Oversight Report

DEFENSE CONTRACT AUDIT AGENCY REVIEWS
OF PRICE PROPOSALS

Report Number PO 98-6-013 June 18, 1998

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Acronyms

ACO	Administrative Contracting Officer
AMIS	Agency Management Information System
CO	Contracting Officer
DCAA	Defense Contract Audit Agency
DCAM	DCAA Contract Audit Manual
DCMC	Defense Contract Management Command
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
FAO	Field Audit Office
FMIS	FAO Management Information System
FPRA	Forward Pricing Rate Agreement
FPRR	Forward Pricing Rate Recommendation
GAS	Government Auditing Standards
MRD	Memorandum for Regional Directors
NAVSEA	Naval Sea Systems Command
PAT	Process Action Team
PCO	Procurement Contracting Officer
SUPSHIP	Supervisor of Shipbuilding, Conversion, and Repair

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June 18, 1998

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

SUBJECT: Evaluation Report on Defense Contract Audit Agency Reviews of Price Proposals (Report No. PO 98-6-013)

We are providing this final evaluation report for review and comment. We considered management comments to our draft report dated January 12, 1998, in preparing the final report.

This report is second in a series of two reports related to field pricing. This report addresses Defense Contract Audit Agency field pricing support to procurement and administration offices. The first, Report No. PO 97-058, "Evaluation of DoD Requests for Field Pricing Audit Support," September 30, 1997, addressed DoD procedures for requesting field pricing.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, we revised Recommendation 1.c. to the Defense Contract Audit Agency to clarify our intention. We request that the Director, Defense Contract Audit Agency provide comments to the final report by August 17, 1998. The Assistant Secretary of the Navy (Financial Management and Comptroller) comments to the draft report conformed to the requirements of DoD Directive 7650.3; therefore, additional comments from the Assistant Secretary are not required.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation should be directed to Ms. Madelaine E. Fusfield at (703) 604-8739 (DSN 664-8739) (email mfusfield@dodig.osd.mil) or Mr. Terrence J. Letko at (703) 604-8759 (DSN 664-8759) (email tletko@dodig.osd.mil). Please refer to Appendix D for the distribution of the evaluation report. The evaluation team members are listed inside the back cover.

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Report No. PO 98-6-013 **June 18, 1998**
(Project No. 6OC-0086.1)

Defense Contract Audit Agency Reviews of Price Proposals

Executive Summary

Introduction. This report is the second related to field pricing. This report addresses Defense Contract Audit Agency field pricing support to procurement and contract administration offices. The first, Report No. PO 97-058, "Evaluation of DoD Requests for Field Pricing Audit Support, September 30, 1997, addressed DoD procedures for requesting field pricing.

Auditors perform field pricing reviews of contractor price proposals when procurement office information is insufficient to perform the cost or price analysis needed to negotiate contract prices. According to Federal Acquisition Regulation part 15, "Contracting by Negotiations," audit services should be tailored to provide the minimum supplementary information necessary. Auditors are responsible for the depth and scope of the audit service as well as helping the contracting officer determine the required field pricing and specific areas of coverage. Informal telephone rate procedures are acceptable when pricing information based on recent audits and existing accounting information is available at the audit office. For FY 1996, the Defense Contract Audit Agency (DCAA) completed more than 11,000 formal audits and reviews, using 414 staff years exclusive of supervision. An additional 167 staff years were expended to review forward pricing rates associated with contractors' proposals.

Evaluation Objectives. The overall objective was to evaluate the processes used to request and complete Defense Contract Audit Agency audits and reviews of contractor price proposals, with emphasis on major weapons programs.

Evaluation Results. Our review of seven field audit offices, six contract administration field offices, and four military procurement offices showed that the scope of audit services was appropriate for large proposals when contractors were required to submit cost or pricing data. However, when pricing information was already available, auditors performed many unnecessary audits on low-risk proposals. Of 85 proposal audits and formal agreed-upon procedure reviews that we judgmentally selected for evaluation during field visits, 58 were unnecessary because pricing information was already available without further review procedures. Additionally, 129 of 255 agreed-upon procedure reviews statistically selected for evaluation were unnecessary for similar reasons. Administrative Contracting Officers located at prime contractor facilities seldom coordinated the requests with auditors or with requestors to explain the information already available. The unnecessary audits and reviews represented an estimated $4.8 million of audit resources during FY 1996. These audit resources were and are critically needed to review contractor incurred cost submissions that are backlogged, contractor compliance with Cost Accounting Standards and with the Truth in Negotiation Act, and contractor reorganization and restructing costs.

Recommendations in this report, if implemented, will result in more effective use of audit resources. The benefits derived from reduced oversight of price proposals will also reduce contractor overhead incurred when supporting low-risk audits and will, therefore, reduce acquisition costs.

Summary of Recommendations. We recommend that the Director, Defense Contract Audit Agency, amend guidance to require that auditors discuss pricing requests with the initial requestor. When requested information is readily available, auditors should advise requestors of that fact. Audit guidance on performing low-risk pricing reviews should be clarified, and the use of telephone rate procedures should be emphasized when pricing information is already available. We also recommend that the Commander, Naval Sea Systems Command, issue guidance to implement Federal Acquisition Regulation part 15 guidance on field pricing assistance and the reporting.

Management Comments. The Office of the Assistant Secretary of the Navy (Research, Development, and Acquisition) concurred with our recommendation and the Naval Sea Systems Command issued guidance to establish early communications with auditors regarding field pricing requests. The Defense Contract Audit Agency partially concurred with our recommendation to revise the Defense Contract Audit Manual to implement the Federal Acquisition Regulation 15.404-2(b)(1)(i) requirement to encourage telephone use to transmit pricing information. The Defense Contract Audit Agency also partially concurred with a recommendation to clarify Defense Contract Audit Manual for methods to use for evaluating low risk proposals. However, they disagreed with a recommendation to require that auditors cognizant of subcontractors discuss field pricing requests with initiating requestors, including prime contractors.

Evaluation Response. Comments from the Assistant Secretary of the Navy (Financial Management and Comptroller) are responsive. As a result of the DCAA response to our recommendation addressing subcontract price proposal requests, we clarified the recommendation to only have the auditors cognizant of the subcontractor coordinate with the initiating requestor. The DCAA comment is responsive on the recommendation to specifically reference FAR 15.404-2(b)(1)(i) requirements to encourage use of telephone procedures. The DCAA comment to consolidate guidance on the different methods for evaluating low risk proposals is also considered responsive. DCAA should provide additional comments on the final report by August 17, 1998.

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Part I - Evaluation Results

Evaluation Background

The Defense Contract Audit Agency. The Defense Contract Audit Agency (DCAA) performs various audits and evaluations of contractor price proposals for the award, modification, or repricing of negotiated Government contracts. The extent of audit services provided depends on the nature and complexity of the audit request for field pricing support and the amount and reliability of information already available. Field pricing audit services include the following:

- contractor estimating system surveys;
- forward pricing rate reviews;
- individual price proposals;
- single cost elements;
- agreed-upon procedures, including cost realism reviews; and
- telephone confirmations of specific cost information.

Estimating system surveys are audits of a contractor's policies, procedures, and practices for preparing cost estimates and price proposals. Adequate estimating systems prevent material misstatements and ensure that identified misstatements are detected and corrected. Adequate systems also reduce the control risk associated with contractor estimates.

Forward pricing rate reviews represent comprehensive audits of contractor annual budgets for labor and indirect rates. The audits may result in formal forward pricing rate agreements (FPRAs) or Government-accepted rates that contractors will use for a specified period to estimate the price of proposed contracts.

Audits of individual price proposals and single cost elements are evaluations of cost or price estimates performed in accordance with Government Auditing Standards (GAS). The DCAA also provides limited cost information using non-audit procedures. The DCAA Contract Audit Manual (DCAM) 9-108, "Review of a Part of a Price Proposal - Agreed-upon Procedures, Specified Cost Element Reviews," defines reviews of limited information, such as verification of current labor or overhead rates. A review of a specified cost element would encompass an audit of just one or two specific cost elements. The agreed-upon procedures are generally limited to verifications of proposed rates to FPRAs, recommendations in recent forward pricing audits, or other pricing data that have been recently audited. The procedures may also include a review of accounting books and records without audit tests and opinions. The DCAA documents the verification procedures by preparing working papers and reporting the results to the contracting officer (CO) in a formal report.

