executive Summary

Introduction. Section 26 of the Federal Procurement Policy Act, Public Law 100-679, (title 41, United States Code, section 422) requires certain contractors and subcontractors to comply with Cost Accounting Standards and to disclose in writing and follow consistently their cost accounting practices. The Cost Accounting Standards establish criteria and principles to employ in selecting from alternative cost accounting practices in estimating, accumulating, and reporting costs. The purposes of the Standards are to increase uniformity and consistency in cost accounting practices in order to improve understanding and communication in contract negotiations and settlements, reduce the incidence of disputes and disagreements, and facilitate equitable contract settlements The continued need for Cost Accounting Standards is explained in Appendix B As the primary agency for performing contract audits, the Defense Contract Audit Agency, acting in an advisory capacity, is responsible for making recommendations to the Administrative Contracting Officer as to whether a contractor's Disclosure Statement adequately describes its cost accounting practices, the disclosed practices comply with applicable Cost Accounting Standards, or the contractor's failure to comply or consistently follow its disclosed or established cost accounting practices results in increased cost to the Government

Evaluation Objectives. The overall objective was to evaluate the adequacy of procedures for auditing contractor compliance with the Cost Accounting Standards The evaluation assessed the adequacy of audit guidance, audit programs, training materials, planning procedures, audit coverage, and reporting

Evaluation Results. The Defense Contract Audit Agency audits of contractor compliance with the Cost Accounting Standards add value and consistency to the negotiation of cost-based contracts. When contracts are negotiated based on costs, which is common practice for most unique weapons systems, the Cost Accounting Standards provide measurement rules that ensure consistency among bids and are understandable by all parties. Compliance with the rules is monitored and verified through audits The Government has realized significant monetary benefits through audit findings related to contractor accounting changes and noncompliances with the standards, as discussed in Appendix B. The Defense Contract Audit Agency could, nevertheless, improve procedures for auditing contractor compliance with the Cost Accounting Standards We identified three conditions that require management actions.

- Audit planning procedures need to be improved. Field audit offices did not fully consider risk and materiality assessments in the planning process and did not update control logs to record audit results for future planning needs The field audit office Management Information System did not generate current and accurate data. Instead, Cost Accounting Standards audits were routinely

scheduled on a 3-year cycle. Unless audits are planned with consideration of all relevant information, audit resources are not used efficiently and effectively (Finding A).

- Field audit offices were not adequately documenting testing for compliance with Cost Accounting Standards 401, "Consistency in Estimating, Accumulating, and Reporting Costs," and 402, "Consistency in Allocating Costs Incurred for the Same Purpose." Also, 25 percent of the workpaper packages that we reviewed on other Cost Accounting Standards audits were either inadequate or did not support the audit opinion. As a result of deficiencies, contractor proposed and incurred costs may be improperly measured and allocated, and the Government may be overpaying on contracts (Finding B).

- Defense Contract Audit Agency guidance allowed for a negative assurance opinion when reporting on contractor compliance with the Cost Accounting Standards. The expressed opinion did not fully adhere to the Government reporting standards. Compliance reports also do not identify the accounting period for which testing was performed. The resulting reports did not necessarily provide procurement officials with relevant and reliable information to use in negotiating and administering Government contracts (Finding C).

Summary of Planned Defense Contract Audit Agency Actions. We discussed the results of our evaluation with management and recommended corrective actions at a March 12, 1998, conference Management responded on May 20, 1998, with a specific action plan to modify or clarify current audit guidance on risk assessments, revise internal control log procedures, assess management information system problems, integrate compliance testing for some standards into all relevant audits, reevaluate standard audit programs, ensure audits are properly supervised, and research Government Auditing Standards to modify reporting procedures as indicated

Summary of Recommendations. The planned actions address the conditions identified during our evaluation However, we recommend that the Defense Contract Audit Agency require regional and field audit office managers to assign responsibilities for the maintenance and updating of data in the information system.

Management Comments. The Defense Contract Audit Agency partially concurred with our findings but nonconcurred with the recommendation, stating that the field audit manager is responsible for the accuracy of data in the information system However, management will issue a guidance memorandum to reemphasize the importance of maintaining current and accurate data on Cost Accounting Standards audits. See Part I for a complete discussion of management comments and Part III for the complete text of management comments.

Evaluation Response. The May 1998 action plan was generally responsive to the majority of report findings. Management's additional planned action on data assurance meets the intent of the recommendation on the maintenance of current CAS audit data in the management information system.

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Part I - Evaluation Results

Evaluation Background

The Cost Accounting Standards. Between 1972 and 1980, the Cost Accounting Standards (CAS) Board issued 19 standards to make the cost accounting practices that govern the measurement, assignment, and allocation of costs to Government contracts uniform and consistent. Periodically, the CAS Board issues interpretations and amendments to the standards. Public Law 100-679 requires contractors and subcontractors to comply with the CAS and to disclose in writing and follow consistently their cost accounting practices provided they meet certain criteria. They must have received either a single CAS-covered contract award of $25 million or more, or received $25 million or more in CAS-covered contract awards during the preceding cost accounting period with at least one award exceeding $1 million.

The CAS are codified in 48 Code of Federal Regulation Chapter 99 Federal Acquisition Regulation (FAR) part 30, "CAS Administration," describes the policies and procedures for applying the CAS rules and regulations to negotiated contracts and subcontracts. FAR subpart 30.2, "CAS Program Requirements," and FAR subpart 30.6, "CAS Administration," address the responsibilities of the contract auditor in implementing the standards

Government Auditing Standards. Government Auditing Standards (GAS) incorporate the auditing standards issued by the American Institute of Certified Public Accountants (AICPA) and go beyond those standards for matters unique to Government audits. Supplemental GAS include requirements for testing compliance with laws and regulations.

Defense Contract Audit Agency (DCAA) Role. The DCAA reports to the Administrative Contracting Officer (ACO) on the adequacy and compliance of contractor disclosure statements and on whether or not disclosed and established practices comply with FAR part 31, "Contract Cost Principles and Procedures," and applicable CAS DCAA must assess whether a contractor is required to file a disclosure statement and determine which standards are applicable and material to the contractor's accounting system The DCAA must also provide timely assistance to the ACO in performing the administrative responsibilities detailed in FAR subpart 30.6.

Value of CAS Compliance Audits. The DCAA audits of contractor compliance with CAS add value and consistency to the negotiation of cost-based contracts. When contracts are negotiated based on costs, which is common practice for most unique weapons systems, CAS provides measurement rules that ensure consistency among bids and are understandable by all parties in the negotiation. Through CAS audits, DCAA monitors and verifies the preparation of claims or change orders, the reimbursement of incurred costs on cost-type contracts, and whether contractor cost accounting systems produce reliable information for bid proposals CAS audits provide reasonable assurance in negotiations that the Government and

contractors are protected against inequitable or inconsistent cost allocations. In recent years, the Government has realized significant monetary benefits related to DCAA findings in CAS audits. See Appendix B.

