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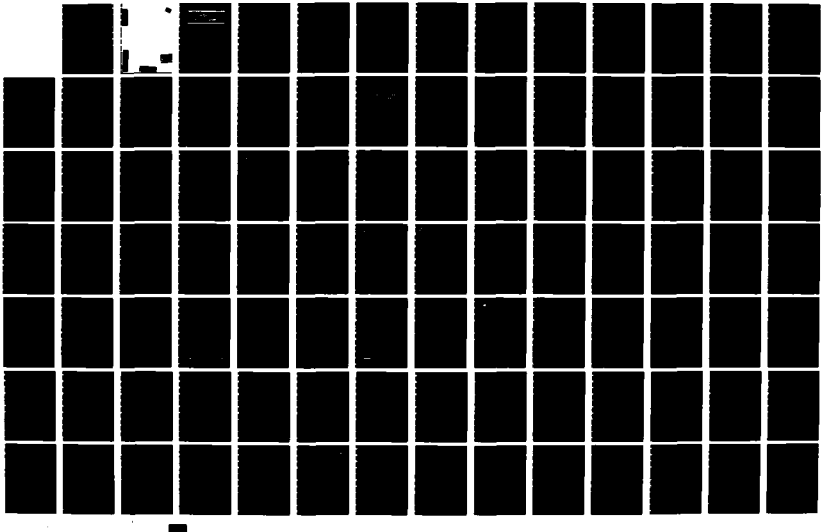

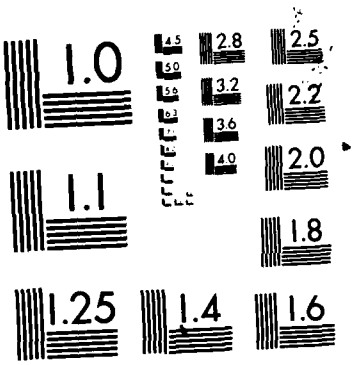

Conduct and Accountability

A Report to the President

by the President's
Blue Ribbon Commission
on Defense Management

June 1986

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Introduction

Our study of defense management compels us to conclude that nothing merits greater concern than the increasingly troubled relationship between the defense industry and government. We have, therefore, given highest priority to development of recommendations which, if implemented, will result in a more satisfactory working relationship between government and that industry. In our *Interim Report*, we made six broad recommendations directed toward improving that relationship. In this conclusion of our work, we offer more detailed observations that will treat the more troublesome aspects of government-industry accountability.

From its earliest days, the United States has relied on private industry for procurement of needed military equipment. The vigor of industry is indispensable to the successful defense of America and the security of our people.

The Department of Defense (DoD) annually conducts business with some 60,000 prime contractors and hundreds of thousands of other suppliers and subcontractors.[1] In 1985, the Department placed contracts worth approximately $164 billion, seventy percent of which went to a group of 100 contractors. Twenty-five contractors did business of $1 billion or more, 147 did $100 million or more, and almost 6,000 did $1 million or more.

Acquisition of the tools of defense is an immense and complex enterprise. The Commission believes that DoD reliance on private industry has not been misplaced. The success of this enterprise, however, is now clouded by repeated allegations of fraudulent industry activity. With notable results, DoD has devoted increased attention and resources to detecting and preventing unlawful practices affecting defense contracts.[2] But a plethora of departmental auditors

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[1]See *The Government's Role in Preventing Contractor Abuse: Hearings before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce*, 99th Cong., 1st Sess. 402 (1985) (Statement of Joseph H. Sherick, Inspector General, DoD). As noted in our *Report on Defense Acquisition*, defense contracting is a business of nearly 15 million separate contract actions each year — an average of 56,000 such actions every working day. Contract goods and services sustain 5,500 defense installations and activities throughout the world.

[2]As of May 1985, 131 separate investigations were pending against 45 of the DoD's 100 largest contractors. These involved such issues as defective pricing, cost and labor mischarging, product substitution, subcontractor kickbacks, and false claims. From June 1983 to April 1985, 12 separate investigations were instituted against one major contractor alone.

and other overseers—and the burgeoning directives pertaining to procurement —also have tended to establish a dysfunctional and adversarial relationship between DoD and its contractors.

Widely publicized investigations and prosecutions of large defense contractors have fostered an impression of widespread lawlessness, fueling popular mistrust of the integrity of defense industry. A national public opinion survey, conducted for the Commission in January 1986, revealed that many Americans believe defense contractors customarily place profits above legal and ethical responsibilities. The following specific conclusions can be drawn from this survey:[3]

- Americans consider waste and fraud in defense spending a very serious national problem and one of major proportions. On average, the public believes almost *half* the defense budget is lost to waste and fraud.

- Americans believe that fraud (illegal activity) accounts for as much loss in defense dollars as waste (poor management).

- While anyone involved in defense procurement is thought likely to commit fraudulent and dishonest acts, defense contractors are widely perceived to be *especially* culpable for fraud in defense spending.

- In overwhelming numbers, Americans support imposition of the severest penalties for illegal actions by contractors—including more criminal indictments—as a promising means to reduce waste and fraud.

- Nine in ten Americans believe that the goal of reduced fraud and waste also could be served through development and enforcement of strict codes of conduct. Americans are almost evenly divided, however, on whether defense contractors can be expected to live up to codes they develop for themselves.

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[3]The survey — *U.S. National Survey: Public Attitudes on Defense Management* (Jan. 1986) — was designed to provide the Commission information about American public opinion on a broad range of defense management issues. These included, among others, the seriousness and causes of waste and fraud in defense spending, as well as possible solutions for these problems. The survey was performed by Market Opinion Research, whose compilation and analysis of survey results are included as an appendix to the *Final Report* of the Commission.

- Four in five Americans think that defense contractors should feel an obligation, when doing business with DoD, to observe ethical standards higher than those observed in their normal business practices.

The depth of public mistrust of defense contracting is deeply disquieting for a number of reasons. First, the public is almost certainly mistaken about the extent of corruption in industry and waste in the Department. While fraud constitutes a serious problem, it is not as extensive or costly as many Americans believe. The nation's defense programs lose far more to inefficiency than to dishonesty.

Second, a lack of confidence in defense contractors may affect public support for important defense programs, and thus weaken our national security. Restoring public confidence in our acquisition system is essential if we are to ensure our defense.

Third, the current popular impression of runaway fraud and waste undermines crucial support for implementing precisely those management reforms that would increase efficiency. These include executive and congressional support for sensible new longer-term planning and budgeting procedures, recommended by the Commission, to eliminate major but hidden costs that instability imposes on our overall defense effort.

Fourth, the Commission is concerned that the current adversarial atmosphere will harm our industrial base. It is important that innovative companies find it desirable to contract with DoD. In current circumstances, important companies could decide to forego this opportunity.

Finally, it is significant that private businesses bear the brunt of public indignation over waste and fraud in our defense programs. With most Americans, we believe that those who contract in the defense of our country must perform at a higher level than business as usual. It stands repeating, from our *Interim Report*, that:

> management and employees of companies that contract with the Defense Department assume unique and compelling obligations to the people of our Armed Forces, the American taxpayer, and our nation. They must apply (and be perceived as applying) the highest standards of business ethics and conduct.

By this measure, the national opinion survey represents a striking vote of no confidence in defense contractors generally.

Though government oversight is critically important to the acquisition process, no conceivable number of additional federal auditors, inspectors, investigators, and prosecutors can police it fully, much less make it work more

effectively. Nor have criminal sanctions historically proved to be a reliable tool for ensuring contractor compliance.[4] We conclude there is a particular urgency in dealing affirmatively with contractor practices.

To this end, leaders in the defense industry recently have committed themselves to an initiative, consistent with recommendations of our *Interim Report* on Government-Industry Accountability, that promises collective and highly constructive action. This noteworthy effort is embodied in a document signed to date by at least 32 major defense contractors who pledge to adopt and to implement a set of principles of business ethics and conduct that acknowledge and address their corporate responsibilities under federal procurement laws and to the public.[5] All signatories pledge to:

- have and adhere to written codes of conduct;
- train their employees in such codes;
- encourage employees to report violations of such codes, without fear of retribution;
- monitor compliance with laws incident to defense procurement;
- adopt procedures for voluntary disclosure of violations and for necessary corrective action;
- share with other firms their methods for and experience in implementing such principles, through annual participation in an industry-wide "Best Practices Forum"; and
- have outside or non-employee members of their boards of directors review compliance.

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[4]Prosecutorial resources are limited. Evidence of criminal conduct is often insufficient for proof beyond reasonable doubt. Some cases lack prosecutive merit or jury appeal. In others, criminal sanctions are deemed less appropriate than administrative remedies. Still other cases involve little or no financial loss to the federal government. For these and other reasons, the Department of Justice declines to prosecute approximately six in ten possible fraud cases referred to it by federal agencies. See U.S. General Accounting Office, *Fraud in Government Programs: How Extensive Is It? How Can It Be Controlled?* GAO/AFMD-81-57, at 28-30 (May 7, 1981).

[5]See *Defense Industry Initiatives on Business Ethics and Conduct* (June 1986), which is included as Appendix A to this report on *Conduct and Accountability*.

To lend additional force and credibility to their initiative, these contractors further propose that a respected organization, independent of both the government and defense industry, be commissioned to report annually the results of a survey assessing compliance with the above principles.

Such a commitment by its leaders would be an impressive undertaking for any industrial group, and it is particularly appropriate for defense contractors. We hope many other firms will make this pledge of self-governance and share in an initiative voluntarily begun and freely joined by defense contractors themselves. At least one major industry association is, we understand, considering making adherence to these principles a condition of membership.

We are convinced that significant improvements in corporate self-governance can redress shortcomings in the procurement system and create a more productive working relationship between government and industry. Corporate managers must take bold and constructive steps that will ensure the integrity of their own contract performance. Systems that ensure compliance with pertinent regulations and contract requirements must be put in place so that violations do not occur. When they do occur, contractors have responsibilities not only to take immediate corrective action but also to make disclosures to DoD.

We do not underestimate this task—it is enormous and demanding. Requirements of diligence imposed on contractor management are unquestionably stringent but are not more stringent than the public has a right to expect of those who hold positions of authority with businesses on which the national security depends. Contractor effort to improve performance should not be impeded by DoD action; instead DoD should foster effective contractor self-governance. It is in this context that we offer the recommendations that follow.

I. Industry Accountability: Contractor Self-Governance

In our view major improvements in contractor self-governance are essential.

Contracting with DoD is markedly different from other commercial contracting activity. Defense contractors must observe various unique and complex contractual, regulatory, and statutory requirements in bidding for, performing, and warranting fixed-price and cost-type contracts. A distinct body of contract principles has evolved in the defense contracting field.

Recent cases have involved violations of specific contractual and regulatory provisions. Many of these violations have resulted from management failure to establish internal controls to assure compliance with unique DoD requirements. Contractors historically relied on DoD auditors to identify instances where standards were not followed, and contractor failure to establish internal controls has developed in this regulated environment. Also in this environment, contractor defaults were largely resolved contractually rather than through criminal or civil actions.

Today, defense contractors should be aware that a concerned and responsible government will aggressively enforce compliance. Contractors will be required to do *much more* than they have done in the past to comply with contractual, regulatory, and statutory standards and to provide adequate supervision and instruction for employees. To do so will necessitate their putting in place broad and effective systems of internal control. The effectiveness of such systems depends upon a host of factors, including:

- good organizational structure, providing for proper delegation of authority and differentiation of responsibilities;
- clear policies and procedures, well adapted to business objectives and to specific tasks and functions;
- training of and communication with employees at all performance levels; and

- ongoing arrangements to monitor compliance with, and to evaluate the continuing efficacy of, internal control.

The requirements of defense contracting establish an especially high standard against which the adequacy of systems of contractor internal control must be measured. It is not prudent or possible to detail specific systems of control adequate to the needs of every defense contractor. This must be determined in light of each contractor's circumstances, including its size, operating habits, nature of business, range of products and services, and geographical dispersion of operations. Contractors should undertake careful review of the adequacy of their specific internal control systems, evaluate potential improvements, and determine what steps will provide greater assurance of compliance with contracting requirements.

Information developed by the Commission indicates that corporate controls could be greatly improved in at least three fundamental areas:

- development of codes of conduct addressing problems and procedures incident to defense procurement;

- promulgation and enforcement of more effective internal control systems to ensure compliance with those codes and the establishment of internal auditing capacity to monitor, among other things, compliance with codes and the efficacy of the control systems; and

- establishment of a more effective oversight of the entire process by an independent committee, such as an outside audit committee of the board of directors.

A. Contractor Standards of Conduct

Defense contractors must promulgate and enforce codes of conduct that address their unique problems.

Written standards of conduct are necessary to establish an environment in which a contractor's goals and its administrative and accounting controls become understood and functional. A well-drafted code is more than a mere direction to employees on what is and what is not permissible conduct, although that is certainly a major function of the code. It can provide a conceptual framework for both management and employees to understand how company policy interrelates with other applicable policies. It can articulate principles on the basis

of which decisions should be made when government regulations fail to address issues specifically. In the broad sense, a code of conduct should be designed to preserve or enhance a contractor's reputation for integrity. In our *Interim Report* we recommended:

> Defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance.

This recommendation was based, in part, on a study undertaken for the Commission by the Ethics Resource Center, Inc.[6] In surveying the practices of a representative sampling of major defense contractors, the Center inquired about the:

- processes for establishing, and the form and content of, corporate policies and procedures for ensuring ethical conduct in dealings with the federal government and with subcontractors, suppliers, and others;
- means contractors use for communicating these policies and procedures;
- internal systems contractors use for monitoring and enforcing their policies and procedures; and
- internal contractor systems for adjudicating and punishing violations.

The Center's survey documents more widespread adoption of business codes of conduct among defense firms than among American companies generally, and suggests relatively greater appreciation by contractors of the risks of unethical conduct and the value of explicit standards of behavior. The survey also indicates, however, that contractors' codes often fail to address areas in government contracting where the incidence of misconduct is highest. For example, matters such as cost allocation, quality control, bidding and billing

[6]Ethics Resource Center, Inc., a non-profit organization located in Washington, D.C., has done extensive study of issues involved in ethical corporate governance. The results of its work for the Commission are set forth in a *Final Report and Recommendations on Voluntary Corporate Policies, Practices, and Procedures Relating to Ethical Business Conduct* (Feb. 18, 1986), which is included as Appendix B to this report on *Conduct and Accountability*.

practices, defective pricing, materials substitution, contract negotiation, the monitoring of contract compliance, and the hiring of former Defense Department personnel were explicitly addressed in only a third of the codes of those defense contractors surveyed.

There are also inadequacies in the communication and enforcement of standards of conduct. For example, only half the contractors with written codes indicated that they distribute copies to all employees, and many reported that distribution was limited to only senior management. Only half the codes specified procedures for employees to follow in reporting possible misconduct, and barely one in five provided procedures for protecting employees who bring unethical practices to light. Finally, although trends indicate an increasing attention by upper management to business ethics issues, the survey documents the need for much better mechanisms at highest corporate levels to monitor and enforce compliance. Too often industry regards promulgation of a code of conduct as the end product and does not aggressively pursue its enforcement.

The Commission makes the following specific recommendations regarding codes of conduct for defense contractors:

1. Each contractor should review its internal policies and procedures to determine whether, if followed, they are sufficient to ensure performance that complies with the special requirements of government contracting. Contractors should adopt—or revise, if they have adopted—written standards of ethical business conduct to assure that they reasonably address, among other matters, the special requirements of defense contracting. Such standards of conduct should include:

a. procedures for employees to report apparent misconduct directly to senior management or, where appropriate, to a member of the committee of outside directors—ideally the audit committee—that has responsibility for oversight of ethical business conduct; and

b. procedures for protecting employees who report instances of apparent misconduct.

2. To ensure utmost propriety in their relations with government personnel, contractor standards of ethical business conduct should seek to foster compliance by employees of DoD with ethical requirements incident to federal service. To this end, contractor codes should address real or apparent conflicts of interest that might arise in conducting negotiations for future employment with employees of DoD and in hiring or assigning responsibilities to former DoD officials. Codes should include, for example,

existing statutory reporting requirements that may be applicable to former DoD officials in a contractor's employ.

3. Each contractor must develop instructional systems to ensure that its internal policies and procedures are clearly articulated and understood by all corporate personnel. It should distribute copies of its standards of ethical business conduct to all employees at least annually and to new employees when hired. Review of standards and typical business situations that require ethical judgments should be a regular part of an employee's work experience and performance evaluations.

4. Contractors must establish systems to monitor compliance with corporate standards of conduct and to evaluate the continuing efficacy of their internal controls, including:

a. organizational arrangements (and, as necessary, subsequent adjustments) and procedural structures that ensure that contractor personnel receive appropriate supervision; and

b. development of appropriate internal controls to ensure compliance with their established policies and procedures.

5. Each major contractor should vest its independent audit committee—consisting entirely of nonemployee members of its board of directors—with responsibility to oversee corporate systems for monitoring and enforcing compliance with corporate standards of conduct. Where it is not feasible to establish such a committee, as where the contractor is not a corporation, a suitable alternative mechanism should be developed. To advise and assist it in the exercise of its oversight function, the committee should be entitled to retain independent legal counsel, outside auditors, or other expert advisers at corporate expense. Outside auditors, reporting directly to the audit committee or an alternative mechanism, should periodically evaluate and report whether contractor systems of internal controls provide reasonable assurance that the contractor is complying with federal procurement laws and regulations generally, and with corporate standards of conduct in particular.

The Commission believes that *self*-governance is the most promising mechanism to foster improved contract compliance. It follows that each contractor must individually initiate, develop, implement, and enforce those elements of corporate governance that are critical to contract compliance, including a proper code of conduct. The extent of each contractor's efforts in doing so will reflect the level of reputation for integrity it intends to set for itself.

B. Contractor Internal Auditing

Contractors must develop and implement internal controls to ensure compliance with corporate standards of conduct and the requirements of defense contracting.

Contractors must also establish an internal audit capacity to monitor whether the controls they have put in place are effective. Internal auditing will help ensure contractor compliance with internal procedures, standards of conduct, and contractual requirements. An internal audit organization, to serve these purposes, must be staffed with competent personnel able to operate with the requisite degree of independence and candor.

Use of internal auditing to review adherence to procurement requirements involves a significant broadening of the traditional application of this monitoring device. In developing new auditing processes to review these issues, contractors must consider which areas are most sensitive and in need of audit review, as well as which auditing devices will be most cost-effective and efficient.

Recommendations in our *Interim Report* encouraging increased self-governance were based, in part, on an internal audit study completed for the Commission by the certified public accounting firm of Peat, Marwick, Mitchell & Co.[7] Over 210 business units—aggregating approximately $90 billion in DoD fiscal year 1985 outlays for negotiated contracts—participated in the survey. The survey was designed to ascertain, among other things, the following:

- the extent to which internal auditing, in addition to its traditional applications, has been utilized to monitor defense contract compliance;
- the scope and coverage of such expanded auditing efforts;
- the effectiveness and usefulness of such internal auditing; and
- the extent to which, in view of recent developments, contractors intend to expand their internal audit capability or coverage.

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[7]Peat, Marwick's *Report on Survey of Defense Contractors' Internal Audit Processes* (Feb. 1986) is included as Appendix C to this report on *Conduct and Accountability*. For survey purposes, "internal auditing" was considered to include any regular, cyclical, or special examination conducted by or on behalf of a company's management to assess the extent of compliance with the company's established policies, procedures,and systems of internal controls. This excluded normal supervisory efforts as well as financial audits performed by a company's independent accountants.

The survey indicates that most contractors have internal audit functions of some kind and that many companies recently have expanded internal auditing to cover more aspects of their government contract operations. But it also provides compelling evidence of a need for defense industry generally to upgrade the capabilities and broaden the mission of its internal auditors. Among other important results of the survey are the following:

Internal Auditing Capacity. Over one-quarter of the business units surveyed had *no* formal internal audit function; over two-thirds had no such function at their operating levels. Seven in ten indicated that they rely for audit coverage, in whole or in part, on the work of independent accountants and on government auditors. Given the added degree of effort needed to monitor government contract work, internal audit staffs are too small: 58 percent of the business units surveyed had fewer than 10 internal auditors, and almost two-thirds reported that their internal audit staffs do not complete a full cycle of auditable areas within a three-year period.

Scope of Internal Auditing. To serve the purpose of improving compliance with federal procurement laws, internal auditing must address a variety of practices specific to government contracts. Effective audits of such practices require more penetrating evaluations performed more frequently than do traditional financial audits. The survey shows that, despite recent efforts by contractors to broaden internal auditing efforts, sensitive issues of contract compliance are not reviewed adequately. These include key areas of labor cost distribution and controls, material management, estimating practices, cost allowability, accuracy of costing and reporting, and contract administration.

