Oversight Report

DEFENSE CONTRACT AUDIT AGENCY
COMPENSATION AUDITS

Report Number PO 99-6-004 March 30, 1999

Office of the Inspector General
Department of Defense

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Acronyms

ACO	Administrative Contracting Officer
CSR	Compensation System Review
DCAA	Defense Contract Audit Agency
DCAAM	Defense Contract Audit Agency Contract Audit Manual
FAR	Federal Acquisition Regulation
FAO	Field Audit Office
ICAPS	Internal Control Audit Planning Summary
USD(A&T)	Under Secretary of Defense for Acquisition and Technology

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March 30, 1999

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation Report on Defense Contract Audit Agency Compensation Audits (Report No. PO 99-6-004)

We are providing this final evaluation report for review and comment. We considered management comments on a draft of this report when preparing the final report and deleted one initial recommedation.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. We request additional comments on Recommendations A.1. and B. in response to the final report by June 1, 1999.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation should be directed to Mr. Wayne C. Berry at (703) 604-8789 (DSN 664-8789) (wberry@dodig.osd.mil). See Appendix B for the report distribution. The evaluation team members are listed inside the back cover.

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Assistant Inspector General
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Office of the Inspector General, DoD

Report No. PO 99-6-004 **March 30, 1999**
(Project No. 7OC-9045)

Defense Contract Audit Agency Compensation Audits

Executive Summary

Introduction. Compensation for personal services is one of the largest components of cost incurred under government contracts. We reviewed audits of compensation costs that totaled more than $3 billion. Compensation includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. Federal Acquisition Regulation 42.302(a)(1) requires administrative contracting officers to review the contractors' compensation structures. The Defense Contract Audit Agency (DCAA) assists the administrative contracting officer in accomplishing that responsibility by determining whether the contractor's compensation system is sound, reliable, consistently applied, and results in reasonable costs charged to government contracts.

Evaluation Objectives. The evaluation assessed the adequacy of audit coverage and reporting, audit guidance, and contractors' compliance with legislation requirements in other related audits. We reviewed the regional offices' participation in the compensation system program such as training packages, audit guidance, monitoring processes and follow up efforts, and assistance provided to the FAOs. We also reviewed corrective measures management took in response to Report No. APO 95-009.

Evaluation Results. The DCAA had properly implemented guidance to determine whether contractors were complying with the legislation limiting executive compensation. However, DCAA needed to improve its audit performance, reporting, and guidance on compensation system reviews. (Finding A).

The DCAA regional offices used significantly different approaches, procedures, and guidance to implement the compensation program. More aggressive measures to identify and spread best practices are needed. (Finding B).

Section 808 of the National Defense Authorization Act for FY 1998 eliminated confusion surrounding the FYs 1995 through 1997 legislation for contractor executive compensation ceilings. However, the legislation did not establish the ceiling for all individuals in a company, only the five most highly compensated executives in each component. Our sample of 4 of the top 10 defense contractors showed that 51 executives were excluded, although they also earn more than the $340,650 ceiling. The average compensation to the excluded executives was $116,232 more than the ceiling, the highest compensation being $818,350 more. As a result, questioning only the salaries of the five most highly compensated individuals that exceeded the ceiling but allowing the salary for others, although they also exceeded the ceiling, could result in unreasonable compensation being charged to Government contracts (Finding C).

Summary of Planned Management Actions. We met with DCAA management on June 18, 1998, to discuss our evaluation results and proposed recommendations. DCAA agreed to revise its audit program, change the threshold for performing compensation reviews to its major contractor designation, and prepare a training course on compensation by April 1999. DCAA also agreed to include a step in the audit program to request audit assistance if the compensation cost records are located at a different audit location or to qualify the report.

In addition to the DCAA planned action, we have drafted a revision to the Federal statutes (Appendix B) to establish the ceiling for all employees, not just the top five, and forwarded it for inclusion in the DoD Omnibus Legislative Proposal for FY 2000.

Summary of Recommendations. We recommend that DCAA revise guidance to clarify the terms and the established time period for questioning unreasonable compensation costs. We also recommend that DCAA ensure the spread of best practices among the regions for a generally consistent and most efficient approach to compensation system reviews and calculating reasonable compensation.

Management Comments. DCAA nonconcurred with a draft recommendation to remind auditors to properly report all unreasonable compensation costs and to properly report system deficiencies. DCAA also nonconcurred with revising its guidance to state that a compensation system is inadequate if the auditor cannot determine whether compensation costs are reasonable. It nonconcurred with revising its guidance to include additional audit steps to determine the reasonableness of compensation when a contractor lacks job descriptions and benchmarking. DCAA concurred with the recommendation to revise the Contract Audit Manual to clarify the terms and the established time period for questioning unreasonable compensation costs. However, it nonconcurred with developing a best practice for ensuring a consistent approach among regions because there was no indication that some regions performed superior to others. Although not required to comment, the Director, Defense Procurement disagreed with the need for the executive compensation legislation. See Part I for a discussion of management comments and Part III for the complete text of management comments.

Evaluation Response. We deleted the draft recommendation on unreasonable compensation because DCAA subsequently reported the unreasonable costs. DCAA actions and comments on other issues were partially responsive. DCAA still needs to revise the guidance to report the system as inadequate when the reasonableness of compensation costs cannot be determined. Furthermore, we disagree with the DCAA comments on best practices because clearly superior practices are not being effectively spread. We also disagree with comments from the Director, Defense Procurement. We believe there is a need for legislation that establishes a ceiling amount for all employees, not just the top five employees at each home office and segment. This issue will be resolved in deliberations on DoD legislative proposals and legislative action for FY 2000.

We request that DCAA reconsider its position and provide additional comments in response to the final report by June 1, 1999.

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Part I - Evaluation Results

Evaluation Background

This evaluation was performed in accordance with Public Law 95-452, "Inspector General Act of 1978," as amended, which assigned to the Inspector General, DoD, the responsibility of providing policy direction and oversight to the contract auditors in DoD. Compensation for personal services is one of the largest components of cost incurred under Government contracts. The Defense Contract Audit Agency (DCAA) primary objective in reviewing the contractors' compensation costs is to evaluate the adequacy of the compensation systems and the related internal controls. Federal Acquisition Regulation (FAR) 42.302(a)(1) requires the administrative contracting officer (ACO) to review a contractor's compensation structures. The DCAA evaluations of compensation systems assist the ACO in accomplishing this responsibility. Contractors must maintain sound compensation systems that consistently provide employee compensation costs that are reasonable, reliable, and compliant with Government laws and regulations. A sound compensation system contains elements, such as organizational structure; established lines of authority, duties, and responsibilities; internal controls and managerial reviews; internal and external equity; pay structures; budgeting; merit and incentive pay programs; and benefits programs.

FAR 31.205-6, "Compensation for Personal Services." The FAR 31.205-6(a), "Compensation for Personal Services," defines compensation as all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. Examples of compensation include salaries, wages, bonuses, incentive awards, employee stock options, stock ownership plans, employee insurance, fringe benefits, contributions to pension plans, directors' fees, allowances for severance pay, and cost of living differential.

Allowable compensation is subject to the general criteria and additional requirements contained in other parts of this cost principle. The FAR allowable compensation must be:

- for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages;
- reasonable for the work performed;
- based upon and conform to the terms and conditions of the contractor's established compensation plan.

Statutory Limitations on Compensation. Section 808 of the National Defense Authorization Act for FY 1998 (Public Law 105-85) limits the amount of compensation that certain senior executives of contractors are allowed to receive each fiscal year. This legislation applies to compensation costs incurred after January 1, 1998, under all covered Government contracts, including those contracts awarded before the enactment of the new cap. The Office of Federal Procurement Policy set the compensation amount at $340,650, which is to be used for contractor fiscal year 1998.

Before enacting the National Defense Authorization Act for FY 1998, Congress enacted yearly executive compensation ceilings that were applicable for a specific period during the fiscal year. The enactments are shown in the following table.

Executive Compensation Ceilings

DFARS*/FAR Criteria	Applicability	Ceiling
Fiscal Year 1995		
1995 DoD Appropriations Act (Section 8117 of Public Law 103-335): DFARS 231.205-6(a)(2)	DoD awards after April 15, 1995	$250,000
Fiscal Year 1996		
1996 DoD Appropriations Act (Section 8086 of Public Law 104-061): DFARS 231.205-6(a)(2)	DoD awards after July 1, 1996	$200,000
Fiscal Year 1997		
1997 DoD Appropriations Act (Section 8071 of Public Law 104-208): DFARS 231.205-6(a)(2)(ii)	DoD awards after September 30, 1996	$250,000
1997 National Defense Authorization Act (Section 809 of Public Law 104-201): FAR 31.205-6(p)	All Government awards after September 30, 1996	$250,000

*Defense Federal Acquisition Regulation Supplement

Section 804 of the FY 1999 Defense Authorization Act (Public Law 105-261) revised the term senior executives to mean the five most highly compensated employees in management positions at each home office and segment of the contractor. The amendment applies to costs of compensation incurred after January 1, 1999.

DCAA Guidance on Compensation System Reviews. The DCAA Contract Audit Manual (DCAAM), section 5-803b, requires that compensation system reviews (CSRs) be performed at least every 3 years at large business contractors. Those contractors must have received in their preceding fiscal year at least $50 million in Government sales under negotiated prime contracts and subcontracts for which such sales represent at least 10 percent of total sales volume. The CSRs may be waived or modified if experience and current audit risk are low. Conversely, if audit risk is considered to be high, then CSRs should be performed more frequently. However, at smaller contractor locations, selected compensation audit steps may be included in incurred cost or forward pricing audits.