Results of DCAA Internal Review. In 1997, the DCAA performed an internal review to determine the efficiency and effectiveness of CAS audit procedures and to improve Agency audit guidance as necessary. We received the results of the internal review, which included no specific recommendations, in January 1998

Evaluation Objectives

The overall objective was to evaluate the adequacy of the DCAA procedures for auditing contractor compliance with the CAS. The evaluation assessed the adequacy of audit guidance, audit programs, training materials, planning procedures, audit coverage, and reporting. See Appendix A for the evaluation scope and methodology.

Finding A. Adequacy of the Audit Planning Process

Field audit offices (FAOs) needed to improve the CAS audit planning process, including risk assessments, updating of control logs, and information system data maintenance.

- FAO management did not properly incorporate risk and materiality assessments in the audit planning process because management was not implementing Agency guidelines. DCAA guidance also required routine scheduling of Cost Accounting Standards audits on a 3-year cycle, which may contribute to the diminished emphasis on risk assessments.

- Auditors did not update the Mandatory Annual Audit Requirements (MAAR) control logs or Internal Control Audit Planning Summary (ICAPS) sheets to record audit results and facilitate risk assessments and future planning. The updating did not occur because field management was not implementing Agency guidelines on control schedule maintenance.

- Information in CAS status reports was not current because FAO management had not clearly assigned responsibilities for monitoring and updating data Also, the available data codes and edit checks were inadequate to produce reliable CAS information.

The scheduling and performance of audits without consideration of appropriate risk factors and the lack of current status information on CAS audits and reports resulted in inefficient management of audit planning and followup efforts.

Risk and Materiality Determinations in the Planning Process

Audit Planning Policy and Guidance. The CAM, the Audit Planning Manual, and standard CAS audit programs contain DCAA audit planning policy and guidance. CAM chapter 8-305, "CAS Compliance Testing," covers the consideration of risk and materiality in developing the extent and frequency of CAS compliance testing. CAM 8-305.2 provides the following criteria for establishing compliance testing requirements:

> Identify those provisions of a standard that are significant to the particular contractor. The materiality criteria published in 48 CFR 9903 305 must be considered carefully ..If a noncompliance with a CAS provision would have no significant impact on either Government contract costs or the administrative and audit effort, there is no reason to test whether the contractor is complying with the provisions. If a provision is considered immaterial, then document this on the requirements plan working papers. The materiality

> decision should be reconsidered whenever relevant circumstances change. This step will be done for each CAS covered contractor . .

Section B of each standard CAS compliance audit program restates these planning considerations. The audit program also requires the supervisor and the auditor to review the risk assessment for agreement on the audit scope and audit resources required

Field Audit Office Performance of Risk and Materiality Assessments. FAOs do not fully consider the risk and materiality of a potential noncompliance with applicable standards when planning CAS audits. Several FAOs either programmed audits for CAS not applicable to the contractor or the segment under the FAO cognizance or did not program an audit for a Standard that was applicable.

FAOs encompass both resident audit offices and branch audit offices The resident audit offices visited maintained CAS permanent files with generally accurate CAS applicability schedules. However, neither the CAS applicability schedules nor the permanent files evidenced materiality assessments of the individual standards The branch audit offices did not maintain CAS applicability schedules on a consistent basis When maintained, the schedules did not have materiality assessments of the individual applicable standards and there was little indication that schedules were used in the planning process. At one branch office, the CAS applicability schedule for a major contractor indicated that 11 standards applied. However, DCAA had performed no compliance audits for the 3-year period covered in our review

FAOs are not implementing DCAA policy and guidance that require the ready availability of information needed for risk and materiality assessments DCAA internal assessment disclosed similar problems related to the inefficient use of audit resources Their assessment noted several instances of audits performed in low risk circumstances when standards were not material at the contractor location

Routine Cycling of CAS Audits

The DCAA policy on CAS compliance audit coverage requires that audits generally be scheduled routinely on a 3-year cycle CAM chapter 8-305.2 states that "As a minimum, CAS compliance audits on all applicable and significant standards should be done every three years." The section further states: "If the three-year cycle is not maintained, explanations should be included in the requirements plan working papers."

Compliance with DCAA Policy. FAOs were adhering to DCAA policy on the 3-year cycle instead of using risk and materiality assessments as a basis for scheduling CAS compliance audits. All except one of the offices in our survey routinely programmed CAS compliance testing on a 3-year cycle. The exception was the FAO that completed no compliance testing at a major contractor in the 3-year evaluation period.

Adequacy of DCAA Policy. The current DCAA CAM guidance promotes scheduling CAS audits routinely on a 3-year cycle without consideration for risk and materiality. Although the DCAA policy permits deviation from the 3-year cycle, it does not discuss the circumstances that would allow for the deviation

As a result, FAOs do not vary from the 3-year cycle. The routine scheduling of audits regardless of risk and materiality considerations is an inefficient use of FAO audit resources.

The FAOs included in DCAA internal assessment believed that a reevaluation of the policy for the 3-year compliance testing cycle is necessary The offices suggested that risk assessment should play a greater part in the scheduling of compliance audits.

Requirements to Update Related Audit Control Logs

DCAA Guidance. The concluding steps in all DCAA standard CAS compliance audit programs include a requirement to update permanent file information such as the MAARs and ICAPS control logs. The requirement facilitates the management of an audit office since permanent files provide FAO management information needed to plan audits and manage resources The audit procedures performed to satisfy the requirements of CAS, MAARs, and system internal control audits bear a close relationship to each other. The results from each of these audits yield information essential to the total risk assessment and the audit planning process.

The MAARs are basic criteria and audit procedures that must be used in the contract audit environment to comply with GAS. The ICAPS summarize the auditor assessment of control risk and the impact of the assessment on related contract audit effort. FAOs generally complete MAARs as part of incurred cost audits. Incurred cost audit objectives determine acceptable costs associated with CAS allocability and measurement criteria The updating of MAARs control logs for CAS compliance audit results and reported CAS issues satisfy the accomplishment of certain MAARs objectives ICAPS should be updated continually to reflect the results of all audits, including CAS

Updating of Control Logs. None of the FAOs updated the MAARs or the ICAPS control logs to reflect the results of CAS compliance testing or reported CAS issues. FAO management was not following agency guidelines to use all relevant information in the planning process The result is duplicative audit effort. To ensure that guidance is properly implemented, management needs to assign responsibilities for maintaining current data in the information system.