The DCAA may also respond to field pricing requests by merely verifying labor and indirect rates by telephone. The results of telephone rate verifications are transmitted orally or recorded in standard telephone rate confirmation memorandums.

The DCAM chapter 9-100, section 1, prescribes the administrative procedures that auditors should follow to coordinate field pricing support.

Contracting Officers. The Federal Acquisition Regulation (FAR) subpart 1.602 outlines contracting officers' (COs) responsibilities. COs have authority to enter into, administer, or terminate contracts and make related determinations and findings. COs may bind the Government only to the extent of the authority delegated to them. No contract shall be entered into unless the CO ensures that all requirements of law, executive orders, regulations, and all other applicable procedures have been met. To determine whether a proposed price is fair and reasonable, COs request field pricing assistance from contract auditors, price analysts, quality control specialists, and engineers. Field pricing assistance may also include information relative to the business, technical, production, or other capabilities and practices of an offeror. The type of information and level of detail requested will vary according to the specialized resources available at the buying command and the magnitude and complexity of the required analysis.

After a contract is awarded, the CO usually delegates contract administration duties to an administrative contracting officer (ACO) located at either the Defense Contract Management Command (DCMC) or Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) field office. In some cases, a CO may also delegate the responsibility for price negotiation to an ACO.

Regulations Governing Field Pricing Support. Our evaluation criteria included the requirements in the FAR in effect during the time of our field work. Also, we reviewed the proposed changes to FAR part 15, "Contracting by Negotiations."

Through October 10, 1997, the Defense Federal Acquisition Regulation Supplement (DFARS) 215-805-5, "Field pricing support," and FAR 15.805-5, "Field pricing support," prohibited field pricing for fixed-price proposals under $500,000 and cost-type proposals under $10 million when no significant estimating system deficiencies existed and cost or pricing information was available. Under certain circumstances, FAR 15.805-5 also allowed for limited or no audits or field pricing without consideration of the dollar amount proposed. Examples of information used to limit or decrease the need for audits included the existence of an FPRA, recently audited information on labor and indirect rates, or other cost information from other awards.

Regulatory changes to FAR part 15 became effective October 10, 1997, after the completion of our field work. The revised FAR 15.404-2, "Information to support proposal analysis," encourages streamlining of procurement through rapid transmittal of information. Accordingly, "[w]henever circumstances permit, the contracting officer and field experts are encouraged to use telephonic and/or electronic means to request and transmit pricing information." Also, field pricing assistance is not required, regardless of contract type and proposal value, when sufficient information is already available at the buying

activity. The revised FAR part 15 does not list the types of pricing information frequently available at cognizant audit offices that could be used in lieu of requesting audits or field pricing reviews. However, the revisions emphasize that requests for field pricing assistance should be tailored to reflect the minimum essential supplementary information needed to conduct a technical or cost or pricing analysis. The revised FAR emphasizes early and direct communication between the contracting officer and the field agencies to define the needed information.

DoD Procurement Process Reform Process Action Team Report. On February 9, 1995, the DoD issued the "Final Report of the Procurement Process Reform Process Action Team," (PAT). The report recommended eliminating field pricing reviews on cost-type price proposals under $10 million. Instead, rate confirmations should be used to evaluate proposals under the threshold unless adverse conditions exist.

Evaluation Objectives

The overall objective was to evaluate the processes used to request and complete DCAA audits and reviews of contractor price proposals, with emphasis on major weapons programs. The evaluation also assessed the adequacy of internal control procedures at field audit offices (FAOs), DoD contract administration offices, and Military Department procurement offices for determining the scope of requested audit assistance. Our first report on this project concentrated on requests for audit support issued by contract administration and procurement offices. This report addresses DCAA assistance provided to the requestors. See Appendix A for a discussion of the evaluation scope and methodology and Appendix B for details on prior coverage related to the evaluation objectives.

Audit Services in Support of Field Pricing Requests

When cost or pricing data were required and proposals exceeded the FAR and DFARS field pricing monetary thresholds, DCAA resident offices responsible for audits of major weapons acquisitions generally provided adequate field pricing support to determine the reasonableness of proposed costs. However, when pricing information was already available, DCAA auditors frequently performed unnecessary audits or agreed-upon procedure reviews of cost or pricing data below the thresholds. Auditors also performed unnecessary review procedures to evaluate cost realism of contractor labor and indirect cost rates when cost or pricing data were not required. The unnecessary reviews resulted from auditor noncompliance with existing audit and regulatory guidelines. The DCAA field pricing reviews did not properly incorporate regulatory guidelines and were contradictory and confusing. The unnecessary audits and reviews represented an estimated $4.8 million of audit resources during FY 1996 that could have been applied to more urgent and beneficial audits that make up the remaining portion of the DCAA mission.

Use of Existing Cost and Price Information to Minimize Field Pricing Support

DCAM 9-103.1d.(3) directs auditors to discuss field pricing review requests with the ACO or the CO before beginning a review. If the field pricing request is for an audit of an immaterial amount or if it could be handled as a rate confirmation, the auditor should discuss the request with the CO that initiated the request and advise accordingly. DCAM 9-107 outlines the procedures to follow when processing written or telephone requests for specific cost information. If a request for field pricing support can be completed using telephone rate confirmation procedures, the auditor should recommend those procedures to satisfy the request.

DCAM 9-102.3, "Applicability of Dollar Thresholds," also requires auditors to understand the unusual circumstances causing the CO to believe that a field pricing review is needed for a proposal below the applicable FAR and DFARS monetary thresholds.

Field Pricing Review Procedures and Reports. The DCAA performed unnecessary review procedures, including the preparation of extensive audit reports in 129 field pricing reviews examined as part of a statistical sample of 255 reports on the application of agreed-upon procedures. The review

procedures were unnecessary because useful, audited information was readily available to meet the requests for audit support without the preparation of administrative working papers and reports.

We initially visited 7 DCAA field offices and examined 85 judgmentally selected proposal audits and agreed-upon procedures reviews, which showed that 58 of the requests for audit assistance could have been satisfied by existing audited data. Because of the significance of our findings, we expanded our evaluation using statistical sampling of all 4,051 FY 1996 DCAA agreed-upon procedures reviews, which substantiated our initial findings.

Appendix C provides a breakdown of the unnecessary reviews of noncompetitive and competitive proposals and the average monetary values of each proposal in our judgment and statistical samples. Competitive procurements differ from noncompetitive procurements in that a field pricing review is not required. Instead, COs usually perform a cost realism analysis of several variables, and the field pricing is usually limited to verifications of contractor direct and indirect cost rates. In the cost realism analyses we evaluated, auditors usually provided only rate information.

Judgment Sample Results. Of the 85 proposal audits and agreed-upon procedures reviews evaluated during field visits performed at 7 DCAA FAOs, 58 (68 percent) were unnecessary. Forty-one (71 percent) of the 58 were below the applicable FAR 15.805-5 and DFARS 215.805-5 thresholds for performing any field pricing review. Auditors expended unneeded effort preparing working papers and written reports on information that was already available as a result of other, recently completed audits. In many cases, those audits pertained to labor and overhead rates, which resulted in FPRAs between the Government and the contractor. The available information could have been transmitted efficiently over the telephone or in a brief rate confirmation memorandum. Appendix C provides a breakdown of the unnecessary field pricing reviews by contract type and average dollar value.

