

AD-A137 466 DEPARTMENT OF DEFENSE PROGRESS IN RESOLVING CONTRACT 1/1

AUDITS(U) GENERAL ACCOUNTING OFFICE WASHINGTON DC

ACCOUNTING AND FINANCIAL MANAGEMENT DIV 27 OCT 83

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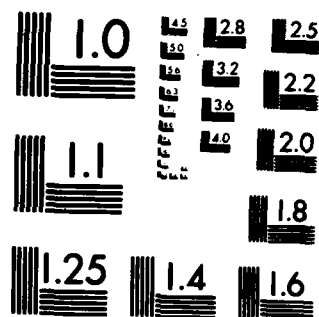
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REPORT BY THE
Comptroller General
OF THE UNITED STATES

**Department Of Defense Progress
In Resolving Contract Audits**

AD A 137466

The Department of Defense has progressed in establishing a contract audit resolution system. The purpose of the system is to ensure that managers appropriately use audit recommendations in the negotiation, administration, and settlement of contracts.

When the system was established in 1981, it had design weaknesses, and managers did not comply with system requirements. Revisions ordered in December 1982 and increased emphasis by top managers appear to have corrected many weaknesses. The revised system just became operational, and it is too early for GAO to determine the extent of compliance with system requirements. If properly implemented, the system should satisfy almost all government requirements for audit resolution. However, GAO thinks a few changes should still be made to improve effectiveness and to ensure economical operations.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-212126

The Honorable Jack Brooks
Chairman, Legislation and
National Security Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your December 14, 1982, request for our evaluation of the Department of Defense's (DOD's) contract audit resolution system. The system was established on August 31, 1981, by Department of Defense Directive 5000.42 and revised on December 29, 1982, by Department of Defense Directive 7640.2. The purpose of this system is to ensure that managers fully consider and implement, when appropriate, contract audit recommendations within prescribed time frames. Almost all the contract audits are conducted by the Defense Contract Audit Agency (DCAA). DCAA audits contractor cost estimates (preaward audits) as well as contractor costs and operations (post award audits).

You requested us to determine if (1) procurement officials comply with resolution system requirements, (2) the system meets government standards, and (3) the system needs improving.

Before the December 1982 revisions, the contract audit resolution system under Directive 5000.42 did not work as it was intended because of design weaknesses and because procurement officials did not comply with system requirements. Also, Defense has experienced mixed results in resolving audits. For instance, as of March 31, 1983 there were about 600 contract audits with questioned costs of \$1.7 billion which were unresolved longer than 6 months. This represented a 55 percent increase over the previous year. On the other hand, progress was made between August 1982 and October 1982 in closing some audits dating back to 1973.

Revisions made in the system by Directive 7640.2 in December 1982 corrected many of the weaknesses in Directive 5000.42. The revised system, though, has just become operational, and it is too early for us to determine the extent of compliance with system requirements. If properly implemented, the system should satisfy almost all government requirements for audit resolution. However, a few changes are still needed to improve effectiveness and ensure the most economical operation as discussed later in this report.

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POLICIES ON AUDIT RESOLUTION PRC:

To protect the government's interest, it is essential that officials promptly resolve audit recommendations and report their actions to top managers. This reporting enables managers to oversee the timeliness and quality of resolution decisions.

We and the Congress have strongly promoted more effective audit resolution for the federal government. The Congress enacted the Supplemental Appropriations and Recission Act, 1980 (Public Law 96-304) which requires agencies to decide within 6 months on the disposition of audits involving questioned costs. We issued three reports which showed problems with audit resolution and recommended better resolution systems.¹ Congressional committees have held several hearings on audit resolution and also recommended better systems.

Subsequently, the Office of Management and Budget (OMB) re-wrote the policy for federal agency audit resolution and issued Circular A-50 in September 1982. Circular A-50 requires agencies to establish audit resolution systems which ensure prompt and proper decisions on audit recommendations and implementation of corrective actions.