DCAA internal assessment also noted that FAOs did not update the MAARs control logs. FAO management attributed this to confusion over the relationship between the CAS and the MAARs.

Maintenance of System Information

According to CAM section 8-304.2, "Compliance Considerations," FAO Management Information System (FMIS) summaries will provide a list of audits

performed that support the opinions on CAS compliance included in audit reports. The summaries are to be used as an audit management tool for assuring that adequate CAS compliance testing is performed.

CAM section 3-104.15, "Planning in Connection with Cost Accounting Standards," also explains that the results of CAS compliance audits can be extremely useful in establishing the audit scope of other assignments. The FMIS CAS Compliance Testing Reports included in the permanent files provide an overview of the status of contractor's compliance with the standards and helps identify specific areas needing consideration.

Maintenance of Accurate Information. Some FAOs are not updating the FMIS CAS status reports because management has not assigned clear responsibilities for monitoring and correcting the information in the information system. In addition, current edit checks do not prevent information from being inappropriately purged from the system. One FAO had reports with "unresolved" issues dating back to the early 1990's. In some cases, FAOs had received evidence of the ACO resolution but did not update the system information Another FAO resolved more than 30 "overage" CAS issues by changing the status codes in the system. The FAO made the changes without communicating with the ACO to determine the actions taken to resolve the issue Because the system included inappropriate criteria for purging data at year-end, one FAO did not know to follow up with an ACO on a Disclosure Statement adequacy determination.

DCAA plans four modifications to the FMIS to correct the problems with data accuracy and completeness. The modifications address coding and edit check problems identified in both the IG and the DCAA reviews. DCAA proposed no action to address the maintenance of FMIS system information

DCAA Comments on Findings and Evaluation Response

DCAA Comments. DCAA partially concurred or concurred in principle with the findings on the adequacy of the audit planning process; however, they took exception to presentation findings DCAA did not agree with our statement that scheduling and performing audits without consideration of appropriate risk factors and without current CAS status information resulted in inefficient management of audit planning and follow-up. DCAA commented that three of the four offices visited performed and documented some level of planning based on risk and materiality They also pointed out that report statements addressing the lack of compliance testing of a major contractor at one branch office did not clearly limit the finding to one office

Evaluation Response. We acknowledge DCAA concerns on certain report statements and have revised the wording in two statements for clarification. The revisions in Finding A are as follows: The first sentence in the paragraph entitled "Field Audit Office Performance of Risk and Materiality Assessments" now reads FAOs do not fully consider the risk and materiality of a potential noncompliance with applicable standards when planning CAS audits. The last sentence in the "Compliance with DCAA Policy" paragraph is clarified as follows· "The exception was the FAO that completed no compliance testing at a major contractor in the 3-year evaluation period. The last sentence in the second paragraph under

"Field Audit Office Performance of Risk and Materiality Assessments" clearly refers to the prior sentence that limits our observation to one major contractor. Therefore, no changes are necessary.

DCAA took exception to the words "without consideration of" in the following statement in Finding A – Adequacy of the Audit Planning Process: "The scheduling and performance of audits without consideration of appropriate risk factors and a lack of current status information on CAS audits and reports resulted in inefficient management of audit planning and followup efforts." We have not changed the original wording. As stated in our report, FAOs, to a greater or lesser degree, were determining and documenting the applicability of standards However, FAOs were not assessing the risk and materiality of a potential noncompliance with a particular standard or with specific provisions within a standard. DCAA audit planning policy and guidance clearly addresses the need to assess risk and materiality of the individual standards and the discrete provisions within the standards. None of the offices visited had documented the consideration of risk and materiality of a potential noncompliance as part of the planning process.

DCAA Corrective Actions

We discussed the results of our evaluation with management and recommended corrective actions. DCAA has prepared the following action plan:

1. Modify Contract Audit Manual guidance on planning Cost Accounting Standards compliance audits to clarify that a risk assessment be performed either during the program planning process or when the assignment is established The modification will also emphasize the importance of determining the applicability dates of revised standards and the applicability of standards controlled by corporate offices. The milestone date for issuing the modified guidance to the regions is June 30, 1999.

2. Develop risk assessment working papers for each Standard to supplement the tailored electronic working papers risk assessment The regions and the field detachment are responsible for working paper development The milestone date for finalizing risk assessments and dissemination to the field audit offices is June 30, 1999.

3. Prepare a point paper on alternative compliance testing cycles, giving consideration to using a risk based audit approach to timing the frequency of performing Cost Accounting Standards compliance audits. Audit policy will be revised and clarified as needed The milestone date for revising and clarifying audit policy is June 30, 1999.

4. Modify compliance audit programs to identify interrelationships between audit steps and the Internal Control Audit Planning Summaries and Mandatory Annual Audit Requirements. Milestone date is June 30, 1999.

5. Revise the Internal Control Audit Planning Summaries and Mandatory Annual Audit Requirements to accommodate Cost Accounting Standards testing results. The milestone date is June 30, 1999.

6. Assess the feasibility of modifying data entry form DCAA Form 7000-S to improve data accuracy and completeness

The planned actions will address all conditions except the need for controls over FMIS information

Recommendation, DCAA Comments, and Evaluation Response

We recommend that the Director, Defense Contract Audit Agency, require regional and field management to specifically assign responsibilities to an individual for the maintenance of current and accurate data on Cost Accounting Standards audits in the Field Management Information System.

DCAA Comments. The DCAA nonconcurred stating that they believe responsibilities for maintaining FMIS are appropriately assigned as described in FMIS User Manual. At the field audit office level, the responsibility for maintaining FMIS accuracy is specifically assigned to the FAO Manager. DCAA further states that their Headquarters Workload Analysis Division (OWD) has recently conducted field visits on FMIS accuracy, which disclosed no findings on FMIS input related to CAS audits. Therefore, they do not believe that the inaccuracies found by the IG are prevalent to warrant a change in Agency policy DCAA does not believe that assigning responsibility to another individual, instead of the FAO manager, would solve the problem. Rather, they will issue a guidance MRD specifically on CAS compliance audits to reemphasize the importance of maintaining current and accurate data for FAO planning

Evaluation Response. Although DCAA nonconcurred, management's planned action to issue a guidance memorandum is responsive to the intent of our recommendation. However, we do not agree with the statement that based on OWD field visits the inaccuracies are not prevalent. We were advised by OWD that their field visits did not test the accuracy of CAS status report information

Finding B. Controls Over Audit Performance

None of the FAOs documented specific testing of CAS 401, "Consistency in Estimating, Accumulating, and Reporting Costs," and CAS 402, "Consistency in Allocating Costs Incurred for the Same Purpose." Also, 25 percent of the CAS audit workpaper packages that we reviewed were either inadequate or did not support the audit opinion. This situation occurred because FAOs were not following DCAA guidance on compliance testing, documentation, and supervisory oversight of audits. Applicable procedures needed improvement to provide better assurance that assignments were performed in accordance with the Government auditing standards on due professional care.