During visits to COs and price analysts at four military procurement offices, we followed up on 20 DCAA field pricing reviews that we considered unnecessary. Our field visits to those offices validated an earlier observation that DCAA auditors did not contact COs before starting detailed audits on low-risk proposals. During field visits to DCAA offices, we did not find any record of auditor and CO discussions of field pricing requests in the working papers for the 58 unnecessary audits identified. Most unnecessary audits and reviews were under the DFARs field pricing thresholds. The working papers also did not document the reasons for performing the detailed audits and reviews on the low-dollar proposals although the DCAM 9-102.3, "Applicability of Dollar Thresholds," requires that auditors understand the unusual circumstances that prompted a request for a low-dollar field pricing review.

Coordination of Requests for Field Pricing Support. Coordination is important because COs requesting field pricing support are frequently unaware that pricing information is already available to evaluate proposed rates at many contractors. DCAM 9-103.1d., "Coordinating the CO Request for an Audit," directs auditors to discuss low-risk requests with either ACOs or COs before starting audits. Auditors did not follow the current DCAM guidance to identify

requestor needs and to recommend that COs accept telephone rate confirmations when the risk of improper pricing is low. Without knowledge of existing, useful information, COs cannot properly tailor the scope of their requests for minimum information as required in the FAR 15.805-5(a)(1) provisions that were applicable before October 10, 1997, or in the revised FAR 15.404-2(a)(1).

Auditor Use of Rate Confirmation Procedures. Some DCAA auditors agreed that they could have used rate confirmation procedures instead of audit procedures for the judgmentally selected reviews because pricing information was readily available. Although most auditors claimed that audits were necessary, DCAA working papers did not substantiate the auditors' claims. The auditors usually did not perform any other substantive procedures beyond verifying rates to information previously audited or readily available in the accounting (payroll) records. Auditors typically only verified rates to current information because labor and indirect rates were already audited, or FPRAs were available; few materials were involved; or auditors had on-line computer access to payroll or purchasing information. All contractors had generally adequate estimating systems, or a reported estimating system deficiency had no direct bearing on the cost elements that required evaluation. Most low-risk proposals excluded costs of materials, or the material costs were insignificant. At the six audit offices cognizant of major contractors, auditors had easy access to payroll information to verify proposed labor rates to actual rates. At the branch office conducting mobile audits, auditors were able to receive facsimile payroll information from contractors to verify labor rates and did not always make field visits. One Navy CO showed that an auditor at the mobile FAO insisted on a detailed audit of a small cost reimbursable change order proposal when only a rate verification was requested.

Statistical Sample of Agreed-upon Procedures Reports. Using a stratified sampling plan, we statistically selected 255 additional DCAA reports on the application of agreed-upon procedures issued during FY 1996. Of the 255 sampled reviews, 129 were unnecessary because other audited data were readily available. Of the 129 unnecessary pricing reviews, 89 left the method or extent of audit to the auditor's discretion. The requests for audit support usually asked only for a verification or review of rates and factors. Detailed information regarding the statistical sample and results is presented in Appendix A.

Our examination of the reports showed that the reported results were based on FPRAs, recent forward pricing rate reviews, or simple verifications of labor and indirect expense rates and cost data. By examining the number and type of proposal audits completed during FY 1996 and recorded in the DCAA Agency Management Information System (AMIS), we also verified that considerable audited cost history was available for the applicable contractors, and recent forward pricing rate reviews had been performed for many contractors. More than 100 separate proposal audits or agreed-upon procedures reviews were performed at several of the contractors during FY 1996.

We projected the sample results to the universe of 4,051 agreed-upon procedures reviews performed by DCAA in FY 1996. Our sampling results showed that 2,105 is the best, unbiased estimate of unnecessary reviews. Further, we estimated that 62,950 audit hours were expended on unneeded audits during FY 1996. Using a standard staff year of 1,505 hours, we

calculated that the unnecessary audit hours represented 42 staff years (62,950/1,505 = 41.82), excluding supervisory hours. Using DCAA FY 1998 reimbursable billing factors, we increased the 62,950 hours by a factor of 1.225 to account for supervisory and administrative hours. The results were multiplied by the $69.19 hourly billing rate resulting in about $5.3 million in resources that could have been put to better use. We reduced the potential benefits by 10 percent to account for the time required to perform the informal telephone rate checks. This resulted in an estimate of $4.8 million that could have been put to better use for the year [$5.3 million - (10%x5.3 million)= $4.8 million]. Appendix A contains the details of our statistical sample and projected results. The $4.8 million estimate applies to agreed-upon procedures reviews and excludes the cost impact of unnecessary FY 1996 audits that DCAA performed of low-risk proposals. The impact of the low-dollar audits could be significant.

Adequacy of Audit Guidance

The DCAM is the field auditor's primary source of guidance on processing and performing reviews to satisfy CO requests for field pricing support. The DCAM chapter 9-100, "Administrative Procedures for Field Pricing Support," and the DCAA FAO Management Information System (FMIS) User Manual, Appendix C, "Activity Code Definitions," provide guidance on different methods for completing field pricing reviews. The methods available to evaluate low-risk proposals include desk audits, agreed-upon procedures, and telephone rate confirmations. To ensure the timeliness of the guidance, the DCAA should promptly update the DCAM when DoD regulatory changes are made. The audit guidance should also include clear criteria to assist auditors in selecting the most appropriate review method.

Incorporation of Regulatory Guidance in DCAM. On April 15, 1996, the DCAA issued a Memorandum for Regional Directors (MRD) on "Audit Guidance on Changes to DFARS," 96-PAC-048. The MRD briefly alerted auditors of a variety of regulatory changes, including the change in the dollar threshold from $1 million to $10 million for requesting field pricing reviews for cost-type proposals. The higher threshold became effective November 30, 1995. The DCAA did not incorporate the guidance in the DCAM until January 1997, 13 months after the revised DFARS became effective.

The DFARS change had a significant effect on the DCAA mission. The number of proposals falling under the new dollar threshold for required field pricing reviews was certain to increase, while the number of required price proposal audits would decrease. The DCAA should have issued a separate MRD explaining the preferred use of telephone rate confirmations or short memorandums instead of extensive written reports to ensure prompt and effective implementation of the regulatory change. The April 15, 1996, four-page MRD covers 15 regulatory changes. The significant threshold revision is mentioned only briefly and is easily overlooked. As a result, most of the

auditors and supervisors we interviewed were unaware of the increased threshold until DCAA incorporated the MRD guidance in the January 1997 DCAM.

Differing Guidance on Telephone Rate Confirmations. In addition to the DCAM, the DCAA FMIS User Manual, Appendix C, provides guidance on rate confirmation procedures for low-risk audit requests. However, the FMIS guidance differs from guidance in DCAM. The FMIS manual explains that auditors should provide informal telephone rate confirmations in response to oral requests for pricing information. Auditors interpret the FMIS to mean that the nature of the request determines the type of audit effort to be expended. The DCAM does not limit the form of response to the form of the request. The DCAM 9-107, "Written and Telephone Requests for Specific Cost Information on Price Proposals," allows for the transmittal of specific cost information by telephone based on either a written or oral request. In practice, auditors followed the FMIS guidance and typically provided telephone rate confirmations only when they received oral pricing requests. Regardless of the dollar amounts proposed or level of risk involved, auditors responded to written requests for rate confirmations with long, written reports, supported by assignment folders containing numerous administrative forms and working papers.

The DCAM provides a sample format for memorandum confirmation of specific cost information on price proposals. Because most FAOs followed the FMIS guidance, the FAOs used a one-page memorandum only when they received oral requests for rate confirmation.

Guidance on Low-Risk Field Pricing Methods. Various procedures for completing and responding to a low-risk field pricing request are provided in DCAM 9-103.3, "Audit Scope," DCAM 9-107, "Written and Telephone Requests for Specific Cost Information on Price Proposals," and DCAM 9-108, "Review of a Part of a Price Proposal - Agreed-upon Procedures, Specified Cost Element Reviews." The procedures include a desk audit, agreed-upon procedures, and telephone rate confirmations. However, the DCAM guidance is inadequate for auditors to determine the circumstances under which those procedures should be used. Consequently, when determining whether to respond to a requestor orally or with a written report, auditors relied on the form of request, oral or written. Although the DCAM elaborates on the differences between desk audits and the processing of requests for specific information, the differences were not discernible. Review procedures in the 58 unnecessary audit files in our judgment sample were primarily limited to the verification of proposed rates and costs to information already available to the auditors. Yet, the auditors prepared a complete working paper file and a formal report on each request. In contrast, a telephone rate confirmation would require only a confirmation memorandum. The principal difference between methods is the significant amount of working papers, administrative forms, and formal reports associated with agreed-upon procedures and desk audits compared to the simple confirmation forms used to provide telephone rate confirmations.