Internal Control System Review Process. The Government Auditing Standards require auditors to obtain a sufficient understanding of the contractor's internal controls and to assess control risk to plan the audit and to determine the nature, timing, and extent of tests to be performed. In FY 1995, DCAA established a process for assessing and documenting the control risk for major contractors. DCAA defines a major contractor as one with a minimum of $70 million of annual reimbursable contract costs. DCAA determined that major contractors have at least 10 common accounting systems,

including compensation systems that may have a significant effect on the pricing, administration, and settlement of Government contracts. DCAA performs the reviews on a cyclical basis.

DCAA audits these systems and the related internal controls, assesses control risk, and identifies the potential effect of risk assessments on the scope of other related audits. Summary analyses of the results of audit for each system are documented on an Internal Control Audit Planning Summary (ICAPS) form. The ICAPS form, which is also used for audit planning, reflects the materiality of costs and transactions processed by the system, the auditor's assessment of control risk for the system reviewed, and the amount and nature of testing needed for other related audit efforts such as forward pricing reviews, billing vouchers, and incurred costs audits. DCAA considers the compensation systems as significant accounting and management systems because of the substantial amount of labor costs charged to Government contracts.

Summary of Prior Coverage. During the last 5 years, the Inspector General, DoD, issued one report on the DCAA reviews of compensation, Report No. 95-009, "Report on the Oversight Review of the Defense Contract Audit Agency Evaluations of Contractor Compensation Systems," July 3, 1995. Of 21 audits of contractor compensation systems reviewed, 18 were inadequate. Auditors did not report $700,000 in unreasonable executive compensation because offsets were allowed without justification, inadequate audit steps were performed, and proper fringe benefit rates were not applied to unreasonable compensation costs. Also, DCAA and the Defense Logistics Agency used different methods for offsetting compensation between labor grades.

The Director, DCAA, agreed with our recommendations to:

- review compensation system reviews where unreasonable executive compensation was offset and determine whether supplemental reports should be issued;
- require the Assistant Director for Operations and the Regional Directors to monitor the performance of compensation system reviews;
- develop a self-study course on compensation system reviews and require the auditors to complete the course prior to starting a compensation system review; and
- include more specific guidance for performing compensation system reviews in the DCAAM.

DCAA Compensation Audits. DCAA spent more than 30,000 audit hours performing CSRs during FY 1997. Additional hours were spent on reviewing compensation costs during incurred cost audits; however, the hours were not separately identified in the DCAA management information system. For FY 1997, DCAA reported 158 audits related to CSRs. DCAA does not maintain statistics on compensation costs audited.

Evaluation Objective

The evaluation assessed the adequacy of audit coverage and reporting, audit guidance, and contractors' compliance with legislation requirements in other related audits. We reviewed the regional offices' participation in the compensation system program such as training packages, audit guidance, monitoring processes and follow up efforts, and assistance provided to the FAOs. We also reviewed corrective measures management took in response to Report No. APO 95-009. See Appendix A for a discussion of the scope and methodology.

Finding A. Adequacy of Compensation System Audits

The DCAA had properly implemented guidance to determine whether contractors were complying with the legislation limiting executive compensation. However, DCAA needed to improve its audit performance, reporting, and guidance on compensation system reviews. Specifically, DCAA did not:

- properly assess or document contractors' processes used to establish the reasonableness of employee compensation,
- review two contractors although they exceeded the threshold for a compensation review,
- properly report that executive compensation was under the cognizance of another DCAA office and not reviewed,
- report unreasonable compensation of $76,617, and
- properly report deficiencies in compensation systems.

The standard agency-wide compensation audit program did not include audit steps for determining whether the contractor had a sound, reasonable compensation system. The auditors were also not adequately trained because DCAA delayed implementing the agreed to recommendation from our prior review to develop a self-study compensation training course. The DCAA did not maintain the necessary sales data to determine the contractors that exceeded the threshold, and did not follow their guidance for reporting the results of their reviews to the contractor and the ACO. Additionally, the audit guidance did not provide clear instruction on reporting compensation system results. As a result, the failure of DCAA to determine the adequacy of contractors' processes, identify contractors for review, and properly report its audit results may have resulted in unreasonable compensation costs being allowed.

DCAA Implementation of Legislation

From FY 1995 through FY 1997, Congress enacted yearly ceilings on executive compensation that were applicable for a specific period during the fiscal year. Section 808 of the National Defense Authorization Act for FY 1998 (Public Law 105-85) placed a permanent limitation on the allowability of compensation for certain senior executives of contractors. The new legislation established a benchmark compensation amount determined by the Administrator, Office of Federal Procurement Policy for compensation costs incurred after January 1, 1998, under all covered Government contracts, including

those contracts awarded prior to the enactment of the new cap. The Office of Federal Procurement Policy set the compensation amount at $340,650 for the contractor fiscal year 1998.

DCAA had properly implemented guidance to determine whether contractors were complying with the legislation limiting executive compensation. Contractors were complying with the legislation by not claiming expressly unallowable costs.

Compensation System Review Coverage

FAR Requirements. FAR 31.205-6, "Compensation for Personal Services," gives the basic criteria for determining the allowability of compensation costs. According to FAR 31.205-6(b), "Reasonableness," compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. Factors which may be relevant include general conformity with the compensation practices of other firms of the same size, other firms in the same industry, other firms in the same geographic area, firms engaged in predominantly non-Government work, and with the costs of comparable services obtainable from outside sources.

DCAA Audit Guidance. DCAAM section 5-808.3, "Review of External Equity or Competitiveness," defines the relevant labor market as the contractor's product and employee competitors. External pay surveys provide detailed data regarding market pay levels for specific jobs and are the primary tools used by the contractor to ensure compliance with its external equity pay policy. Benchmarking is the process of matching the contractor's job to market survey positions based on job content contained in job descriptions. DCAAM section 5-808.3 further defines an adequate market comparison process as one that:

> (i) documents the benchmarking analyses, which identify the established benchmarked jobs, pay survey(s) used, survey codes, and pay levels used.
>
> (ii) demonstrates the validity of benchmarked jobs to the appropriate job matches to the pay survey descriptions.
>
> (iii) establishes at least 40 percent of the jobs assigned to a pay structure as benchmarked jobs, as appropriate.
>
> (iv) provides the basis of adjustments to the survey data such as escalation and lump-sum payments.
>
> (v) demonstrates how pay survey data are integrated with pay structure design and how benchmarking results are used in the formal budgeting process.

DCAAM section 6-413, "Reasonableness of Compensation Costs," requires the auditor to benchmark the reasonableness of the contractor's compensation costs if the contractor had not properly benchmarked its jobs.

DCAA Audit Program. The DCAA agency-wide audit program for CSRs, "Audit Program for Reviewing and Reporting on Contractor Compensation System and Related Internal Controls," April 1, 1996, does not include steps necessary for testing whether employee compensation costs were sound and reasonable in accordance with criteria set forth in FAR 31.205-6. The current audit program focuses on documenting the understanding of the contractor's control environment, accounting system, and control procedures such as management reviews, organization, policies and procedures, and training as they related to the compensation system. While the audit program covered important areas for obtaining an understanding of the internal control structure, the audit program contained no steps to instruct the auditor to test the reasonableness of compensation costs or to evaluate the adequacy of the contractor's market comparisons (benchmarking process) of its own jobs to external pay surveys. Several of the regional offices and field audit offices (FAOs) had revised the audit program for their auditors to include the additional steps necessary for performing the market comparison.

Adequacy of Compensation System Audits. Six of the sixteen audits reviewed did not have adequate documentation of the contractor's benchmarking techniques and did not use external market surveys to evaluate the reasonableness of the contractor's compensation. Two audits attempted to perform benchmarking analyses; however, the workpapers did not contain evidence of the contractor's benchmarking process and types of documents the auditor reviewed, such as grade levels benchmarked, positions benchmarked, appropriateness of surveys used, salary comparisons, and dates when the benchmarks were performed. The workpapers did not document whether the contractor's benchmarking was adequate, the auditor reviewed and relied on the contractor's benchmarking, or additional benchmarking was performed by the auditor.

The workpapers for four audits contained no documentation of benchmarking. Those audits simply included a collection of policies and procedures and no testing of the reasonableness of the contractor's compensation system. The DCAA auditor did not follow the audit guidance for testing the reasonableness of employee compensation. The DCAAM audit guidance contained numerous pages of detailed definitions, analyses, descriptions of compensation elements, and essential steps the auditor should use when testing whether the contractor adequately performed benchmarking techniques for comparing benchmarked jobs to market pay surveys. However, the DCAA standard audit program did not include steps for testing whether the employee compensation was reasonable in accordance with FAR requirements.

DCAA Threshold for Compensation Reviews. The DCAAM, section 5-803b, "DCAA's General Audit Policy for Compensation System Review(s) (CSR)," requires that CSRs be performed at least every 3 years at large business contractors, who in their preceding fiscal year received at least $50 million in Government sales under negotiated prime contracts and subcontracts for which such sales represent at least 10 percent of total sales volume. The CSRs may be waived or modified if experience and current audit risk are considered to be low. Conversely, if an audit risk is considered to be high, compensation system reviews should be performed more frequently.