Inadequate audit coverage increases the risk that contractor proposed and incurred costs are improperly measured and allocated and costs paid by the Government are overstated as a result.

Quality of Audit Performance

GAS requires due professional care in the performance of audits and the preparation of related reports Due professional care means the exercise of judgment in establishing the audit scope, the performance and documentation of tests and procedures in workpapers to support an audit opinion, and adequate supervisory guidance and review. Under the additional GAS requirements, auditors are required to design tests to provide reasonable assurance of compliance with laws and regulations applicable to the costing and pricing of Government contracts, describe the scope of compliance testing in audit reports; and report on instances of noncompliance.

All GAS requirements are addressed in the CAM and incorporated in audit programs, including supervision, documentary evidence, preparation of working papers, and reporting requirements CAM chapter 2, "Auditing Standards," relates GAS to the DCAA audit process. Accordingly, DCAA must.

- maintain accurate and reliable records that summarize the applicability and materiality of the CAS to contractors, the adequacy of contractor disclosure statements, provide a history of compliance testing and reporting of noncompliances, and record the current status of outstanding issues,
- plan and manage the performance of CAS audits to ensure efficient use of resources; and
- ensure that the performance and reporting of CAS audits comply with GAS.

DCAA Guidance on Performing CAS Audits. DCAA establishes a separate workpaper package for audits of all standards except CAS 401 and 402

CAS 401 and 402 address the overall consistent application of a contractor's accounting practices, and the criteria are pervasive. As a result, auditors are to be continuously aware of any estimating or accounting practice that is inconsistent with the requirements of the two Standards. DCAA policy on the testing of CAS 401 and 402 is addressed in the CAM and in the Agency's audit planning manual, as follows:

> Plan testing for compliance with CAS 401 and 402 during the performance of audit assignments such as proposal evaluations and incurred cost audits (CAM 8-305).
>
> Separate activity codes for CAS Standards 401 and 402 compliance testing have not been established as these audit steps are considered to be such an integral part of every audit of a CAS covered contractor that compliance testing and documentation are to be recorded in each individual audit assignment (DCAA Audit Planning Manual).

Adequacy of CAS Audit Coverage and Reporting. FAOs neither performed nor documented testing of contractor compliance with CAS 401 and 402 In addition, approximately 25 percent of the special CAS audit assignments covering the remaining Standards needed improvements in testing, documentation, and supervisory guidance and review to comply with GAS and DCAA policy.

The credibility and usefulness of the information DCAA provides to contracting officers depend on auditor adherence to GAS. Management controls incorporated in the supervisory review and FAO quality control process did not ensure that these assignments were performed in accordance with the GAS on due professional care.

Compliance Audits. The level of testing in 15 of 50 CAS compliance audits was not sufficient to support the overall audit opinion In one audit, the auditor relied on an internal audit report as a basis for expressing the opinion that the contractor complied with CAS 411, "Accounting for Acquisition Costs of Material." However, the internal audit was limited to testing the Material Management Accounting System standards unrelated to the cost accumulation and allocation requirements contained in CAS 411. Another compliance audit was limited to performing tests of criteria already known to be noncompliant and awaiting ACO determination. The limitation in scope was not documented in the workpapers, the audit program, or in the audit report issued to the ACO. Although the FAO used over 240 hours to complete the assignment, the audit report on contractor compliance with CAS 410, "Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives," provided no new information

Disclosure Statement Audits. We reviewed 14 disclosure statement audits The workpapers in four of the audits did not support the opinions in the reports issued to the ACO. In two cases, we found that the audit workpapers did not support the basis for the auditor's conclusions on the adequacy and compliance of the revised accounting practices or, in one case, the immateriality of the cost impact In two other cases, the supervisor limited the scope of the audit to an adequacy determination without coordinating with the ACO. Despite the supervisor's scope limitation, the auditor identified potential noncompliance issues with three Standards. Both the regulations and DCAA policy require the auditor to report material noncompliant practices to the ACO for a determination

DCAA policy requires notification in a separate report The FAO never issued noncompliance reports to the ACO and never established and performed separate compliance audits for the revised cost accounting practices.

Noncompliance Reports. The workpaper files in four of 31 CAS noncompliance report assignments did not document why a report was never prepared or explain how the issue was resolved.

Use of Special CAS Audits for Compliance Testing. The establishment of separate CAS audit workpaper packages to test contractor compliance with each standard provides visibility of audit accomplishments However, DCAA also recognizes the need for continuous monitoring of contractor compliance with CAS 401 and 402 in other audits, particularly in forward pricing audits, because these standards apply to most audits. The same rationale applies to CAS 405, "Accounting for Unallowable Costs," and CAS 406, "Cost Accounting Period." In meetings with DCAA, management agreed to consider the feasibility of revising current audit programs to incorporate compliance testing for some CAS in incurred cost or forward pricing audits.

DCAA Comments on Findings and Evaluation Response

DCAA Comments. DCAA partially concurred with our observations on audit adequacy. While agreeing that auditors had not adequately documented CAS 401 and 402 testing, DCAA did not believe that a lack of documentation of testing represents inadequate audit coverage. However, management stated that they have revised all relevant audit programs to clearly identify audit steps necessary to perform compliance testing of CAS 401 and 402 to facilitate better documentation. DCAA partially concurred with our observations on the audits considered inadequate. They did not agree that 8 of the 23 audits cited were inadequate. In regard to our observations on Disclosure Statement audits, DCAA provided the following comments: "While we agree that the reasons for not issuing a report should have been documented, we do not believe merely failing to document the adequate resolution of the issues either affected the credibility and usefulness of the information provided to the contracting officers." Additionally, management took exception with our opinion that existing procedures were insufficient to ensure that these assigments were performed in accordance with GAS on due professional care

Evaluation Response. We consider the DCAA May 20, 1998, corrective action plan to be responsive to the report findings on the need for improved controls over audit performance. DCAA comments indicated that they interpreted our statement on the credibility and usefulness of information provided to the ACO as applying solely to the observations on Disclosure Statement audits The statement cited in DCAA response applies to all the assignments considered inadequate For clarification, we have moved this statement to the first paragraph under "Adequacy of CAS Audit Coverage and Reporting" previously discussed in this report The reported observations were based on an evaluation of workpaper packages using GAS criteria and DCAA CAM guidance. Due professional care is a general standard that is not limited to auditor qualifications The Standard imposes an audit responsibility to observe the standards of field work and reporting This includes planning and supervision, knowledge of the organization being audited,

obtaining sufficient competent evidential matter to support the auditor's opinion, and preparing working papers that support the auditor's conclusions and judgments. In our opinion, of the 95 workpaper packages evaluated, 23 did not comply with either the requirements of GAS or DCAA audit guidance. In most cases, the workpaper packages did not contain sufficient competent evidential matter to support the auditor's conclusions, which in turn, reflects on the adequacy of supervision. We considered DCAA guidance to be adequate in terms of clearly communicating the requirements for performing audits with due professional care. We concluded that the cause of the identified deficiencies was that existing management quality control procedures were not ensuring the proper implementation of DCAA guidance.