The DCAM states that auditors should use their professional judgment in assessing materiality and risk to determine whether sufficient information is available to justify a desk review. However, the DCAM contains no guidance on when to use the less expensive and more efficient telephone or memorandum

procedures for confirming pricing information. Because desk audits are generally interpreted to require an audit opinion, they expend audit resources unnecessarily when information is already available.

Guidance for Administrative Contracting Officers. The lack of specific guidance for ACOs also contributed to the performance of unnecessary field pricing reviews. The ACO plays a key role in coordinating a CO request for audit support with DCAA. ACOs located at prime contractor facilities seldom coordinated the requests with auditors or with the requestor to explain the information already available. No specific DCMC guidance requires ACOs to suggest to prime contractors that telephone rate confirmations would satisfy their needs. The Navy Acquisition Policy Supplement used by the Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) only briefly mentions that ACOs should coordinate audit requests. The DCMC is in the process of issuing instructions for ACOs to coordinate requests and to accept telephone rate confirmations when current information is available. We believe the planned DCMC corrective action will preclude requests for redundant audits. At the time of our draft report, the Naval Sea Systems Command (NAVSEA) guidance had not been changed to reflect the FAR changes on field pricing assistance and to encourage the use of telephone procedures. NAVSEA management asked that our report include a recommendation on the required improvement.

Summary

Overall, the DCAA and the Navy have not fully implemented guidance to comply with regulatory changes and the DoD procurement process reform initiative designed to eliminate unnecessary field pricing reviews. DoD management addressed its concerns regarding unnecessary oversight of price proposals in the DoD "Final Report of the Procurement Process Reform Process Action Team," January 1995. Although changes to DFARS, effective November 30, 1995, raised the threshold for required field pricing to reduce unnecessary reviews, the DCAA did not issue adequate and timely guidance to implement those changes. As a result, about 42 staff years have been expended unnecessarily and detailed reviews of low-risk price proposals are still being performed.

Auditors have readily available pricing information as a result of recently performed audits and are, therefore, able to advise COs on how their information needs may best be met without excessive review procedures or reports. Although auditors must meet the needs of the requestor, they are also responsible for the scope of review required to meet the requestor's needs. If a CO needs written confirmation of pricing information that is readily available without additional audit procedures, auditors should inquire whether an oral confirmation of specific cost information is sufficient or whether a report on information already available elsewhere is necessary.

We do not believe the revised FAR part 15 will adequately correct conditions we observed in this evaluation and discussed in our previous report on DoD

Requests for Field Pricing Audit Support," Report No. PO 97-058, September 30, 1997. (See Appendix B for additional information.) We are concerned with the inadequate implementation of DFARS changes designed to eliminate unnecessary field pricing reviews and believe the DCAA and Navy must take further action to properly implement the recent revisions to FAR part 15 and provide more specific guidance to its field pricing and contract administration personnel.

Management Comments on the Finding and Evaluation Response

The DCAA provided comprehensive comments on the finding. For the full text of management comments, see Part III.

DCAA Comments on the Finding. DCAA partially agreed that many of the audits and agreed-upon procedure reviews evaluated during field visits were unnecessary. However, DCAA disagreed that the agreed-upon procedure reviews evaluated in our statistical sample were unnecessary and asked field audit offices (FAOs) to respond. The FAOs accepted only 14 of the 140 reports identified in the statistical sample review as unnecessary.

DCAA provided a list of explanations to explain why telephone rate procedures were not used for the assignments evaluated during our field visits. Requestors sometimes insisted on a formal report or the request covered more than could be furnished by rate verification. Other reasons included: lack of available information on file; need to verify proposed costs to actual cost records, for example payroll; and the need to perform analytical procedures, such as application of escalation rates to base labor rates.

Management also commented that some of the 10 subcontracts evaluated during field visits may not have been below the DFARs dollar threshold for field pricing. Management also stated that we overestimated the cost impact of $5.7 million for audit resources that could be put to better use by not accounting for the resources required for telephone rate verifications.

Evaluation Response. Management did not comment on the causes we identified for the unnecessary reviews. Auditors did not consider recently audited pricing data or use information readily available in the accounting records. Instead, the DCAA management relied on FAO responses that did not adequately address our report findings. The FAOs did not explain why they performed comprehensive reviews on low dollar proposals and did not furnish adequate documentary support for their nonconcurrences.

We visited DCAA Headquarters to examine any documentation supporting FAO rebuttals. Although the documentation was inadequate to alter our overall assessment, and none of the judgmental sample items required revision, we revised the rating for 11 of the 140 unnecessary reports in the statistical sample. We adjusted the Evaluation Results section of our report to reduce the number

of unnecessary reviews identified in our sample to 129 from 140. We also reprojected the results of our statistical sample to reflect the 129 unnecessary reviews and we recomputed the amount associated with resources that could be put to better use.

Management's explanation for the unnecessary reviews was that most of the requests for audit support required auditors to perform procedures more extensive than those for telephone rate verifications. However, the DCAM does not limit the review procedures that can be performed for telephone rate verifications. Also, FAO responses to Headquarters stated that DCAA performed formal reviews because formal written requests were received. That was one of the most common explanations and, in some cases, the only explanation FAOs gave for why a review was performed.

The DCAA response indicated that they offered to provide telephone rate responses but the requestor wanted a report. The Contract Audit Manual specifies that the auditor determines the scope of audit necessary to perform the review. When readily identified information is available to evaluate a proposal, a telephone rate review should be acceptable. As an independent audit organization, DCAA should not waste resources performing unnecessary reviews where adequate data are available. DCAA has instituted numerous risk based initiatives because of resource reductions. Yet we found DCAA wasting resources by performing a full audit even when adequate information was available to be provided as a simple rate request, solely because the requestor wanted an audit report. Auditors are expected to exercise independent judgment in planning the type and extent of audit testing sufficient to render unqualified audit opinions, but they will consider and address special areas of concern or informational needs of requestors. However, it is important that DCAA apply its resources in the most economical and efficient manner by using telephone verifications, when current data is available.

Based on DCAA comments, we have adjusted our cost impact by 10 percent to account for the additional time necessary to perform the rate request.

Recommendations, Management Comments, and Evaluation Response

Revised Recommendation. As a result of management comments, we revised draft Recommendation 1.c. to clarify the intent of the recommendation.

1. We recommend that the Director, Defense Contract Audit Agency, amend Defense Contract Audit Manual, chapter 9 guidance to:

a. Implement the revised Federal Acquisition Regulation 15.404-2(b)(1)(i), which states, "Whenever circumstances permit, the contracting officer and field pricing experts are encouraged to use telephonic and or electronic means to request and transmit pricing information." Emphasize that

auditors should use telephone rate confirmation procedures to the maximum extent possible when pricing information is readily available.

DCAA Comments. Management partially concurred. Although DCAM already meets the intent of the FAR to provide telephone rate verifications where possible, DCAA agreed to add the guidance in the revised FAR 15.404-2(b)(1)(i) to DCAM. DCAA will also issue a MRD on the need to document communications with customers prior to starting audits and to address the treatment of proposals under the FAR/DFARS dollar thresholds. The MRD will be issued within 60 days of the receipt of the final IG report.

b. Clarify the methods to use for low-risk proposals, telephone rate confirmations, agreed-upon procedures reviews, and desk audits by establishing specific criteria for the use of each method for completing field pricing. Based on the usefulness of information readily available, instruct auditors to provide telephone rate confirmations as the preferred method.