In two instances, contractors were not reviewed although their sales exceeded the DCAA threshold for a compensation review. Because DCAA did not maintain the sales data to

determine which contractors exceeded the threshold, there was no assurance that all contractors were reviewed. DCAA indicated that the $50 million threshold was an arbitrary amount established years ago based on the threshold for a Material Management and Accounting System review. Since that time, the Material Management and Accounting System review threshold has been increased to the $70 million auditable dollar volume used to identify major contractors. No regulation or statute required the $50 million sales threshold. Because DCAA offices did not track sales data, we believe the threshold for a CSR review should be changed to the DCAA major contractor designation.

Auditor Training. As a result of our prior evaluation of DCAA Compensation System Reviews, DCAA agreed to develop a CSR self-study course by FY 1996, to train auditors in the proper techniques and procedures of performing CSRs and to require auditors to complete the course before starting a CSR. As of August 1998, the course had not been developed. DCAA asserts that lack of resources and the gradual change of having technical specialists perform or assist in those reviews delayed the process. DCAA further added that regional offices updated the previously established course to meet their own training needs. DCAA revised the course completion date to April 1999.

Although DCAA contended that the majority of CSRs were performed by trained technical specialists and compensation teams instead of FAO auditors, several CSRs were not performed by the technical specialists or compensation teams. In addition, inadequately trained auditors performed several inadequate audits.

Compensation System Review Reports

Coordination Among DCAA Offices. DCAAM, section 5-803.2, "CAC/CHOA Network Coordination," requires that FAOs coordinate compensation audits with all major DCAA network components. When control over executive compensation is at the corporate office, the corporate auditor is required to audit the executive compensation. Before completing the segment CSR, the division is to obtain input from the corporate office auditor on the division executive compensation. Lack of coordination and planning can cause increased audit effort, inconsistency among components, and invalid audit findings.

Three DCAA audits improperly reported that compensation systems were adequate and reasonable, although the executive compensation was not reviewed. FAO representatives stated that they did not review the executive compensation because employee salaries were often determined by the company's corporate or home office, which was under audit cognizance of another DCAA audit office. There was no evidence in the workpapers of an assist audit request to the cognizant corporate FAO or information on whether another FAO had determined the executive compensation to be reasonable.

The DCAA failure to report that executive compensation was not reviewed resulted in an inaccurate and misleading audit report to the ACO. Executive compensation is a high risk cost element in the contractor's compensation system. The cognizant FAO must request assistance from the cognizant audit office or qualify the audit report when

executive compensation costs were not reviewed. The overall compensation system should not have been reported as "adequate" and "reasonable" by the FAO if all major compensation elements were not reviewed.

Reporting Significant Compensation System Deficiencies. DCAAM, section 10-408, "Results of Audit for Functional Reports," requires that items found during system reviews that do not affect the adequacy of the system, but would enhance the system if corrected, be reported as suggestions to improve the system, not as system deficiencies. Two audits improperly reported significant compensation system deficiencies as suggestions to improve the system. The audits reported that the contractor had no documented methodology for benchmarking and market comparisons, and that the contractor did not have current written policies and procedures for key elements of the compensation system. They also reported that the compensation systems were "inadequate in part" with other significant deficiencies affecting major parts of the system. FAO representatives stated that the contractor was not required to correct those items that were listed as suggestions to improve the system. Significant deficiencies, such as lack of methods for benchmarking and no current compensation system policies, should be reported as system deficiencies with conditions and recommendations so that the contractor will be required to implement corrective actions.

Assessment of Overall Compensation System. DCAAM, section 5-811.2, "Reporting on CSR Results of Audit," states that control deficiencies will be reported even if the CSR does not find unreasonable costs caused by those deficiencies. However, the guidance did not address the course of action to be taken if significant deficiencies did not allow the auditor to determine whether the compensation costs were reasonable. DCAAM, section 5-811, "Compensation System Review and Audit Report," also refers the auditor to section 10-400 for additional reporting guidance on system reviews. According to DCAAM, section 10-408, "Results of Audit for Functional Reports," ". . .if the deficiencies affect only parts of the system, then the audit opinion should state that the system is inadequate in part. . . , and if the deficiencies are so significant that the entire system is unreliable, then the audit opinion should report that the system is inadequate."

In one assignment, the auditor reported in the "Results of Audit" section of the audit report that the compensation system and related internal control policies and procedures were "inadequate in part", but the auditor should have reported that the compensation system was "inadequate". The report further stated that system deficiencies adversely affected the contractor's ability to ensure that reasonable and allowable employee compensation costs were included in Government proposals and charged to Government contracts and subcontracts in accordance with applicable Government contract laws and regulations. Because of the nature of the deficiencies, a cost impact could not be determined. The contractor disagreed with the auditor's recommendations. Consequently, the auditor recommended that the ACO instruct the contractor to immediately put into effect an action plan to correct the deficiencies within a reasonable period. However, the ACO had reservations about making a determination on that issue because DCAA was unable to calculate whether unreasonable compensation existed. The failure to properly assess whether the compensation system was sound and reasonable may result in unreasonable compensation costs being allowed. DCAA needs guidance to assist the auditor when deficiencies prevent assessing whether a

contractor's compensation system is reasonable. The guidance should instruct the auditor to perform benchmarking techniques and other steps necessary to determine reasonableness of compensation.

Clarification of Audit Guidance. DCAAM, section 5-811.2, "Reporting on CSR Results of Audit," requires that unreasonable compensation costs identified during a CSR be reported as cost avoidance to allow the contractor time to correct the compensation system. Section 5-811.2 also states that an ensuing report should include a recommendation that the ACO put the contractor on notice of the Government's intent to disallow unreasonable compensation costs if the contractor fails to take timely corrective action. It should also recommend that the ACO identify the first period during which it would be feasible for the contractor to make significant changes to its system. A contractor's corrective actions are expected to reduce compensation costs to reasonable levels and to correct related system deficiencies within 1 year. DCAAM, section 5-811, further states that if prior CSRs identified unreasonable compensation and the ACO issued a Notice of Intent to Disallow Costs, then all compensation costs that are unreasonable after the allowed period for implementing corrective action should be questioned in forward pricing reviews, proposals, and incurred cost audits. If the ACO has not made a final determination on the unreasonable costs in a CSR, the auditor should continue to question any unreasonable compensation until a final determination is made.

DCAAM used different terms for the period for questioning unreasonable compensation costs. There were references to *first period*, *that period*, *periods subsequent to the aforementioned date(s)*, *periods subsequent to the date*, and *after the allowed period.* However, the guidance did not clearly specify, explain, or define these time frames and did not clearly explain when to question unreasonable compensation costs. Furthermore, DCAAM, section 5-811.4, "Dispositioning CSR Report Findings," mentioned *recording* cost avoidance and *continuing* to question unreasonable compensation costs, but the guidance did not establish when DCAA was required to question unreasonable compensation findings. The guidance also did not define the effective date of the 12-month period for the contractor's corrective action. The guidance needs to be clarified to reduce the confusion in determining the established period for questioning unreasonable compensation costs in forward pricing reviews, incurred cost audits, and proposals audits.

Other Matter of Interest

Reporting of Unreasonable Compensation. DCAAM, section 5-811.2c. and e., "Reporting on CSR Results of Audit," require that unreasonable costs be reported in the compensation system report as a cost avoidance and that a recommendation be made to the ACO to put the contractor on notice of the Government's intent to disallow unreasonable compensation costs if the contractor fails to take timely corrective action within 1 year. Report No. 95-009, stated that $700,000 in unreasonable executive compensation was not reported. During this evaluation, we identified $76,617 of unreasonable costs that were not reported in one CSR review report. Management indicated that those costs were not reported because the CSR review was intended to focus on the internal controls to satisfy the agency's ICAPS requirements and another review would be set up to report the unreasonable costs found in the compensation

system review. As a result, the cost exceptions were not formally presented to the contractor so that corrective actions could be taken. In the draft evaluation report, we included a recommendation (A.1.) related to this matter. In commenting on the draft, the DCAA indicated that the $76,617 of unreasonable costs had been identified in a subsequent incurred cost audit report. Although the CSR report would have been the preferred reporting vehicle, this information obviated at least part of our concern. We deleted the initial recommendation from this final report; however, we urge DCAA to ensure coverage of this area in its future quality assurance assessments.

Corrective Actions Planned by Defense Contract Audit Agency

On June 18, 1998, we discussed with DCAA Headquarters representatives the deficiencies found and potential recommendations. DCAA agreed to revise the audit program to include steps for testing and documenting benchmarking techniques and steps for requesting assist audits on executives whose cognizance is under another DCAA office. DCAA stated that a lack of resources and the gradual change to having technical specialists perform or assist in CSRs have lessened the priority for developing the self-study course. However, DCAA agreed that the course should have already been completed, and it is now scheduled for completion by April 1999. DCAA also agreed to revise the threshold for CSRs to their major contractor designation.

The DCAA planned actions should correct the CSR condition on coverage and partially correct the condition identified on reporting. In addition, DCAA needs to re-emphasize reporting unreasonable compensation and system deficiencies and to clarify its guidance on compensation system reviews.

Management Comments on Finding and Evaluation Response

Management Comments. In comments on the draft report, DCAA stated that there were few material instances of DCAA failing to determine the adequacy of contractors' compensation processes, identify contractors for review, properly report audit results or question unallowable costs. It stated that several of the summary conclusions were not adequately supported by the review findings. DCAA contends that, based on the evidence gathered, in all material respects the audit coverage was generally adequate. DCAA disagreed that the observations regarding the adequacy of audit documentation were accurate and systemic.