DCAA Corrective Actions

We discussed the results of our evaluation with management and recommended corrective actions DCAA has prepared the following action plan

1. Review all relevant audit programs to determine whether audit steps are included to test the provisions of Cost Accounting Standards 401, 402, 405, and 406 and, if not, where such testing would logically occur. Modify Contract Audit Manual guidance and audit programs as needed to more clearly establish the link between the requirements of each of those four standard and specific audit steps or procedures. DCAA issued guidance on September 30, 1998.

2. Address the level of transaction testing in the risk assessment working papers being developed for each standard as proposed in Finding A, Corrective Action 2

3. Evaluate each Cost Accounting Standard compliance audit program for improvements to provide additional guidance on testing for compliance with significant provisions The action will be accomplished together with the development of the risk assessment workpapers proposed in Finding A, Corrective Action 2.

4 Direct the regions to take management actions to ensure that Cost Accounting Standards audits are properly managed and supervised to accomplish an acceptable level of audit quality by June 30, 1998, and evaluate audit quality by December 31, 1998.

5. Extend the concept of integrating compliance testing into all relevant audits for Cost Accounting Standards 405, "Accounting for Unallowable Costs," and 406, "Cost Accounting Period."

The planned corrective actions are responsive to the finding and no additional recommendations are being made in this report.

Finding C. Cost Accounting Standards Compliance Reporting

Opinion statements in compliance reports did not follow prescribed AICPA and Government Auditing Standards when a negative assurance statement was used and compliance reports did not specify the period of audit performance.

The expression of an inappropriate opinion and the omission of performance period information from the report lessen the usefulness of the information to the ACO and can increase the risk of Government not being able to enforce the price adjustment provisions of the CAS clause.

Use of Negative Assurance Statements

Government Auditing Standards Requirements. GAS reporting standards establish specific circumstances under which a negative assurance statement is allowed The use of negative assurance is limited to circumstances where the scope of work performed is less than an audit and the limitation is significant enough to prevent the auditor from expressing a positive opinion When a negative assurance statement is used, the report must clearly indicate the scope limitations and must also disclaim a positive opinion

AICPA standards purposely limit circumstances under which a negative assurance statement is allowed since a negative assurance wording is vague and ambiguous and, therefore, has the potential to mislead the user of the audit report Furthermore, a qualified opinion combined with a negative assurance statement is not an option under reporting standards.

DCAA Reporting Practices. The DCAA opinion statement does not conform with the prescribed reporting standards. CAM chapters 8, "Cost Accounting Standards," and 10, "Preparation and Distribution of Audit Reports," cover reporting practices CAM 10-805 specifically addresses the reporting of compliance audit results. DCAA policy requires a report to be issued to the ACO under all circumstances. When no noncompliances are found, guidance requires the report to express a qualified opinion and to include a negative assurance statement.

Reporting Period of Audit Performance

Performance and Reporting Requirements. DCAA guidance on reporting the results of compliance audits does not require the report narrative to identify the cost accounting period in which compliance testing was performed CAS compliance audit program guidance generally limits the performance of required

compliance tests to the contractor's current fiscal year accounting practices although CAS compliance audits are planned and performed only once every 3 years.

Contracting Officer Requirements. Information on contractor compliance with CAS is required for various contract audit issues. Contracting officers need to be aware of a contractor compliance status when awarding contracts, when negotiating forward pricing rates and factors, and when negotiating prior year overhead rates and factors. These actions involve different cost accounting periods. The identification of the accounting period to which the compliance testing applies provides the procurement officials with useful information in negotiating and administering Government contracts.

Under the price adjustment provisions of the contract clause in FAR subpart 52.230-2, "Cost Accounting Standards," the date of compliance testing becomes an important factor in protecting the Government's right to cost recovery. FAR 52.230-2(a)(5) requires contractors and subcontractors to agree to contract price adjustments, with interest, if their failure to comply with CAS or to consistently follow their disclosed and established cost accounting practices results in increased costs to the Government. Identifying the period to which the specific CAS compliance testing applies would limit the opportunities for a defense based on estoppel should a routine forward pricing or incurred cost audit reveal a noncompliance issue in an accounting period in which no specific CAS audits were performed.

DCAA Corrective Actions

We discussed the results of our evaluation with management and recommended corrective actions. DCAA has prepared the following action plan.

1. Modify the Contract Audit Manual to provide examples of Cost Accounting Standards audit reports that are appropriately adjusted for scope limitations Reconcile reporting requirements to audit programs for scope limitations, as necessary.

2. Research the Government Auditing Standards regarding opinions with negative assurance Identify other audits that provide negative assurance to develop a consistent approach for reporting such audit results.

The milestone for issuance of guidance to the regions on the action items is June 30, 1999.

The planned corrective actions are responsive to the finding and no additional recommendations are being made in this report

Part II - Additional Information

Appendix A. Evaluation Process

Scope

Work Performed. We conducted the evaluation from October 1997 through January 1998 and made field visits to four FAOs. We evaluated the overall adequacy of DCAA procedures for auditing contractor compliance with CAS. The evaluation assessed the adequacy of audit guidance, audit programs, planning procedures, audit coverage, and audit reporting. Our scope was limited in that we did not include tests of management controls.

DoD-Wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Department of Defense 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.

> **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 objective and goal

> **Objective:** Internal reinvention **Goal:** Minimize cost growth in major defense acquisition programs to 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 Department of Defense. This report provides coverage of the Defense Contract Management high-risk area

Methodology

Use of Computer-Processed Data. No computer-processed data were used in the course of the audit.

Universe and Sample Selection. We judgmentally selected four offices from four DCAA regions The office selections were based on an analysis of data extracted from the DCAA Agency Management Information System. The four FAOs included two resident audit offices and two branch offices to ensure oversight of DCAA audit coverage at both major and non-major contractors. Additional criteria used for field office selection included. the overall volume of CAS activity, the type of audit activity generating noncompliance reports, and, whether office staff included a CAS technical specialist

Our visits included a review of: contractor CAS planning documents; Contract Audit Coordinator documentation, when applicable; and assignments in all CAS activity areas. We evaluated a total of 101 assignments as follows:

Assignment Code	Description	Assignments Reviewed
19100	Disclosure Statement Audits	14
19200	Noncompliance Reports [1]	31
19400	Compliance Audits	50
19500	Cost Impact Audits	4
Misc.		2

Contacts During the Evaluation. Discussions were held with representatives from DCAA Headquarters, Regional Offices, FAOs, and the Defense Logistics Agency.