Competence of Internal Audit Staff. Internal audit staffs—where they exist—generally have a satisfactory professional background. They need substantially more formal training, however, in areas critical to compliance with federal procurement law, including Cost Accounting Standards, Federal Acquisition Regulation, Truth in Negotiations Act, and fraud detection. Approximately a quarter of the units surveyed provide training in none of these areas, and less than a quarter provide training in all of them.

Effectiveness of Internal Auditing. Internal auditors must operate with independence and objectivity.[8] By this measure, the basic design of contractors' internal audit programs appears to be good. The survey nonetheless indicates

[8]The independence of internal auditors depends in part upon the organizational levels to which they communicate results of their work and to which they report administratively. These are indicative of internal auditors' ability to act independently of individuals responsible for the functions being audited. The objectivity of internal auditors may be judged from findings and recommendations made in their reports, the frankness of which can depend in important part

several areas of concern. Audit design may be inadequate because its scope is determined largely by management requests. Management may not in all cases be assuming proper responsibility or taking necessary action for follow-up on problems identified through internal auditing. Moreover, the wide availability to government personnel of internal audit reports and supporting work papers may not be conducive to auditors' candor and objectivity concerning the performance of the individuals responsible for the functions being audited.

We conclude that defense contractors have failed to take advantage of assistance that internal auditors may provide to management responsible for the design and function of systems of internal control of government contracting. Identifying important elements of such systems and remedying their weaknesses and deficiencies should be matters of the highest priority to all defense contractors. This demands ongoing study and evaluation of a sort that cannot be provided by either a company's outside auditors or by government auditors.[9]

Defense contractors must individually develop and implement better systems of internal controls to ensure compliance with contractual commitments and procurement standards. To assist in this effort and to monitor its success, we recommend contractors take the following steps:

1. *Establish internal* auditing of compliance with government contracting procedures, corporate standards of conduct, and other requirements. Such auditing should review actual compliance as well as the effectiveness of internal control systems.

2. Design systems of internal control to ensure that they cover, among

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on the extent to which such reports are regularly accessible to others, particularly to government agencies. See American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 9*, "The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination."

[9]A company's outside auditors ordinarily review and evaluate internal control (primarily accounting control) only to determine the nature, extent, and timing of audit tests they must conduct annually in examining a contractor's financial statements. Even for this limited purpose, however, internal control of government contracting poses audit considerations broader than has yet been reflected in the accounting profession's formal guidance to its own members on traditional financial audits of government contractors. See American Institute of Certified Public Accountants, *Audits of Government Contractors* (2d ed. 1983). A Task Force of the American Institute of Certified Public Accountants is now at work on a revised industry audit guide that promises to be of greater assistance to outside auditors, internal auditors, and contractor management.

other things, compliance with the contractor's standards of ethical business conduct.

3. Establish internal audit staffs sufficient in numbers, professional background, and training to the volume, nature, and complexity of the company's government contracts business.

4. Establish sufficient direct reporting channels from internal auditors to the independent audit committee of the contractor's board of directors to assure the independence and objectivity of the audit function. Auditors should *not* report to any management official with direct responsibility for the systems, practices, or transactions that are the subject of an audit. Such structure assures frank reporting of and prompt action on internal audit results. To encourage and preserve the vitality of such an internal auditing and reporting process, DoD should develop appropriate guidelines heavily circumscribing the use of investigative subpoenas to compel disclosure of contractor internal auditing materials.

Major contractor improvements in recommended self-governance will, no doubt, require considerable effort over several years. Making these improvements will also require greater involvement by contractors' boards of directors and top management. The importance of the executive leadership role in achieving a proper control environment cannot be overemphasized. The necessary initiatives must be instituted by industry, not government. Defense contractors must take the steps described above or run the risk of action by government, in response to public expectations, that may be both excessive and unavailing. We share the concerns of the Ethics Resource Center that:

> intensive federal regulation has not only increased costs and lead-time, but may have actually decreased the sense of individual and corporate responsibility for the quality of products and services delivered to the federal government. The standard of ethical business conduct seems to have become regulatory compliance, rather than responsible decision making. In areas where these are not coincidental or where regulations do not dictate conduct, the management conscience may fail. The sense of moral agency and ethical responsibility may be overridden by the "gamesmanship" attitude fostered by regulatory adversarialism.
>
> Whatever actions the present Administration or the Congress may take to improve the effectiveness of federal regulations and oversight activities, serious attention must be paid to the inherent limitations and possible

counter-productivity of an approach that is almost entirely a matter of external policing.[10]

The process by which a contractor recognizes and distinguishes responsibility for compliance from a mere facade of compliance is self-governance, and essential elements of that process are implementation and enforcement of proper codes of conduct and internal auditing systems.

Vigorous programs of the sort recommended hold far greater potential for ensuring the integrity of defense contracting than does increased government oversight. Successful self-policing by defense contractors has the considerable advantage of making such oversight more efficient and effective. For very practical reasons, therefore, government must exert its authority to oversee the defense acquisition process in ways calculated to hasten the progress of responsible companies toward improved self-governance. Our study of Defense Department practices—with respect to administering its own standards of ethical conduct, coordinating its own auditing and oversight efforts, and employing the range of possible sanctions against contractor misconduct—suggests various areas for improvement. These we address below.

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[10]See Ethics Resource Center, *Final Report and Recommendations*, Appendix B, at 49.

II. Government Accountability: DoD Auditing and Oversight, Standards of Conduct, and Enforcement

To ensure accountability for its own operations and programs, the federal government has systems of administrative and accounting control that are analogous to those in the private sector. Their effectiveness is dependent on comparable factors such as organization, policies and procedures, and personnel. Our study persuades us that, much as with defense industry, DoD must exert substantially better internal control if it is to improve the effectiveness of its programs for contract auditing and oversight, employee standards of conduct, and civil and administrative enforcement.

A. Department of Defense Auditing and Oversight

Oversight of defense contractors must be better coordinated among DoD agencies and Congress. Guidelines must be developed to remove undesirable duplication of official effort and, when appropriate, to encourage sharing of contractor data by audit agencies. The new Under Secretary of Defense (Acquisition) should establish appropriate overall contract audit policy.

As stated in our *Interim Report*, there is an unquestioned need for broad and effective administrative oversight of defense acquisition. DoD monitors the performance of defense contractors and the integrity of contractor compliance by a number of processes, including investigations, inspections, and special-purpose reviews conducted by personnel of:

- the Defense Contract Administration Services (DCAS) of the Defense Logistics Agency (DLA);
- the Services' respective plant representative offices (PRO), audit agencies, investigative services, and inspectors general;
- the Defense Contract Audit Agency (DCAA);
- the Defense Criminal Investigative Service;
- the DoD Office of the Inspector General (OIG); and
- DoD's many procurement and contract management organizations.

Overseeing these efforts are the General Accounting Office (GAO), committees and subcommittees of Congress, and congressional staff.

The oversight apparatus within DoD has evolved over time. As various organizations and activities have been established, their jurisdictions, functions, and responsibilities have emerged, often without clear delineation. Today, a distinction may be drawn between criminal investigative and internal auditing responsibility—largely consolidated under the OIG—and procurement and contract administrative responsibility—traditionally exercised by the DCAS and cognizant Service PRO with the advice and assistance of DCAA auditors. Proper coordination and economy of oversight effort have proven particularly difficult to achieve in view of the multiplicity of DoD organizations involved.

At the outset of our work we were aware of concerns that control over DoD contract oversight efforts had degenerated. Most notably, the Senate Armed Services Committee has expressed the view that contract auditing requires sound overall coordination to promote efficiency and minimize duplication of effort.[11] In December 1985, the OIG reported the results of a survey conducted by that office to determine whether effective coordination exists among various DoD organizations involved in the oversight of contractor operations in order to avoid unnecessary duplicative efforts.[12] The survey examined 25 separate Department reviews conducted in 1984 at two major contractor locations. Fourteen of these 25 oversight exercises—involving altogether some 13

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[11]S. Rep. No. 41, 99th Cong., 1st Sess., 214 (1985).

[12]See Office of the Inspector General, DoD, *Report on The Survey of Department of Defense Oversight of Contractors' Operations*, No. APO 86-001, at 4 (Dec. 1985).

different DoD organizations, the GAO, and a prime contractor—were found to involve elements of needless duplication. The Inspector General concluded, "Unless specific actions are taken to address the problems of coordination, unnecessary duplicative reviews (of this sort) are likely to continue."

Our own work confirms the Inspector General's conclusion. It also underscores the enormity of the problem.

In December 1985, we engaged the certified public accounting firm of Arthur Andersen & Co. to study DoD contract auditing and oversight, including its overall design and any duplication of effort.[13] Arthur Andersen & Co. reviewed pertinent laws and regulations, consulted with responsible DoD officials, and made nationwide field visits to ascertain the recent experience of some 15 major defense contractors that together do substantial work for each of the Services and for the DLA. Figure 1 reflects the principal findings and recommendations that emerged from this study. It is noteworthy that Arthur Andersen & Co. and the OIG found identical problems of a systemic nature among DoD contract oversight organizations:

- Their efforts lack advance planning and coordination.
- Their respective responsibilities are ill-defined.
- They are unwilling to rely on each other's work.
- They are reluctant to share information.

Arthur Andersen & Co. concluded that "duplication in the oversight process is *extensive*. Changes are clearly required to enhance efficiency and reduce costs to both contractors and the government." (Emphasis added.)

In our view, necessary changes are not likely to be accomplished, however, without first consolidating the authority to make and implement contract audit policy in a senior DoD official.

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[13]The full report of Arthur Andersen & Co.'s work — *Study of Government Audit and Other Oversight Activities Relating to Defense Contractors* (Feb. 25, 1986) — is included as Appendix D to this report on *Conduct and Accountability*.

Figure 1
ARTHUR ANDERSEN & CO.
STUDY OF GOVERNMENT OVERSIGHT ACTIVITIES

PRINCIPAL PROBLEMS IDENTIFIED

PERVASIVE LACK OF COORDINATION AMONG DoD ORGANIZATIONS

* Reluctant to rely on each other's work
* Unwilling to share information
* Deficient in advance planning
* Inconsistent in interpreting
  —contract and other requirements
  —results of audits and reviews
* Respective responsibilities poorly defined
  —e.g., increased DCAA involvement in non-financial areas
* Not observing DoD regulations designed to ensure coordination of audit and oversight
* Organizations possess no centralized coordinating authority

INDISCRIMINATE APPROACH BY DoD ORGANIZATIONS

* Nature, timing, and extent of audit and oversight shows inadequate attention to
  —contractors' past performance
  —results of prior and ongoing reviews
  —relative costs and benefits

ERODING AUTHORITY OF ADMINISTRATIVE CONTRACTING OFFICERS (ACOs)

* DoD Directive 7640.2 (Dec. 29, 1982) limits ACO authority to resolve audit recommendations
* ACO no longer functioning as government's "team leader"
* Indecision, delays, unnecessary and costly disputes

RECOMMENDATIONS AND COMMENTS

REAFFIRM AUTHORITY OF ACO

* To function as DoD's team leader in all dealings with contractor
* Responsible for
  —determining final overhead rates
  —coordinating all DoD auditing and other oversight at contractor location
* Supported by DCAA in advisory capacity
  —reevaluate DoD Directive 7640.2

REEVALUATE AND CLARIFY RESPECTIVE AUDIT AND OVERSIGHT RESPONSIBILITIES

* For example, those of contract administrative organizations versus DCAA in the areas of
  —operational auditing
  —compensation and insurance reviews
* More generally, to improve planning, organization, and control

IMPROVE DAY-TO-DAY WORKING RELATIONSHIPS

* Organizations should rely on each other's work
* Share data base of contractor information

ADHERE TO REGULATORY PRINCIPLES THAT PROMOTE EFFICIENCY

* Audit and oversight plans should reflect appropriate consideration of
  —contractors' past performance
  —effectiveness of their internal control systems
  —results of prior and ongoing reviews
  —relative costs and benefits

For these purposes, we recommend the following:

1. Among his other responsibilities, the new Under Secretary of Defense (Acquisition) should:

a. oversee DoD-wide establishment of contract audit policy, particularly policy for audits conducted in support of procurement and contract administration;

b. except for criminal investigations and DoD internal audits, supervise establishment of policy for all DoD oversight of defense contractors, including oversight performed by procurement and contract management organizations; and

c. recognize established GAO and professional auditing standards.

2. To optimize the use of available oversight resources by eliminating undesirable duplication of official effort, contract audit policy should be designed to:

a. delineate clearly respective responsibilities and jurisdictions of DoD oversight organizations;

b. develop guidelines and mechanisms for DoD oversight organizations to share contractor data and otherwise to rely more extensively upon each other's work; and

c. improve audit strategies for the conduct, scope, and frequency of contract auditing. These strategies should reflect due consideration for contractors' past performance, the proven effectiveness of their internal control systems, the results of prior and ongoing reviews conducted by DoD organizations and by contractors themselves, and relative costs and benefits.

B. Department of Defense Standards of Conduct

DoD should vigorously administer current ethics regulations for military and civilian personnel to assure that its employees comply with the same high standards expected of contractor personnel. This effort should include development of specific ethics guidance and specialized training programs concerning matters of particular concern to DoD acquisition personnel, including post-government relationships with defense contractors.

An extensive body of law and regulation exists to prevent conflicts between personal interest and public duty of current and former uniformed personnel and civilian employees of DoD. These laws and regulations:

- impose financial disclosure reporting obligations on broad categories of DoD personnel, including extremely detailed reporting by the most senior officials;

- describe standards of behavior for all DoD personnel, including the general requirement that they avoid any circumstance, whether or not expressly prohibited, that might create the "appearance" of impropriety;

- broadly penalize conduct by DoD or other federal employees that could involve personal enrichment in connection with ongoing official duty, including bribes and gratuities, the so-called private supplementation of federal salaries, representation of private parties in matters of federal concern, and official acts that affect personal or family finances or the financial interests of a prospective private employer; and

- restrict in various ways what former federal employees generally, and DoD personnel specifically, may do upon leaving government service. Figure 2 summarizes current post-employment disqualifications and certain related statutory provisions.

Standards thus established for the conduct of current and former DoD acquisition personnel seek to maintain an environment in which DoD's internal fiscal and managerial controls can work. Like codes of conduct adopted by private contractors, they help protect the integrity and promote the efficiency of the contracting process, minimize conflicts of interest, and assure the public that defense contracting is managed effectively and honestly.

The Commission conducted a careful review of the adequacy of DoD's ethics programs for military and civilian acquisition personnel.[14] Several facts prompted this review. In defense acquisition, as throughout the government, there is a substantial incidence of federal employee involvement in reported cases of fraud and other unlawful conduct. Many cases have involved bribery or other criminal activity by relatively low-level purchasing officials at military procurement facilities, and others have involved gratuities for senior personnel. Such official misconduct in the acquisition system is doubly destructive: it

[14]Our public meeting of May 5, 1986, was devoted exclusively to testimony on this subject. As part of our review of relevant laws and administrative practices, we received an extensive briefing and detailed conclusions and recommendations from the Office of the Inspector General.

Figure 2
THE REVOLVING DOOR: CURRENT POST-EMPLOYMENT DISQUALIFICATIONS AND CERTAIN RELATED PROVISIONS

STATUTE	*PROVISIONS*
18 U.S.C. 207(a)	Permanently bans representation to the government of any person on any "particular matter involving a specific party" in which a former Executive Branch employee "participated personally and substantially" while in government.*
18 U.S.C. 207(b)(i)	Bans for two years representation to the government of any person on any particular matter over which a former Executive Branch employee exercised "official responsibility" while in government.*
18 U.S.C. 207(b)(ii)	Bans for two years representation by a former "senior employee" of Executive Branch, through his "personal presence at any formal or informal appearance" before the government, of any person on any particular matter in which such former employee personally and substantially participated while in government.*
18 U.S.C. 207(c)	Bans for one year representation by a former "senior employee" of Executive Branch of any person to his former agency on any particular matter before or of substantial interest to that agency.*
18 U.S.C. 208	Prohibits an employee of Executive Branch from participating "personally and substantially" as such in any "particular matter" in which any person with whom he is "negotiating" or has any "arrangement" concerning post-government employment has a financial interest.*
18 U.S.C. 281	Prohibits retired military officers from representing any person in the sale of anything to the government through their former department.*
18 U.S.C. 283	Bans for two years following retirement participation by military officers in prosecution of claims against the United States involving their former department.*
37 U.S.C. 801	Prohibits payment of compensation to military officers engaged, within three years after retirement, "in selling, or contracting or negotiating to sell, supplies or war materials" to DoD or other agencies.
10 U.S.C. 2397	Requires reporting by certain military personnel and civilian officials of DoD of employment by defense contractors occurring within two years prior or subsequent to government service.†
10 U.S.C. 2397a	Requires reporting by military personnel and civilian officials having procurement responsibilities in DoD of "contacts" regarding post-government employment opportunities with certain defense contractors.†
P.L. 99-145, 99 Stat. 693	Prohibits a "Presidential appointee" who acts as a "primary government representative" in the "negotiation" or "settlement" of a contract with a defense contractor to accept, within two years thereafter, employment from that contractor.*

*Violation punishable by fine and/or imprisonment.
†Violation subject to administrative penalty in amount up to $10,000.

subverts operations of DoD and defense industry, and corrodes public confidence in government and business generally. It is critical in defense management to establish and maintain an environment where official standards of conduct are well understood, broadly observed, and vigorously enforced. We believe that significant improvements are required.

Our study indicates, for example, that—much as is the case with the defense industry—DoD's published conduct regulations do not provide timely or effective guidance to personnel engaged in the acquisition process. DoD Directive 5500.7, Standards of Conduct, has not been updated since 1977 or revised to reflect such subsequent legal developments as passage of the Ethics in Government Act of 1978. Even in its current version, Directive 5500.7 provides only general ethical guidance to personnel and components throughout DoD. No comparable directive provides more specific guidance to all of DoD's acquisition personnel.

Nor does any system exist to ensure that all DoD acquisition personnel receive, on a periodic basis, a prescribed minimum of ethics training specifically related to the acquisition function. Just as among defense contractors, considerable disparity exists in the efforts that DoD acquisition organizations expend in this area. An effective program of instruction and compliance concerning ethics matters, including post-employment disqualifications and reporting, should be established and implemented. To do so will require sustained leadership throughout DoD and a commitment of greater personnel and administrative resources.[15]

In our *Interim Report*, we thus expressed the general view that the important challenge for defense management lies in improving compliance with existing ethical standards, not in defining new or more stringent standards. We nonetheless also have reviewed the substance of current laws and regulations from two distinct points of view: first, for their effect on recruitment of capable senior-level personnel to run the acquisition system; and second, for their adequacy to protect the integrity of that system from perceived dangers posed by the so-called revolving door phenomenon. The "revolving door" refers, in

[15]At the Commission's May 5, 1986, meeting, DoD's General Counsel reviewed plans, pursuant to the President's April 1986 directive, for improved administration of current ethics regulations for DoD personnel, as recommended in our *Interim Report*. We support this effort. It should, we believe, focus in important part on the need for specialized guidance and training of DoD acquisition personnel. It should also seek to establish better mutual understanding between, and promote complementary efforts to address the respective ethical concerns of, government and industry.

this context, to the movement of a DoD acquisition employee into a position with a private company for whose government contracts he has or had some official responsibility.

Both our *Interim Report* and our *Report on Defense Acquisition* emphasize the importance of improving the government's ability to attract and retain the highly qualified people needed for effective senior management of defense acquisition. We agree with the Presidential Appointee Project of the National Academy of Public Administration that ethics regulations:

> have assumed a very important role in the appointment process. Their impact is mixed. In some ways, these laws have brought genuine benefits to the American people by eliminating blatant potential conflicts of interest and enhancing opportunities for the identification and prosecution of those who would violate the public trust. On the other hand, these changes have been costly: *costly to the government's ability to recruit presidential appointees*, costly to the relations between the news media and public officials, and costly in financial sacrifices to a number of honest and dedicated public officials.[16]

Our examination of the substance of current ethics regulations underscores an important truth: ethical standards are only as easy to observe, administer, and enforce as they are certain in scope, simple in concept, and clear in application. Undue complexity and vagueness—for example, that we believe characterizes current financial disclosure reporting requirements—serve no legitimate public purpose. Either can transform ethical standards from matters of principle to mere traps for the unwary, and put at risk the reputation of anyone who enters or leaves a responsible position in government.