DCAA Comments. Management partially concurred. Although the DCAM already includes adequate guidance to determine the circumstances in which to use telephone procedures, desk reviews, or agreed-upon procedure evaluations, management agreed that its presentation may be improved. DCAA will consolidate information on the different types of evaluations in one location and will define each type of service, reference where in DCAM more comprehensive guidance is located, and summarize the important aspects of the audit/evaluation/specific information. Management will issue an MRD advising the Regions of the DCAM revision within 60 days of the receipt of the final IG report. The response to Recommendation 1.a. addresses telephone rate confirmations.

Evaluation Response. The proposed actions are responsive to the recommendation. Although the management response to Recommendation 1.a. does not specifically address telephone rate confirmations, the planned MRD will address the FAR requirement to provide minimum essential services. The transmittal of information telephonically or through electronic means serve that purpose.

c. Amend the Defense Contract Audit Manual, section 9-103.1d.(3), to include the higher tier requestor among those that the auditor should discuss field pricing requests with. Guidance should state that auditors should discuss field pricing requests with the initiating requestor who may be a prime contractor or higher-tier subcontractor, in addition to a contracting officer or an administrative contracting officer.

DCAA Comments. Management nonconcurs because auditors cognizant of subcontractors should not be required to contact every contractor to discuss requests for services. Contracting officers and ACOs are already interfacing with the contractor to determine whether providing assistance is in the Government's interests. DCAM requires the auditor at the higher-tier contractor level to be satisfied that the audit/evaluation of the subcontractor be in the Government's interests and to coordinate on the appropriateness of the

request with the contracting officer or the ACO. Auditors at the subcontractor level do not have the visibility needed to determine whether assisting the contractor is in the best interest of the Government.

Evaluation Response. Although management comments were not responsive, we have clarified the recommendation because of DCAA comments. We have revised the recommendation to eliminate contacting the contractor. This appears to confuse the intent of our recommendation. The objective of our recommendation is for the lower level auditor to convey to the requestor that current data is available that would satisfy the request without a formal audit being performed. A significant number (61 of 129) of unnecessary reviews were for subcontract proposals. DCAA comments misinterpret the purpose of field pricing assistance and the objectives of our evaluation. DCAA disagreement centered on requiring the auditor to contact the contractor. The intent of the recommendation is to ensure that field pricing is completed in the most economical and efficient manner, with elimination of unnecessary formal field pricing reports. To accomplish the objective, the subcontract auditor must advise the requestor of a full audit when a review is unnecessary because the subcontract pricing information is readily available. FAR 15.404-2 encourages these communications and acquisition reform encourages avoiding unnecessary audits. We have revised the recommendation to clarify its intent.

We request that DCAA reconsider its response in comments to the final report.

2. We recommend that the Director, Defense Contract Audit Agency revise guidance in the Field Audit Office Management Information System User Manual on the use of rate confirmations to avoid interpretations that telephone rate confirmations should only be used to respond to an oral request. That guidance should be consistent with the guidance in the Contract Audit Manual.

DCAA Comments. Management concurred with the recommendation and will clarify the FMIS user guidance. An MRD advising the Regions of the FMIS revision, will be issued within 60 days of the receipt of the final IG report.

3. We recommend that the Commander, Naval Sea Systems Command, issue guidance for prompt implementation of Federal Acquisition Regulation 15.404-2(a) and (b) on field pricing assistance and the reporting of field pricing information. The guidance should emphasize the use of telephone rate confirmations to request and transmit information on low-risk proposals and should encourage early communication with cognizant auditors regarding field pricing requests.

NAVSEA Comments. NAVSEA concurred with the recommendation and already issued guidance to the field to encourage early communications with auditors and to allow use of telephone rate verifications when pricing information is available.

Part II - Additional Information

Appendix A. Evaluation Process

Scope

Our evaluation covered DCAA audits and reviews performed in response to DoD and non-DoD requests for field pricing. We visited seven DCAA FAOs where we evaluated a judgment sample of reviews and internal control procedures for processing field pricing requests. We also reviewed a statistical sample of 255 DCAA reports on the application of agreed-upon procedures. In addition, we visited four military procurement activities to follow up on the requests associated with 20 of the judgmentally selected DCAA reviews.

To determine the reasonableness of DCAA review procedures used to respond to requests for field pricing reviews evaluated, we considered the following:

- Government agreements on forward pricing rates, audit reports on forward pricing rates, and documentation in field pricing reports;
- audit accessibility to payroll, purchasing, and job cost ledgers and the availability of information in other, recently completed, audit files;
- the availability to auditors and price analysts of on-line computer access to contractor pricing information for easy updating of rate information and confirmation of proposed rates; and
- reports on estimating system surveys and ACO determinations on the adequacy of contractor estimating systems.

To determine the reasonableness and necessity of review procedures described in the statistically selected reports, we considered information discussed in the reports on FPRAs, audited forward pricing rates, labor agreements, and other documentation that indicated whether sufficient data existed without the need for additional audit procedures. We also reviewed the DCAA AMIS to identify other recent audits and forward pricing reviews that should have yielded labor and indirect rate information precluding the need for additional reviews.

DoD-wide Corporate Level Government Performance and Results Act (GPRA). 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 objectives and goals.

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

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

> **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 DoD. This report provides coverage of the Defense Contract Management high risk area.

Methodology

Use of Computer-Processed Data. We relied on computer-processed data from the DCAA AMIS to select audit offices to visit and assignments to review. Although we did not perform a formal reliability assessment of the computer-processed data, we determined that the assignment numbers, dollars examined, and questioned costs for the selected audit assignments generally agreed with the information in the computer-processed data. We did not find errors that would preclude use of the computer-processed data to meet the evaluation objectives or that would change our report conclusions.

Evaluation Universe. We used the AMIS to identify field audit offices issuing field pricing reports from October 1, 1995, through September 30, 1996. We also used information in the Washington Headquarters Services publication, "100 Companies Receiving the Largest Dollar Value of Prime Contract Awards, FY 1996" to identify large contractors and major weapons programs.

We visited seven DCAA field offices, six contract administration offices, and four military procurement offices. We reviewed 85 judgmentally selected DCAA field pricing reviews and 255 statistically selected audit reports on limited field pricing review procedures.

Sampling Procedures

Judgment Sample. We judgmentally selected six DCAA field offices cognizant of major contractors and associated contract administration offices located in each of the five DCAA regions. Each office had a high volume of price proposal audit reports issued during FY 1996. The six offices at major contractor locations audited major weapons systems representing the Army, the Navy, and the Air Force. We also evaluated some small contractors at one DCAA branch office. At the 7 DCAA offices, we judgmentally selected 85 audits or agreed-upon procedures reviews of primarily low-dollar (below

$10 million) proposals with few or no dollars questioned as a result of the field pricing reviews. The 85 field pricing reviews covered price proposals ranging in value from $14,000 to $440 million, and 10 of the 85 field pricing reviews represented agreed-upon procedures reviews of the cost realism.

We selected four military procurement offices to visit based on the volume of audit requests issued to the DCAA locations. During visits to the 4 offices, we followed up on 20 of the 85 field pricing reviews evaluated at DCAA. We reviewed the files of the COs and price analysts who initiated the requests.

Because the audit assignments were judgmentally selected, we are not projecting the results of our evaluation of those assignments on a DCAA-wide basis.

Statistical Sample. We developed a stratified statistical sample of 255 audit reports issued under DCAA activity code 280, agreed-upon procedures reviews. The objective was to estimate the number of unnecessary code 280 reports and the number of corresponding hours spent on those reports. The universe consisted of the total number of reports issued during FY 1996 in each of the five DCAA regions. We employed the stratified sampling plan as the sampling design for this audit. We used the five regions as the five strata and randomly selected the sample of reports from each of these regions as shown below.

Table A-1. Universe and Sample Size of Agreed-upon Procedures Reviews and Sample Results

Region	Universe Size	Sample Size	Unnecessary Reports
Eastern	1,026	55	28
North Eastern	445	45	18
Mid-Atlantic	1,082	55	31
Western	797	50	34
Central	701	50	18
Totals	**4,051**	**255**	**129**

Statistical Results. Using the sample results, we calculated the statistical projections for the number of unnecessary DCAA agreed-upon procedures reviews over the FY 1996 universe. We also calculated the statistical projections for the number of hours spent in FY 1996 on the unnecessary reviews. The projected results are shown below.