[1]DCAA uses special noncompliance report audit assignments, code 19200, to account for the additional audit effort required to report and resolve a noncompliance issue discovered during another audit The special assignment is only opened after the auditor has completed all audit work in the original assignment in which the issue was discovered The DCAA management information system disclosed that for the period reviewed, FYs 95-97, less than 30 percent of CAS noncompliance issues reported resulted from CAS compliance audits. The remaining issues were discovered during other, routine audits.

Appendix B. Continued Need for Cost Accounting Standards

From October 1, 1995, through March 31, 1998, the Government saved $138 million related to DCAA findings of improper contractor accounting changes and other CAS noncompliances. During FY 1997, major contractors also voluntarily deleted over $2 billion of unallowable expenses from claims submitted to the Government. The amounts are significant and evidence the continued validity of General Accounting Office 1970 conclusions in a report to Congress on the need for uniform cost accounting standards.

General Accounting Office Study. Congress had requested the 1970 General Accounting Office study because of the significant increase in non-competitive, negotiated procurements in which the Government used contractor cost estimates to negotiate the contract price. The study concluded that the Government cost principles contained in the FAR were not adequate for contract costing. The cost principles are based on Generally Accepted Accounting Principles (GAAP) and accounting methods accepted for income tax purposes by the Internal Revenue Service.

The purpose of GAAP is to report cost information for financial statement purposes GAAP was developed primarily for stockholder use and protection, not to control expenditures on Government contracts GAAP allocates costs between fiscal years but not between products and services within a fiscal year Tax laws and regulations are designed to meet social goals, such as revenue raising, and accounting procedures designed to comply with tax regulations are also not useful for contract costing or to prevent overpricing.

The GAO concluded that when prices are set without competition and the restraints of the market place, cost data needs to play an important role in the negotiation, administration, and settlement of contracts Cost accounting standards would provide uniformity and consistency in accounting practices used for negotiating and administering contracts, improve understanding and communication between contractors and the Government, and reduce contract disputes.

Continued Protection Warrants Continued Need. CAS continues to provide some protection for the Government and contractors against inequitable or inconsistent cost allocations. The Government continues to negotiate many large contracts for unique items for which cost or pricing data are required The Government may also allow equitable adjustments of costs on fixed-price contracts provided the contractor can substantiate a cost overrun. The maintenance of a reliable cost accounting system for the consistent accumulation and recording of costs is essential for an equitable adjustment to be approved Without uniform and consistent standards for allocating costs to contracts, costs can readily be shifted from commercial contracts, for which cost adjustments may not be available, to Government contracts that provide for changes and price adjustments Some of the standards are of special significance in the current environment of numerous corporate consolidations. Other standards facilitate contractor preparation of cost proposals that exclude costs unacceptable for reimbursement with Government revenues.

Asset Valuations. GAAP requires that assets be revalued after mergers and acquisitions. If the purchase method is used to revalue assets, depreciation and amortization costs may increase drastically to be passed on as increased costs on Government contracts. Assets may also have been purchased specifically for use on Government contracts, and the Government may already have reimbursed the contractor fully for the assets through normal depreciation.

Contractor Pension Plans. Government-funded pension assets must be properly allocated during business combinations to ensure that future contracts do not bear a disproportionate share of pension costs. CAS 412, "Composition and Measurement of Pension Costs," and CAS 413, "Adjustment and Allocation of Pension Costs," provide contractors and the Government criteria for assigning, valuing, and allocating pension costs. CAS 413 also provides guidance for ensuring that Government-funded pension assets, which amount to billions of dollars, remain available to offset future pension costs on Government contracts

Accounting for Unallowable Costs. CAS 405 facilitates the negotiation, audit, administration, and settlement of contracts by requiring contractors to identify expressly unallowable costs. Major contractors voluntarily delete large amounts of FAR unallowable expenses from overhead claims. Unless contractors are required to account for unallowable expenses, the Government assumes an unacceptable risk that those costs will be included in contract prices.

Conclusion. CAS enhances and promotes competition by increasing comparability between cost estimates and actual cost performance In addition, the proper implementation and enforcement of CAS prevents requests for unnecessary Government directed deviations from disclosed cost accounting practices. CAS does not generally require contractors to charge costs in a certain manner, only that they consistently follow their disclosed practice.

CAS does not apply to commercial contracts and should not be viewed as an impediment to civil-military integration. Congress has also given DoD the authority to use "Other Transactions" to encourage commercial firms to advance dual-use technology and broaden the industrial base. These "Other Transactions" are exempt from typical audit requirements including CAS However, where the Government continues to base procurement decisions on cost measurements, the Standards will serve an essential purpose.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Director, Defense Procurement
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer

Other Defense Organizations

Director, Defense Contract Audit Agency

Non-Defense Organizations and Individuals

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 National Security
  House Committee on Governmental 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

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

14 October 1998

PAC 730.40/98-2

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

SUBJECT: Response to DoDIG Draft Report on Evaluation of DCAA Audits of Contractor Compliance with Cost Accounting Standards (Project No 70C-9047)

As requested, we have reviewed the subject draft report Our response to the draft report follows:

As you know, prior to your review we had already initiated a review of the effectiveness of CAS compliance audits. We identified the areas of potential improvement to the CAS compliance audit process through our field visits This assessment of the areas of improvement was provided to you in our 29 January 1998 memorandum During the 12 March 1998 exit conference, you advised us that many of your findings were similar to our review results Our action plan to improve CAS audits was provided to you during the 20 May 1998 follow-up exit conference. We believe these DCAA initiatives should be reflected in the Executive Summary (section entitled Planned Management Actions) and the Evaluation Background (section entitled Results of DCAA Internal Review). Although we are experiencing delays with some of the milestones identified in the action plan, we have made significant progress on the action items. We will advise you when the milestones are complete

The draft report identified one recommendation that would require regional or field managers to specifically assign responsibilities to an individual for maintaining current and accurate data in the Field Management Information System (FMIS). We do not concur with this recommendation We believe the assignment of responsibilities is adequately addressed in the current FMIS User Manual

More importantly, we do not agree with certain conclusions and characterization of the findings. We believe that the magnitude of the problems is unfairly presented in the draft report Further, we strongly disagree with the IG finding that DCAA audit procedures were "insufficient to ensure that these assignments were performed in accordance with the Government Auditing Standards on due professional care "