Figure 2 outlines established criminal statutory restrictions on what federal employees and retired military officers may or may not do once they have left government. Actions of officials still in federal service have been restricted to exclude matters in which they, or prospective private employers with whom they are negotiating, have a financial interest. These statutes should be enforced more vigorously, and their import made clear to DoD employees far more effectively, than is now done.

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[16]*Leadership in Jeopardy: The Fraying of the Presidential Appointments System* (Final Report of the Presidential Appointee Project), November 1985, at 13 (emphasis added).

Figure 2 also outlines the one current criminal statute, Public Law 99-145, concerning for whom defense acquisition officials may work after they have left DoD. This new provision, and comparable measures now pending in Congress, significantly depart from prior law in attempting to define as criminal conduct certain post-government employment *per se*. They do so on a highly selective basis—applying only to personnel involved in the acquisition process, and only to such personnel as are employed by DoD. More significantly, they pose serious problems of definition, never satisfactorily resolved in statutory form, concerning precisely which DoD personnel should be covered and precisely what sort of exposure to a contractor should lead to the employment prohibition. In practice, these definitions are very difficult to work out sensibly and fairly. This is reflected in the confusion concerning the applicability of Congress' one current venture into restricting post-government employment *per se*, Public Law 99-145. The highly uncertain impact of these new and proposed statutes, and the understandable desire of law-abiding individuals to avoid even the remote chance of a criminal violation, may well prompt talented people not to work for DoD in the first place or to leave once such restrictions appear imminent.

While mindful of the critical need to recruit and retain capable acquisition personnel, we do not minimize the importance of upholding the real and apparent integrity of the acquisition process. Our recommendations seek to achieve vigorous enforcement of ethical requirements and steadfast attention to ethics programs and training by government and industry alike. We believe that our recommendations, if fully implemented, would go much further toward improving the ethical environment of defense acquisition than would any legislative proposal. Had such administrative efforts been undertaken by DoD heretofore, the adequacy of the existing legislative scheme would be far more evident.

Public Law 99-145, and the additional revolving-door restrictions now proposed, in part reflect a legitimate dissatisfaction with individual enforcement of existing DoD standards of conduct. They also reflect a widespread concern that opportunities for post-government employment with defense contractors may seem to tempt acquisition officials to favor improperly those contractors over whose affairs they exercise authority. We do not dismiss this concern. Acquisition officials must scrupulously avoid any action that might create even the appearance of giving preferential treatment to any contractor or losing complete independence or impartiality of action. Existing standards of conduct demand nothing less. The real challenge, we believe, is to establish and maintain an ethical environment for defense acquisition that applies this principle across the board. This will not be accomplished through piecemeal legislation that

subjects special classes of government employees to imprecise standards, unpredictable restrictions on future conduct, and harsh criminal penalties.

Instead, the revolving-door concern must be addressed where it originates, in the relations of DoD and the defense industry. Complementary efforts must be undertaken by DoD and defense industry to define appropriate and highly specific limitations in the area of post-government employment relationships. These limitations should not be legislated but instead should be articulated through complementary prohibitions in both government and industry standards of conduct, for the clear guidance of putative employers (i.e., contractors) and employees (i.e., former DoD officials) alike. This exercise would reinforce a healthy, ongoing dialogue between industry and government. Appropriate voluntary disqualifications by private employers and prospective employees could and should become an accepted aspect of the official and professional responsibilities assumed by those who work in and contract with DoD. Were statutory requirements to report employment with defense contractors properly observed and administered, DoD, industry, and the public could monitor the success of the approach we recommend. In this way, DoD and defense industry could assume leadership roles for the public and private sectors, and set a standard that others—notably Congress and other Executive departments—should emulate.

For these purposes, we recommend the following:

1. DoD standards of conduct directives should be developed and periodically reviewed and updated, to provide clear, complete, and timely guidance:

a. to all components and employees, on ethical issues and standards of general concern and applicability within DoD; and

b. to all acquisition organizations and personnel, on ethical issues and standards of particular concern to DoD acquisition process.

2. The acquisition standards of conduct directive should address, among other matters, specific conflict-of-interest and other concerns that arise in the course of official dealings, employment negotiations, and post-government employment relationships with defense contractors. With respect to the last category, the Secretary of Defense should develop norms concerning the specific personnel classification, type of official responsibility, level of individual discretion or authority, and nature of personal contact that, taken together, should disqualify a former acquisition official from employment with a given contractor for a specified period after government service. These

recommended norms, observance of which should be monitored through existing statutory reporting requirements, would establish minimum standards to guide both acquisition officials and defense industry.*

3. DoD should vigorously administer and enforce ethics requirements for all employees, and commit necessary personnel and administrative resources to ensure that relevant standards of conduct are effectively communicated, well understood, and carefully observed. This is especially important for all acquisition personnel, to whom copies of relevant standards should be distributed at least annually. Review of such standards should be an important part of all regular orientation programs for new acquisition employees, internal training and development programs, and performance evaluations.

***Comment by Herbert Stein:**

Although I do not disagree with what the Commission says about the "revolving door," I wish to add the following comment:

Department of Defense officials whose position in the acquisition process enables them to affect substantially the interests of particular contracting companies should not be employed by those companies for a period, such as two years, after leaving the Department, except in special cases where the national security clearly dictates otherwise. This principle is not now adequately recognized in the standards of proper conduct in the Department or among defense contractors. For the Department, the Secretary should clearly state the principle, define the categories of officials to which it applies and identify the individual officers and their contractor-relationships covered. Undoubtedly the line between covered and uncovered relationships will be difficult to draw, but it will be better to draw the line imperfectly than either to ignore the revolving door problem or to leave officials and contractors in a state of uncertainty. Contractors' codes of conduct should include a bar to employment that violates this principle.

I believe that if the standards of permissible employment are clearly defined both officials and contractors will voluntarily abide by them. In line with the Commission's desire to foster an atmosphere of trust among the Department, contractors and the public, I would much prefer to see the problem handled in this voluntary way. But if experience shows that reliance on voluntary observance of the principle is inadequate, legislative remedies should be considered.

C. Civil and Administrative Enforcement

Suspension and debarment should be applied only to protect the public interest where a contractor is found to lack "present responsibility" to contract with the federal government. The Federal Acquisition Regulation should be amended to provide more precise criteria for applying these sanctions and, in particular, determining "present responsibility."

Specific measures should be taken to make civil enforcement of laws governing defense acquisition still more effective.

Failure to establish internal disciplines necessary to responsible self-governance subjects a defense contractor to a variety of governmental enforcement remedies. Thus, the government may seek relief against a contractor for breach of contract and, even in the absence of technical breaches, criminal and civil sanctions for contractor and contractor-employee misconduct. Our *Interim Report* recommended "continued, aggressive enforcement of federal civil and criminal law governing defense acquisition." This was predicated on the view that such enforcement "punishes and deters misconduct by the few, vindicates the vast majority who deal with the government lawfully, and recoups losses to the Treasury." In this section we discuss noncriminal relief by which the government can protect its interests.

Unlike criminal or other punitive measures, suspension and debarment are sanctions intended to ensure that DoD may "solicit offers from, award contracts to, and consent to subcontracts with *responsible contractors only*."[17] The Federal Acquisition Regulation sets forth specific circumstances in which suspension (disqualification pending the completion of investigation or legal proceedings) or debarment (disqualification for a specific period of time) may be applied.[18] Imposed in appropriate circumstances, these sanctions seek to serve "a public interest for the Government's protection" rather than to provide for increased punishment for wrongdoing.[19]

While suspension and debarment are indispensable tools in assuring that DoD not contract with those lacking present responsibility, they nevertheless are severe remedies that should be applied only in accordance with their stated purpose and legal standards. Members of the defense contracting industry claim that neither the purpose nor the standards have been observed, and that the

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[17]Federal Acquisition Regulation (hereinafter FAR) § 9.402(a) (emphasis added).

[18]FAR §§ 9.406-1, 9.407-1(b). Following imposition of the sanction, a contractor and its subcontractors may continue to perform work on ongoing contracts, but the contractor is rendered ineligible for future awards during the period of suspension or debarment.

[19]FAR § 9.402(b).

threat of imposition of the sanctions has become the government's primary negotiating weapon in criminal prosecutions to force contractors to enter guilty pleas to avoid suspension or debarment.[20] There is concern that DoD has improperly concluded that the fact of a criminal indictment of a contractor or a management employee is an "automatic" ground for suspension, without sufficient regard for corrective actions already taken.[21] Such claimed abuses are said not only to constitute arbitrary denials of protected personal and property rights, but also to eliminate as the criteria for suspension, the measure of a contractor's "present" responsibility.[22]

Whatever the merit of defense industry claims, it is clear that nowhere is the attitude of mutual mistrust between DoD and the defense industry more in evidence than in DoD's exercise of its powers of suspension and debarment.

In recent years there has been a marked increase in the number of actions taken to suspend or debar individual or corporate contractors from entering into new contracts with DoD. In 1975 there were 57 suspensions and debarments by DoD; in 1980 there were 78. In 1985 there were 652 suspensions and debarments, a greater than eightfold increase in just five years. This increase is due in part to a more determined and aggressive enforcement stance by DoD and a greater willingness to apply the sanctions.

Today's problems can be addressed by developing a sounder basis for both government and industry to carry out their respective functions. By working

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[20]There is little doubt that suspension or debarment, whether properly or improperly imposed, can be devastating to a contractor wholly or heavily engaged in the defense industry. While such contractors may suffer but survive heavy civil and criminal penalties, they may not survive a lengthy suspension or debarment. Not intended and not imposed as punitive measures, suspension or debarment may nevertheless be the most severe sanction confronting a wayward contractor.

[21]It is generally conceded by suspending/debarring authorities that suspension occurs upon issuance of an indictment, and that the contractor is thereafter afforded opportunity to show cause why the suspension should not be terminated. Any one of the three Military Services and the Defense Logistics Agency (DLA) may suspend or debar a contractor, and the other Services and the DLA will honor the sanction.

[22]While contractor conduct that justifies a criminal indictment may be *prima facie* evidence of irresponsibility, such conduct often precedes an indictment in the contracting industry by two or more years. The bare fact of an indictment may thus be an improper measure of the contractor's "present responsibility" should suspension occur at the time of indictment. During the period following the misconduct alleged in the indictment, the contractor may have replaced employees guilty of wrongdoing, corrected faulty systems, made restitution, better communicated and implemented a corporate code of conduct, improved internal auditing practices, and otherwise taken actions demonstrating its current responsibility. An "automatic" suspension does not afford opportunity for such proof, and may defeat incentives for implementing more responsible self-governance.

together with more cooperation and dedication to performance and less mistrust and suspicion, a renewed commitment to excellence can be made.

1. Circumstances in Which a Contractor May Be Suspended or Debarred

a. Current Rules for Suspension

Suspension of a contractor is in the nature of a preliminary remedy available to the government before full development of the facts. It should be imposed "on the basis of adequate evidence . . . when it has been determined that immediate action is necessary to protect the government's interest."[23] Adequate evidence is defined as "information sufficient to support the reasonable belief that a particular act or omission has occurred."[24]

The Federal Acquisition Regulation sets forth particular conditions in which suspension may be applied. A contractor may be suspended, for example, upon "adequate evidence" of the commission of a fraud or criminal offense in the procurement process, the violation of federal or state antitrust statutes, the commission of various other criminal offenses, and the commission of any other offense showing "lack of business integrity or business honesty" that "directly affects" the contractor's present responsibility. Indictment for any of these delineated actions constitutes adequate evidence for suspension. A contractor may also be suspended for any other cause that shows an absence of present responsibility.[25]

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[23]FAR § 9.407-1(b).

[24]FAR § 9.403.

[25]FAR § 9.407-2, Causes for Suspension, provides:

> (a) The suspending official may suspend a contractor suspected, upon adequate evidence, of—
>
> (1) Commission of a fraud or a criminal offense in connection with (i) obtaining, (ii) attempting to obtain, or (iii) performing a public contract or subcontract;
>
> (2) Violation of Federal or State antitrust statutes relating to the submission of offers;
>
> (3) Commission of embezzlement, theft, forgery, bribery, falsification or destruction of records, making false statements, or receiving stolen property; or
>
> (4) Commission of any other offense indicating a lack of business integrity or business honesty that seriously and directly affects the present responsibility of Government contractor or subcontractor.
>
> (b) Indictment for any of the causes in paragraph (a) above constitutes adequate evidence for suspension.
>
> (c) The suspending official may upon adequate evidence also suspend a contractor for any other cause of so serious or compelling a nature that it affects the present responsibility of a Government contractor or subcontractor.

b. Current Rules for Debarment

Regulations governing debarment provide that the responsible official "may debar" a contractor if it has been convicted for any offense listed above that may provide a basis for suspension. The regulations further state that the existence of one of the described causes does not require debarment. "[T]he seriousness of the contractor's acts or omissions and any mitigating factors should be considered in making any debarment decision."[26]

2. Improvements in Regulations Governing Conditions Under Which a Contractor May Be Suspended or Debarred

Existing regulations can be improved in crucial respects by providing criteria for government officials making present responsibility determinations.

a. Determination of Present Responsibility

The requirement that all suspension/debarment decisions be based on a present responsibility determination should be more clearly set forth by amendment of particular provisions of the Federal Acquisition Regulation. Such amended provisions should include an explicit requirement that suspension and debarment must be related to a lack of present responsibility before either sanction is applied. For example, adequate evidence of the occurrence of a criminal offense by a contractor or its employee should not necessarily result in suspension. Nor should conviction for a prior offense be the sole predicate for debarment. Basis for imposition of suspension or debarment is lacking unless the suspending or debarring authority determines that conditions causing the criminal misconduct are *present* problems within the company. Provisions referred to above setting forth particular conditions in which a contractor may be suspended or debarred should be amended to clarify that such a condition is a sufficient basis *only* if it can be linked to a lack of contractor present responsibility.[27]

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[26]FAR § 9.406-1(a).

[27]The cited regulatory provision (FAR 9.407-2(b)), stating that indictment for any of the listed causes "constitutes adequate evidence of suspension," is particularly troublesome. Given the time-consuming nature of litigation, indictments are invariably based on prior misconduct. The events causing an indictment generally precede an indictment by one or more years. Thus,

b. Criteria for Present Responsibility

Administration of suspension/debarment would also be improved if regulations were amended to include specific criteria to be considered in determining whether a contractor is "presently responsible." Such criteria are not now set forth in the regulations. The following are recommended for consideration as proper criteria:

- The nature of integrity programs, if any, currently being implemented by the contractor. The debarring/suspending authority should be particularly interested in the extent of the contractor's affirmative efforts to implement ethical standards of conduct that address contract performance and systems of internal controls to monitor compliance with those standards.

- The contractor's reputation for probity on recent procurements with DoD and other federal agencies.

- The reputation of the contractor's management and directors in recent circumstances as persons of good character and integrity.

- The extent to which misconduct is symptomatic of basic systemic problems within the corporation as opposed to isolated, aberrational corporate behavior.

- The nature and extent of voluntary disclosure and cooperation offered by the contractor in identifying and investigating the misconduct.

- The sufficiency of remedial measures taken to eliminate the causes of the misconduct.

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where an agency suspends a contractor on the sole basis of an indictment, it applies this sanction without regard to the requirement that suspension should be predicated on lack of *present* responsibility. Such administrative action involves an abdication of the suspending authority's obligation under current law. This provision of the Federal Acquisition Regulations — stating that indictment constitutes adequate evidence — should be reexamined.

c. Determination of Public Interest

Before suspending or debarring a contractor the responsible official must determine, in addition to present responsibility, whether such action serves the "public interest." To an extent, consideration of public interest is subsumed in the determination whether the contractor is currently responsible. Some factors affecting public interest are, however, distinct from those affecting present responsibility and should be considered separately. Except where a contractor's misconduct endangers life or property, in which case the government's interest is clearly indicated, the Federal Acquisition Regulation should be amended to mandate review of the effect a proposed suspension/debarment might have on the ability of DoD and other government agencies to obtain needed goods or services.

In making the public interest determination, the suspending or debarring agency should consult with agencies both within and outside DoD. The decision that suspension or debarment will serve the public interest requires a careful balancing of public needs against any potential harm that might occur from continued dealings with the contractor.

d. Cursory Suspension of Contractors

The current practice of "automatic" suspension of contractors following indictment on contract fraud should be reconsidered by DoD with a view that it be more discriminating and take into account all circumstances of a particular situation. In our *Interim Report* we stated, "Suspension and Debarment should not be imposed solely as a result of an indictment or conviction predicated upon former (not ongoing) conduct . . . ."

A device that has been used by a military department in lieu of "automatic" suspension is the so-called "shock and alarm" letter. Such a letter brings sharply to the attention of the executive of a defense firm DoD's cause for concern of wrongdoing, and the executive is urged to take immediate corrective action. What distinguishes the "shock and alarm" technique is that it does not carry with it the formal and immediate sanction of suspension. It provides the contractor an opportunity to put its own house in order before suspension becomes imperative.

e. Scope of Suspension or Debarment Orders

Once a determination is made to suspend or debar a contractor, the Military Service or DLA must determine the appropriate scope of the order. The

government may elect to suspend or debar a particular division or similar organizational component of the contractor, a number of divisions or organizational components, or the entire corporate structure of which the contractor is a part.

An overly broad suspension or debarment of a contractor involved in numerous procurements can deny DoD important sources of supply and cause economic and commercial harm to the contractor. On the other hand, an inappropriately narrow application of these sanctions can lead to continued government dealings with irresponsible parties.

Current regulations give the responsible agency wide authority to tailor the scope of a suspension or debarment order without providing guidance about how the agency should exercise its discretion. Suspension applies to "all divisions or other organizational elements of the contractor, unless the suspension decision is limited by its terms to specific divisions, organizational elements or commodities."[28] Similarly, "debarment constitutes debarment of all divisions or other organizational elements of the contractor, unless the debarment decision is limited by its terms to specific divisions, organizational elements or commodities."[29]

Given the significance and difficulty of these determinations, responsible officials should have more specific guidance in considering the scope of possible suspension or debarment actions. The Federal Acquisition Regulation should mandate review of the following criteria:

- the extent to which the misconduct was confined to a particular organizational unit and the autonomy of that unit;
- the extent of knowledge corporate management and directors had of the relevant misconduct;
- the extent to which sanctions must be imposed to provide minimum protection of the public interest; and
- other effects that could occur if organizational units other than that within which the misconduct occurred are suspended or debarred.

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[28]FAR § 9.407-1(c).
[29]FAR § 9.406-1(b).

Suspending and debarring authorities should craft application of these sanctions as narrowly as possible to exclude only those organizational units that threaten the integrity of the procurement process.

f. Independence of Determinations

The government, because of broad discretionary powers entailed in declaring contractors ineligible for awards, carries a heavy burden. It must affirmatively seek to avoid arbitrary action. DoD should ensure that opportunities for abuse are reduced by insulating decisionmakers in the suspension and debarment process from untoward pressure from within or without DoD. Present policies do not provide sufficient insulation for officials involved in the process.

g. Procedures Guiding Suspension and Debarment Within Components of DoD

Under current regulations, the several suspending and debarring authorities are given discretion to "establish procedures" governing suspension and debarment "decision-making" processes.[30] This discretion has resulted in each of the authorized agencies developing different and somewhat inconsistent procedures. The Inspector General made the following pertinent observations:

> Each suspension/debarment authority within DoD has developed its own method of processing suspension and debarment determinations and implementing suspension and debarment procedures regarding the provision of notice to contractors and the conduct of hearing procedures.
>
> For example, if a contractor requests and is provided a hearing on a debarment matter in DLA, the General Counsel, as the suspension/debarment authority, conducts the hearings. Argument and testimony is directly presented to the suspension/debarment authority, who can assess the credibility of witnesses and can examine all evidence. In the Air Force, suspension and debarment hearings are held before the Debarment and Suspension Review Board, which in turn makes recommendations to the suspension/debarment authority.[31]

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[30]FAR §§ 9.406-3(b)(1), 9.407-3(b)(1).

[31]Office of the Inspector General, DoD, *Review of Suspension and Debarment Activities within the Department of Defense*, at 86-87 (May 1984).

Given the severity of suspension and debarment, the Commission believes that uniform procedures should guide the review and decision-making process in each of the agencies. It is, for example very important that debarring officials in each agency should be of a similar stature and that hearing procedures should be comparable. In the absence of uniformity, inconsistent and unfair results may follow. The Secretary of Defense should ensure that uniform policies govern each agency's decision-making process and the Federal Acquisition Regulation should be amended to so require.

h. Alternative Civil Remedies

The government should expand its use of and more aggressively pursue civil remedies. To make civil enforcement more effective, our *Interim Report* recommended specific measures that included the passage of Administration proposals to amend the Civil False Claims Act and to establish administrative adjudication of small civil false claims cases.