Evaluation Response. The wording of this final report has been adjusted to avoid perceptions of unsupported generalization and one initial recommendation was deleted, as discussed above. In addition, this report acknowledges the corrective actions already planned by DCAA, without which further recommendations would have been needed. The results of the review indicate several areas where improvement is both possible and necessary.

Recommendations, Management Comments, and Evaluation Response

Deleted and Renumbered Recommendations. As a result of management comments, we deleted draft recommendation A.1. Draft recommendations have been renumbered accordingly.

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

1. Revise Defense Contract Audit Agency Contract Audit Manual, section 5-811.2, "Reporting on Compensation System Review Results of Audit," to state that if an audit cannot determine whether compensation costs are reasonable, then the compensation system should be reported as inadequate.

Management Comments. DCAA nonconcurred, stating that the current guidance is adequate. DCAA contends that our report erroneously concluded that because the nature of the system deficiencies prevented the determination of a cost impact, the deficiencies resulted in the entire system being unreliable. It further stated that, as is true with many internal control areas, the adequacy of the compensation system was unrelated to the auditor's ability to compute a cost impact for system deficiencies.

Evaluation Response. The DCAA comments were nonresponsive. An adequate compensation system is one that generates reasonable costs. No other definition of adequacy is appropriate. The DCAA guidance does not address a situation in which DCAA cannot assess the reasonableness of costs. If a contractor's system does not allow an assessment of the reasonableness of costs, the system should not be deemed adequate, even in part. We request that DCAA reconsider its position and provide additional comments in response to the final report.

2. Revise guidance to include instructions on additional steps the auditor should take to determine the reasonableness of a compensation system when a contractor does not have job descriptions and benchmarking.

Management Comments. DCAA nonconcurred, stating that in the one instance cited in our report, the audit office failed to follow guidance. DCAA stated that regional management will reemphasize its guidance on additional steps to take to determine the reasonableness of compensation when there are no job descriptions and benchmarking at the next regional compensation workshop.

Evaluation Response. Although DCAA nonconcurred, we accept its planned action to reemphasize its guidance as being responsive to the intent of the recommendation.

3. Revise guidance to clarify the terms and the established time period for questioning unreasonable compensation costs.

Management Comments. DCAA concurred, stating that it will revise the Contract Audit Manual and clarify the terms and time period for questioning unreasonable compensation costs. The updated guidance will be issued by July 31, 1999.

Finding B. Regional Offices Approaches to the Compensation Program

The five DCAA regional offices had significantly different approaches, procedures, practices, and guidance involving the compensation program. The regions had different:

- staffing approaches for compensation system reviews,
- compensation system training packages,
- surveys and guidance for using survey information when calculating unreasonable compensation, and
- practices for monitoring and requesting feedback from the FAOs on final audit results.

While complete standardization is probably unnecessary, some approaches and practices are clearly superior to others. DCAA needs a more aggressive approach to benchmarking and spreading best practices among its regions for the compensation audit area.

Regional Compensation Programs

Regional Approach and Procedures. Each DCAA region established its own compensation system review program. Headquarters, DCAA provided some overall guidance on CSRs, but generally allowed the five regional offices to issue their own compensation-related guidance, training, and information to their FAOs. Consequently, the regions had different procedures for performing compensation system reviews. The regions also differed in their use of audit personnel. Three regions had area technical specialists performing compensation system audits of large contractors while FAO auditors performed other compensation reviews. The two remaining regions had a compensation specialist that provided compensation-related guidance to the FAOs, and FAO auditors performed the CSRs. One region had a team approach to perform compensation system audits and executive compensation reviews. In areas with inadequate coverage, two offices generally used FAO auditors, not technical specialists, to perform the CSRs.

Regional Assistance to the FAOs. Each region participated in the compensation program differently and at varying levels. Several regional office representatives received requests for information from the FAOs involving CSRs, requests for wage survey data, executive compensation reviews, severance pay, benchmarking techniques, incurred cost audits, proposal audits, and legislative caps. Regional office personnel also provided analyses and benchmark results for reasonable compensation and guidance on

audit programs and report findings. One regional representative indicated that FAOs were required to contact the compensation audit team to obtain benchmark analyses for reviews of executive compensation. One of the regional offices had very little input in assisting in compensated-related requests, because area technical specialists performed CSRs, and were also given the responsibility to give guidance to the field on compensation issues.

Regional Methods for Determining Reasonable Compensation. The regions had different methods on using market survey information when calculating a contractor's reasonable compensation. One region, which used the compensation audit team method for reviewing compensation, had access to 10 or more market surveys for determining reasonable compensation. The team calculated reasonable compensation by averaging several surveys to obtain a better benchmark of the contractor's jobs and strengthen the audit position. We agree with the compensation team representatives' comments that using several surveys provided for a more solid audit position, thus lessening disputes on unreasonable compensation findings. That approach had been sustained in two recent Armed Services Board of Contract Appeals cases. The other four regions generally used the survey that DCAA provided to all regions. DCAA needs to determine the best regional practices for all five regions to ensure they have access to the same surveys and that the FAOs have the most defensible position.

Monitoring of Compensation Reviews. At four of its five regions, DCAA had no monitoring system for CSRs nor a method for requesting feedback on unreasonable compensation findings to determine whether costs questioned were sustained. Two regions provided assistance and market survey information to the FAOs, but did not maintain files of FAO requests or perform followup procedures to determine how the information was used. Regional representatives stated that individual FAOs were responsible for tracking findings and unresolved issues. Two other regions provided the FAOs with pages from the market survey; however, the regions did not follow up on whether the FAO auditor used the survey data correctly. The regions that provided market survey information did not know how the FAO used the survey data or whether the information was useful to final results of the review. One regional compensation audit team monitored the results of its audit efforts for executive compensation by attaching a data sheet to the benchmark analyses and requested feedback from the FAO on costs questioned and sustained relative to the audit results.

Regional Training Packages on Compensation. Each region had its own compensation training package and workshop presentations. Some regional training materials were similar with excerpts from the prior DCAA compensation course and updated guidance involving new legislation for executive compensation. However, much of the training information contained various interpretations of compensation system reviews, ICAPS, audit programs, and benchmarking techniques. Some training materials were detailed and somewhat organized, while others included miscellaneous pages with no clear method of instruction. It is unlikely that the various training approaches and materials are equally effective.

Recommendation, Management Comments, and Evaluation Response

B. We recommend that the Director, Defense Contract Audit Agency ensure the spread of best practices for ensuring a generally consistent and most efficient approach among regions for the review of the compensation program.

Management Comments. DCAA nonconcurred. The regions are empowered to administer their own compensation review programs. DCAA further stated that our report did not link any of our findings to differences in regional practices or suggest that some regions performed in a superior manner because of their individual practices. DCAA contends that best practices are shared through regional compensation workshops with other regions. DCAA did not believe that the recommendation was adequately supported by the review findings. Thus, it believes our report does not make a compelling case to change its policy and procedures relative to compensation audits.

Evaluation Response. The DCAA comments were not responsive. We noted various regional procedures that enhanced the compensation reviews that would be useful if used by all regions. For example, one region used multiple market surveys that resulted in a more defensible position than the one survey others used. In addition, we believe contractors may try to exploit the different procedures and approaches DCAA regions use; therefore, the need for a generally consistent approach to the compensation program. While totally standardized approaches and practices are probably unnecessary, there are clear differences in the efficacy of the various approaches and practices now in use. Although DCAA intends the regional compensation workshops to be the mechanism for ensuring the spread of best practices, the results of our review indicated that they have not been particularly effective thus far in doing so. More aggressive measures to identify and spread best practices would not be incompatible with devolving responsibility for administering the compensation audit program, and would in fact assist those managers who are accountable. We have reworded the recommendation to clarify its intent. We request that DCAA reconsider its position and provide additional comments in response to the final report.

Finding C. Executive Compensation Legislation

Section 808 of the National Defense Authorization Act for FY 1998 eliminated confusion surrounding the FYs 1995 through 1997 legislation on the ceilings and applicable contract basis for executive compensation. However, the legislation did not establish the ceiling for all individuals in a company, only the five most highly compensated executives in each component. A sample of four of the largest defense contractors revealed that 51 executives' salaries exceeded the $340,650 ceiling; however, because they are not one of the five most highly compensated executives in each home office and segment, their salaries would be allowed. As a result, questioning only the salaries of the five most highly compensated individuals that exceeded the ceiling could result in unreasonable compensation being charged to Government contracts.

Executive Compensation Legislation

National Defense Authorization Act for Fiscal Year 1998. Section 808 of the National Defense Authorization Act for Fiscal Year 1998 (Public Law 105-85) placed a permanent limitation on the allowability of compensation for certain contractor senior executives. The new legislation established a benchmark compensation amount determined by the Administrator, Office of Federal Procurement Policy for compensation costs incurred after January 1, 1998, applicable to all covered Government contracts, including those contracts awarded before the enactment of the new limitation. The Office of Federal Procurement Policy set the compensation amount at $340,650 for the contractor fiscal year 1998. Section 808, defines "senior executive" as the chief executive officer of the contractor, or any individual acting in a similar capacity for the contractor; the four most highly compensated employees in management positions of the company other than the chief executive officer; and, in the case of a contractor that has components that report directly to the contractor's headquarters, the five most highly compensated employees in management positions.