Also, we established an audit resolution standard on June 1, 1983, pursuant to requirements of the Federal Managers' Financial Integrity Act of 1982. The standard for audit resolution states:

Managers are to (1) promptly evaluate findings and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

The contract audit resolution system established by DOD requires contracting officers and acquisition managers to pursue resolution, including final disposition of contract audits, within 6 months of report issuance. It also requires them to report to top managers how contracting officers resolve audit recommendations. Specific features of the system common to both Directives 5000.42 and 7640.2 provide for

--tracking resolution, including final disposition of audits;

¹More Effective Action is Needed on Auditors' Findings--
Millions Can Be Collected or Saved" (FGMSD-79-3; Oct. 25, 1978).

Disappointing Progress in Improving Systems for Resolving
Billions in Audit Findings" (AFMD-81-27; Jan. 23, 1981).

Federal Agencies Negligent in Collecting Debts Arising from
Audits" (AFMD-82-32; Jan. 22, 1982).

- preparing resolution status reports every 6 months for specified types of audits;
- reviewing significant differences that contracting officers have with audit recommendations; and
- auditing the resolution system's effectiveness every 2 years.

Senior acquisition managers in each military department, the Defense Logistics Agency, and other acquisition organizations are designated as focal points to ensure proper implementation of the resolution system.

Although there are some features common to both directives, there are differences such as specific requirements for reporting resolution status and for reviewing significant disagreements that contracting officers have with audit recommendations. As discussed later in this report, Directive 7640.2 clarifies these requirements which caused problems in implementing Directive 5000.42.

SYSTEM UNDER DIRECTIVE 5000.42
DID NOT WORK PROPERLY

Defense Department internal auditors reported numerous instances when the resolution system under Directive 5000.42 did not work as it was intended. These problems were caused sometimes by unclear DOD directions and other times by noncompliance with clearly stated requirements. The following examples selected from internal audits completed during calendar year 1982 show some of the problems.

- The department's internal auditors reported that disputes between contracting officers and auditors were not always elevated to managers for resolution as called for in Directive 5000.42 to ensure that government negotiations with military contractors result in fair and reasonable prices. For example, 16 of 20 cases evaluated by Air Force auditors were not elevated appropriately. Also, auditors reported that one Army activity did not elevate 87 of 116 disputed recommendations from seven audits. In addition, Navy auditors found their service misdirected its personnel on which disputes to elevate. The military auditors attributed some of the problems to unclear DOD directions.
- The internal auditors also determined that resolution status reports to DOD managers required by Directive 5000.42 to hold contracting officers accountable for resolving audits within 6 months, omitted audits that should have been reported. For example, Defense auditors found that 35 of 141 audits that should have been reported by the Defense

Logistics Agency were not reported. Army auditors found another 37 audits omitted out of 88 reportable audits reviewed. In addition, Air Force auditors identified 37 audits that had not been reported. Navy auditors also found omissions, but they did not report how many. The military auditors attributed these omissions to unclear DOD directions on the types of audits that should have been reported.

--In addition, the internal auditors determined that Army and Air Force contracting officers did not always account for their use of audits. Directive 5000.42 required them to write contract negotiation memoranda explaining the rationale for their decisions on audit recommendations. Air Force auditors reported that only 2 of 121 memoranda examined properly explained the rationale for the officers' decisions. Thirty-one of 61 memoranda audited in the Army were inadequate. Army and Air Force auditors concluded that the contracting officers neglected their responsibilities for this requirement. On the other hand, Navy and Defense auditors did not report this problem.

Also, the inspector general's followup office identified problems similar to those found by internal auditors. For example, in 17 of 40 field trips made in 1982 and 1983 to procurement organizations, the office noted that the military services had not tracked or reported some audit dispositions.

SYSTEM UNDER DIRECTIVE 5000.42 ALSO HAD
MIXED RESULTS IN RESOLVING AUDITS PROMPTLY

The resolution system under Directive 5000.42 also was not effective in stemming an increase of questioned costs in audits unresolved for 6 months or longer; however, some progress was made in closing audits.