It is suggested that those officials charged with administration of suspension/debarment — in particular instances when the propriety of imposition of suspension is questionable — give greater consideration to civil sanctions as a complete remedy. For such an alternative to be effective, DoD must have available to it expanded civil remedies for recovery of assets. Expansion of traditional civil money judgments is a much needed resource, and by endorsing legislation still pending in the Congress — i.e., the Program Fraud Civil Remedies Act — the Commission has sought to encourage the grant of sweeping new administrative powers to levy fines more effectively against individuals and corporations engaged in wrongdoing of a lesser nature.

3. Voluntary Disclosure of Irregularities

Contractors have a legal and moral obligation to report to government authorities misconduct discovered in the process of self-review. The Departments of Defense and Justice should jointly initiate a program encouraging the voluntary disclosure of irregularities by contractors. Such a program, if successful, could afford the government timely notice of improprieties that otherwise might not be available, and provide details of known wrongdoing without the expense and compulsion of an adversarial investigation.

A voluntary disclosure program will be effective if there are inducements that assure skeptical contractors they will not suffer greater sanctions by coming

forward. Private companies that fail to disclose should not be rewarded by the fortuitous inability of government investigators to make a timely discovery of an irregularity. Nor should contractors benefit that come forward only under compulsion of imminent discovery.

Guidelines considered by DoD in a voluntary disclosure program should include:

- The timing of the disclosure with respect to the contractor's initial awareness of the irregularity and the proximity of government oversight action.

- The completeness, accuracy, and truthfulness of the disclosure, as well as other factors supporting voluntariness.

- Management levels at which the wrongdoing occurred and at which the decision to disclose was made.

- Whether internal corporate procedures or standards of conduct covered the conduct of those involved in the wrongdoing and in the disclosure decision.

- Whether there were in place internal auditing systems that, when properly implemented, addressed the irregularity.

For these purposes, we recommend the following:

1. The Federal Acquisition Regulation should be amended:

a. to state more clearly that a contractor may not be suspended or debarred except when it is established that the contractor is not "presently responsible," and that suspension or debarment is in the "public interest"; and

b. to set out criteria to be considered in determining present responsibility and public interest.

2. The Department of Defense should reconsider:

a. "automatic" suspensions of contractors following indictment on charges of contract fraud;

b. suspending and debarring the whole of a contractor organization based on wrongdoing of a component part;

c. insulating its suspending/debarring officials from untoward pressures; and

d. establishing uniform procedures to guide the review and decision-making process in each agency exercising suspension/debarment authority.

3. DoD should give serious consideration to:

a. greater use of broadened civil remedies in lieu of suspension, when suspension is not mandated; and

b. implementation of a voluntary disclosure program, and incentives for making such disclosures.

4. Specific measures should be taken to make civil enforcement of laws governing defense acquisition still more effective. These include passage of Administration proposals to amend the Civil False Claims Act and to establish administrative adjudication of small, civil false claims cases. In appropriate circumstances, officials charged with administration of suspension/ debarment should consider application of civil monetary sanctions as a complete remedy.

APPENDIX A

Defense Industry Initiatives on Business Ethics and Conduct

Business Ethics and Conduct

The defense industry companies who sign this document already have, or commit to adopt and implement, a set of principles of business ethics and conduct that acknowledge and address their corporate responsibilities under federal procurement laws and to the public. Further, they accept the responsibility to create an environment in which compliance with federal procurement laws and free, open, and timely reporting of violations become the felt responsibility of every employee in the defense industry.

In addition to adopting and adhering to this set of six principles of business ethics and conduct, we will take the leadership in making the principles a standard for the entire defense industry.

I. Principles

1. Each company will have and adhere to a written code of business ethics and conduct.
2. The company's code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code.
3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code to the company without fear of retribution for such reporting.
4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.
5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.
6. Each company must have public accountability for its commitment to these principles.

II. Implementation: Supporting Programs

While all companies pledge to abide by the six principles, each company agrees that it has implemented or will implement policies and programs to meet its management needs.

Principle 1: Written Code of Business Ethics and Conduct

A company's code of business ethics and conduct should embody the values that it and its employees hold most important; it is the highest expression of a corporation's culture. For a defense contractor, the code represents the commitment of the company and its employees to work for its customers, shareholders, *and* the nation.

It is important, therefore, that a defense contractor's written code explicitly address that higher commitment. It must also include a statement of the standards that govern the conduct of all employees in their relationships to the company, as well as in their dealings with customers, suppliers, and consultants. The statement also must include an explanation of the consequences of violating those standards, and a clear assignment of responsibility to

operating management and others for monitoring and enforcing the standards throughout the company.

Principle 2: Employees' Ethical Responsibilities

A company's code of business ethics and conduct should embody the basic values and culture of a company and should become a way of life, a form of honor system, for every employee. Only if the code is embodied in some form of honor system does it become more than mere words or abstract ideals. Adherence to the code becomes a responsibility of each employee both to the company and to fellow employees. Failure to live by the code, or to report infractions, erodes the trust essential to personal accountability and an effective corporate business ethics system.

Codes of business ethics and conduct are effective only if they are fully understood by every employee. Communication and training are critical to preparing employees to meet their ethical responsibilities. Companies can use a wide variety of methods to communicate their codes and policies and to educate their employees as to how to fulfill their obligations. Whatever methods are used—broad distribution of written codes, personnel orientation programs, group meetings, videotapes, and articles—it is critical that they ensure total coverage.

Principle 3: Corporate Responsibility to Employees

Every company must ensure that employees have the opportunity to fulfill their responsibility to preserve the integrity of the code and their honor system. Employees should be free to report suspected violations of the code to the company without fear of retribution for such reporting.

To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism.

It is critical that companies create and maintain an environment of openness where disclosures are accepted and expected. Employees must believe that to raise a concern or report misconduct is expected, accepted, and protected behavior, not the exception. This removes any legitimate rationale for employees to delay reporting alleged violations or for former employees to allege past offenses by former employers or associates.

To receive and investigate employee allegations of violations of the corporate code of business ethics and conduct, defense contractors can use a contract review board, an ombudsman, a corporate ethics or compliance office or other similar mechanism.

In general, the companies accept the broadest responsibility to create an environment in which free, open and timely reporting of any suspected violations becomes the felt responsibility of every employee.

Principle 4: Corporate Responsibility to the Government

It is the responsibility of each company to aggressively self-govern and monitor adherence to its code and to federal procurement laws. Procedures will be established by each company for voluntarily reporting to appropriate government authorities violations of federal procurement laws and corrective actions.

In the past, major importance has been placed on whether internal company monitoring has uncovered deficiencies before discovery by governmental audit. The process will be more effective if all monitoring efforts are viewed as mutually reinforcing and the measure of performance is a timely and constructive surfacing of issues.

Corporate and government audit and control mechanisms should be used to identify and correct problems. Government and industry share this responsibility and must work together cooperatively and constructively to ensure compliance with federal procurement laws and to clarify any ambiguities that exist.

Principle 5: Corporate Responsibility to the Defense Industry

Each company must understand that rigorous self-governance is the foundation of these principles of business ethics and conduct and of the public's perception of the integrity of the defense industry.

Since methods of accountability can be improved through shared experience and adaptation, companies will participate in an annual intercompany "Best Practices Forum" that will bring together operating and staff managers from across the industry to discuss ways to implement the industry's principles of accountability.

Each company's compliance with the principles will be reviewed by a Board of Directors committee comprised of outside directors.

Principle 6: Public Accountability

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception —a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

Questionnaire

1. Does the company have a written code of business ethics and conduct?
2. Is the code distributed to all employees principally involved in defense work?
3. Are new employees provided any orientation to the code?
4. Does the code assign responsibility to operating management and others for compliance with the code?
5. Does the company conduct employee training programs regarding the code?
6. Does the code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?
7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?
8. Does the mechanism employed protect the confidentiality of employee reports?
9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?
12. What are the specifics of such a program?
    a. Written communication?
    b. One-on-one communication?
    c. Group meetings?
    d. Visual aids?
    e. Others?

13. Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?
14. Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
15. Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?
16. Does the company participate in the industry's "Best Practices Forum"?
17. Are periodic reports on adherence to the principles made to the company's Board of Directors or to its audit or other appropriate committee?
18. Are the company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing the company's code of conduct?

APPENDIX B

Final Report and Recommendations on Voluntary Corporate Policies, Practices and Procedures Relating to Ethical Business Conduct

Prepared by
ETHICS RESOURCE CENTER, INC.

Ethics Resource Center, Incorporated

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Admiral Thomas B. Hayward, USN, Ret.
Chairman of the Board

Honorable Griffin B. Bell
Vice Chairman

Gary Edwards
Executive Director

February 18, 1986

The Hon. David Packard
Chairman
The President's Blue Ribbon Commission
on Defense Management
736 Jackson Place Northwest
Washington, DC 20503

Dear Mr. Packard:

I am pleased to transmit herewith the Ethics Resource Center's Report and Recommendations on Voluntary Corporate Policies, Practices and Procedures Relating to Ethical Business Conduct. Our report is based on the experience of the Center in advising defense contractors and other major corporations on ethics in management and on the Center's resource collection, updated by a survey performed on behalf of the Center by the Opinion Research Corporation for the Commission. Appended to our report is the survey instrument, tabulation of data and analysis by the Opinion Research Corporation.

On behalf of the Directors and staff of the Ethics Resource Center, I wish to express our appreciation for the opportunity to contribute to the work of the Commission. We hope that our report will testify effectively to the importance of self-governance in ensuring the highest level of ethical practices in defense-related business.

Sincerely,

Gary Edwards

GE:LL
Enclosure

INTRODUCTION

At the request of the President's Blue Ribbon Commission on Defense Management, the Ethics Resource Center, Inc. has prepared an analysis of formal efforts by defense contracting firms to ensure ethical conduct by their employees and responsible policies and practices by the companies themselves. Based on that analysis and on the Center's extensive knowledge of and experience with major companies within and outside the defense industry, the Center offers recommendations to the Commission regarding actions that might be taken by defense contractors for the purpose of improving the level of ethical conduct by individuals and organizations involved in providing products and services for national defense.

Present Situation and Need for Change

The falsification of timecards and test results, poor quality controls, defective pricing, waste, fraud, and overall mismanagement of defense contracts have incensed the general public, the Congress, and the Administration. A perception of pervasive misconduct on the part of defense contractors has weakened public support for increased military and Department of Defense expenditures, thereby undercutting the Administration's efforts to strengthen U.S. defense capabilities.

The types of misconduct alleged are not new. They have occurred under administrations led by each party and in times of decreased, as well as increased, spending. They persist in spite of legislative and administrative efforts to eradicate them. Indeed, intensive federal regulation has not only increased costs and lead-time, but may have actually decreased the sense of individual and corporate responsibility for the quality of products and services delivered to the federal government. The standard of ethical business conduct seems to have become regulatory compliance, rather than responsible decision making. In areas where these are not coincidental or where regulations do not dictate conduct, the management conscience may fail. The sense of moral agency and ethical responsibility may be overridden by the "gamesmanship" attitude fostered by regulatory adversarialism.

Whatever actions the present Administration or the Congress may take to improve the effectiveness of federal regulations and oversight activities, serious attention must be paid to the inherent limitations and possible counterproductivity of an approach that is almost entirely a matter of external policing.

Enhancing Regulatory Effectiveness

To complement its own regulatory activities, the federal government should encourage private industry to develop and implement codes of conduct that exceed the requirements of the law and the present expectations of the public. *Compliance* with laws and regulations and their underlying public policy objectives may be enhanced by effectively communicated and enforced corporate standards of ethical business conduct. Such standards may serve to improve compliance by removing ambiguity or vagueness with respect to acceptable conduct, by clarifying management's expectations and overriding competing performance incentives, and by encouraging employee "whistleblowing."

For instance, marketing is an area where misconduct may arise because of the absence of clear standards of conduct. Management that rewards marketing personnel for gathering

competitors' intelligence, but provides no guidelines for acceptable conduct for obtaining the information, may, in effect, encourage unethical or illegal behavior. Not only may performance incentives thus encourage employees to behave illegally or unethically, but consultants may be similarly influenced indirectly by employees who feel neither obliged nor encouraged to inquire into their activities.

Some misconduct arises, of course, not from the lack of clear standards of conduct but from greed, personal or corporate. To discover and deter such conduct requires specificity in the laws and regulations, vigilant monitoring of compliance, and swift enforcement of penalties that are certain and appropriately severe. The efficiency and effectiveness of federal *monitoring of compliance* may be greatly enhanced where corporate policy and practice require self-policing.

Corporate self-policing will itself be most credible and effective where employees can report misconduct anonymously, outside normal reporting channels, and where the disposition of such reports is overseen by outside directors. In an effort to ensure such self-policing, companies may provide employees access to an ombudsman who is independent from their supervisors or to a toll-free phone line staffed by persons reporting directly to internal audit, corporate counsel, or the chief executive.

Corporate efforts to ensure compliance with laws, regulations, and high standards of ethical business conduct have intensified in recent years.

In 1979, an Ethics Resource Center survey of the 500 largest industrial and the 150 largest nonindustrial corporations revealed that 73 percent of these firms had adopted written codes of ethics or standards of conduct.[1] Half of those documents were adopted for the first time during the previous five years.

More recently, companies have created programs to assist in implementation, compliance monitoring, and enforcement of their standards of conduct. A recent survey of 279 major industrial and service companies by Bentley College indicates the breadth of such undertakings. Company efforts have included creation of ethics committees on boards of directors and at senior management level (14%), establishment of ombudsmen to receive employee allegations of unethical conduct (6%), and some discussion of the company standards and issues of ethics within training and development programs (35%).

In order to inform its recommendations to the President's Commission, the Ethics Resource Center undertook research on the extent to which written standards of conduct, and substantive programs for education and compliance monitoring, have been adopted by defense contractors.

The Research Project

At the request of the President's Blue Ribbon Commission on Defense Management, the Ethics Resource Center surveyed a representative sampling of defense contracting firms regarding:

- the process by which corporate policies and procedures are established for ensuring ethical conduct in dealings with the federal government and with subcontractors, suppliers, and others;
- the form and content of such corporate policies and procedures;
- the means for communicating such policies and procedures to employees, subcontractors, suppliers, and others;
- the internal system for monitoring and enforcing compliance with corporate policies and procedures; and
- the internal system for the adjudication of allegations of misconduct and for the determination of penalties.

Consistent with its proposal to the

[1]The terms "code of ethics" and "standards of conduct" are used interchangeably throughout this document.

President's Commission, the Ethics Resource Center retained the services of Opinion Research Corporation to assist in drafting the survey instrument, in a pretest of it, and in processing the final survey returns.

The pretest instrument was mailed to five defense contracting firms on November 15. All five returned the pretest questionnaire by the 27th. Based on these responses and on suggestions of Commission staff, the instrument was revised. The final version of the questionnaire was sent to 91 defense contractors on December 3. At the suggestion of the Commission staff, these were sent by overnight delivery to chief executives of the defense contracting firms, who received them on December 4, for return to Opinion Research Corporation by December 13. Sixty-one (61) firms (67%) responded in time for inclusion in the study.

In addition to the survey responses, the Center requested from the defense contractors documents setting forth their corporate ethics policies and procedures; information on methods of communicating standards, including materials used internally for training and development; and job descriptions, committee charters, and other materials pertaining to the structure and functioning of compliance monitoring and enforcement activities.

Based on the survey results and on an analysis of accompanying corporate documents, the Ethics Resource Center offers the following report and recommendations to the President's Commission regarding voluntary programs to ensure ethical conduct that have been or might usefully be adopted by defense contractors.

REPORT AND RECOMMENDATIONS FOR VOLUNTARY CORPORATE ACTIONS

I. Corporate Policies and Procedures Relating to Ethical Business Conduct

Research sponsored by the Ethics Resource Center in 1979 determined that among 650 of the largest U.S. corporations, 73 percent had developed written standards of conduct or codes of ethics. Of these, 50 percent had been first adopted during the previous five years. Bentley College reported in 1985 that it had surveyed 279 major corporations and found virtually no change, with 208 firms (74.6%) reporting written codes of conduct.

Although defense contractors matched the general profile of American companies in 1979, this is no longer the case. Our survey for the Commission found that, like American firms generally, 73 percent of respondent defense contractors also had adopted codes by 1979; however, by the end of 1985, the figure for the defense industry had risen to 92 percent.

The widespread adoption of business codes of ethics in the late 1970s appears to have been in response to publicized stories of corporate misconduct, especially in connection with the Watergate scandal, illegal corporate political contributions, and overseas bribery payments. That business interest in codes generally seems to have peaked by 1979 while continuing unabated among defense contractors suggests a greater appreciation among this group of the risks of unethical conduct and the value of explicit standards of conduct. That significant problems of misconduct continue to affect the defense industry suggests that the standards may be flawed or inadequately communicated and enforced. Our research seems to confirm this.

A content analysis of the codes of ethics of respondents to our current survey reveals that many defense contractors have not developed standards of conduct for activities that seem particularly vulnerable to misconduct. For example, the following topics were addressed by the standards of conduct of the parenthetically indicated percentage of defense contractors:

- General conduct (96%)
- Kickbacks (89%)
- Bribery (88%)
- Conflicts of interest (88%)
- Gifts and entertainment for government officials (82%)
- Accuracy of books and records (79%)
- Corporate political contributions (75%)
- Protecting proprietary information (68%)
- Abuse of insider information (61%)
- Disciplinary actions for violations of standards of conduct (61%)
- Antitrust issues (57%)
- Personal expense reports (54%)
- Relations with subcontractors and suppliers (50%)
- Procedures for reporting alleged violations of standards of conduct (50%)
- Accuracy of timecards (46%)
- Employee relations (45%)
- Industry competition (41%)
- Accuracy of information included in proposals (34%)
- Hiring former Department of Defense or military personnel (34%)
- Procedures for adjudicating alleged violations of standards of conduct (32%)
- Cost allocation (30%)
- Quality control (30%)
- Bidding practices (27%)
- Billing practices (27%)
- Defective pricing (27%)
- Materials substitution (27%)

Contract negotiation practices (25%)
Protection of whistleblowers (21%)
Procedures for monitoring contract compliance (20%)
Advertising practices (18%)
Customer service (14%)
Primary contracting (13%)

Analysis and Recommendation

Undoubtedly, many companies provide policies and guidelines for conduct that address these topics in places other than the corporate code of ethics. For other topics, such as defective pricing and accuracy of timecards, the only policy required may be to prohibit or to prescribe the conduct or the result. Even here, detailed procedures and stipulations may be essential to ensure compliance with the policy.

In some areas, where standards and guidelines for ethical business conduct are essential to the integrity of defense contracting, the President's Commission should not assume that what has not been addressed in company codes will have been treated adequately elsewhere in corporate policies. For example, based on the survey results, documents analysis, and interviews and discussions with executives, managers, and employees of several defense firms, we have found that clear standards of ethical business conduct are especially needed with respect to contract negotiating practices and bidding practices, including the related activities involved in gathering competitors' intelligence.

RECOMMENDATION ONE: All companies involved in defense-related business with the federal government should adopt written standards of ethical business conduct, and these standards should specifically address activities most vulnerable to misconduct.

Content analysis of company codes and related policy documents suggests two other areas for concern. Only one-half (50%) of the codes submitted by defense industry companies specify procedures for employees to follow for reporting alleged violations of standards of conduct. Even among firms whose codes provide procedures, many only direct employees to report misconduct to their immediate supervisors. Because there may be situations in which the conduct or complicity of the supervisor is itself in question, alternative means for reporting misconduct must be available and known by all employees.

RECOMMENDATION TWO: All companies involved in defense-related business with the federal government should adopt and effectively communicate to all employees procedures for reporting apparent misconduct directly to senior management, or to appropriate corporate officers and directors, whenever an employee believes that reporting to an immediate supervisor would be inappropriate or ineffective.

Directly related to inadequate procedures for reporting misconduct, and undermining many of the procedures that do exist, is a scarcity of policies (21%) to ensure the protection of "whistleblowers," employees who bring to light unethical practices of the firm or the misconduct of other employees. The success of the defense industry's efforts to restore public trust and confidence in the integrity of its practices will be directly dependent on the seriousness with which management endeavors to identify and eliminate unethical conduct. That seriousness will be properly called into question if "whistleblowers" are punished or left unprotected.

RECOMMENDATION THREE: All companies involved in defense-related business with the federal government should adopt and effectively communicate to all employees a written policy to protect "whistleblowers" from repercussions and to

secure, to the extent possible, their anonymity.