Our detailed response to the recommendation and comments to your findings are enclosed If you have any questions, please contact Ms. Hyosun Ro, Program Manager, at (703) 767-3257, or Ms. Frances Cornett, Chief, Accounting and Cost Principles Division, at (703) 767-3250

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosure: Response to DoDIG Draft Report

Response to DoDIG Draft Report on Evaluation of DCAA Audits of Contractor Compliance with Cost Accounting Standards (Projects No. 70C-9047)

Recommendation for Corrective Action - Maintenance of System Information

We recommend that the Director, Defense Contract Audit Agency, require regional and field management to specifically assign responsibilities to an individual for the maintenance of current and accurate data on Cost Accounting standards audits in the Field Management Information System

DCAA Response

We do not concur. We believe responsibilities for maintaining FMIS are appropriately assigned as described in FMIS User Manual. At the field audit office level, the responsibility for maintaining FMIS accuracy is specifically assigned to the FAO manager. The Manual states:

> The Assistant Director, Operations, has overall responsibility for the following:
>
> - Design and operation of the FMIS.
> - Maintaining the FMIS User Manual on a current and complete basis.
> - Providing advice regarding the technical accuracy of data elements included in the FMIS and ensuring definitions are consistent with existing audit policy and guidance.
>
> Regional Directors, Heads of Principal Staff Members, Headquarters, DCAA, and **FAO managers** are responsible for ensuring that the instructions prescribed in this manual are adhered to in the preparation and submission of FMIS data. (emphasis added)

DCAA Headquarters Workload Analysis Division (OWD) has recently conducted field visits on FMIS accuracy. They found no processes or data inaccuracies that affect the Agency's statistics as a whole. However, OWD identified some areas for improvement and has issued an MRD (98-OWD-077(R), dated 10 August 1998) reemphasizing the importance of the accuracy of the FMIS data. The MRD required each FAO to reassess their own FMIS processes and internal controls related to those areas identified and initiate corrective actions It also reinforced that the regions should continue to monitor FMIS data accuracy as part of their quality assurance programs.

The OWD field visits disclosed no findings on FMIS input related to CAS audits. Therefore, we do not believe that the FMIS inaccuracy on CAS audits found by the IG is prevalent to warrant the change in Agency policy Assigning responsibility to another individual instead of the FAO manager would not seem to solve the problem. Rather, we will issue an

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MRD specifically on CAS compliance audits to reemphasize the importance of the maintenance of current and accurate data for FAO planning.

Finding A. Adequacy of the Audit Planning Process

Field audit offices (FAOs) needed to improve the CAS audit planning process, including risk assessments, updating of control logs, and information system data maintenance.

.. The scheduling and performance of audits without consideration of appropriate risk factors and the lack of current status information on CAS audits and reports resulted in inefficient management of audit planning and follow-up efforts.

DCAA Response

Partially concur. We agree that improvement is needed in documentation of risk and materiality factors considered in planning CAS audits However, we do not agree with the statement that the scheduling and performance of audits **without consideration of** appropriate risk factors and the lack of current status information on CAS audits and reports resulted in inefficient management of audit planning and follow-up efforts. As discussed below, the FAOs do consider risk factors and current information on CAS audits in planning and performing CAS audits We believe the detailed description of the reported condition and the nature of the finding are overstated.

Field Audit Office Performance of Risk and Materiality Assessments.

Revised

FAOs do not consider the risk and materiality of a potential noncompliance with applicable standards when planning CAS audits.

...At one branch, the CAS applicability schedule for a major contractor indicated that 11 standards applied However, DCAA had performed no compliance audits for the 3-year period covered in our review .

DCAA Response

Partially concur. We agree that the process can be improved to ensure more efficient planning and better documentation of materiality and risk considerations. We disagree with the global statement that FAOs do not consider risk and materiality of a potential noncompliance with applicable standards when planning CAS audits Three of the four offices visited by the IG performed and documented some level of planning based on the risk and materiality as demonstrated to the IG during the field visits One FAO, which is a resident office for a major contractor, maintained a CAS three-year planning schedule, which we believe is adequate for a major contractor where all standards that are scheduled for review are applicable and material. The FAO also used the FMIS system as an audit management tool to assure that required reviews

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were adequately planned and performed. Another FAO, also a resident office, uses a matrix planning document that covers the 3 year cycle for coverage of applicable standards for the various profit centers for the contractor. This document clearly displays the compliance reviews for each standard by profit center, the year of the last review, and the year of the next planned review. The IG reviewed this document and stated that it appears to demonstrate coverage of all relevant CAS standards over a 3-year period. The third FAO manager at a branch location maintains a status board showing mobile CAS covered contractors and the status of each planned CAS compliance audit. Thus, CAS covered contractors and CAS applicability are identified and controlled by the FAO manager for the branch as a whole. In addition, one mobile team maintained formal documentation regarding CAS planning, and two suboffice locations also maintained CAS applicability schedules and schedules showing results of recent compliance testing.

Regarding the statement that "DCAA had performed no compliance audits...", the example used by the IG was an isolated case at one contractor location at one branch office. This statement wrongly implies that this was a DCAA-wide problem.

Updating Control Logs

FAOs are not updating the MAARs or the ICAPS control logs to reflect the results of CAS compliance testing or reported CAS issues. FAO management is not following agency guidelines to use all relevant information in the planning process The result is duplicative audit effort. To ensure that guidance is properly implemented, management needs to assign responsibilities for maintaining current data in the information system

DCAA Response

Concur in principle. Although no instances were identified in the draft report that the failure to update the MAARs or the ICAPS control logs to reflect the results of CAS audits resulted in duplicative effort, we agree that documentation would be useful to avoid potential duplicative effort. As included in our action plan, we will modify the CAS compliance audit programs and MAARs and ICAPS forms to better identify the interrelationship between CAS compliance audit steps and specific ICAPS and MAARs.

Routine Cycling of CAS Audits

The exception was an FAO that completed no compliance testing in the 3-year evaluation period.

Revised
Page 5

DCAA Response

This is an incorrect statement. It was only one contractor at a branch location where no separate audit for compliance testing was performed in the 3-year evaluation period.

Response to DoDIG Draft Report on Evaluation of DCAA Audits of Contractor Compliance with Cost Accounting Standards (Projects No. 70C-9047)

Finding B. Management Needs to Improve Controls Over Audit Performance

FAOs did not document specific testing required by CAS 401, "Consistency in Estimating, Accumulating, and Reporting Costs," and CAS 402, "Consistency in Allocating Costs incurred for the same purpose...." Also 25% of all CAS audit workpaper packages were either inadequate or did not support the audit opinion... Existing procedures were insufficient to ensure that these assignments were performed in accordance with the Government auditing standards on due professional care

Inadequate audit coverage increases the risk that the contractor proposed and incurred costs are improperly measured and allocated and costs paid by the Government are overstated as a result.