For the 12 months ending March 31, 1983, the inspector general's office reported that unresolved questioned costs from post award audits increased 55 percent. At the start of the period, 557 contract audit reports were over 6 months old and involved questioned costs of \$1.1 billion. At the end of the period, 606 reports, with questioned costs of \$1.7 billion, were older than 6 months. In addition, our analysis of Defense Contract Audit Agency data shows that unresolved questioned costs from post award audits over 1 year old increased 65 percent between September 30, 1980 and September 30, 1982. By comparison, costs questioned by DCAA in all post award audits increased only 27 percent during the same period. Although the data that we analyzed includes some audits issued before the resolution system under Directive 5000.42 was established, our analysis demonstrates that unresolved questioned costs increased at a substantially greater rate than total questioned costs increased.

On the other hand, the inspector general's office reported some progress in closing audits that were completed between 1973 and 1979. Of 118 audits that the secretary of defense had directed be closed, 62 percent (73 audits) were closed or in litigation as of October 1982. The 38 percent (45 audits) reported open mostly concerned defective pricing, overhead rates, and cost accounting standards.

The secretary of defense, who is committed to strengthening audit resolution, stated that the overall audit resolution results did not meet all his expectations. In an April 1983 memorandum to the secretaries of the military departments and the director, Defense Logistics Agency, he stated, "The Department's performance here may be related to insufficient personal attention on the part of higher management."

To a large extent, we think the success of contract audit resolution depends on the attention Defense procurement managers pay to it. Many did not want a contract audit resolution system. After reviewing proposals for establishing the resolution system, they commented that the administrative burden and costs outweighed the benefits of such a system. If the resolution system is to show better results, these managers will have to ensure that audit resolution gets more emphasis.

The appearance of the worsening performance in audit resolution reported by the inspector general may also be attributed to improved reporting. For example, Defense Logistics Agency officials told us that they reported audits as open that previously had not been reported. Internal auditors also found omissions from the reports, as we discussed earlier.

Furthermore, other factors affect audit resolution. For example, contractors may resist negotiating complex issues pertaining to cost accounting standards that may be precedent setting, or they may lack a financial incentive to settle a defective pricing audit.

PROGRESS MADE TO IMPROVE AUDIT RESOLUTION,
BUT SOME ADDITIONAL CHANGES ARE NEEDED

The deputy secretary of defense acted to improve contract audit resolution by revising DOD Directive 5000.42 and reissuing it as DOD Directive 7640.2 in December 1982. The revisions were made to clarify the directions with advice from the military departments, the Joint Logistics Commanders, and internal auditors and to implement OMB Circular A-50 requirements. The revisions, if properly implemented, should correct the problems experienced with Directive 5000.42.

The design of DOD's contract audit resolution system prescribed by Directive 7640.2 generally meets our recently established standard. The DOD system requires procurement managers, within 6 months of the audit report issuance, to (1) evaluate contract audit findings and recommendations, (2) determine proper

actions in response to them, and (3) pursue resolution, including final disposition of contract audits.

The design of the revised DOD system also generally complies with OMB's Circular A-50. Although there are some differences between the DOD system and what is called for in the OMB circular, OMB officials told us that the DOD system satisfies their objectives. OMB intended that its circular be policy guidance and not a prescription for how audit resolution will occur.

In one respect, the DOD system under both Directives 5000.42 and 7640.2 is designed to go beyond Circular A-50 requirements by urging all actions recommended by the auditors to be completed within 6 months. The circular requires that managers decide within 6 months what actions are needed in response to an audit, but it allows an unspecified period for completing the needed action.

One policy change, which was made with Directive 7640.2 in response to OMB Circular A-50, requires reporting all significant contract audits that are open and closed during a 6-month period. Previously only the audits that were open over 6 months were reported. The policy change will give management information to monitor the appropriateness of contracting officer decisions in closing audits.

Another policy change, which was made to eliminate confusion and differing interpretations of criteria in Directive 5000.42, clarified dollar thresholds and situations for elevating disputes and reporting to managers. According to the inspector general's followup office, the changed thresholds were intended to capture a high percentage of questioned costs while minimizing administrative burdens. For example, the inspector general's office estimated that the threshold of \$500,000 in questioned costs for elevating disputed preaward audits would have captured 90 percent of the \$17 billion questioned one year, but would only require covering 10 percent (2,700) of the audits. Our analysis shows this estimate is reasonably accurate.