Section 804 of the FY 1999 Defense Authorization Act (Public Law 105-261) revised the term senior executives to mean the five most highly compensated employees in management positions at each home office and segment of the contractor. The amendments apply to costs of compensation incurred after January 1, 1999.

Senior Executives Not Covered. Public Law 105-85 clarified considerable confusion as to the applicable periods and Public Law 105-261 clarified the individuals covered. However, the legislation does not cover all individuals in the company. Our sample of 4 of the top 10 defense contractors showed that 51 executives were excluded, although they earned more than the $340,650 ceiling. The average compensation to the excluded executives was $116,232 more than the ceiling, the highest compensation being $818,350 more. It has been the long-standing position of the Inspector General, DoD, that the cost

of compensation with respect to the services of any individual, not just the top five senior executives, be limited to a statutory cap. That is not a limitation on total compensation paid, but only a limit on the costs that may be charged to Government contracts.

To ensure that unreasonable compensation is not being charged to Government contracts, legislation should be revised to include all executives over the set benchmark compensation amount. Consequently, we drafted a revision to the Federal statutes (Appendix B) and forwarded it for inclusion in the DoD Omnibus Legislative Proposal for FY 2000.

Management Comments on Finding and Evaluation Response

Management Comments. Although not required to comment, the Director, Defense Procurement, Office of the Under Secretary of Defense for Acquisition and Technology (OUSD[A&T]) disagreed with the legislative proposal. The Director stated that the Department has consistently opposed all statutory caps on allowable compensation as unfair, administratively burdensome, contrary to acquisition reform initiatives, and having the potential to create a new impediment to the integration of the defense and commercial industrial base. The Director strongly opposed extending the current statutory cap to all contractor employees. She stated that DoD devoted significant resources to ensuring that the Government reimburse an allocable share of contractor compensation costs that are reasonable in comparison to those being paid by comparable firms. She also stated that a key part of the DCAA compensation reviews involve verification of a firm's procedures for maintaining comparability with similar firms through external pay surveys and market comparisons. She also noted that Section 804 of the FY 1999 Defense Appropriations Act already broadened the definition of senior executives subject to the statutory cap to include such individuals "at each home office and each segment of the contractor." The new definition no longer limits the cap to senior executives only at components that report directly to the contractors headquarters.

Evaluation Response. We disagree with the OUSD(A&T) position. While the language in Section 804 should reduce some of the confusion regarding to whom the cap is applicable, it could be further improved. Our proposal would eliminate the confusion and apply one cap to all employees. We believe this is a more logical and fair approach to congressional concerns about unreasonable compensation. It does not make sense to reimburse a contractor a set amount for the top five executives' compensation, however defined, but fully reimburse the same contractor for employees whose compensation is less but still more than the cap. In addition, the law only applies to managerial employees. Although the USD(A&T) noted that the DCAA uses external pay surveys and market comparisons for determining reasonableness in compensation, the surveys have little impact on salaries for large companies. Such surveys are self-serving in that they are based on excessive salaries of other contractors and have been unsuccessful as a sound basis to determine reasonableness of costs.

Our revision amends the statute to reflect the way the Office of Federal Procurement Policy and DCAA calculate the benchmark cap amount. The DCAA benchmarked cap is the median amount of compensation for the five most highly compensated employees

obtained from the Securities and Exchange Commission reports. However, the statute reads that the Office of Federal Procurement Policy and DCAA would have to benchmark the top five executives at each home office and each segment. That would be a monumental tasking because the data are not available. The proposed legislation agrees with the benchmark method that is employed by the Office of Federal Procurement Policy and DCAA. Although the legislation would benefit contractors by keeping the cap higher, the cap amount is readily determinable from the Securities and Exchange Commission reports without extensive audit effort and intrusion on contractors.

Part II - Additional Information

Appendix A. Evaluation Process

Scope

Work Performed. We conducted an evaluation of DCAA compensation audits that included visits to six DCAA FAOs and one regional office. We reviewed compensation system audits and followup compensation system reviews performed in FYs 1995, 1996, and 1997. The evaluation assessed the adequacy of audit coverage and reporting, audit guidance, and contractors' compliance with legislation requirements in other related audits. We reviewed the regional offices' participation in the compensation system program such as training packages, audit guidance, monitoring processes and follow up efforts, and assistance provided to the FAOs. We also reviewed corrective measures management took in response to Report No. APO 95-009.

We obtained compensation data on 4 of the top 10 DoD contractors executive compensation to estimate the cost impact of the latest $340,650 executive compensation cap for Contractor Fiscal Year 1998. The information was available for costs incurred in Contractor Fiscal Year 1996.

DoD-wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to the GPRA, 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. We selected FAOs to review based on data we received from the DCAA Agency Management Information System. Based on our previous reviews of the accuracy of DCAA data in the Inspector General, DoD, Semiannual Report to Congress and the actions DCAA has taken in response to conditions identified, we considered the data adequate for our review.

Universe and Sample Selection. We judgmentally selected six offices to visit from the five DCAA regions. The selections were based on our analyses of information we obtained from the DCAA Agency Management Information System. The criteria we used for office selection were the volume and most recent audits completed. We visited the Mid-Atlantic Region Compensation Team to determine how it accomplished compensation reviews.

We reviewed 16 compensation system audits, 4 follow-up compensation system reviews, related assignments such as incurred costs audits, forward pricing reviews, proposal audits, and regional office documentation received from the field on compensation issues. At one DCAA resident audit office, DCAA was unable to locate the audit working papers for the compensation system review or provide an explanation for the missing records. Although the working papers were not available for our review, we included that audit location in our evaluation because we were able to evaluate the contractor's methods for complying with the legislations involving executive compensation.

We interviewed representatives from each region to assess their participation in the compensation program. We sampled FAO requests from three of the five regions to determine the scope of assistance provided to the FAOs, how the information was used, whether unreasonable compensation was properly reported, and whether questioned costs were sustained. We did not request this information from two of the regions because they did not maintain FAO requests in their files.

Evaluation Type, Dates, and Standards. We performed this evaluation from October 1997 through June 1998 in accordance with standards implemented by the Inspector General, DoD. We did not include tests of management controls.

Contacts During the Evaluation. We visited or contacted representatives from DCAA Headquarters, regional offices, and FAOs. Details are available on request.

Appendix B. Proposed Legislation

SEC. ___ LIMITATION ON ALLOWABILITY OF COMPENSATION FOR CERTAIN CONTRACTOR PERSONNEL.

Section 2324 of title 10, United States Code is revised by eliminating subsection (l)(5), redesignating subsection (l)(6) as subsection (l)(5), and amending section 2324(e)(1)(P) of title 10 to read as follows:

Section 2324 (e) **Specific costs not allowable.**

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

(P) Costs of compensation of all employees of a contractor for a fiscal year, regardless of the contract funding source, to the extent that such compensation exceeds the benchmark compensation amount determined applicable for the fiscal year by the Administrator for Federal Procurement Policy under section 39 of the Office of Federal Procurement Policy Act (41 U.S.C. 435). The term "contractor" shall include all corporate offices and other entities, which report directly or indirectly to the contractor.

Section 306 of the Federal Property and Administrative Services Act of 1949 (41 U.S.C. 256) is revised by eliminating subsection (m)(2), redesignating subsection (m)(3) as subsection (m)(2), and amending section 41 U.S.C. 256(e)(1)(P) to read as follows:

Section 41 U.S.C. 256(e) **Specific costs not allowable.**

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

(P) Costs of compensation of all employees of a contractor for a fiscal year, regardless of the contract funding source, to the extent that such compensation exceeds the benchmark compensation amount determined applicable for the fiscal year by the Administrator for Federal Procurement Policy under section 39 of the Office of Federal Procurement Policy Act (41 U.S.C. 435). The term "contractor" shall include all corporate offices and other entities, which report directly or indirectly to the contractor.

Section 39 of the Office of Federal Procurement Policy Act (41 U.S.C. 435) is revised by eliminating subsection (c)(2), redesignating subsections (c)(3), (c)(4), and (c)(5) as subsections (c)(2), (c)(3), and (c)(4), respectively, and amending section 41 U.S.C. 435(b) to read as follows:

Benchmark compensation amount. The benchmark compensation amount applicable for a fiscal year is the median amount of the compensation provided for the five most highly compensated employees of all benchmark corporations for the most recent year for which data is available at the time the determination under subsection (a) is made.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
    Deputy Under Secretary of Defense (Acquisition Reform)
    Director, Defense Procurement
    Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Assistant Secretary of Defense (Legislative Affairs)
Assistant Secretary of Defense (Public Affairs)
General Counsel

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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 Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform

Part III - Management Comments

Under Secretary of Defense for Acquisition and Technology Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

January 6, 1999

DP/CPF

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

SUBJECT: Evaluation Report on Defense Contract Audit Agency Compensation Audits (Project No. 70C-9045)

We wish to offer the following comments regarding Finding C (Executive Compensation Legislation) and the accompanying DoD Inspector General (DoDIG) legislative proposal (Appendix B) in the subject draft audit report. This proposal, which the DoDIG forwarded for inclusion in the DoD Omnibus Legislative Proposal for FY 2000, would amend 10 U.S.C. 2324 and 41 U.S.C. 256 to extend the current statutory limitation on allowable compensation costs for senior executives of Government contractors to all employees of such contractors.