II. Communication of Corporate Ethics Policies and Procedures

Dissemination: Defense contractors report a variety of methods being used to communicate corporate ethics policies to employees. These include (with the percentage of firms utilizing each in parentheses):

- Distribution of written code of ethics/ standards of conduct (93%)
- Informal discussion and guidance from supervisors (90%)
- New personnel orientation (85%)
- Memoranda from senior management (85%)
- Group meetings and briefings (82%)
- Speeches by senior executives (80%)
- Articles in *internally* distributed company periodicals (64%)
- Training and development programs (57%)
- Videotape program (57%)
- Employee handbook (51%)
- *Posted notices* (41%)
- Articles in *externally* distributed company periodicals (11%)

Analysis and Recommendation

Significantly, although 93 percent of respondent firms indicate that they rely on distribution of a written code of ethics or standards of conduct to communicate to employees "company policies and procedures relating to ethical business conduct," only 50 percent of the companies that have written codes distribute the code to *all* employees. In many firms, code distribution is limited to senior management.

Many employees may never need standards or guidelines concerning gifts and gratuities, conflicts of interest, or some other area of conduct addressed by company codes. In other areas, such as the accuracy of timecards or the protection of proprietary information, employees at any level of the firm may have significant ethical responsibilities that should be communicated to them as such. Moreover, reliance on employees to "blow the whistle" on unethical conduct presupposes that they have been made familiar with standards of ethical business conduct.

RECOMMENDATION FOUR: All companies involved in defense-related business with the federal government should distribute the corporate standards of ethical business conduct to all employees on at least an annual basis and to all new employees at the time they are hired.

Training and Development: During the 1980s companies have, in general, shifted from the development and dissemination of written standards of conduct to the education of managers and employees regarding the application (and limitations) of the standards in dealing with difficult business decisions and ethical dilemmas. Much of this education is going on within companies in their own training and development programs.

A survey of a cross-section of manufacturing and service industries, defense and non-defense together, found that 35 percent of respondent firms provide "training for employees in the area of ethics."[2] By comparison, 49 percent of defense contractors claim to provide such training. Half of the defense industry ethics training programs were developed in the past two years and over three-quarters (77%) of them since 1980.

Analysis and Recommendation

Employees attending ethics training programs in the defense industry are most likely to be drawn from "all departments" of the firm (83%). This suggests, and materials provided by respondent defense firms confirm, that many of these programs are part of new employee norientation. By contrast, only 37 percent of firms with educational

[2]Bentley College Survey, 1985.

programs indicated that contracting and procurement personnel would be specifically selected for such training.

Most firms did not comply with the request to provide materials describing their training program. It is apparent from materials that were received, however, that the scope of subject matter covered and the depth of treatment vary considerably. Some firms provided videotaped messages by their chief executives addressing ethical business conduct generally or the corporate code of ethics in particular. Other firms indicated that external consultants directed training programs narrowly focused on such topics as protecting proprietary information and filling out timecards accurately.

The integration of discussions of ethics codes, issues, and dilemmas into corporate training and development programs can afford employees the opportunity to understand how the code of ethics applies to their own responsibilities, and can encourage employees to anticipate and properly resolve ethics issues and dilemmas on the job.

RECOMMENDATION FIVE: All companies involved in defense-related business with the federal government should make discussion of the corporate standards of ethical business conduct and of ethics issues and dilemmas representative of those facing the company and likely to face the employees a part of all new employees' orientation, of regular performance evaluations, and of internal training and development programs.

III. Monitoring and Enforcing Corporate Ethics Policy

The development and communication of ethics policies by defense contracting firms must be accompanied by a sustained effort to ensure that those policies are understood, that compliance is monitored, and that alleged violations are adjudicated.

Managers in the defense industry are most likely to rely on "informal discussion" (80%) and "group meetings with subordinates" (80%) to ensure that subordinates understand corporate policies and procedures relating to ethical issues. Managers rely less on "individual meetings with subordinates" (75%), "requiring signature on written policy statements" (69%), "performance appraisals" (39%), and "requiring completion of a written questionnaire" (31%).

Monitoring and enforcing compliance in defense firms is usually the responsibility of corporate counsel (85%) and/or internal audit (77%).

Similarly, these offices are the most likely to be responsible for *investigation* of an allegation of unethical conduct (89% and 79% respectively). For such investigations, over half (52%) of respondent firms would also draw upon corporate security.

By contrast, the *adjudication* of allegations of unethical conduct is likely to involve the chief executive officer (49%) and personnel (41%), as well as corporate counsel (64%).

To monitor and enforce compliance, defense contractors rely on a broad array of procedures and practices at the corporate, division, and department levels. Among the most frequently cited were:

- Internal audits
- Annual certification
- Compliance reviews
- Spot checks
- External audits
- Interviews and questionnaires
- Reviews by board of directors ethics committees
- Reviews by corporate ethics offices or contract review boards
- Reports to ombudsmen

Analysis and Recommendation

Internal and external audits are beyond the scope of this report. Annual certification and compliance reviews are usually connected with the audit functions and are not discussed here. Although there is some value to spot checks, neither the frequency nor effectiveness of these

was evaluated in this study.

Board of directors ethics committees, corporate ethics offices and contract review boards (at the corporate, division, and plant facility levels), and ombudsmen all represent attempts to formalize and to improve the effectiveness of the compliance monitoring and enforcement of corporate standards of ethical conduct. The use of these mechanisms by defense firms was examined in the Ethics Resource Center's survey.

Board of Directors Ethics Committee: There is more likely to be a board of directors ethics committee in defense contracting firms (36%) than in U.S. companies generally (14%).[3] Our survey shows this to be a trend that is increasing, with 46 percent of the defense industry committees being established in the last 10 years, 14 percent in 1985 alone.

Ninety-one percent (91%) of the defense firms with ethics committees reported that there were no inside directors on the committee. In many firms the ethics committee has the same membership, and may have the same charter and responsibilities, as the audit committee. Reflecting this is the fact that internal audit is the office most likely (64%) to be required to report to the ethics committee. Corporate counsel (59%) and the chief financial officer (41%) are also likely to be required to report to the ethics committee.

The ethics committees report regularly, with 45 percent reporting on a quarterly basis, 32 percent semiannually and 9 percent annually. Five percent (5%) report monthly. Although all ethics committees report to the full board of directors, 5 percent report also to the shareholders. None provides a report for the general public.

Defense firms tend not to encourage employees to contact the board of directors' ethics committees directly, either for advice or to report questionable business conduct. In those companies with an ethics committee, the most likely means for an employee to contact the committee would be interoffice mail (45%). Other options include "walk-in" contacts (41%), which, since most ethics committee members are outside directors, would require off-site travel by an employee or directing information or inquiries through one's supervisor, which might have a chilling effect on employees' willingness to contact the ethics committee.

Toll-free phone lines (18%) and outside postal box addresses (23%) are made available to employees in a small number of firms.

RECOMMENDATION SIX: All companies involved in defense-related business with the federal government should establish a committee of outside directors to oversee corporate policies, procedures, and practices pertaining to the monitoring and enforcement of compliance with the corporate standards of ethical business conduct. The committee should be required to report its findings to the board of directors at least annually.

Corporate Ethics Office:[4] A corporate ethics office has been established in nearly one-fourth (23%) of the respondent defense contracting firms, with over one-third (36%) of these being created in 1985. The principal functions of the corporate ethics offices include:

- Communication of corporate ethics policies (86%)
- Educating employees about corporate ethics policies (86%)
- Receiving allegations of violations of corporate ethics policies (86%)
- Monitoring compliance with corporate ethics policies (79%)
- Investigating allegations of violations of corporate ethics policies (71%)
- Adjudicating allegations of violations of corporate ethics policies (50%)
- Assessing penalties for violations of corporate

[3]Ibid.

[4]Defined in the survey as "a senior management level group or individual with overall responsibility for developing and/or implementing corporate standards of ethical business conduct."

ethics policies (36%)

Although the corporate ethics office has significant responsibilities with respect to corporate ethics policies, the office is poorly staffed. There is *no full-time professional staff* for 64 percent of the firms with ethics offices. In 21 percent, there is only one full-time professional. The number of professional staff available on a part-time or as-needed basis varies, but 42 percent report that fewer than 10 are available.

Sixty-four percent (64%) of the ethics offices report at least quarterly. Half of the ethics offices are required to report directly to a board of directors' ethics committee.

Employee access to the corporate ethics office is most likely to be through interoffice mail (100%), through the employee's supervisor (86%), and through walk-in contact (86%). Toll-free "hot lines" (64%) and outside postal box numbers (29%) are less likely to be made available.

Contract Review Board: Contract review boards are slightly more prevalent (30%) than corporate ethics offices (23%) as a means for monitoring and enforcing compliance with corporate standards of ethical conduct. Although contract review boards generally operate at the corporate level (89%), there are also boards at the division (28%) and plant facility (67%) levels.

Only 34 percent of the contract review boards report regularly, and only 6 percent report to a board of directors' ethics committee. Thirty-nine percent (39%) of the contract review boards report only "as prompted by events" and are most likely to report to top management at the corporate level. Seventeen percent (17%) report to division management.

Contract review boards tend to be less accessible to employees, with "walk-in contact" (72%) the most likely means, and toll-free "hot-lines" (67%) and outside postal box numbers (11%) the least likely.

Ombudsman: Ombudsmen have been established in 28 percent of defense contracting firms, and most of these are of quite recent origin, 71 percent having come into being since 1980. By contrast, ombudsmen are found in only 6 percent of U.S. businesses generally.

Although ombudsmen function most frequently at the corporate level (71%), over half (53%) operate at the divisional level, and (6%) at the plant facility level as well.

The most common function of the ombudsman is to receive allegations of violations of corporate ethics policies (88%). Additionally, the ombudsman may be involved in:

- Communication of corporate ethics policies (47%)
- Educating employees about corporate ethics policies (41%)
- Monitoring compliance with corporate ethics policies (41%)
- Investigating allegations of violations of corporate ethics policies (12%)
- Assessing penalties to violators of corporate ethics policies (12%)

Only 18 percent of the defense firms with ombudsmen report that this is a full-time position. In 53 percent of the firms, the ombudsman's function requires less than one-quarter of his/her time.

None of the ombudsmen report to the board of directors ethics committee and only about half (51%) report to senior corporate management.

Employee access to the ombudsman is principally through "walk-in contact" (88%) or interoffice mail (82%). In nearly two-thirds (65%) of the firms surveyed, employees contact the ombudsman through their supervisor. Among defense contractors with ombudsmen, 29 percent provide direct access through a toll-free "hot line" and 18 percent through an outside postal box number.

Analysis and Recommendation

The corporate ethics office, contract review board, and ombudsman represent different means by which defense contractors have tried to monitor compliance with corporate standards of ethical business conduct. They share important common features, as well as having significant differences.

Corporate ethics offices are the most broadly conceived of the three and have additional responsibilities for communicating ethics policies. Contract review boards take the narrower focus that the name suggests. Ombudsmen serve principally as an alternative path for pointing out problems or raising allegations of misconduct.

None of these vehicles seems adequately staffed to monitor compliance with corporate ethics policies, even though that is a major responsibility for each:

- The *corporate ethics offices* and the *ombudsmen* are poorly staffed functions.
- Reports from the *contract review boards* and *ombudsmen* may never be brought to the attention of outside directors or of a board of directors ethics committee.
- *Contract review boards* and *ombudsmen* may be difficult for employees to contact anonymously because of the relatively few toll-free "hot-lines" and outside postal box numbers.

RECOMMENDATION SEVEN: All companies involved in defense-related business with the federal government should maintain and regularly publicize to employees the availability of means for employees to report apparent violations of corporate standards of ethical business conduct directly and anonymously to the board of directors committee that has oversight for corporate policies, procedures, and practices pertaining to the monitoring and enforcement of compliance with those standards.

CONCLUSION

Many defense contracting firms have taken significant action to establish, communicate, monitor, and enforce policies and procedures to ensure a high level of ethical business conduct. In each area, the actions taken can be improved upon.

Corporate codes of ethics and standards of conduct provide the broadest, most comprehensive statements of company policy regarding ethical conduct. As such, they can provide a conceptual framework for management and employees to understand the relationship between corporate and public policy. In addition to prohibiting some forms of conduct and mandating others, company codes can also articulate the principles on the basis of which business decisions should be made in areas where neither corporate procedures nor government regulations yet determine conduct.

Standards of conduct can only be as effective as they are applicable, either as *specific rules or as principles, to the conduct* of employees. In this respect, all of the codes examined can and should be improved.

The effectiveness of corporate standards of conduct among defense contractors is further constrained by the limited distribution the standards receive. This can and should be remedied immediately by distribution to all present employees and to all new hires in the future.

That codes of ethics, and the issues, ambiguities, and ethical dilemmas they address, are being brought into corporate training and development programs is encouraging. However, the relative novelty of this approach and the wide variety in format and content of the courses make it difficult at present to assess the merits of these educational activities. To the extent that they increase employees' understanding of how corporate ethics policies relate to their own responsibilities, they will serve the interests

of the public as well as those of the company.

Finally, it is important to note that corporate standards of ethical business conduct are not identical with laws and government regulations. Although they may develop out of common concerns and may overlap in their attempts to govern employee and corporate behavior, they have somewhat different objectives. Standards exist not only to constrain behavior but also to inform judgment. Business relies for efficiency and effectiveness on discretionary decision making. Codes of ethics and standards of conduct, in addition to mandating or prohibiting certain conduct, should provide the principles and values on the basis of which such decisions are made.

Also, where laws and regulations are intended to protect the public's interest, company codes and standards are meant to protect a company's interests, especially its reputation for integrity.

These different objectives expand the need for compliance monitoring beyond the reach of most internal or external auditors. They require an environment in which employees monitor the conduct and the decisions of one another and feel free to call attention to bad judgments and to misconduct in order to preserve the integrity and reputation of the firm. Defense contractors, like companies in other industries, are still experimenting with ways to foster and manage such an environment. Corporate ethics offices, contract review boards, and ombudsmen are part of the experimentation. No recommendation can be made at this time with respect to which one or more of these functions will prove most effective, but the objective of an open, self-policing environment is as desirable as it will be difficult to achieve.

ETHICS RESOURCE CENTER,
INCORPORATED
Washington, D.C.
April 16, 1986

The Hon. David Packard
Chairman
President's Blue Ribbon Commission
on Defense Management
Washington, D.C. 20503

Dear Sir:

The Ethics Resource Center was pleased to be able to provide recommendations earlier this year to the *President's Blue Ribbon Commission on Defense Management*. At that time the Center reviewed current self-governance policies and practices among defense contractors and recommended strengthening of corporate codes of ethics and standards of conduct, as well as improvements in communication, education, and compliance-monitoring activities.

This letter will expand on certain of the recommendations in the Center's February 18 report to the Commission and proffer additional recommendations for the Commission's consideration.

As the Commission recognizes in its Interim Report to the President, public confidence and trust in defense contractors has been severely shaken: "Numerous reports of questionable practices have fostered a conviction, widely shared by members of the public and by many in government, that defense contractors place profits above legal and ethical responsibilities."

The Commission has acknowledged the important role of improved industry self-governance in rebuilding public confidence. Appropriately, the Commission has focused its recommendations on corporate codes of ethics: "To assure that their houses are in order, defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance."

The Ethics Resource Center strongly endorses this recommendation by the Commission. However, based on extensive research on implementation and enforcement of corporate codes of ethics, the Center finds that codes often are either not read or their application is not understood by all employees. The Center therefore strongly reiterates its recommendations of February 18, that:

RECOMMENDATION FOUR: All companies involved in defense-related business with the federal government should distribute the corporate standards of ethical business conduct to all employees on at least an annual basis and to all new employees at the time they are hired;

and that:

RECOMMENDATION FIVE: All companies involved in defense-related business with the federal government should make discussion of the corporate standards of ethical business conduct, and of ethics issues and dilemmas representative of those facing the company and likely to face the employee, a part of all new employees' orientation, of regular performance evaluations, and of internal training and development programs.

Effective self-governance is dependent upon an environment where all employees understand what is expected and permitted and where corporate commitment to the proper standards of business conduct is unambiguous and is constantly, consistently reinforced. Such an environment requires more than a policy document such as a code of ethics. It requires frequent and effective communication regarding the standards and their application, as well as their underlying principles, so that decisions and conduct in areas not explicitly addressed by the code of ethics will, nonetheless, be consistent with those principles.

Integrating discussions of ethics issues and questions into existing company programs of orientation and of training and development affords a relatively low-cost, recurring opportunity for communication about the code and its application. Moreover, this continuing focus on ethical responsibilities can help to create an atmosphere within a company where employees understand that it is acceptable, even expected, that they will raise and participate in the resolution of questions regarding ethical practices.

Difficult ethics issues that confront a given company frequently confront other companies in the same

industry. Because some of these issues concern competitive practices, a company may be unwilling to take corrective action without assurances that others in the industry will as well. An example of such an issue is the gathering of competitors' intelligence. Very few firms in the defense industry (or other industries, for that matter) have promulgated standards of conduct to guide marketing and other personnel in this area.

Because of the absence of clear standards and because of the rewards and incentives to obtain competitors' intelligence, many firms may be at risk that employees will engage in unethical or even illegal practices. Should such practices of defense contractors come to public attention, the confidence and trust of the public and of the government would be further eroded. In order quickly and effectively to address this and other industry-wide issues, the Center offers the following additional recommendation:

RECOMMENDATION EIGHT: Trade associations serving defense contractors should be called upon to take the lead in drafting and implementing industry codes of ethics that would set minimum standards of acceptable conduct and provide guidelines for all their defense contractor members. In order to avoid restraint of trade accusations, industry-wide standards and enforcement mechanisms should be reviewed not only by the Department of Defense, but also by the Antitrust Division of the Department of Justice.

Although there are some inherent difficulties and limitations in industry-wide self-regulation, if self-regulatory activities are carefully circumscribed and monitored by the Department of Defense, they may provide an effective means of ensuring proper conduct by companies within the defense industry. The Securities and Exchange Commission has long recognized this, and it has leveraged its own effectiveness by mandating and monitoring self-regulatory actions by companies in the financial field.

Finally, the Center has encountered widespread concern among defense contractors regarding alleged unethical conduct of government officials and employees with whom the contractors deal. There seems to be considerable skepticism that all military and civilian personnel of the federal government are aware of, or in compliance with, the codes of ethics and standards of conduct that govern their own practices.

Without making a judgment on the validity of these concerns, the Ethics Resource Center urges the Commission to recommend that the Department of Defense, the Armed Services, and the Congress review the adequacy of standards of conduct that cover their own practices, as well as the effectiveness of communication and educational programs to ensure that the standards are understood.

We hope that these observations and recommendations will be useful to the Commission in preparing its final report to the President.

Sincerely,

GARY EDWARDS
Executive Director

APPENDIX C

Report on Survey of Defense Contractors' Internal Audit Processes

Prepared by
PEAT, MARWICK, MITCHELL & CO.

PEAT MARWICK

Peat, Marwick, Mitchell & Co.
1990 K Street, N.W.
Washington, D.C. 20006
202-223-9525

February 17, 1986

President's Blue Ribbon Commission
on Defense Management
736 Jackson Place, Northwest
Washington, D.C. 20006

Gentlemen:

Peat, Marwick, Mitchell & Co. has completed its engagement to conduct a Survey of Defense Contractors' Internal Audit Processes. Phases I, II, and III of the engagement were completed as reported in our status report to you dated December 20, 1985. The enclosed report completes our engagement and presents the results of the survey. The report contains an executive summary, a narrative evaluation of responses to the survey instrument, and a statistical summary of replies received.

Considering the extremely high response rate, and the quality of responses received, this was an extremely successful and meaningful survey. The companies surveyed responded in a timely fashion, and top company executives supported the survey. We were very pleased with the cooperation we received, and with the concern which the companies demonstrated over providing complete and responsive replies in this critical area of contract compliance monitoring.

We would be pleased to meet with Commission representatives to further discuss the survey and its results, or to answer any questions which you may have about the report. Peat Marwick is pleased to have had the opportunity to be of service to the Commission in performing its important assignment.

Very truly yours,

Peat, Marwick, Mitchell & Co.

Enclosure

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EXECUTIVE SUMMARY

Military-industry contractual relationships have undergone a significant change in recent years. In today's climate, optimum compliance with government acquisition statutes and regulations is vital. Contractors' practices must comply, and the internal audit function is a valuable tool in monitoring practices and informing management of any needed corrective actions.