Table A-2. Projected Statistical Sample Results
Agreed-upon Procedures Reviews

Attributes (Number of Unnecessary Reviews)

	Lower Bound	Point Estimate	Upper Bound
Eastern	381	522	664
Northeastern	113	178	243
Mid-Atlantic	462	611	758
Western	434	542	650
Central	155	252	350
Total DCAA	**1,861**	**2,105**	**2,348**

For mathematical reasons, regional upper and lower bounds do not sum to upper and lower bounds of the total.

Variables (Hours Spent)

	Lower Bound	Point Estimate	Upper Bound
Total DCAA	54,337	62,950	71,562

We are 95-percent confident that between 1,861 and 2,348 agreed-upon procedure reviews performed during FY 1996 were unnecessary and that 2,105 is the best unbiased point estimate for the number of unnecessary reports. We are also 95-percent confident that between 54,337 and 71,562 hours, exclusive of supervisory hours, were spent on the unnecessary reviews, and that 62,950 is the best unbiased point estimate for the hours spent on unnecessary reports issued in FY 1996 under activity code 280, application of agreed-upon procedures.

Use of Technical Assistance. The Analysis Planning and Technical Support Directorate, Office of the Assistant Inspector General, for Auditing, DoD, prepared the statistical sample for the evaluation of the agreed-upon procedures reviews and projected the sample results.

Contacts During the Evaluation. We visited or contacted individuals and organizations within the DoD. We also spoke to representatives of four Government contractors. Further details are available upon request.

Appendix B. Summary of Prior Coverage

During the last 5 years, the Office of the Inspector General, DoD, issued three reports related to requesting and completing cost and price analyses for contractor price proposals.

Audit Report No. PO 97-058, "DoD Requests for Field Pricing Audit Support, September 30, 1997." The report concludes that audit requests and the scope of requested services were appropriate for large proposals when cost or pricing data were required. However, 54 of 83 field pricing requests of cost or pricing data were unnecessary because pricing information was already available. Also, 8 of 10 formal field pricing requests for cost realism reviews of rates were unnecessary because FPRAs or audited rates were already available. The Military Departments used different methods for evaluating cost realism, and the Air Force was most likely to use alternative methods and rate confirmation procedures over formal audit requests when information was available. The Under Secretary of Defense for Acquisition and Technology agreed that training is necessary to implement the revised FAR part 15 provisions on the need to identify existing information and to use telephone rate confirmation procedures when the risk of faulty pricing is low. The Under Secretary also advised that guidance was being prepared for incorporation in the *Contracting Pricing Reference Guides* to document pricing information frequently available at cognizant audit offices, informal procedures acceptable for meeting pricing requirements for low-risk proposals, and common guidance on performing cost realism.

Audit Report No. 97-207, "Contracting Officer Price Analysis," August 26, 1997. The report concludes that Government resources were not used economically when COs requested DCAA audits and reviews on contractor price proposals under $500,000. The report recommended that the Army, Navy, Air Force, and Defense Logistics Agency issue guidance reminding COs to use a price analysis instead of a cost analysis to evaluate contractor proposal prices under $500,000 except in the limited circumstances cited in FAR subpart 15.8. The Services and Defense Logistics Agency agreed to reemphasize policy and regulatory requirements on the use of a price analysis on proposals up to $500,000. The report followed up on recommendations made in Report No. 94-004, which noted similar conditions.

Audit Report No. 94-004, "Contracting Officer Price Analyses," October 15, 1993. The report states that contracting organizations did not properly perform or adequately document the use of price analyses for proposals under $500,000 to determine whether contract proposal prices were fair and reasonable. The report also states that Government resources were not used economically when a cost analysis was used instead of a price analysis for proposals under $500,000. The conditions occurred because contracting organizations inappropriately relied on cost analysis, did not use various price analysis available, and did not comply with regulations covering the proposal evaluation process. The report recommended that the Army, Navy, Air Force, and Defense Logistics Agency issue internal control objectives and confirmation techniques to require that contracting officers perform price analyses and use

independent Government cost estimates or other price analysis techniques detailed in the Armed Services Pricing Manual, and as required by FAR 15.805, to evaluate price proposals. The Air Force and Defense Logistics Agency agreed to implement regulations and took corrective action. The Navy agreed to revise the Naval Acquisition Procedures Supplement. The Army believed that its guidance on using a price analysis instead of a cost analysis was adequate.

Appendix C. Summary of Evaluation Results by Contract Type

Field Pricing Reviews of Contractor Price Proposals

	DCAA Reviews		Average Dollar Values	
	Unnecessary	Necessary	Unnecessary	Necessary
Judgment Sample:				
Noncompetitive				
Cost Type	33	12	$ 2,715,637	$ 20,394,919
Fixed Price	17	13	656,059	21,557,446
Competitive [1]				
Cost Realism:	8	2	12,559,162	220,403,556
Total	**58**	**27**		
Statistical Sample:[2]				
Noncompetitive	94	97	6,322,440	10,982,483
Competitive	35	29	8,636,591	49,596,077
Total	**129**	**126**		

[1]Most proposals included a mix of fixed-price, fixed-price incentive, and cost-type line items. However, the fixed-price incentive contract line item was the most dominant.

[2]The statistical sample included proposals for fixed-price, fixed-price incentive, cost-type, time and materials, and indefinite quantity labor hour contracts. The cost-type, time and materials, and indefinite quantity labor hour were the most dominant contract types identified in the sample.

Appendix D. 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 Center
Under Secretary of Defense (Comptroller)
Assistant Secretary of Defense (Public Affairs)

Department of the Army

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

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Assistant Secretary of the Navy (Research, Development, and Acquisition)
Auditor General, Department of the Navy
Commander, Naval Sea Systems Command

Department of the Air Force

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

Other Defense Organizations

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

Non-Defense Federal Organizations and Individuals

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

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

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

Part III - Management Comments

Assistant Secretary of the Navy (Research, Development, and Acquisition) Comments

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
RESEARCH, DEVELOPMENT AND ACQUISITION
1000 NAVY PENTAGON
WASHINGTON DC 20350-1000

MAY 5 1998

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Draft Report on Defense Contract Audit Agency Reviews of Price Proposals, Project No. 6DC-0086.1 - INFORMATION MEMORANDUM

REF: (a) DODIG Memo of 12 Jan 98

ENCLOSURE: (1) DON Response to DODIG Audit Report, Project No. 6DC-0086.1

This memorandum is in response to the draft audit report forwarded by reference (a).

The Department of the Navy response is Enclosure (1). The Commander, Naval Sea Systems Command, has implemented the recommendation and issued guidance for prompt implementation of Federal Acquisition Regulation 15.404-2(a) and (b) on field pricing assistance and the reporting of field pricing information.

M. P. Sullivan
RADM, USN
Principal Deputy

Copy to:
NAVINSGEN (2)
FMO-31
COMNAVSEA(00N3)

Department of the Navy Response
to
DODIG Draft Report of 12 January 1998
on
Defense Contract Audit Agency
Reviews of Price Proposals
Project No. 60C-0086.1

Recommendation 3: We recommend that the Commander, Naval Sea Systems Command, issue guidance for prompt implementation of Federal Acquisition Regulation 15.404-2(a) and (b) on field pricing information. The guidance should emphasize the use of telephone rate confirmations to request and transmit information on low-risk proposals and should encourage early communication with cognizant auditors regarding field pricing requests.

DON Position: Concur. NAVSEA issued memorandum Ser 02C-BW/8 of 11 February 1998 to NAVSEA headquarters and field personnel to remind them to consider using informal procedures, such as telephone cost or rate verifications, and to establish early communication with cognizant auditors regarding field pricing requests. Action is complete.