Efforts are under way to implement the changes instituted by DOD Directive 7640.2. The four major DOD contracting components, the Army, Air Force, Navy, and the Defense Logistics Agency, issued implementing instructions in April and June 1983. We reviewed those instructions and found that they generally comply with DOD Directive 7640.2. However, at the time of our review, the instructions had not been implemented. The first reports showing audit resolution results under the revised system are due in October 1983. Further, internal audits of the revised system are planned for 1984.

Also, the secretary of defense directed managers to be more committed to resolving contract audits. He told the military department secretaries to submit management action plans for contract

audit resolution showing overall program objectives and specific goals. Plans for each military service and the Defense Logistics Agency were completed in May 1983. Although the specificity of goals and objectives vary, each organization plans to give audit resolution additional emphasis.

Although we are encouraged by DOD's efforts with Directive 7640.2, we identified four aspects of the new resolution system where changes are needed to improve effectiveness and to ensure the most economical operations.

Need to address resolution
in performance appraisals

To help ensure that managers attend to audit resolution, DOD should require that performance appraisals of appropriate officials reflect their effectiveness in acting on audits. OMB Circular A-50 requires this, and the House Committee on Government Operations and we have recommended similar action in the past as a way of ensuring accountability for audit resolution.

However, there is no DOD-wide requirement for performance appraisals to address audit resolution. A survey by the inspector general's office found that resolution was not a factor in appraisals of any high level procurement officials. Among the services, only Navy had plans to require resolution as a factor. The need for accountability is especially important in view of the (1) secretary of defense's statement that top managers' attention is needed to ensure effective audit resolution and (2) internal audit findings of noncompliance with resolution system requirements.

In contrast, the General Services Administration, whose audit resolution system we compared with DOD's, has established an agency-wide policy requiring senior executive service and merit pay performance plans to include audit resolution as an objective. Executive performance requirements include following audit resolution procedures, taking satisfactory and prompt corrective actions, documenting actions taken before and after contract negotiations, and ensuring that implementation of Circular A-50 is in the merit pay performance plans of appropriate merit pay officials. We agree with this policy and think it is equally appropriate for DOD.

Need to determine the cost of
having DCAA report resolution results

DOD procurement officials estimate that it costs them \$2.3 million annually to report information on contract audit resolution status as required by Directive 7640.2. DCAA, which already collects most of the information, may be able to report the information for less cost. DOD should determine the more cost effective method.

DOD procurement officials complained of the high cost for them to report resolution results and some officials thought DCAA could prepare the reports at lower cost. We found that DCAA's management information system already contains all the information that procurement officials are required to report on closed audits and most of the information required for open audits. DCAA would need to gather some information, for example, the contracting officer's target date for acting, to provide all the data required. Although, because our audit time was limited, we did not determine the cost of having DCAA prepare the reports, it appears that DCAA, with minimal additional effort, could assume the reporting responsibility.

Need to improve audit resolution
information provided to the Congress

Information that DOD currently gives the Congress does not explain the extent to which DCAA recommendations are upheld. For instance, the semiannual inspector general report to the Congress showing DCAA's "questioned costs" and "questioned costs sustained" does not refer to the same set of audits. Questioned costs refers only to audits issued in the report period, but questioned costs sustained refers to audits issued in prior periods as well as some issued during the report period. With information on a comparable set of audits, the Congress could better monitor the extent to which auditors' recommendations are upheld. Also, the semiannual report contains examples of contract audit settlements, but the examples do not explain the basis for contracting officer decisions. For instance, the report shows the amount of reduction made to a contractor's payment after an audit, but it does not show the amount questioned by the auditors or why the reduction may differ from the amount questioned. Such added information could help the Congress determine whether DOD appropriately uses its contract audits.

Need to periodically evaluate
contracting officer use of audits

DOD Directive 7640.2 requires that the inspector general "monitor and evaluate program performance and the adherence of DOD components to contract audit followup policies and procedures." To more effectively carry out this requirement and to help ensure proper resolution of contract audits, the inspector general should periodically evaluate contracting officer resolution decisions. The authors of OMB Circular A-50 told us that they expect internal auditors to review contracting officer use of audits.