To assess the extent of such internal audit actions, a survey was conducted by soliciting replies from contractors that were substantially engaged in defense contract work. About 85 percent of the 250 business units surveyed responded. These respondents represented about $90 billion of annual government sales, involving more than 1,375,000 employees and reflecting almost 89 percent of the Department of Defense annual outlays for negotiated contracts in fiscal year (FY) 1985.

The survey replies reflected internal audits as being conducted at virtually all sites, with less than 50 respondents reporting a formal audit organization at their operating level. The majority of internal audits were performed by professional staff that were assigned to the corporate or group levels of management. In addition, about 25,000 hours of annual effort were provided by external professionals. There are indicators that more staffing is required and that it may be desirable to place additional internal audit staff at the operating levels. The use of external auditors is usually acceptable, but care needs to be exercised to ensure that the reliance placed on such audits is compatible with the company's objective for contract compliance.

The internal audit staffs appear to be professional and sufficiently objective and independent to perform effectively. There are indications that more formal training is needed in specific government-sensitive areas. Additionally, career paths for advancement are desirable to enhance the professionalism of the staff.

The independence of the audit function appears assured, with a caveat about potential excess audit response to management requests. The audit reports are addressed to sufficiently high levels of management, and follow-up procedures are appropriate to make the reports and the audit recommendations effective. However, responsibility for ensuring timely responses from auditees should be assigned to a high management level, not to the internal audit staffs.

With respect to detected irregularities or suspected violations of law, the replies reflect that these situations are generally handled in a forthcoming manner. However, some 42 respondents did not answer positively about reporting these cases to the government authorities.

The audit reports and working papers are reported as being available internally to all appropriate levels. The reports and working papers are also made available externally, but to a lesser degree with respect to government agencies.

The scope of internal audits has been significantly altered to encompass many government-sensitive areas. This appears to be a relatively recent change and there are indications of further augmentation in FY 1986. Although recognizing this favorable evolution and change of attitude to cover areas sensitive to government contracting, additional and more rapid enhancements are needed on the following matters:

Comparison of wage rates with external sources.

Effectiveness of controls over the authorization of work orders.

Clear definition and delineation of sensitive technical labor classifications.

Frequency of reviews of time-charging practices.

Use of budgets as a control device over the actual charging of costs.

More emphasis on the review of make-or-buy procedures and decisions.

Accountability, safeguarding, and use of government property.

More reviews of the efficacy of the cost-estimating systems.

Greater emphasis on a system approach, to ensure segregation of unallowable costs.

More reviews of data supporting reports and claims submitted to the government.

Enhancement of financial aspects of contract administration.

More evidence of the written documentation supporting communications and training provided to employees.

Need to consider establishing a hot line and an ombudsman reporting procedure.

It is evident from the questionnaire replies that the internal audit function has been expanding to cover government-sensitive areas. Some additional efforts appear warranted, as discussed above. Notwithstanding the very best efforts of defense contractors to fully comply with contract requirements, perfection can never be achieved. Consequently, a set of Criteria for Contract Compliance (CCC) is suggested in Concluding Remarks in Section IV of this report. The concept advanced is both practicable and equitable; it protects the government and the public to an optimum degree, and offers fair treatment to the contractor.

I. BACKGROUND

As one of its major tasks, the President's Blue Ribbon Commission on Defense Management inquired into the role played by defense contractors' internal audit processes as one means to ensure compliance with government acquisition statutes and regulations. The Commission engaged Peat, Marwick, Mitchell & Co. (Peat Marwick) to develop a questionnaire and conduct a survey of a significant number of defense contractors, in order to learn what their past internal audit practices have been and to appraise the extent of changes they plan for the future.

To place the results of this survey in a proper perspective, it is essential to understand the conditions and circumstances that form the background of the seemingly high incidence of contractor noncompliance and much-publicized fraud cases. In tracing Department of Defense (DoD) industry-government contractual relationships over the past many years, there is no intent to justify or pass judgments on either past or current practices. Instead, such history is presented solely to set the background for today's strong emphasis on what is characterized as fraud and white-collar crime in the defense contract environment.

In the late 1930s, military contracts began using the cost of contract performance as a major factor in establishing a fair and reasonable price. During World War II, virtually all Army and Navy weaponry was acquired by means of such cost-based contracts, principally cost-plus-fixed fee and fixed-price redeterminable contracts. This great reliance on the cost of contract performance, which continues up to the present time, made it essential that uniform rules and standards be set to provide the necessary benchmarks for establishing the composition of the "costs" of contract performance.

Beginning in the 1940s with Treasury Decision (TD) 5000, the government issued cost principles to industry. Today, the Federal Acquisition Regulations (FAR) provide criteria for recognizing costs that are allowable and those that are unallowable. The Cost Accounting Standards (CAS), promulgated under P.L. 91-379, provide formal guidance as to the measurement of costs and the assignment of costs to final cost objectives, or the allocation of costs to contracts. In addition, these regulations provide for uniformity and consistency in the manner that contractors estimate, accumulate, and report costs incurred in the performance of government contracts.

Throughout these more than 40 years, contractors' accounting practices were varied. Starting with little or no controls or consistency, external discipline was gradually introduced, primarily as a result of government surveillance and the issuance of regulations. The policies, procedures, and systems of internal controls instituted by contractors during most of this period, however, were usually directed toward the overall financial integrity of the company; that is, the primary concerns of the company dealt with preserving the assets, minimizing liabilities, and earning a net profit for the owners. Relatively little attention was given to the assignment or allocation of costs to projects or contracts. Neither the internal audit function, where one existed, nor the annual financial audit performed by the company's independent CPAs, provided much surveillance over the cost distribution methodology employed within a company's projects and contracts.

Similarly, there was only a modest effort exercised by contractors in ensuring that claims submitted to the government were free of errors and did not include any unallowable costs.

In this kind of environment, government auditors and contracting officers often detected errors in contractors' claims. Costs were disallowed, overhead allocations were challenged, and cost disputes were not uncommon. In a number of instances, the circumstances surrounding some of the contractor claims made it necessary to refer the matter for investigation. All too often, these referrals were not investigated and even more rarely were there any prosecutions. This condition was highlighted in a 1981 GAO report which stated that two-thirds of all fraud cases referred to the Department of Justice (DOJ) for criminal actions were declined. The majority of the cases were declined because DOJ did not have adequate resources to pursue prosecution, not necessarily because there was insufficient evidence to conclude that a fraud may have been committed.

As a result of the somewhat lax controls exercised by contractors and the lack of government prosecution of suspected wrongdoings, government auditors and contracting officers usually resolved the many costing problems through administrative procedures. These administrative procedures usually did not obtain effective remedial actions by contractors. The lack of positive measures, financial or otherwise, did not provide incentives for contractor corrective measures. The attitude seemed to be that "if the auditors find it, they will disallow the cost." This same attitude was reflected in other contractor practices in such sensitive areas as employee time-keeping procedures and the preparation of bids and proposals submitted to the government.

In about 1980, the government began to tighten its surveillance and more actively investigate and prosecute cases where wrongdoing was detected. This government effort was somewhat unexpected and contractors soon found that it was no longer "business as usual." Where contractor management was not exercising due care in charging and claiming costs under government contracts, the instances were no longer settled by negotiated financial restitution. As a result, many cases began to be investigated and prosecuted, and companies were suspended and debarred when, heretofore, the same or similar practices resulted only in financial adjustments.

It is at this time, probably at the peak of a dynamically changing environment, that the survey of Defense Contractors' Internal Audit Processes was conducted. Through this specially designed questionnaire, we intended to assess the role that the internal audit function has performed, and can perform, in ensuring that contractors are in compliance with government statutes and regulations.

II. CONCEPTUAL FRAMEWORK

For purposes of this survey, the internal audit function has been defined to include any regular or special examination conducted by or on behalf of a company's management to assess the extent of compliance with the company's established policies, procedures, and systems of internal controls. The examinations may be conducted by fully dedicated employees, by company ad hoc groups, or by specially engaged external professional organizations. The term does not include routine operational activities performed in conjunction with day-to-day functions such as operating and accounting controls, technical inspections, and other normal supervisory efforts; nor does it include the regular annual financial audits performed by a company's independent CPAs.

Fundamental to an effective internal audit function are operational policies and procedures, and an organization with adequate checks and balances among the various activities in order to effectively implement the company's business objectives. The internal audit function performs surveillance over such systems and informs management of system success or failure.

Policies are statements that express management's decisions for attaining a company's business objectives. They include basic decisions promulgated at the highest level of management; are usually supplemented by top managers; and are further implemented and reduced to operational policies at lower management levels.

Procedures implement a company's policies by prescribing directions for performing tasks or functions in terms of what to do; who will do it; how to do it; and when, where, and why it is done. These procedural instructions are generally contained in handbooks, manuals, and procedural memorandums.

A well-managed company provides for systems of internal controls in the organizational alignment of the many tasks and functions that need to be performed to effectively carry out the enunciated policies and procedures. A system of internal controls comprises all coordinated methods and measures adopted to safeguard the company's resources, to ensure the accuracy and reliability of its accounting and cost data, to promote operational efficiency, and to ensure adherence to established management policies and procedures. A satisfactory system of internal controls includes a plan or organization that provides for delegation of authority and segregation of functional responsibilities by departments or individual employees. Additionally, the personnel assigned the various responsibilities must have the necessary qualifications to perform satisfactorily.

A competent internal audit staff that informs management whether company policies are being effectively implemented provides an additional and a very significant internal control. Where such a staff is well-trained in the many and varied requirements of government acquisition rules and regulations, the internal audit function can be most effectively used to ensure that the company's practices, procedures, and policies are in conformance with those government requirements.

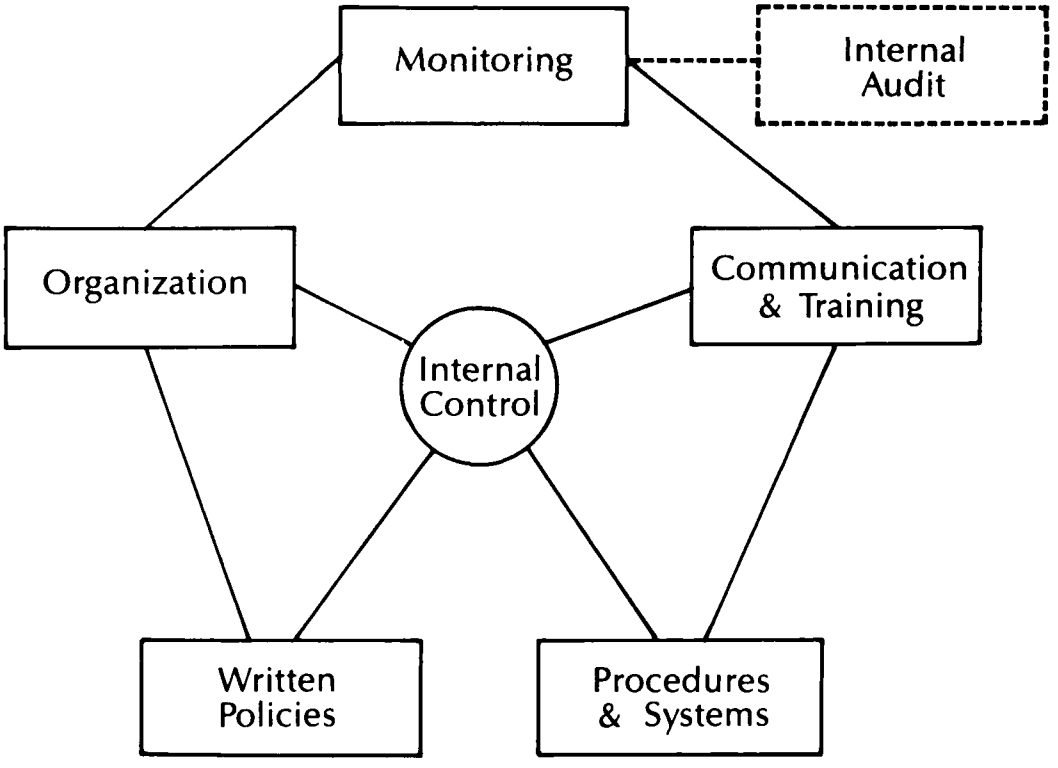
This survey questionnaire was specifically designed to evaluate the extent that the internal audit function actually performed in this somewhat more specialized area of government contract operations. It was anticipated that the replies to the questionnaire would also reflect changes that respondents were planning in

order to make this function a more effective tool for ensuring compliance and avoiding financial and other more drastic sanctions that may be levied where irregularities occur.

The foregoing briefly outlines the entire system and philosophy of management in a well-conceived organization. The extent of compliance with those statutory and regulatory requirements needed in the performance of government contracts depends on the effectiveness and efficiency of the entire system. Internal audit is one means for performing a critical function of the system; namely, that of monitoring. Other surveillance methods are also often utilized: for example, statistical reporting, management reviews and reports, a company hot line, and an ombudsman for referrals.

A system of adequate contract compliance rests on the efficacy of all its component parts, i.e., issuance of needed policies, effective procedures, sound organization, communications to all needed levels, and effective monitoring. Such a system can be portrayed by the following figure:

Contract Compliance Framework



III. CONDUCT OF SURVEY

The survey was conducted exclusively by written questionnaires which were mailed to selected contractor organizations that had performed an appreciable amount of government contract work in recent years. More than one segment was solicited within the same corporate entity, depending on the extent of government contract work performed. In some instances, because of the significant work performed company-wide, the corporate home office may have received a questionnaire independent of, but in addition to, the several business segments of the company.

Each segment solicited was informed that full anonymity of the respondents would be observed. Survey procedures embodied appropriate safeguards so that the replies could not be attributed to the respondents by Peat Marwick, the President's Blue Ribbon Commission, or the law firm of Hogan & Hartson, which controlled the replies to ensure such nonattribution.

The mailing list for the questionnaire was designed to obtain a sample size that could be reasonably evaluated in the constricted time frame available for the survey. At the same time, it was essential to obtain information from those business segments that made up a large and significant portion of the work performed by the private sector under negotiated contracts with the Department of Defense. To achieve both these objectives, a list of government contractors was obtained from the Defense Contract Audit Agency (DCAA). This list contained all major defense contractors, so designated by DCAA, excluding colleges, universities, and government-owned-contractor-operated (GOCO) plants. DCAA designates major contractors as those contractor locations where DCAA maintains a cadre of auditors on a full-time basis. These are called DCAA resident offices or DCAA sub-offices.

These criteria produced a list of 250 contractor sites, and a questionnaire was mailed to each.

A cutoff date of January 27, 1986, was set for survey responses, and we achieved a response of over 85 percent. We estimate that the aggregate annual government contract work load for the responding sites exceeded $90 billion, which is more than 70 percent of the FY 1985 DoD annual negotiated procurement volume. The responses also reflect about 89 percent of the FY 1985 DoD annual outlays for negotiated contract work. Some of the respondents may have included contract work for NASA and other non-defense agencies, but the extent is deemed minimal and does not detract from the high percentage of DoD annual contract expenditures included in this survey.

The questionnaire was designed to achieve several objectives:

- To learn the extent to which the internal audit function has been used in the past at these major defense contractor sites.
- If the internal audit function has been utilized in the past, to determine whether it covered those policies, practices, and procedures that are peculiar, pertinent, and sensitive to the performance of government contracts.
- To the extent that internal audits were performed in the past or are planned for the future, to determine how effective those audits are likely to be, considering that the effectiveness of an internal audit function depends on:
  - management's motivation for its establishment;

the extent of independence from internal and external influences;
the extent of responsibility and delegated authority;
its status in the organization; and
the sufficiency and professional level of personnel resources made available to perform the assigned functions.

In light of the recent great emphasis on disclosures of irregularities by government contractors, to identify the extent to which the internal audit function plans to expand its FY 1986 scope of review in areas that are government contract sensitive.

To learn the extent to which employees and internal auditors have been trained in government statutes and regulations with which their employers are required to comply, such as FAR, CAS, and the Truth in Negotiations Act (P.L. 87-653).

IV. ANALYSIS OF SURVEY REPLIES

In most instances, the responding business segments reported annual government sales that were well over $50 million. Only 4 percent (9 respondents) reported lower annual volume, whereas 37 percent (80 respondents) reported sales in excess of $500 million for the year. Similarly, the segments generally reported that their government sales were more than 50 percent of their total business in over 80 percent of the cases, with almost 29 percent showing that government activities constituted more than 95 percent of their total annual revenue.

The survey results and all observations relate only to businesses that are substantially engaged in DoD contracts. The results are not necessarily equally appropriate to smaller government contractors. With respect to the internal audit function, it is more than likely that the smaller companies have far less such activity and many may have none at all.

The questionnaire and the tabulation of the replies were designed to assess the varying degrees of internal audit performance in a variety of groupings. For example, the replies can reflect the differences, if any, at those contractor sites where the preponderance of government work is performed on a firm fixed-price basis, as contrasted with locations preponderantly engaged in cost-reimbursement contracts. The data can reflect practices where both firm fixed-price and cost-type contracts are performed to a significant degree.

Similarly, analyses can be made of the practices at sites that are predominately involved in government contract work, as contrasted with locations where a substantial amount of commercial work is also performed along with the government work. Another potential analysis would be to compare the responses from different segments of the private sector, e.g., primarily manufacturing operations, construction, research and development, and services.

Although the analyses identified above might yield interesting results, they probably would not really affect the primary purpose of the survey, which is to assess the role that internal audits can play in ensuring contractor compliance with government statutes and regulations as they affect the procurement process. Admittedly, some of these requirements are more rigid, and more surveillance is required for contracts priced on a cost basis than for firm fixed-price contracts. Nonetheless, the pricing of the latter types of contract is equally sensitive in many respects, and disclosures of wrongdoing, prosecution of fraud, implementation of defective pricing adjustments, and overpricing of spare parts are not confined to cost-based contracts.

On the other hand, one might expect that the degree of contractor attention, including the performance of internal audits, might vary according to the annual volume of government work. The questionnaire replies were therefore tabulated to permit an analysis by six strata of annual government volume. However, the first analysis of data was made considering only three strata, i.e., under $200 million, $201 to $500 million, and over $500 million. The observations and conclusions drawn from this analysis did not vary to any significant degree nor in any substantive way from the analysis of the replies from the total sample. Consequently, the tabulated questionnaire results are given at the end of this section, while the section itself addresses the total universe, relative to the following subject matter:

- Extent of Internal Auditing.
- Profile of the Internal Audit Staff.

- Independence and Effectiveness of the Internal Audit Function.
- Level of Performance in Government-Sensitive Areas:
  - Labor Management,
  - Material Management,
  - Estimating,
  - Cost Accounting Standards,
  - Costing and Reporting,
  - Contract Administration, and
  - Employee Training.
- Other:
  - Hot Line,
  - Ombudsman.
- Concluding Remarks.

EXTENT OF INTERNAL AUDITING

Some 155 respondents (72 percent) reported having a formal internal audit function, whereas 60 units reported no such activity at their reporting level. However, with 164 replies showing the function to be at a higher management level (i.e., group or corporate), and approximately 25,000 hours being applied by outside professionals, it may reasonably be concluded that virtually all reporting segments reflect some degree of auditing which is in addition to the annual financial audits performed by outside CPAs. It is noteworthy that less than 50 segments report formal internal audit groups at their operating levels; the remaining respondents are audited by group-level or corporate-level audit staffs.

Organizationally, the internal audit function reports to a sufficiently high level in the management structure to ensure independence and objectivity, with 60 percent reporting to the chief financial officer or higher (board of directors, audit committee, etc.), and an additional 16 percent reporting to the controller level. While the remaining 24 percent report to a variety of other echelons, these, too, generally reflect appropriate levels to ensure integrity of the audit function.

Many respondents (70 percent) stated that they rely on their outside auditors and government auditors for audit coverage, either fully or to supplement their own internal audits. Reliance such as this may be inappropriate because most external CPA audits do not normally incorporate coverage of areas that are so critical to government contract compliance. These audits deal primarily with a company's financial reports, which reflect total operating results, and with the status of assets and liabilities at the financial reporting date. Government audits, on the other hand, are designed to assess the assignment of costs of specific cost objectives. However, too much reliance on government audits for compliance could also place a company in jeopardy. This has become evident from investigations that have been initiated in recent years as a direct result of referrals stemming from government audit findings.

With regard to the size of the internal audit staff, 58 percent of the reporting units have fewer than 10 auditors, and only 40 respondents have more than 25. Although an assessment of the sufficiency of qualified staff is subjective and cannot be made with a high degree of precision, the internal audit staffing levels as reported appear to need enhancement because of the following indicators:

- Fourteen segments with government annual volume of $201 to $400 million reported internal audit staffs of three or fewer professionals.
- Nineteen other segments in the same dollar range reported internal audit staffing of 10 or fewer professionals.
- Eight segments in the $500 million volume category have 10 or fewer internal auditors.
- Almost 65 percent of the units reporting state that their internal audit staffs do not complete a full cycle of all auditable areas within a three-year period.