Enclosure (1)

Defense Contract Audit Agency Comments

DEFENSE CONTRACT AUDIT AGENCY
9725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PFC 225.4 31 March 1998

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND OVERSIGHT

SUBJECT: Response to DoDIG Draft Evaluation Report on Defense Contract Audit Agency Reviews of Price Proposals (Project No. 6OC-0086.1)

We have reviewed the subject draft report and our comments relative to the findings and recommendations are as follows:

Finding: *Of the 85 proposal audits and agreed-upon procedures reviews evaluated during field visits performed at 7 DCAA FAOs, 58 (68 percent) were unnecessary. Forty-one (71 percent) of the 58 were below the applicable FAR 15.805-5 and DFARS 215.805-5 thresholds for performing any field pricing review. Auditors expended unneeded effort preparing working papers and written reports on information that was already available as a result of other, recently completed audits.*

DCAA Response: We partially concur with this finding. Of the 85 assignments evaluated during field visits, it is our opinion that 21 (25 percent of 85) could have been performed as requests for specific cost information. Field Audit Offices (FAOs) reported that the other 37 assignments (46 percent of the 85) required evaluation procedures greater than a provision of specific cost information. The breakout of the evaluations classified as unnecessary by region is as follows:

Region	DoDIG Unnecessary	DCAA Unnecessary
Central	14	1
Eastern	19	5
Mid-Atlantic	9	0
Northeastern	7	6
Western	9	9
Total	**58**	**21**

FAOs determined that it was appropriate to provide more than specific cost information for the following reasons:

*Original management comments were marked "For Official Use Only." On April 14, 1998, DCAA agreed to the removal of the "For Official Use Only" marking from this response to the draft report in order to include it in our final report.

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SUBJECT: Response to DoDIG Draft Evaluation Report on Defense Contract Audit Agency Reviews of Price Proposals (Project No. 6OC-0086.1)

- Contacted requester and offered to provide a telephone rate response (25000). Requester wanted a report.
- Request is for more than verification of rates, for example, CAS/FAR compliance, system status, ODC review, fringe benefit basis, analysis of proposed cost basis, review of material cost, etc.
- Cost Realism evaluation was coordinated with Headquarters.
- Information not readily available in files to perform as a request of specific cost information.
- Verification tests beyond providing specific cost information provided.
- Performed for a contracting officer with no knowledge of the contractor.
- Analytical procedures required, e.g., format subcontract costs when detail not releasable to prime.

Forty-one assignments were classified by the DoDIG as being under the FAR/DFARS threshold for requesting field pricing. Of those assignments, we believe that the proposals identified with the following assignments are over the threshold as follows:

- 1621-96H21000005 (Observation No. 4) is a firm-fixed price proposal for $840,830.
- 1621-96H27000023 (Observation No. 41) is a firm-fixed price subcontract proposal for approximately $676,000.
- 3131-96B21000013 (Observation No. 8) is a proposal for approximately $13 million. (The FAO visited by the IG was only requested to review approximately $3 million.)

In addition, proposals for 10 of the assignments were for subcontractor effort. Determination as to whether a proposal meets the FAR/DFARS threshold test is applied at the prime contractor proposal level, not at the subcontract level. The FAR 15.805-5(b) regulatory language in effect during the period of the field visits addresses proposed contracts or modifications, not subcontract proposals. Therefore, the proposal value of the associated prime level proposals should be verified before suggesting that field pricing support was provided for these proposals contrary to the regulations.

While we do not agree on the number of reviews that should be considered unnecessary, we do agree that 21 of the 58 assignments judgmentally selected for evaluation should have been accomplished by providing specific cost information. To reinforce guidance in responding to customer requests for forward pricing services, we will issue a Memorandum for Regional Directors as described in response to Recommendation 1.a.

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Finding: *Using a stratified sampling plan, we statistically selected 255 additional DCAA reports on the application of agreed upon procedures issued during FY 1996. Of the 255 sampled reviews, 140 were unnecessary because other audited data were readily available. Of the 140 unnecessary pricing reviews, 100 left the method or extent of audit to the auditor's discretion. The requests for audit support usually asked only for a verification or review of rates and factors.*

Our examination of the reports showed that the reported results were based on FPRAs, recent forward pricing rate reviews, or simple verifications of labor and indirect expense rates and cost data. By examining the number and type of proposal audits completed during FY 1996 and recorded in the DCAA Agency Management Information System (AMIS), we also verified that considerable audited cost history was available for the applicable contractors, and recent forward pricing rate reviews had been performed for many contractors. More that 100 separate proposal audits or agreed-upon procedures reviews were performed at several of the contractors during FY 1996.

DCAA Response: We nonconcur with this finding. Of the 140 evaluations classified as unnecessary, it is our opinion that 126 were necessary and only 14 were unnecessary. The breakout of the evaluations by region is as follows:

Region	Evaluations Examined	DoDIG Unnecessary	DCAA Unnecessary
Central	50	20	0
Eastern	55	31	4
Mid-Atlantic	55	32	0
Northeastern	45	21	1
Western	50	36	9
Total	**255**	**140**	**14**

FAOs determined that it was appropriate to respond to these requests as applications of agreed-upon procedures for reasons including:

- Little or no information in FAO files (including other assignments).
- Not all information requested was in the FAO files.
- Information at the FAO was not current.
- Evaluation tests were required beyond use of available data in files.
- Performance of analytical techniques required.
- Inadequate internal controls.
- Contact was made with the requestor who confirmed evaluation request.

3

Final Report Reference

PFC 225.4
SUBJECT: Response to DoDIG Draft Evaluation Report on Defense Contract Audit Agency Reviews of Price Proposals (Project No. 6OC-0086.1)

Documentation that we gathered to support the need for each application of agreed-upon procedures is by individual assignment. This supporting documentation is voluminous and is available at our Headquarters location for your review.

Appendix A, Evaluation Process, explains that statistical projections were calculated for the number of unnecessary agreed-upon procedure reports over the FY 1996 universe and on the number of hours spent in FY 1996 on the unnecessary reviews. This resulted in an estimate that $5.7 million in resources could be saved. From the write-up in Appendix A, it appears that the DoDIG is assuming that no hours would be required to respond to a request for services if an agreed-upon procedure evaluation is not conducted. We do not agree that this is a correct assumption. In these circumstances, DCAA has received a request to provide financial advisory assistance, and will provide some level of support to the contracting officer. Therefore, the calculation of unnecessary hours should be adjusted downward for the hours needed to assist the customer. Because of the overstatement of unnecessary reports and the understatement of hours required to provide even rate verifications, we believe that the projected savings of $5.7 million is greatly overstated. Revised Page 8

Recommendation 1. *We recommend that the Director, Defense Contract Audit Agency, amend Defense Contract Audit Manual, chapter 9 guidance to:*

a. Implement the revised Federal Acquisition Regulation 15.404-2(b)(1)(i), which states, "whenever circumstances permit, the contracting officer and field pricing experts are encouraged to use telephonic and or electronic means to request and transmit pricing information." Emphasize that auditors should use telephone rate confirmation procedures to the maximum extent possible when pricing information is readily available.

DCAA Response: Partially Concur. CAM already requires auditors to discuss requests for services with the contracting officer and to recommend use of specific cost information techniques (telephone rate requests) where appropriate. This addresses the intent of Federal Acquisition Regulation (FAR) 15.404-2(b)(1)(i). CAM 9-103.1(d)(3) states that the auditor should be:

> Obtaining a clear understanding of the requester's needs and identifying areas of the contractor's proposal for special consideration (in addition to any specified by the PCO). Discussions with the ACO and/or PCO, should be held before beginning the reviews. If the request is for an audit of something that is immaterial or that could be handled as a request for specific cost information (see 9-107), the auditor should discuss this with and make an appropriate recommendation to the contracting officer. However, the final decision regarding the need for a complete audit rests with the contracting officer.