I do not concur in this legislative proposal. The Department consistently has opposed all statutory caps on allowable compensation costs as unfair, administratively burdensome, contrary to acquisition reform initiatives, and having the potential to create a new impediment to the integration of the defense and commercial industrial bases. We believe that compensation for defense industry executives should fall within the same range as compensation for comparable executives in U.S. industry, so that the defense industry can continue to attract capable top management. Moreover, if contractors are barred from recovering a fair portion of their labor costs on DoD contracts, the Department's ability to attract offerors for future procurements could be impaired. Accordingly, we are strongly opposed to extending the current statutory cap to all contractor employees.

As a justification for its legislative proposal, the DoDIG asserted that capping only senior executive compensation "could result in unreasonable compensation being charged to Government contracts." This is incorrect. Independent of the statutory cap, DoD devotes significant resources to ensuring that we only

reimburse our allocable share of contractor employee compensation costs that are reasonable in comparison to those being paid by comparable U.S. firms. A key part of the Defense Contract Audit Agency's (DCAA) regular compensation reviews for large defense contractors involves verification of a firm's procedures for maintaining comparability in compensation with similar firms through such tools as external pay surveys and market comparisons. Our contracting officers act upon DCAA's recommendations either to disallow compensation amounts they determine to be unreasonable or to reach agreement that such costs will not be claimed on Government contracts.

It also appears that the DoDIG is unaware that Section 804 of the FY99 Defense Authorization Act (P.L. 105-261) has already greatly broadened the definition of senior executives subject to the statutory cap, to include such individuals "at each home office and each segment of the contractor." Contrary to the arguments advanced by the DoDIG in support of its legislative proposal, this new definition no longer limits the cap to senior executives only at components that report directly to the contractor's headquarters. Therefore, we recommend the DoDIG delete Finding C and Appendix B from its audit report.

Eleanor Spector

Eleanor R. Spector
Director, Defense Procurement

Defense Contract Audit Agency Comments

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

IN REPLY REFER TO

PIC 225 [IG 70C-9045] 26 January 1999

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

ATTN: Ms Barbara Smolenyak

SUBJECT: Response to DoDIG Draft Evaluation Report on Defense Contract Audit Agency Compensation Audits (Project No. 70C-9045)

From an overall perspective, there were clearly few material instances of DCAA failing to determine the adequacy of contractors' compensation processes, identify contractors for review, properly report audit results or question unallowable costs Several of the report's summary conclusions are not adequately supported by the review findings Finally, we nonconcur with four out of five report recommendations.

Based on the evidence gathered, we believe the conclusion is that in all material respects, DCAA's audit coverage of contractors' compensation systems and costs is generally adequate It is unfortunate that the draft report failed to recognize this

In view of the external interest in the communications between our organizations regarding your reviews, we stand ready to work with you and your staff before the final report is issued to ensure that: (1) factual differences are eliminated and (2) findings and recommendations are based on material instances of noncompliance with DCAA audit policy. When significant problems are identified, we will quickly take corrective action However, we cannot afford to make widespread changes in audit procedures without credible evidence that there is a problem

Enclosed is a detailed analysis of the report You may delete the FOUO markings when including our response in your final report Questions regarding this memorandum should be directed to Mr. Peter Roppolo, Chief, Incurred Cost Division (PIC), at (703) 767-3245, or to me at (703) 767-3280

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosures - 2
1. DCAA Analysis of Draft DoDIG Evaluation Report, Project No. 70C-9045
2 DCAA, Northeastern Region Memo on Compensation Training Meeting Follow-up, 4 Mar 1996

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

1. Unsupported Summary Statement

DoDIG [Executive Summary, Evaluation Results, p i Also, Finding A, p.6]:

> ***Evaluation Results.*** *The DCAA had properly implemented guidance to determine whether contractors were complying with the legislation limiting executive compensation. However, DCAA needed to improve its audit performance, reporting, and guidance on compensation system reviews.* ***As a result, the failure of DCAA to determine the adequacy of contractors' compensation processes, identify contractors for review, and properly report its audit results may have resulted in unreasonable compensation costs being allowed*** *(Emphasis added.)*

DCAA: We do not believe the IG's broad characterization of DCAA audit work is adequately supported by the review findings DCAA performed 437 compensation audits in Government Fiscal Years (GFYs) 1995, 1996, and 1997 - the years principally covered by the subject IG review These 437 audits included compensation system reviews, follow-up audits and reviews of executive compensation Each audit entailed multiple analyses, decisions, judgments, and conclusions. The IG evaluators judgmentally reviewed 16 DCAA audits performed in GFYs 1995, 1996, and 1997 This limited review has not provided conclusive, objective data as to the relative significance or rate of instances where DCAA audit work was materially insufficient to support the conclusions reached. Based on the evidence gathered, we believe the conclusion is that in all material respects, DCAA's audit coverage of contractors' compensation systems and costs is adequate.

2. General Comments

DoDIG [Finding A Adequacy of Compensation System Audits, p 8]:

> *Six of the sixteen audits reviewed did not have adequate documentation of the contractor's benchmarking techniques and did not use external market surveys to evaluate the reasonableness of the contractor's compensation*

DCAA: These observations actually cover two parts: (1) six of the sixteen audits reviewed did not have adequate documentation of the contractor's benchmarking techniques and (2) six of the sixteen audits reviewed did not use external market surveys to evaluate the reasonableness of the contractor's compensation

We do not believe that the observations regarding the adequacy of audit documentation are accurate with respect to four of the six contractors. However, we do agree the observations are accurate as they apply to compensation audits at two of the contractors These two observations occurred at the same Field Audit Office (FAO) As such, we believe they are anomalies, not evidence of systemic inadequacies. The FAO Manager has agreed to ensure that future compensation audits document the review of the contractors' benchmarking techniques In addition, the Regional Audit Manager will follow-up and discuss the IG report findings with the FAO manager and supervisory auditors to emphasize documentation requirements

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

Adequate Documentation of Benchmarking

At four of the contractors cited, we believe that documentation exists to support the adequacy of the benchmarking

Contractor A. The auditor relied on a previous compensation audit that determined the system was adequate This previous audit included an extensive review of the contractor's benchmarking technique Section C of the audit working papers reviewed by the DoDIG documented the results of prior review and the reliance the auditor placed on the prior review. The auditor's review of the contractor's policies and procedures disclosed no significant system changes from the prior compensation review. Additionally, in working paper section G, the auditor performed compliance testing using a probe sample of 30 employees to review various attributes of the contractor's procedures The auditor did use external market surveys as part of this probe sample No exceptions were noted in that analysis The previous and current audits both assessed risk as low The completed Internal Control Audit Planning Summary (ICAPS) for the previous audit was included in the working papers Since the benchmarking procedures in effect had not changed from the prior review, no additional review, other than the sample probe, was considered necessary.

Contractor B. We believe the audit working paper file contains adequate documentation supporting the contractor's benchmarking technique such as (i) a listing of positions benchmarked by the contractor's Human Resources Office, (ii) copies of job descriptions, and (iii) copies of external surveys used by the contractor to benchmark positions The working papers explain the benchmarking technique used by the contractor and that the auditor relied on audit work from the prior compensation review Additionally, the auditor performed compliance testing of the contractor's benchmarking technique by verifying the contractor's benchmarking analysis to the contractor's market survey for several job positions The compliance tests disclosed no exceptions; accordingly, the auditor concluded the controls and policies reviewed were adequate to ensure compensation levels maintained by the contractor were reasonable

Contractor C. The corporate office is cognizant of the compensation system, wage and salary structure, and policies and procedures Thus, there was no need for the local auditor to review the contractor's benchmarking or use the contractor's external market surveys. However, we agree the audit report should have clearly explained this reduced audit scope

Contractor D. We performed extensive benchmarking of the majority of positions available at several contractor locations At other locations, the contractor had just performed a 100 percent evaluation and we reviewed its work product We reached an agreement with the contractor that only the positions determined to be unreasonable would be copied and included in the working papers because the contractor was concerned with this very sensitive data being available for anyone to see We documented our level of effort (including the positions benchmarked) in our working papers, but the actual schedules with detailed personnel data were not included The benchmarking revealed no unreasonable compensation

Use of External Market Surveys

We do not believe the observations regarding the use of external market surveys are accurate As noted in the three cases described above (all except Contractor C), we reviewed the contractors' benchmarking as part of these compensation audits by virtue of the fact that we tested and relied on the contractor's benchmarking and external surveys These audits disclosed no system deficiencies or specific policies or procedures that appeared to promote unreasonable compensation costs Consequently, it was not necessary to perform extensive auditor benchmarking of employee compensation costs The criteria set forth in FAR 31 205-6, and our Agency guidance contemplated that the auditor use good judgment in establishing the scope of audit For example:

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

- FAR 31 205-6 (b)(1) states, "In administering this principle, it is recognized that not every compensation case need be subjected in detail to the tests described in this cost principle. The tests need be applied **only when a general review** reveals amounts or types of compensation that appear unreasonable or unjustified " (Emphasis added)

- CAM 6-413 2 states, "If it is determined that the contractor has established and maintained a sound compensation system, **it should not be necessary** to apply the tests of reasonableness per FAR 31.205-6 (b)(1), unless warranted by specific policies or procedures that appear to promote unreasonable costs." (Emphasis added.) CAM 6-413 also states, "The scope and extent of any testing for reasonableness should be based on the control risk assessment and results of the review of internal controls over compensation "

Based upon these precepts, the testing of the contractor's benchmarking was deemed sufficient to satisfy the audit objectives.