When considering an overall volume of $90 billion of annual government sales involving more than 1,375,000 employees, the average size of internal audit staffing appears to need augmentation.

As discussed later, the internal audit organizations are now extending the scope of their reviews from traditional financial audits to audits which include management and financial areas that are particularly germane to government contract compliance requirements.

All of these indicators suggest a need for staffing increases, either permanently or for a two-to-three-year period, as necessary, to achieve a greater emphasis in government-sensitive areas and better contract compliance on a system-wide basis. Concomitant with staff increases, there is a need to assess whether internal audit personnel should be assigned locally to the operating segments in instances where all internal audits are now being performed by personnel from the group or corporate headquarters offices.

PROFILE OF THE INTERNAL AUDIT STAFF

The questionnaire replies portray a satisfactory level of professional background for the internal audit staff. For example, 85 percent of the respondents indicated that the internal audit staff had accounting expertise. Knowledge of electronic data processing represented another noteworthy internal audit skill. Additionally, 87 percent of the respondents reported that internal auditors were required to comply with the standards for the professional practice of internal auditing as issued by the Institute of Internal Auditors.

With regard to specialized formal training of the professional staff, there are indicators that areas which are highly critical to compliance with government statutes and regulations are part of recently developed training curriculums, i.e., CAS, FAR, Truth in Negotiations Act, and fraud detection. Although formal training in these areas is apparently under way, the responses did reflect that considerably more emphasis is needed, probably on an expedited basis, if the staffs are to be fully effective in monitoring the pertinent policies and practices. The survey showed that only 52 segments had provided training in all four sensitive areas mentioned above. At the other end of the spectrum, 56 segments reported no such specialized training at all. Of the four areas, a relatively lower incidence of training was reported for the Truth in Negotiations Act, which is directly related to the efficacy and adequacy of a company's system for estimating costs. The need for greater training in this area is manifested by the apparent lack of audit coverage of estimating systems, which is discussed in a later section of this report. A summary observation of training needs is that all four areas—CAS, FAR, Truth in Negotiations Act, and fraud detection—require greater coverage, with particular emphasis on cost-estimating systems.

To round out the professionalism of the internal audit staff, companies should provide attractive career paths for internal auditors. Part of such a program would be a defined tour of duty, with career opportunities in the management structure of the organization. The survey responses suggest that such a career path has generally not been established.

INDEPENDENCE AND EFFECTIVENESS OF THE INTERNAL AUDIT FUNCTION

The basis for designing and establishing audit programs, as reported in response to a series of survey questions, appears good, in that the scope and scheduling of the audits are established by the audit group or by a higher level of management. This procedure provides an optimum degree of independence and

objectivity. Decisions relative to what will be audited, and how and when audits are to be performed, are largely divorced from the functional activities that are subject to audits, with one potential exception. Almost all replies indicated that the scope of audits is responsive to "management requests," and such reaction is both proper and laudable. However, the internal audit group must safeguard against the potential of applying all available internal audit resources to management requests, thus negating the independence and objectivity of the function because of its inability to audit other areas that may have critical need of surveillance.

Internal audits were reported to be management oriented as well as financial, and the audit reports are addressed to sufficiently high levels of management for appropriate action. Additionally, auditees are required to respond in a timely manner to reported findings and recommendations. To further enhance the effectiveness of the audit reports, most survey responses reflected that disagreements with audit reports are resolved at a management level sufficiently high to promote an independent and objective decision on the merits of any dispute.

Follow-up actions on audit reports are also generally prescribed, but, in responding to this question, many units indicated that the internal audit group was assigned follow-up responsibilities. Such assignment is satisfactory for assessing the extent of remedial action taken by functional managers. However, the procedures should also provide for policing the corrective actions. This policy should be implemented by a level of authority above the functional manager, e.g., chief executive officer, chief financial officer, chief operating official. At such levels, the follow-up procedures are likely to be more effective in getting timely action on matters requiring attention.

With regard to detected irregularities and suspected violations of laws, the summary replies indicated that these situations are generally handled in a forthcoming manner, pursued fully and timely, and ultimately reported to appropriate levels of authority for disposition. One significant exception was noted. In 39 responses, where violations were reported to in-house counsel and/or external counsel, there was no indication that the violations were reported to any government authority. These 39 replies did suggest that even after examining internal referrals which proved to be violations, they would not be reported to government authorities. Additionally, we noted three instances where reports were made neither to counsel(s) nor to government authorities. It is conceivable that these responses did not intend to portray a failure to report such instances; however, to the extent that companies do follow such a policy, there is an urgent need for them to reconsider their position.

Regarding the availability of the final internal audit reports and supporting working papers, survey responses reflected appropriate access to all levels within the company. As might be expected, both reports and working papers were generally available to outside CPA firms. A surprising percentage of replies reflected availability to DCAA as well—67 percent for audit reports and 45 percent for working papers. The reports and working papers were also reported as available to other government agencies, but to a much more limited extent.

LEVEL OF PERFORMANCE IN GOVERNMENT-SENSITIVE AREAS

The primary thrust of the survey was to assess the role of the internal audit function as a tool in achieving contractor compliance with government regulations and statutes. A complete and comprehensive set of policies and procedures and an organizational structure that optimizes the checks and balances, thus providing an effective system of internal control, are essential to achieving contract

compliance. The internal audit function represents a monitoring device that informs management how effectively the entire system is functioning. Accordingly, the survey questionnaire was designed to obtain the extent of auditing of specific practices (policies and procedures) that are government contract oriented. Many of these areas usually require more penetrating evaluations, performed more frequently, than those that are essential to determine acceptability of the more traditional audit areas dealing with revenue, expenses, assets, and liabilities. The responses in this regard relate to Section IV of the questionnaire, and cover questions 30 through 136.

As a summary observation, there is evidence that major defense contractors have enhanced the internal audit function to an appreciable extent in providing coverage for government-sensitive areas. The survey responses show that many of these areas have been covered in recent audits, and audit plans clearly evidence a further augmentation for FY 1986. This change of attitude can be reflected best by the following two excerpts from contractors' statements regarding internal audit coverage.

One company reported:

> The focus of most internal audit generally is business systems and functions. As a result of this historical role and the department's limited expertise in areas relating exclusively to government contracting, such as government cost accounting standards or subcontract administration, the Internal Audit Department has performed relatively few audits that are contract specific or otherwise relate specifically to a DoD program.
>
> [The Company] has recognized that in order to respond fully to the management control weaknesses recently identified both from outside and within the Company, it must expand the role and technical expertise of its Internal Audit Department to include greater oversight of contract and program related controls. The Company believes that the new internal audit initiatives detailed below, in conjunction with other initiatives . . . will provide an adequate mechanism to monitor and control compliance with federal statutory, regulatory, and contract requirements.
>
> Nevertheless, [the Company] is committed to developing and institutionalizing an internal audit function for all aspects of contract compliance. This is an audit responsibility far outside the traditional role of a corporate internal audit department, and [the Company] has not yet determined which organization entity should fulfill this function.

Another company stated:

> The reporting unit has a DCAA residency and is under AFPRO administrative cognizance. It has successfully passed Air Force Contract Management Division Contract Operational Review audits. For these reasons, no formal Internal Audit reviews on the matters addressed in this section were considered to be necessary or cost-effective in the past.
>
> During 1985, the Company retained outside legal and public accounting firms to conduct an independent and comprehensive compliance review on the reporting unit and other units engaged in business with the government. This review encompassed the functional areas covered in this section. While no major deficiencies were found, the compliance review report did make several recommendations on improving policies and procedures. A corrective action plan, embracing these recommendations, is under way. The Company Internal Audit Group is planning reviews during 1986 at the reporting unit as indicated in the following pages to assure the recommendations are implemented and all functional areas continue to perform in a satisfactory manner.

Although the total internal audit effort shows signs of appreciable change from the traditional financial audit to one that encompasses the government-sensitive areas, there are indicators that more emphasis may be needed to attain an acceptable level of compliance with government requirements. Observations are provided in each major survey grouping.

LABOR MANAGEMENT

Validity of the Payroll (Questions 30-36)

The responses in this area generally reflected adequate coverage. However, only minor increases are planned in some significant areas such as controls over compensatory time, overtime authorizations, and fringe benefit payments. Particularly noteworthy is the fact that coverage of timekeeping and attendance areas was appreciably higher than that of other areas, and that these areas are expected to receive even greater attention in FY 1986.

Payroll Preparation and Payment (Questions 37-49)

The comments made in the prior section regarding adequacy of coverage are equally appropriate here. There is indicated emphasis, both past and for the future, on sensitive functions dealing with control of time cards, required approvals, appropriateness of charges, etc. With respect to comparing the company's wage scales with external sources, the coverage seems inadequate and there is no planned increase indicated. These comparisons relate to the reasonableness of pay rates, and failure to conduct them periodically may cause problems in light of the recent emphasis placed by the government on conducting formal reviews of contractors' compensation systems.

Labor Cost Distribution (Questions 60-65)

This is a highly sensitive area. It deals with procedures and controls over direct charging of work as well as charging of labor through intermediate cost objective, such as allocations from a variety of overhead account classifications, or from allocations of Independent Research and Development (IR&D) and Bid and Proposal (B&P) projects.

Not surprisingly, the internal audit coverage of labor cost distribution was reported as being significantly higher than that of any other audit area. Moreover, at least a 10 percent increase in audit coverage was reported as planned for 1986. However, to make a value assessment of coverage in the area, the number and quality of audits would need to be known. The need to repeatedly conduct examinations would suggest that a frequency of three times per year would be minimum for effective audit coverage. On such a basis, only 30 to 40 percent of the respondents had performed three or more tests during the last fiscal year. While the planned FY 1986 program showed greater emphasis, it is doubtful that even half of the business segments will achieve three or more scheduled audits during the next year.

Within the overall labor cost distribution function, certain sensitive areas did not seem to receive sufficient audit attention. These areas included, for example, the effectiveness of controls over the authorization of work orders, and the clear definition and delineation of work order authorizations. These have proven to be problem areas in the past, particularly with respect to contract project versus IR&D and B&P projects versus indirect technical labor charged to overhead accounts. With regard to the latter, i.e., indirect labor categories, the guidance and controls to identify the work classified as "downtime," or non-productive work, need considerable attention.

Conversely, there are indications of increased activity in conducting surprise floor checks of time-charging practices and in conducting employee interviews. This increased activity is desirable, and even essential, in light of the government's strong emphasis on the labor cost distribution area.

Labor Cost Controls (Questions 66-69)

The use of various management controls can be very effective to:

- validate incurred labor costs as charged to various account classifications, and

- provide indicators for possible errors or unauthorized practices.

Well-managed companies will periodically check actual labor costs with budgets for both program and cost center charges. Similar checks should be made in other labor-charging areas, e.g., IR&D and B&P costs.

The survey replies suggest a need for more internal audit coverage in these sensitive areas of labor cost controls. Although some respondents indicated increased activity in this area for FY 1986, almost half of the reporting segments did not show *any* planned audit activity of labor cost controls. On the other hand, 88 percent of the replies showed planned audits in FY 1986 that are designed to detect labor cost mischarging, thus reflecting recognition of the importance of the area.

Material Management (Questions 71-84)

Generally speaking, the replies in this area reflected adequate audit coverage, with some modest increases planned for FY 1986. However, we noted that certain sensitive areas need more audit emphasis. The following areas fall into this category:

- Review of make-or-buy practices.
- Accountability, safeguarding, and use of government-furnished property.

Reviews of Estimating Practices (Questions 92, 97-103)

The respondents reflected an appreciable level of audit interest in compliance with the Truth in Negotiations Act (P.L. 87-653), but did not show a comparable level of activity in reviewing the estimating system and practices. This would suggest that audits are being made to identify individual potential defective pricing situations rather than assess the estimating practices that are usually the root cause of defective pricing. Many companies use the internal audit function as a way of providing management with the means to ensure that proposals furnished to the government reflect cost data that are accurate, complete, and current by reviewing the efficacy of the cost-estimating function as a system. This approach can also be used to provide company officials with reasonable assurance for signing the Certificate of Current Cost and Pricing Data required by the Public Law.

Cost Accounting Standards (CAS) (Questions 104-109)

The survey replies indicated an acceptable level of audit in this area. With regard to compliance with CAS 405, which requires an identification of unallowable costs, a higher level of audits has been performed and the plans suggest a further increase during FY 1986. Other recent actions, both statutory and regulatory, have increased the number of cost items that are unallowable. In addition, sanctions and penalties are being added for those instances where unallowable costs are included in contractors' cost representations to the government. Consequently, companies need to modify existing practices to ensure that all unallowable costs are clearly defined and communicated to all appropriate employee levels. The system should also provide for identifying and segregating unallowable costs, as incurred, so that such costs will be excluded from cost representations made to the government. Finally, internal audit staffing should be increased to ensure, on an ongoing basis, that the system is functioning as designed.

Accuracy of Costing and Reporting (Questions 110-122)

Generally, the replies to questions in this category reflected a need for more surveillance. Contractors should consider some enhancement of the audit surveillance over the following sensitive areas:

- Clear definition and delineation of criteria for costing technical labor, e.g.,

contracts, IR&D and B&P projects, and overhead accounts.

- Audit review of the documentation and data supporting reports and related certifications on claims submitted to the government for progress payments, billings on public vouchers, hourly rate billings, and overhead representations.

Contract Administration (Questions 123-128)

In the area of contract financial management, the reported level of audit activities also reflected a need for enhancement. Although some audits have been reported for this function in the past, the audit plans for FY 1986 show little or no enhancement. Yet this area of management, if neglected, can be financially harmful to a company.

Employee Training

Adequate surveillance of management's communication to employees is reflected by the responses to questions in this area. However, it appears that insufficient attention is being given to formal documentation of training activities. This, in turn, suggests that the audit evaluation of actual practices may be weakened by deficiencies in the written evidence available. For example, files should be examined to ascertain that employees have provided written acknowledgement of their understanding of such important matters as the code of ethical practices, military security regulations, and timekeeping and labor-charging practices.

Ombudsman and Hot Line

The role of these two activities is closely related to the internal audit function. Where properly maintained by an organization, they provide an objective and independent avenue for information flow and are therefore part of a monitoring system. Like the internal audit function, they can make information available concerning the overall effectiveness of the company's management system and controls. The questionnaire responses in both these areas show very little recognition of the merits of either an ombudsman (20 percent) or a hotline (29 percent).

Both of these activities can enhance the effectiveness of the internal audit function because they provide independent leads that can be examined by auditors. In substance, the internal auditors' scope of review can be enlarged to cover areas that need special coverage, as disclosed by responsible leads stemming from the ombudsman or hotline communication facility.

CONCLUDING REMARKS

The survey portrays an increasing awareness on the part of major defense contractors that compliance with statutory and regulatory requirements needs to be practiced to a much greater extent than was true in the past. Contract compliance is critical and vital for those engaged in government work; to perform the required surveillance over contractors' practices, the internal audit function is playing an ever-increasing role. In fact, internal audit is now regarded by most major government contractors as an essential monitoring device. Consequently, the scope of the internal audit function has been significantly broadened to embrace those areas that are sensitive to government contracting. The survey results also suggest the need for enhancement of the function to more speedily emphasize certain aspects of the current plans and programs.

As described earlier in this report, the internal audit function cannot achieve optimum contract compliance on its own. Its effectiveness is dependent on a sound, comprehensive system of policies, procedures, organization, and communication, all of which

are consistent with government statutory and regulatory requirements.

A typical example and a vital factor in achieving contract compliance is a company statement of ethical practices that are expected of all employees. This company Code of Ethics should be issued as a formal document, clearly stating the company's policies and providing sanctions for violations. The implementation, in the form of procedures, should assign organizational responsibilities for conducting examinations, hearings, etc., for detecting violations, and the methods for imposing sanctions. These formal documents need to be disseminated to all personnel, including the newly employed. Moreover, there is a need for periodic acknowledgements by all personnel of their understanding of the Code of Ethics. The internal auditor would then periodically validate the above process, including the evidence that the practices are in place and in compliance with written policies and procedures.

Notwithstanding all efforts to use internal auditors more extensively and effectively, along with a continuing effort to keep the related policies, procedures, and organizational structure current, "full" or "perfect" compliance can never be achieved. Therefore, the measure of a contractor's compliance should consider appropriate criteria. In short, the following could be deemed acceptable criteria for contract compliance:

- The extent to which top management commitment to contract compliance is articulated and practiced.
- The efficacy of the organization's ongoing efforts as demonstrated by:
  - —written policies that are current, complete, and clear;
  - —procedures that are comprehensive and comprehensible at all need-to-know levels;
  - —policies and procedures that are in compliance with government requirements;
  - —an organization that produces an optimum degree of checks and balances;
  - —a trained cadre of professionals to monitor all the above; and
  - —an ombudsman and/or hotline procedure to augment the internal audit function.
- Prompt remedy of disclosed breaches.
- Prompt examination of all reported problem areas.
- Speedy, comprehensive, and vigorous pursuit, within the company, of suspected violations.
- Sanctions against violators, appropriate to the irregularity.
- Financial restitution and appropriate disclosures, made to the appropriate government officials.

In such an environment, the company will have made an optimum effort to be in compliance with requirements. Although it is recognized that violators of law or regulations cannot be given blanket immunity, it appears that the government's reaction could be along the following lines:

- An examination could be conducted of the actions taken by the contractor to evaluate whether:
  - —they are appropriate to the circumstances;
  - —the financial restitution offered is sufficient;
  - —the sanctions are sufficient;
  - —additional prosecution is appropriate; and
  - —the remedial actions taken are sufficient to minimize further similar exposures, thus safeguarding the government's interests in future operations.
- Based on the above evaluations, the government could conclude that the contractor has performed in an optimum manner to achieve contract compliance

and:

—suspension or debarment actions are not needed to preclude similar actions in the future;

—further investigation by the government is not warranted;

—if warranted, permit the contractor to conduct the investigation and report back to the government;

—disclosures or releases to the media are not appropriate because the actions are those of a prudent contractor; and

—the entire incident can be treated as a normal matter in the conduct of an ongoing business, not warranting any unusual problems, investigations, or disclosures outside the normal channels.

All the above is not to gainsay that where the violations by individuals warrant prosecution by government authorities, an investigation will be conducted and appropriate additional sanctions will be levied by the government.

TABULATED QUESTIONNAIRE RESULTS

The following pages contain the tabulated results of all questionnaires returned. All questions that required the respondents to circle one or more of the listed answers have been tabulated with both an actual response count and percentage of each response. The total counts vary slightly from question to question because some respondents chose not to answer some questions. Questions 27 through 136 each have two response tabulations. The first tabulation describes the level of current audit coverage, and the second tabulation describes the planned audit coverage for FY 1986. The "not applicable" responses for questions 27 through 136 have not been included in the percentage tabulations to provide a more accurate display of how often the companies that are affected in each of these areas perform internal audits.

The results of questions 6, 7, 9, and 13 provide the mean or average response (when a response was provided). The minimum and maximum responses to question 7 are also provided.

All questions have been weighted for the questionnaires being tabulated that represent more than one operating segment involved with DoD acquisitions. For example, if a company returned one questionnaire that represented five operating segments, that questionnaire is tabulated as if five duplicate questionnaires were returned.