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We believe that CAM already meets the intent of the FAR and provides guidance to auditors to use requests for specific cost information where possible with customer concurrence; however, we will enhance guidance in Chapter 9-100, Administrative Procedures for Field Pricing Support, to specifically reference FAR 15.404-2(b)(1)(i) coverage. To reinforce guidance in responding to customer requests for forward pricing services, we will issue a Memorandum for Regional Directors, addressing:

- The need to communicate with the customer to gain a clear understanding of the services required before starting the audit/evaluation.
- The need to document conversations with the customer for audits/evaluations, even when conducted by the supervisor prior to setting up the assignment.
- The FAR requirement to provide minimum essential services.
- Treatment of proposals which are under the FAR/DFARS thresholds.
- Proper application of risk assessment, especially when dealing with lower value proposals.

Within 60 days of the receipt of the final IG report, we will issue this Memorandum for Regional Directors which will also advise them of the CAM revision.

b. Clarify the methods to use for low-risk proposals, telephone rate confirmations, agreed-upon procedures reviews, and desk audits by establishing specific criteria for the use of each method for completing field pricing. Based on the usefulness of information readily available, instruct auditors to provide telephone rate confirmations as the preferred method.

DCAA Response: Partially concur. We disagree that CAM does not provide adequate guidance for auditors to determine the circumstances in which to use specific cost information techniques, desk reviews, or an agreed-upon procedure evaluation. CAM 9-107.1a. identifies specific cost information techniques as applying to specific contractor costs without review of the contractor's proposal. CAM 9-107.1 states:

> In connection with a pricing action, a PCO may request specific information concerning a contractor's costs without requesting any review of the contractor proposal . . . . The PCO may request specific cost information by telephone, or in writing, directly from the field auditor. Written requests are sometimes desirable for clarity, but will not be required.

CAM 9-103.3 defines a desk review, identifies when use of a desk review may be appropriate, and provides criteria for auditors to use in determining if it is appropriate to conduct a desk review. CAM 9-103.3e. and f. state:

> . . . A desk review consists of a comparison of the contractor's proposal with audit data available or readily obtainable at the FAO . . . . It involves more than merely checking the contractor's

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> arithmetic . . . . Desk review procedures . . . may result in a conclusion that sufficient information is available in the files from other audits to form the basis for expression of an opinion on the contractor's cost statement (estimate or incurred). In such cases, care should be taken to assure that the auditor has complied with government auditing standards.

CAM 9-108 defines an application of agreed-upon procedure, indicates when it will be applied, and guides auditors to gain a clear understanding of the requester's needs, which includes conveying information which may be considered in finalizing the request. CAM 9-108 states:

> Applications of agreed-upon procedures are reviews of limited information . . . . Applications of agreed-upon procedures include cost realism reviews and all reviews of information other than cost or pricing data submitted in support of a price proposal. In performing an application of an agreed-upon procedure, only a portion of a proposed cost element is reviewed, not the entire cost element proposed.

The principal difference between these methods is not as the draft report contends, "the significant amount of working papers, administrative forms, and formal reports associated with agreed-upon procedures and desk audits compared to the simple confirmation forms used to provide telephone rate confirmation." The principal difference is in the level of assurance that the auditor provides:

- A desk review renders an audit opinion on the contractor's proposal taken as a whole.
- An agreed-upon procedure evaluation, while disclaiming an opinion on the proposal taken as whole, includes performance of procedures requested by the customer.
- Use of specific cost information techniques involves the application of no current procedures. It merely provides data that is contained in the audit files, and is based on previously provided contractor data and prior audits/evaluations.

Over the years, DCAA has increased the different types of forward pricing services offered in an effort to meet our customers' needs, provide better service, and conserve audit resources. As a result we no longer just provide full proposal reviews and reviews of specific cost information. Guidance on all these types of evaluations and when they are to be used are included in CAM Chapter 9 in various places. Nevertheless, we agree that its presentation may be improved. Therefore, for auditor ease in comparison of the different types of services that can be accomplished, we will enhance Chapter 9 to succinctly present, in one location, the different types of forward pricing evaluations.

This presentation will define each type of service, reference where in CAM more comprehensive guidance is located, and summarize the important aspects of the

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audit/evaluation/specific information. Within 60 days of the receipt of the final IG report, we will issue a Memorandum for Regional Directors advising them of this CAM revision. Our response to recommendation 1.a. addresses telephone rate confirmations.

Revised

c. Amend the Defense Contract Audit Manual, section 9-103.1(d).(3), to include contractors and higher tier subcontractors among those that the auditor should discuss field pricing requests with. Guidance should state that auditors should discuss field pricing requests with the initiating requestor who may be a prime contractor or higher-tier subcontractor, in addition to a Contracting Officer or an Administrative Contracting Officer.

DCAA Response: Nonconcur. Both FAR Part 15 and the proposed rule for the Department of Defense Federal Acquisition Regulation Supplement (DFARS) Part 215 provide that the contracting officer is responsible for the determination of price reasonableness. Proposed DFARS 215.404-3(a)(ii) provides that the contracting officer or the ACO should consider assisting the contractor if it is in the Government's interests. It states:

> It may be appropriate for the contracting officer or the ACO to provide assistance to a contractor at any tier where the contractor has been denied access to a subcontractor's records . . . Under these circumstances, the contracting officer or the ACO should consider whether providing audit or field pricing assistance will serve a valid Government interest.

We disagree that DCAA policy should require auditors cognizant over subcontractors to contact each and every contractor to discuss requests for services. Contracting officers and/or ACOs are already interfacing with the contractor to determine if providing assistance is in the government's interest. This requires an understanding of what the contractor is requesting. CAM 9-106 requires the auditor at the higher-tier contractor level to be satisfied that the audit/evaluation of the subcontractor be in the government's interests and to coordinate on the appropriateness of the request with the contracting officer/ACO. Auditors at the subcontractor level do not have the visibility needed to determine if assisting the contractor is in the best interests of the government.

DCAA's customer is the contracting officer/ACO, not the contractor. This is the customer that DCAA would interface with to obtain an understanding of the services required. Since government representatives, including the auditor cognizant of the contractor, are actively interfacing with the contractor prior to the auditor cognizant of the subcontractor receiving the request, having the government representatives at both the contractor and subcontractor levels interface with the contractor does not serve a useful purpose. In most cases, the government representatives at the higher level will be able to provide clarification of services to be performed. When they cannot, it is essential that the government representatives at the higher level obtain such clarification from the contractor, so that they remain aware of the scope of the audit being conducted at the subcontract level. If time is of the essence, current policy does not prohibit auditors at the subcontractor level from having clarifying discussions with the contractor.

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Recommendation 2. *We recommend that the Director, Defense Contract Audit Agency revise guidance in the FAO Management Information System User Manual on the use of rate confirmations to avoid interpretations that telephone rate confirmations should only be used to respond to an oral request. That guidance should be consistent with the guidance in the Contact Audit Manual.*

DCAA Response: Concur. The draft report states that "the DCAA FMIS User Manual, Appendix C provides guidance on rate confirmation procedures for low-risk audit requests. However, the FMIS guidance differs from guidance in CAM." This is not correct. The FAO Management Information System (FMIS) User Manual does not provide guidance on the conduct of requests for specific cost information (telephone rate requests). Rather it provides guidance and instructions to the audit and administrative staff for the operation and maintenance of FMIS. The FMIS Manual in Appendix C includes a description of the time codes that auditors are to use in classifying their time charges. CAM prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in the performance of the DCAA mission. Auditors look to the CAM for guidance on the performance of requests for specific cost information not to the FMIS User Manual.

While we believe that auditors understand that the use of the time code 25000 is not limited to the form of the request, but to the type of services that are provided to a customer, we will clarify the FMIS User Manual description of 25000 – Telephone Rate Requests which currently states:

> Represents effort expended to respond to verbal requests for confirmation of rates or other pricing data which have already been determined. Dollars will not be reported under these assignments.

The clarification will focus on the auditor action of providing confirmation of data that has already been determined regardless of the manner in which the service was requested and move away from the use of the term "verbal requests". Within 60 days of the receipt of the final IG report, we will issue a Memorandum for Regional Directors advising them of this FMIS revision.

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