DoDIG [Finding A Adequacy of Compensation System Audits, p 8]:

> *Two audits attempted to perform benchmarking analyses; however, the workpapers did not contain evidence of the contractor's benchmarking process and types of documents the auditor reviewed, such as grade levels benchmarked, positions benchmarked, appropriateness of surveys used, salary comparisons, and dates when the benchmarks were performed The workpapers did not document whether the contractor's benchmarking was adequate, the auditor reviewed and relied on the contractor's benchmarking, or additional benchmarking was performed by the auditor.*

DCAA: We do not believe these observations properly reflect the facts of the two compensation audits cited

Contractor A. As discussed above, the FAO based the audit scope and degree of compliance testing on the prior compensation audit, related audit effort and permanent files The reliance on this information and the resulting risk assessment was documented in the audit working papers The conclusions of the subject review were documented stating that the contractor's controls and system are adequate to ensure the contractor maintains compensation at reasonable levels.

Contractor B. The audit working paper file includes copies of the contractor's benchmarking surveys, a listing of positions benchmarked by the contractor, copies of contractor job descriptions and a clear opinion that no exceptions or discrepancies were disclosed with respect to the contractor's benchmarking. The working papers also include a clear statement of the continuing adequacy of the contractor's compensation system. The conclusion was based on reviews in the prior audit The audit file documented the subject audit supporting the contractor's continued practice of using procedures previously audited and determined adequate.

DoDIG [Finding A. Adequacy of Compensation System Audits, p 8]:

> *The workpapers for four audits contained no documentation of benchmarking Those audits simply included a collection of policies and procedures and no testing of the reasonableness of the contractor's compensation system*

DCAA: We agree that two of the four observations are accurate However, as noted above, these two observations occurred at the same FAO As such, we believe they are anomalies, not evidence of

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

systemic inadequacies To ensure that this office adequately considers benchmarking in future compensation audits, we will take the following action:

- The Regional Audit Manager will discuss the IG report findings with the FAO manager and supervisory auditors, and
- The FAO will prepare an audit lead sheet to note the requirement to include a review of the contractor's benchmarking techniques and processes in the next scheduled compensation system audit

For the other two audits, we do not believe the observations are accurate as they apply to the compensation audits at the following two contractors:

Contractor C. As noted above, the corporate office is cognizant of the compensation system, wage and salary structure, and policies and procedures Thus, there was no need for the local auditor to review the contractor's benchmarking or use the contractor's external market surveys However, we agree the audit report should have clearly explained this reduced audit scope

Contractor D. As outlined above, we believe the audit file contains the documentation to support that we used the contractor's benchmarking schedules and found no unreasonable costs We also documented the various Grade Levels and categories covered by the benchmarking

DoDIG [Finding A Adequacy of Compensation System Audits, p 9]:

> *In two instances, contractors were not reviewed although their sales exceeded the DCAA threshold for a compensation review Because DCAA did not maintain the sales data to determine which contractors exceeded the threshold, there was no assurance that all contractors were reviewed. DCAA indicated that the $50 million threshold was an arbitrary amount established years ago based on the threshold for a Material Management and Accounting System review Since that time, the Material Management and Accounting System review threshold has been increased to the $70 million auditable dollar volume used to identify major contractors No regulation or statute required the $50 million sales threshold Because DCAA offices did not track sales data, we believe the threshold for a CSR review should be changed to the DCAA major contractor designation.*

DCAA: We agree with one of the observations The FAO did not perform a compensation system review during the third year of the three-year cycle (GFY 1998) because the contractor is not a major contractor ($70 million threshold). As observed above, this is not in accordance with guidance in existence at the time of the DoDIG review. However, as suggested by the DoDIG, the CAM has been revised to require compensation system reviews at major contractors

We do not believe the second observation is accurate. The previous audit, performed in 1995, showed that the compensation system, except for severance pay, was adequate The review was a follow-up to evaluate the corrective action taken by the contractor for the severance pay The compensation system was deemed low risk, except for severance As the DoDIG draft report correctly noted; CAM, section 5-803b, "DCAA's General Audit Policy for Compensation System Review(s) (CSR)," provides that "The CSRs may be waived or modified if experience and current audit risk are considered to be low " This is what was done in this case

DoDIG [Finding A Adequacy of Compensation System Audits, p 10]:

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

Reporting of Unreasonable Compensation. DCAAM, section 5-811.2c. and e, "Reporting on CSR Results of Audit," require that unreasonable costs be reported in the compensation system report as a cost avoidance and that a recommendation be made to the ACO to put the contractor on notice of the Government's intent to disallow unreasonable compensation costs if the contractor fails to take timely corrective action within one year. Report No 95-009, stated that $700,000 in unreasonable executive compensation was not reported ***During this evaluation, we identified $76,617 of unreasonable costs that were not reported*** (Emphasis added.) *Management indicated that those costs were not reported because the CSR review was intended to focus on the internal controls to satisfy the agency's ICAPS requirements and another review would be set up to report the unreasonable costs found in the compensation system review As a result, the cost exceptions were not formally presented to the contractor so that corrective actions could be taken*

DCAA: We do not agree with the observation that $76,617 of unreasonable compensation costs was not reported. Our audit report identified six reportable deficiencies in contractor's system, stated the contractor did not adequately monitor compensation for executives, and rated the system overall as inadequate in part. We also stated we would question the costs in subsequent forward pricing reviews as well as in incurred cost audits. We did, in fact, subsequently question the cost in our incurred cost audit report The IG's finding must refer to the fact that we did not mention the amount of the unreasonable costs in the compensation system report reviewed Although the specific amount of excessive executive compensation was not mentioned in the report, we did discuss it with the ACO and we questioned the cost in a separate incurred cost audit report We also mentioned in the internal control report that the contractor had significant deficiencies that needed correction immediately.

The IG's reference to the $700,000 in unreasonable executive compensation reported in DoDIG Report No. 96-009, dated 3 July 1995, is not appropriate for inclusion in this report That report observed that $700,000 of unreasonable executive compensation may have resulted by allowing offsets without appropriate justification. We agreed in our response to that report to review and supplement the identified DCAA audit reports if inappropriate offsets were used The alleged unreported unreasonable cost in the current report (which, as stated above, we dispute) does not relate to contractor offsets. Even if it did, the nearly 90 percent reduction in the dollar amount would seem to be evidence of a significant improvement rather than a continuing systemic problem

DoDIG [Finding A. Adequacy of Compensation System Audits, p 10]:

Reporting Significant Compensation System Deficiencies. DCAAM, section 10-408, "Results of Audit for Functional Reports," requires that items found during system reviews that do not affect the adequacy of the system, but would enhance the system if corrected, be reported as suggestions to improve the system, not as system deficiencies ***Two audits improperly reported significant compensation system deficiencies as suggestions to improve the system.*** (Emphasis added) *The audits reported that the contractor had no documented methodology for benchmarking and market comparisons, and that the contractor did not have current written policies and procedures for key elements of the compensation system They also reported that the compensation systems were "inadequate in part" with other significant deficiencies affecting major parts of the system. FAO representatives stated that the contractor was not required to correct those items that were listed as suggestions to improve the system Significant deficiencies, such as lack of methods for benchmarking and no current compensation system policies, should be reported as system deficiencies with conditions and recommendations so that the contractor will be required to implement corrective actions*

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DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

DCAA: The observations pertaining to the two contractors are not fully accurate We do not agree that the lack of written procedures for benchmarking should have been reported as a significant deficiency At both contractors we determined that the deficiency was not significant because each contractor actually performed adequate benchmarking One contractor benchmarked over 50 percent of its positions and the other had an outside consulting firm do 100 percent benchmarking of all positions in the year that we reviewed The lack of written procedures did not adversely affect each contractor's compliance with the FAR Nevertheless, in both audits, because of the other significant deficiencies, the compensation systems were reported as 'inadequate in part " We believe the opinion expressed in both audits was correct

DoDIG [Finding A Adequacy of Compensation System Audits, p 10]:

> *Assessment of Overall Compensation System. DCAAM, section 5-811 2, "Reporting on CSR Results of Audit," states that control deficiencies will be reported even if the CSR does not find unreasonable costs caused by those deficiencies. However, the guidance did not address the course of action to be taken if significant deficiencies did not allow the auditor to determine whether the compensation costs were reasonable DCAAM, section 5-811, "Compensation System Review and Audit Report," also refers the auditor to section 10-400 for additional reporting guidance on system reviews According to DCAAM, section 10-408, "Results of Audit for Functional Reports," " . .if the deficiencies affect only parts of the system, then the audit opinion should state that the system is inadequate in part. , and if the deficiencies are so significant that the entire system is unreliable, then the audit opinion should report that the system is inadequate "*
>
> ***In one assignment, the auditor reported in the "Results of Audit" section of the audit report that the compensation system and related internal control policies and procedures were "inadequate in part", but the auditor should have reported that the compensation system was "inadequate".*** (Emphasis added) *The report further stated that system deficiencies adversely affected the contractor's ability to ensure that reasonable and allowable employee compensation costs were included in Government proposals and charged to Government contracts and subcontracts in accordance with applicable Government contract laws and regulations Because of the nature of the deficiencies, a cost impact could not be determined The contractor disagreed with the auditor's recommendations Consequently, the auditor recommended that the ACO instruct the contractor to immediately put into effect an action plan to correct the deficiencies within a reasonable period However, the ACO had reservations about making a determination on that issue because DCAA was unable to calculate whether unreasonable compensation existed.* ***The failure to properly assess whether the compensation system was sound and reasonable may result in unreasonable compensation costs being allowed. DCAA needs guidance to assist the auditor when deficiencies prevent assessing whether a contractor's compensation system is reasonable. The guidance should instruct the auditor to perform benchmarking techniques and other steps necessary to determine reasonableness of compensation.*** (Emphasis added)