Internal audit officials said they occasionally review contracting officer resolution decisions, but only one agency had a plan for a review, and none of the four internal audit agencies could give us examples of their reviews. Audit officials are reluctant to evaluate contracting officer decisions because they think it is impossible to duplicate the exact situations in which

the decisions were made and they do not want to second guess the officers' judgment. In our view, auditing a contracting officer's resolution decision for the most part is not substantially different from other internal audits of procurement decisions, but there can be some difficulties in conducting such an evaluation when contracting officers do not properly account for their use of audits in procurement decisions as the internal auditors previously reported.

After our evaluation was completed, the inspector general told his auditors in August 1983 that he would like them to review contracting officer decisions on recent contract audits. We support the idea of this review and think similar reviews should be performed periodically.

CONCLUSIONS

The Department of Defense has progressed in establishing a system to resolve contract audits. Although the system initially had shortcomings, important corrections have been ordered. The first reports under the revised system are due in October 1983.

The revised system is designed so that it generally satisfies OMB policy and our audit resolution standard. However, we think the four additional actions discussed previously are needed.

RECOMMENDATIONS

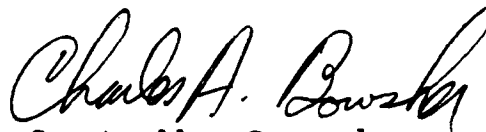
We recommend that the secretary of defense require performance appraisals to reflect officials' effectiveness in resolving contract audits. We also recommend that the secretary compare the cost of having the Defense Contract Audit Agency report the status of audit resolutions with the cost of current requirements and implement the less costly approach. In addition, we recommend that the inspector general revise the contract audit resolution information provided to the Congress in his semiannual report to explain more fully how the Department of Defense uses contract audits. Finally, we recommend that the inspector general periodically audit contracting officer resolution decisions.

Details about our objectives, scope, and methodology are in appendix I. We discussed issues in the report with appropriate DOD officials; however, as requested, we did not obtain official agency comments.

B-212126

As arranged with your Office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

A handwritten signature in cursive script, reading "Charles A. Bowsher". The signature is written in dark ink and is positioned above the printed name and title.

Comptroller General
of the United States

OBJECTIVES, SCOPE, AND METHODOLOGY

We conducted this review at the request of the Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations. Our objectives were to determine if (1) procurement managers comply with Department of Defense contract audit resolution system requirements, (2) the system meets government standards, and (3) the system needs improving. We did not determine if the resolution system results in the effective use of contract audits, but we have an ongoing audit which is examining that.

To determine if the Department of Defense properly implemented the resolution system, we reviewed the reports and available workpapers from four internal audits of compliance with Defense Directive 5000.42 which established the system. The Defense Audit Service, Army Audit Agency, Air Force Audit Agency, and Naval Audit Service audited 59 procurement locations of the Defense Logistics Agency, Army, Air Force, and Navy. We did not compare resolution system compliance among the military departments and the logistics agency because the scope of the internal audits varied. In addition to reviewing audits, we examined reports of 40 field visits by audit followup officials in the DOD inspector general's office.

We reviewed Defense's planned implementation of Directive 7640.2 by interviewing DCAA, Army, Navy, Air Force, and Defense Logistics Agency officials and examining their implementing instructions.

We assessed the promptness of contract audit resolution by reviewing DOD inspector general semiannual resolution status reports and analyzing DCAA data. We also reviewed Defense management action plans for resolving contract audits.

To determine if the resolution system design meets government standards, we compared Defense Directive 7640.2, which currently governs the system, with our recently issued audit resolution standard and OMB Circular A-50 which is the governmentwide policy for audit resolution. We also interviewed the authors of Directive 7640.2 and Circular A-50.

We discussed contract audit resolution with officials from DCAA, the Army, Navy, Air Force, Defense Logistics Agency, DOD inspector general's office, and DOD internal audit agencies. We reviewed the General Services Administration and the National Aeronautics and Space Administration contract audit resolution systems for design features that could improve DOD's system.

We conducted our evaluation from January through June 1983, in the Washington, D.C. area. We discussed issues in the report with appropriate DOD officials; however, as requested, we did not obtain official agency comments. Except for that, the evaluation was conducted in accordance with generally accepted government auditing standards.

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