DCAA Response

Partially concur. We agree that CAS 401 and 402 testing was not always documented. However, we do not believe that the lack of documentation of CAS 401 and 402 represents inadequate audit coverage based on the reasons discussed below under Adequacy of CAS Audit Coverage and Reporting. In addition, we do not concur with the statement that 25% (23/95) of all CAS audit workpaper packages reviewed were either inadequate or did not support the audit opinion The IG found 23 audits inadequate We analyzed the 23 audits and found 8 audits which should not fall under this inadequate category. Of the 15 remaining audits, 8 were attributable to one FAO, one supervisor and one auditor, which we believe represent an isolated performance matter that is being addressed by management. Based on our calculation, at most, the percentage of the inadequate audits of the total audits reviewed should be 16% (15/95). If the anomaly relates to the single performance matter is removed, the percentage would be further reduced to 8% (7/95)

In light of the above, we strongly disagree with the IG statement that existing procedures were insufficient to ensure that these assignments were performed in accordance with the Government auditing standards on due professional care.

Adequacy of CAS Audit Coverage and Reporting

FAOs neither performed nor documented testing of contractor compliance with CAS 401 and 402 ...

The level of testing in 15 of 50 CAS compliance audits was not sufficient to support the overall audit opinion .

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Response to DoDIG Draft Report on Evaluation of DCAA Audits of Contractor Compliance with Cost Accounting Standards (Projects No. 70C-9047)

DCAA Response

Partially concur. We disagree with the statement that FAOs did not perform testing of contractor compliance with CAS 401 and 402. While we agree that CAS 401 and 402 testing was not adequately documented, contractor compliance with CAS 401 and 402 is considered in potentially all transaction testing in most audit assignments. Certain Agency standard audit programs already contain specific audit steps requiring consideration of CAS 401/402 requirements. For example, the audit programs for forward pricing rates and price proposals contain audit steps requiring testing for compliance with disclosed or established practices. This step, although it is not always annotated as such, is testing compliance with CAS 401.40(a) During our field visits, we found no instances where any FAO failed to identify noncompliances with CAS 401 and 402. Further, we determined that during FYs 1995 and 1996, about 16 percent of all noncompliance reports issued were noncompliance with CAS 401 and 402. Some of these noncompliance reports were provided to the IG by the FAOs during the IG field visits. Nevertheless, we have already revised all relevant audit programs to clearly identify the audit steps necessary to perform compliance testing of CAS 401 and 402 to facilitate better documentation.

Regarding the statement that the level of testing in 15 of 50 CAS compliance audits was not sufficient to support the overall audit opinion, our analysis shows 3 of the reported audits do not fall under this category One of the audits was cited for not supporting the testing of all CAS provisions. Although this was not discussed during the exit conference, you informed us that the provisions that were not supported were CAS 404.50(d) and (e). These CAS 404 provisions relate to asset valuations as a result of business combination. The contractor had no such acquisitions that would trigger applicability of these provisions, and, therefore, these audit steps were not applicable at this contractor. Also, we found that the IG counted one audit as three because there were three assignment numbers associated with that audit. This audit covered three profit centers which had identical accounting practices, and the assignment numbers merely represented the profit centers. Only one audit assignment was established, and only one report was issued for this audit. Of the 12 audits remaining, 9 audits are attributable to one FAO, of which 8 audits were performed by one supervisor and one auditor. The nature of inadequate performance was identical in all eight assignments. Therefore, we believe the magnitude of the finding is misleading since the majority (8/12) of the inadequate audits represents an anomaly attributable to one supervisor and one auditor involving the identical audit technique for the eight audits. At most, these audits should be counted as one occurrence of inadequacy.

Disclosure Statement Audits

We reviewed 14 disclosure statement audits The workpapers in 4 of the audits did not support the opinions in the reports issued to the ACO.. . In two cases, we found that the audit workpapers did not support the basis for the auditor's conclusions...

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In two other cases, the supervisor limited the scope of the audit to an adequacy determination without coordinating with the ACO. Despite the supervisor's scope limitation, the auditor identified potential noncompliance issues with three standards .

. . The FAOs never issued noncompliance reports to the ACO and never established and performed separate compliance audits for the revised cost accounting practices.

DCAA Response

Partially concur. We do not concur with two of the four audits found inadequate. As discussed with the IG during the field visit, the FAO coordinated with the ACO who requested to limit scope to an adequacy review to expedite the report on adequacy. Although this was not documented, the FAO provided the IG a copy of the ACO adequacy determination letter that stated a compliance review would be done later The ACO believes that his determination letter provides adequate evidence for FAO coordination and declined to provide a written confirmation. Therefore, we do not believe this finding is accurately presented.

Regarding the statement, "the FAOs never issued noncompliance reports...," the FAO explained to the IG that the matter had been resolved internally. Based on the discussions between the auditor and the supervisor/FAO manager, it was determined that there were no noncompliances to report

Revised

Also, the word, "*FAOs*", is incorrect because it was one FAO involved in this issue

Noncompliance Reports

The workpaper files in 4 of 31 CAS noncompliance report assignments did not document why a report was never prepared or explain how the issue was resolved

The credibility and usefulness of the information DCAA provides to contracting officers depend on auditor adherence to GAS. Management Controls incorporated in the supervisory review and FAO quality control process did not ensure these assignments were performed in accordance with the GAS on due professional care.

DCAA Response

Partially concur We do not concur with three of the four audits found inadequate. The FAOs provided to the IG adequate explanations as to why a report was never issued or how the issue was resolved. One of these assignments was closed with no audit effort expended because the issue was determined immaterial. Another audit was opened based on an audit lead from a review of an incurred cost submission. However, as indicated in the contractor's response to the draft noncompliance report, the contractor revised the incurred cost submission to correct the condition upon which the audit lead was based. As a result, no noncompliance report was issued In the third audit, the ACO was fully apprised of the matter and negotiated a settlement with the

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Response to DoDIG Draft Report on Evaluation of DCAA Audits of Contractor Compliance with Cost Accounting Standards (Projects No. 70C-9047)

contractor before the audit report was issued. Since the matter was settled, an audit report would serve no useful purpose. Thus, the FAO decision was proper.

While we agree that the reasons for not issuing a report should have been documented, we do not believe merely failing to document the adequate resolution of the issues either affected the credibility and usefulness of the information provided to contracting officers. Further, we do not believe failure to document the resolution of the issue justifies the IG finding that these audits were not performed in accordance with the GAS.

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

Barbara E. Smolenyak
Madelaine Fusfield
Janet Stern