DCAA: We do not agree that the contractor's compensation system should be reported as "inadequate". When some parts of the system are adequate, the determination whether a system as a whole is "inadequate" or "inadequate in part" is a matter of auditor judgement (after giving consideration to DCAA guidance) The deficiencies related only to two of the four control objectives (policies and procedures and management reviews) and affected only parts of the overall compensation systems The contractor had adequate internal controls related to the control objectives for training and

Final Report Reference

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

organizational structure. Therefore, the auditor's determination as "inadequate in part" is considered correct and in accordance with Agency guidance (CAM 10-408a(2))

The DoDIG report erroneously concludes that since the nature of the system deficiencies prevented the determination of a cost impact, the deficiencies resulted in the entire system being unreliable. The latter portion of the finding quoted above further suggests that the auditor is unable to conclude whether a system is adequate or not unless a cost impact CAN be determined. As is true with many internal control areas, the adequacy of the compensation system is unrelated to the auditor's ability to compute a cost impact for system deficiencies

DoDIG [Finding A. Adequacy of Compensation System Audits, p.6]:

> *The auditors were also not adequately trained because DCAA delayed implementing the agreed to recommendation from our prior review to develop a self-study compensation training course*

DCAA: We do not agree This observation is not adequately supported by the review findings. We believe the auditors are adequately trained Training is disseminated from each region to the compensation technical specialists. The technical specialists either work with the auditors performing the reviews, or they perform the audits themselves. Each region has updated the basic DCAI Course No. 1291 on compensation reviews for their use. In March 1996, the Northeastern Region took the lead to informally update the course for the other regions as part of an ad hoc group on compensation audits (see Enclosure). The updated compensation course material has been shared among the regions several times and each region has also updated the course for its individual needs The formal Agency-wide course update was scheduled for completion by 31 December 1998 However, since each region had adequate training material for compensation audits, the urgency for a new Agency-wide training course was reduced This new training course is now scheduled for completion by 30 September 1999.

3. Recommendations

The draft report contains five separate recommendations We concur with Recommendation A-4 and have taken appropriate action to close out this recommendation However, we nonconcur with Recommendations A-1, A-2, A-3 and B. Our comments regarding the five recommendations are detailed below

DoDIG Recommendation A-1

> *We recommend that the Director, Defense Contract Audit Agency remind auditors to properly report all unreasonable compensation costs and to properly report compensation system deficiencies*

Deleted

DCAA: Nonconcur The first part of this recommendation, *remind auditors to properly report all unreasonable compensation costs*, is based on a DoDIG-alleged single occurrence of $76,617 of unreasonable compensation not reported As discussed in 2. above, those unreasonable compensation costs were reported. The DoDIG report disclosed only a few instances where auditors failed to report compensation system deficiencies As discussed above, these one or two occurrences primarily relate to a single field audit office and do not reflect evidence of significant systemic inadequacies.

DCAA Analysis of Draft DoDIG Evaluation Report on DCAA Compensation Audits (Project No.70C-9045)

DoDIG Recommendation A-2

We recommend that the Director, Defense Contract Audit Agency revise Defense Contract Audit Agency Contract Audit Manual, section 5-811 2, "Reporting on Compensation System Review Results of Audit," to state that if an audit cannot determine whether compensation costs are reasonable, then the compensation system should be reported as inadequate

DCAA: Nonconcur We believe that current CAM guidance is adequate This recommendation relates to the finding that one audit report contained an inappropriate opinion regarding the adequacy of the contractor's compensation system An discussed above, we disagree that the audit opinion was inappropriate. The determination whether a system is "inadequate" or "inadequate in part" is a matter of auditor judgement (after giving consideration to DCAA guidance). A review of the working papers, however, disclosed that this was not the case. The deficiencies related to only two control objectives and affected only parts of the overall compensation systems The contractor's internal controls for the training and organizational structure control objectives were considered to be adequate Therefore, the auditor's determination as "inadequate in part" is considered correct and in accordance with Agency guidance (CAM 10-408a(2))

We further believe that the DoDIG report erroneously concludes that since the nature of the system deficiencies prevented the determination of a cost impact, the deficiencies resulted in the entire system being unreliable As is true with many internal control areas, the adequacy of the compensation system is unrelated to the auditor's ability to compute a cost impact for system deficiencies.

DoDIG Recommendation A-3

We recommend that the Director, Defense Contract Agency revise guidance to include instructions on additional steps the auditor should take to determine the reasonableness of a compensation system when a contractor does not have job descriptions and benchmarking

DCAA: Nonconcur. The IG's report describes a case where DCAA issued a report that found the contractor's compensation system to be partially inadequate and which recommended changes The contractor did not agree to revise its system, and the ACO was reluctant to make a determination on the issue. DCAA guidance already requires the auditor to determine the reasonableness of a compensation system when a contractor lacks job descriptions and benchmarking CAM 6-413.2.b states:

> Should the results of review of the contractor's compensation system (see 5-800) determine that significant deficiencies exist, specific testing for the reasonableness of the compensation resulting from the system should be conducted under FAR 31 205-6(b)(1)

In the one case cited in the report, the FAO failed to follow the existing guidance. Regional management will reemphasize this guidance to all FAOs during the next regional compensation workshop We do not, however, believe that any DCAA guidance revisions are necessary

DoDIG Recommendation A-4

We recommend that the Director, Defense Contract Audit Agency revise guidance to clarify the terms and the established time period for questioning unreasonable compensation costs.

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DCAA: Concur. We are in the process of revising the CAM guidance. As part of this revision, we will clarify the terms and the established time period for questioning unreasonable compensation costs The updated CAM guidance will be issued by 31 July 1999.

DoDIG Recommendation B

We recommend that the Director, Defense Contract Audit Agency develop a best practice for ensuring a generally consistent approach among regions for the review of the compensation program.

DCAA: Nonconcur We agree that there are differences in the way each of the regions administer their compensation system audit program. Indeed, the regions are empowered to administer their own compensation programs However, the IG report does not link any of its findings to differences in regional practices, or suggest that some regions performed in a superior manner because of their individual practices Each region shares their best ideas and practices during regional compensation workshops that include participants from other regions We do not believe the recommendation is adequately supported by the review findings Therefore, the report does not make a compelling case to change our current policy and procedures relative to compensation audits

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DEFENSE CONTRACT AUDIT AGENCY
NORTHEASTERN REGION
83 Hartwell Avenue
Lexington, Massachusetts 02173-3163

IN REPLY REFER TO

RST-2 322.1

4 March 1996

MEMORANDUM FOR DISTRIBUTION

SUBJECT: Compensation Audit Training Meeting Follow-up

As requested, enclosed please find copies of the Northeastern Region's proposed course revisions for Compensation Course No. 1291 and the Northeastern Region's Compensation Reference Book.

Our Regional Support Team prepared the course revisions after conducting the compensation workshop last spring. The team also developed the Compensation Reference Book to assist auditors conducting compensation audits. Feedback on the course and the reference book has been positive We hope you can use the information to your benefit.

Please note that, among other materials, the reference book contains pro-forma audit working papers developed by the Mid-Atlantic Region and a sample compensation audit report developed by Deborah Brightful of our Technical Programs Division. We are providing the working papers and audit report sample to you in both hard copy and file form. We are updating the files using the new software and will forward them to you when complete.

We are interested in receiving similar information from other regions regarding new audit approaches and regional training materials. We would also like a list of regional compensation contact points so that we can share information of mutual benefit. The following individuals are involved with providing regional support for compensation audits in the Northeastern Region:

Name	Title	cc:Mail	Telephone/Fax
Joseph D. Meehan	Technical Programs Manager	*RST-2	(617) 377-9830/9762
Al Allegretto	Staff Specialist	*RST-2	-9834/9762
Nancy Hiatt	Staff Specialist	*RST-2	-9812/9762
Joyce McKenna	Staff Specialist	*RST-2	-9813/9762

As discussed at the training meeting, we believe that establishing a cc:Mail network/distribution list of individuals involved in compensation (e.g., HQs Program Manager, Regional Monitors and Technical Specialists, DCAI, and Committee

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RST-2 322.1 4 March 1996
SUBJECT: Compensation Audit Training Meeting Follow-up

Members) would be an efficient way to share information including "best practices" and to keep each other up to date on current compensation topics.

We would like more information on how the compensation monitoring function is organized in other regions. In this regard, we are interested in receiving copies of any Regional Instructions that cover regional compensation monitoring and support.

We are also interested in information regarding any surveys other regions purchase in addition to the U. S. Chamber of Commerce Employee Benefits Report and the Wyatt Compensation Surveys Specifically, names of the surveys, how they have proven useful, how many years have they been used, what positions the survey covers (e.g., executives, technical personnel) the type of survey (compensation, fringe benefits), the cost of the survey, and a purchasing source.

We also invite comments on the enclosed reference book and instructional materials. Please direct comments or questions to Mr Joseph Meehan, RST-2, at (617) 377-9830.

RONDA L. CHINN
Special Programs Manager

Enclosures, a/s

DISTRIBUTION:
HQs (PIC) (w/o Encls.)
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Evaluation Team Members

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

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