Survey of Defense Contractors' Internal Audit Processes

QUESTION 1—*What is the type of business entity of which the reporting unit is a part?*

	Count	%
Corporation	215.0	99.5
Partnership	1.0	0.5
Proprietorship	0.0	0.0
Total	216.0	100.0

QUESTION 2—*What is your predominant type of government sales in the reporting unit?*

	Count	%
Manufacturing	132.0	61.1
Research and Development	35.0	16.2
Construction	6.0	2.8
Services	28.0	13.0
Other	15.0	6.9
Total	216.0	100.0

QUESTION 3—*What are the total annual sales of the reporting unit? (Government and Commercial)*

	Count	%
$11–$25 Million	0.0	0.0
$26–$50 Million	3.0	1.4
$51–$100 Million	11.0	5.1
$101–$200 Million	41.0	19.1
$201–$500 Million	56.0	26.0
Over $500 Million	103.0	47.9
No Sales	1.0	0.5
Total	215.0	100.0

QUESTION 4—*What are the total annual government sales of the reporting unit?*

	Count	%
$11–$25 Million	1.0	0.5
$26–$50 Million	8.0	3.7
$51–$100 Million	18.0	8.4
$101–$200 Million	44.0	20.5
$201–$500 Million	63.0	29.3
Over $500 Million	80.0	37.2
No Sales	1.0	0.5
Total	215.0	100.0

QUESTION 5—*What percentage of total sales of the reporting unit is government sales?*

	Count	%
Less Than 10%	7.0	3.3
10%–50%	33.0	15.4
51%–80%	55.0	25.7
81%–95%	58.0	27.1
Over 95%	61.0	28.5
Total	214.0	100.0

QUESTION 6—*What is the percentage of government sales by contract type?*

	Average %
Cost-Type	36.6
Fixed-Price Incentive	19.6
Firm Fixed Price	40.8
Hourly, Time and Material	2.2
Others	0.8
Total	100.0

QUESTION 7—*What is the approximate number of employees who usually charge?*

	Average	Minimum	Maximum
Direct	5,444	0	55,000
Indirect	2,430	0	29,785

QUESTION 8—*Do you maintain a formal internal audit organization staffed by fully dedicated employees?*

	Count	%
Yes	155.0	72.1
No	60.0	27.9
Total	215.0	100.0

QUESTION 9—*If internal audits are performed by specially engaged outside auditors or consultants, approximately how many hours are they engaged per year?*

Average	Minimum	Maximum	Total
272	0	4,000	25,168

QUESTION 10—*Where a formal organization within the company performs internal audits, at what organizational level are they assigned? (Circle all appropriate values.)*

	Count	%
Corporate	140.0	90.3
Group	24.0	15.5
Division or Segment	45.0	29.0
Other	5.0	3.2
Total Respondents	155.0	100.0
Total Responses	214.0	

QUESTION 11—*To whom does the audit group report?*

	Count	%
Audit Committee	24.0	15.5
Board of Directors	1.0	0.6
Chief Operating Officer	7.0	4.5
Chief Financial Officer	69.0	44.5
Controller	24.0	15.5
Other	30.0	19.4
Total	155.0	100.0

QUESTION 12—*How many professional personnel are there in the internal audit organization at your reporting unit?*

	Count	%
Zero	5.0	3.3
1–3	32.0	21.1
4–10	51.0	33.6
11–24	24.0	15.8
25–50	13.0	8.6
Over 50	27.0	17.8
Total	152.0	100.0

QUESTION 13—*In percentages, what are the primary professional backgrounds of the internal audit staff?*

	Average %
Accounting	81.1
Engineering	4.0
Methods Analysis	0.9
Electronic Data Processing	10.9
Other	3.1
Total	100.0

QUESTION 14—*At your reporting unit, what is the fixed term of duty for internal auditors?*

	Count	%
None	87.0	71.9
Less Than 1 Year	1.0	0.8
1 to 2 Years	2.0	1.7
More Than 2 Years	31.0	26.6
Not Applicable	32.0	—
Total	153.0	100.0

QUESTION 15—*Are internal auditors required to receive formal training (classroom or self-study) on Federal Acquisition Regulation (FAR) and Department of Defense FAR Supplement?*

	Count	%
Yes	78.0	52.0
No	72.0	48.0
Total	150.0	100.0

QUESTION 16—*Are internal auditors required to receive formal training (classroom or self-study) on Cost Accounting Standards?*

	Count	%
Yes	83.0	55.0
No	68.0	45.0
Total	151.0	100.0

QUESTION 17—*Are internal auditors required to receive formal training (classroom or self-study) on P.L. 87-653 "Truth in Negotiations Act"?*

	Count	%
Yes	60.0	40.3
No	89.0	59.7
Total	149.0	100.0

QUESTION 18—*Are internal auditors required to receive formal training (classroom or self-study) on detection of fraud?*

	Count	%
Yes	81.0	53.6
No	70.0	46.4
Total	151.0	100.0

QUESTION 19—*If you do not maintain a formal internal audit organization, what are the most significant reasons for not having such an organization at your reporting unit? (Circle all appropriate responses.)*

	Count	%
Corporate Group Level	58.0	92.1
Outside Auditor	30.0	47.6
Gov't Auditors	15.0	23.8
Business Segment Too Small	4.0	6.3
Other	9.0	14.3
Total Respondents	63.0	100.0
Total Responses	116.0	

QUESTION 20—*Is the internal audit staff required to comply with the standards for the professional practice of internal auditing issued by the Institute of Internal Auditors?*

	Count	%
Yes	162.0	86.6
No	25.0	13.4
Total	187.0	100.0

QUESTION 21—*How are areas of internal audit coverage established? (Circle all appropriate responses.)*

	Count	%
Audit Cycle Criteria	169.0	90.4
Indicate Prob. Areas	183.0	97.9
Coord. W/Outside Aud.	160.0	85.6
Sensitive Areas	168.0	89.9
Management Requests	186.0	99.5
Gov't Audit Focus	133.0	71.1
Pre-est. Mgt. Plan	95.0	50.8
Dollar Materiality	128.0	68.4
Follow-Up Prior Find	172.0	92.0
Pot. Cost Savings	113.0	60.4
Cons. W/Audit Committee	95.0	50.8
Obj. Risk Analysis	112.0	59.9
Other	25.0	13.4
Total Respondents	187.0	100.0
Total Responses	1739.0	

QUESTION 22—*Who finally determines the scope of the audit examinations?*

	Count	%
Internal Audit Group	44.0	23.5
Chief Financial Officer	35.0	18.7
Chief Operating Officer	2.0	1.1
Chief Executive Officer	9.0	4.8
Outside Auditor	0.0	0.0
Corp. Int. Audit Staff	68.0	36.4
Audit Committee	15.0	8.0
Other	14.0	7.5
Total	187.0	100.0

QUESTION 23—*Who finally determines the time schedule for each review?*

	Count	%
Internal Audit Group	76.0	40.6
Chief Financial Officer	14.0	7.5
Chief Operating Officer	2.0	1.1
Chief Executive Officer	2.0	1.1
Outside Auditor	0.0	0.0
Corp. Int. Audit Staff	75.0	40.1
Audit Committee	9.0	4.8
Other	9.0	4.8
Total	187.0	100.0

QUESTION 24—*When is the audit plan time schedule for each review coordinated with interested organizational elements?*

	Count	%
Before the Fiscal Year	22.0	11.8
Prior Specific Audit	156.0	83.9
Not At All	8.0	4.3
Total	186.0	100.0

QUESTION 25—*What cycle does the scope and schedule of review include to completely cover all designated areas?*

	Count	%
A One-Year Cycle	9.0	4.8
A Cycle of 1–3 Years	57.0	30.6
A Cycle of 3–5 Years	64.0	34.4
No Designated Period	56.0	30.1
Total	186.0	100.0

QUESTION 26—*How may the primary coverage of internal audits be generally characterized?*

	Count	%
Financial Audit Only	8.0	4.3
Mgt. Audits Only	1.0	0.5
Both Fin. and Mgt. Audit	177.0	95.2
Total	186.0	100.0

QUESTION 27—*What is the extent of the internal audit coverage in the validation of fixed assets, including the cost of internally manufactured assets and the provisions for depreciation?*

	Count	%
>3 During Last FY	6.0	2.9
1–2 During Last FY	125.0	61.3
0 Lst Yr–>1 Lst 3 FY	44.0	21.6
0 During Last 3 FY	29.0	14.2
Not Applicable	3.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	128.0	64.0
No	72.0	36.0
N/A	3.0	—
Total	203.0	100.0

QUESTION 28—*What is the extent of the internal audit coverage in verifying the treatment of leases capitalized during the year by review and/or confirmation of lease terms?*

	Count	%
>3 During Last FY	6.0	3.3
1–2 During Last FY	99.0	55.0
0 Lst Yr–>1 Lst 3 FY	28.0	15.6
0 During Last 3 FY	47.0	26.1
Not Applicable	27.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	103.0	57.9
No	75.0	42.1
N/A	26.0	—
Total	204.0	100.0

QUESTION 29—*What is the extent of the internal audit coverage in verifying the classification treatment of leases accounted for as operating leases, by review and/or confirmation of lease terms?*

	Count	%
>3 During Last FY	6.0	3.1
1–2 During Last FY	108.0	56.3
0 Lst Yr–>1 Lst 3 FY	30.0	15.6
0 During Last 3 FY	48.0	25.0
Not Applicable	14.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	109.0	56.8
No	83.0	43.2
N/A	12.0	—
Total	204.0	100.0

QUESTION 30—*How often is a review conducted of procedures for determining personnel requirements, including budgeting and manloading schedules and controls?*

	Count	%
>3 During Last FY	16.0	8.9
1–2 During Last FY	55.0	30.6
0 Lst Yr–>1 Lst 3 FY	11.0	6.1
0 During Last 3 FY	98.0	54.4
Not Applicable	26.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	70.0	38.9
No	110.0	61.1
N/A	22.0	—
Total	202.0	100.0

QUESTION 31—*How often are reviews conducted of the policies and procedures for hiring, assigning and dismissing individuals?*

	Count	%
>3 During Last FY	3.0	1.5
1–2 During Last FY	62.0	31.6
0 Lst Yr–>1 Lst 3 FY	40.0	20.4
0 During Last 3 FY	91.0	46.4
Not Applicable	11.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	79.0	40.5
No	116.0	59.5
N/A	9.0	—
Total	204.0	100.0

QUESTION 32—*How often are reviews conducted of the policies and procedures for establishing job categories and pay rates?*

	Count	%
>3 During Last FY	16.0	8.7
1–2 During Last FY	37.0	20.0
0 Lst Yr–>1 Lst 3 FY	34.0	18.4
0 During Last 3 FY	98.0	52.3
Not Applicable	22.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	73.0	39.2
No	112.0	60.2
N/A	19.0	—
Total	204.0	100.0

QUESTION 33—*How often are reviews conducted of the policies and procedures for establishing attendance and timekeeping records?*

	Count	%
>3 During Last FY	58.0	28.4
1–2 During Last FY	91.0	44.6
0 Lst Yr–>1 Lst 3 FY	38.0	18.6
0 During Last 3 FY	17.0	8.3
Not Applicable	3.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	165.0	82.5
No	35.0	17.5
N/A	4.0	—
Total	204.0	100.0

QUESTION 34—*How often are reviews conducted of the policies and procedures for authorizing and controlling overtime and multi-shift operations?*

	Count	%
>3 During Last FY	30.0	14.9
1–2 During Last FY	79.0	39.3
0 Lst Yr–>1 Lst 3 FY	52.0	25.8
0 During Last 3 FY	40.0	19.9
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	141.0	70.9
No	58.0	29.1
N/A	5.0	—
Total	204.0	100.0

QUESTION 35—*How often are reviews conducted of the policies and procedures for authorizing and controlling compensatory time?*

	Count	%
>3 During Last FY	20.0	13.1
1–2 During Last FY	37.0	24.2
0 Lst Yr–> 1 Lst 3 FY	29.0	19.0
0 During Last 3 FY	67.0	43.8
Not Applicable	54.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	71.0	45.8
No	84.0	54.2
N/A	49.0	—
Total	204.0	100.0

QUESTION 36—*How often are reviews conducted of the policies and procedures for payroll allowances—fringe benefits?*

	Count	%
>3 During Last FY	10.0	5.1
1–2 During Last FY	76.0	39.0
0 Lst Yr–> 1 Lst 3 FY	46.0	23.6
0 During Last 3 FY	63.0	32.3
Not Applicable	12.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	101.0	51.8
No	94.0	48.2
N/A	9.0	—
Total	204.0	100.0

QUESTION 37—*How often have reviews been made of the internal controls in the following payroll preparation area—accuracy of basic records?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	49.0	23.7	Yes	176.0	86.3
1–2 During Last FY	104.0	50.2	No	28.0	13.7
0 Lst Yr–> 1 Lst 3 FY	39.0	18.8	N/A	0.0	—
0 During Last 3 FY	15.0	7.2			
Not Applicable	0.0	—	Total	204.0	100.0
Total	207.0	100.0			

QUESTION 38—*How often have reviews been made of the internal controls in the following payroll preparation area—reconciliations of attendance records with time tickets?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	45.0	26.5	Yes	139.0	83.2
1–2 During Last FY	81.0	47.7	No	28.0	16.7
0 Lst Yr–> 1 Lst 3 FY	22.0	12.9	N/A	35.0	—
0 During Last 3 FY	22.0	12.9			
Not Applicable	37.0	—	Total	202.0	100.0
Total	207.0	100.0			

QUESTION 39—*How often have reviews been made of the internal controls in the following payroll preparation area—acceptable method for adjusting time records?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	53.0	25.7	Yes	176.0	86.7
1–2 During Last FY	103.0	50.0	No	27.0	13.3
0 Lst Yr–> 1 Lst 3 FY	39.0	18.9	N/A	1.0	—
0 During Last 3 FY	11.0	5.3			
Not Applicable	1.0	—	Total	204.0	100.0
Total	207.0	100.0			

QUESTION 40—*How often have reviews been made of the internal controls in the following payroll preparation area—supervisory approvals for adjusting time records?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	55.0	26.7	Yes	179.0	88.2
1–2 During Last FY	104.0	50.5	No	24.0	11.8
0 Lst Yr–> 1 Lst 3 FY	37.0	18.0	N/A	1.0	—
0 During Last 3 FY	10.0	4.9			
Not Applicable	1.0	—	Total	204.0	100.0
Total	207.0	100.0			

QUESTION 41—*How often have reviews been made of the internal controls in the following payroll preparation area—pay rates supported by written authorization?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	31.0	15.0	Yes	160.0	78.4
1–2 During Last FY	102.0	49.3	No	44.0	21.6
0 Lst Yr–> 1 Lst 3 FY	48.0	23.2	N/A	0.0	0.0
0 During Last 3 FY	26.0	12.6			
Not Applicable	0.0	0.0	Total	204.0	100.0
Total	207.0	100.0			

QUESTION 42—*How often have reviews been made of the internal controls in the following payroll preparation area—testing of pay rates to union agreements where applicable?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	4.0	2.7	Yes	98.0	67.1
1–2 During Last FY	76.0	51.3	No	48.0	32.9
0 Lst Yr–> 1 Lst 3 FY	35.0	23.7	N/A	55.0	—
0 During Last 3 FY	33.0	22.3			
Not Applicable	58.0	—	Total	201.0	100.0
Total	206.0	100.0			

QUESTION 43—*How often have reviews been made of the internal controls in the following payroll preparation area—testing of pay rates/salaries to comparable area survey data?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	18.0	10.5	Yes	58.0	33.1
1–2 During Last FY	31.0	18.2	No	117.0	66.9
0 Lst Yr–> 1 Lst 3 FY	21.0	12.4	N/A	28.0	—
0 During Last 3 FY	100.0	58.9			
Not Applicable	37.0	—	Total	203.0	100.0
Total	207.0	100.0			

QUESTION 44—*How often have reviews been made of the internal controls in the following payroll preparation area—controls to prevent overpayments?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	27.0	13.0	Yes	159.0	77.9
1–2 During Last FY	104.0	50.2	No	45.0	22.1
0 Lst Yr–> 1 Lst 3 FY	54.0	26.1	N/A	0.0	0.0
0 During Last 3 FY	22.0	10.6			
Not Applicable	0.0	0.0	Total	204.0	100.0
Total	207.0	100.0			

QUESTION 45—*How often have reviews been made of the internal controls in the following payroll preparation area—disposition of unclaimed checks?*

	Count	%
>3 During Last FY	17.0	8.3
1–2 During Last FY	95.0	46.6
0 Lst Yr–> 1 Lst 3 FY	49.0	24.0
0 During Last 3 FY	43.0	21.1
Not Applicable	3.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	149.0	74.1
No	52.0	25.9
N/A	3.0	—
Total	204.0	100.0

QUESTION 46—*How often have reviews been made of the following payroll preparation area —payroll records in agreement with personnel records?*

	Count	%
>3 During Last FY	25.0	12.2
1–2 During Last FY	108.0	52.7
0 Lst Yr–> 1 Lst 3 FY	50.0	24.4
0 During Last 3 FY	22.0	10.7
Not Applicable	2.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	155.0	77.1
No	46.0	22.9
N/A	3.0	—
Total	204.0	100.0

QUESTION 47—*How often have reviews been made in the following payroll preparation area —reconciliation of payroll with labor cost distribution?*

	Count	%
>3 During Last FY	40.0	19.4
1–2 During Last FY	98.0	47.5
0 Lst Yr–> 1 Lst 3 FY	48.0	23.3
0 During Last 3 FY	20.0	9.7
Not Applicable	1.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	165.0	81.3
No	38.0	18.7
N/A	1.0	—
Total	204.0	100.0

QUESTION 48—*How often have reviews been made of the internal controls in the following payroll preparation area—verifying payroll and related accounts accrued based on ultimate amounts paid?*

	Count	%
>3 During Last FY	28.0	13.7
1–2 During Last FY	97.0	47.3
0 Lst Yr–> 1 Lst 3 FY	44.0	21.5
0 During Last 3 FY	36.0	17.6
Not Applicable	2.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	150.0	74.6
No	51.0	25.4
N/A	2.0	—
Total	203.0	100.0

QUESTION 49—*How often have reviews been made of the internal controls in the following payroll preparation area—witnessing payroll payments on a surprise basis?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	16.0	8.2	Yes	104.0	54.2
1–2 During Last FY	57.0	29.1	No	88.0	45.8
0 Lst Yr–> 1 Lst 3 FY	52.0	26.5	N/A	11.0	—
0 During Last 3 FY	71.0	36.2	Total	203.0	100.0
Not Applicable	11.0	—			
Total	207.0	100.0			

QUESTION 50—*How often have reviews been made of the internal controls in the labor cost distribution area—the clock/time cards are adequately controlled?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	81.0	39.7	Yes	184.0	92.5
1–2 During Last FY	87.0	42.7	No	15.0	7.5
0 Lst Yr–> 1 Lst 3 FY	29.0	14.2	N/A	3.0	—
0 During Last 3 FY	7.0	3.4	Total	202.0	100.0
Not Applicable	3.0	—			
Total	207.0	100.0			

QUESTION 51—*How often have reviews been made of the internal controls in the labor cost distribution area—the clock/time cards are maintained on current basis?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	83.0	40.7	Yes	187.0	93.5
1–2 During Last FY	89.0	43.6	No	13.0	6.5
0 Lst Yr–> 1 Lst 3 FY	27.0	13.2	N/A	2.0	—
0 During Last 3 FY	5.0	2.5	Total	202.0	100.0
Not Applicable	3.0	—			
Total	207.0	100.0			

QUESTION 52—*How often have reviews been made of the internal controls in the labor cost distribution area—the clock/time cards are signed by each employee?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	79.0	39.1	Yes	186.0	93.9
1–2 During Last FY	89.0	44.1	No	12.0	6.1
0 Lst Yr–> 1 Lst 3 FY	27.0	13.4	N/A	4.0	—
0 During Last 3 FY	7.0	3.5	Total	202.0	100.0
Not Applicable	4.0	—			
Total	206.0	100.0			

QUESTION 53—*How often have reviews been made of the internal controls in the labor cost distribution area—the time cards are prepared only in ink?*

	Count	%
>3 During Last FY	81.0	40.3
1–2 During Last FY	86.0	42.8
0 Lst Yr–> 1 Lst 3 FY	25.0	12.4
0 During Last 3 FY	9.0	4.5
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	189.0	95.9
No	8.0	4.1
N/A	5.0	—
Total	202.0	100.0

QUESTION 54—*How often have reviews been made of the internal controls in the labor cost distribution area—the clock/time cards are approved by the responsible supervisor?*

	Count	%
>3 During Last FY	82.0	39.8
1–2 During Last FY	88.0	42.7
0 Lst Yr–> 1 Lst 3 FY	27.0	13.1
0 During Last 3 FY	9.0	4.4
Not Applicable	1.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	190.0	94.5
No	11.0	5.5
N/A	1.0	—
Total	202.0	100.0

QUESTION 55—*How often have reviews been made of the internal controls in the labor cost distribution area—all changes made have documented reasons for the change (no "white outs")?*

	Count	%
>3 During Last FY	79.0	38.5
1–2 During Last FY	82.0	40.0
0 Lst Yr–> 1 Lst 3 FY	29.0	14.1
0 During Last 3 FY	15.0	7.3
Not Applicable	2.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	187.0	94.0
No	12.0	6.0
N/A	3.0	—
Total	202.0	100.0

QUESTION 56—*How often have reviews been made of the internal controls in the labor cost distribution area—all changes are signed or initialed by employee and by responsible supervisor?*

	Count	%
>3 During Last FY	79.0	38.7
1–2 During Last FY	88.0	43.1
0 Lst Yr–> 1 Lst 3 FY	27.0	13.2
0 During Last 3 FY	10.0	4.9
Not Applicable	2.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	188.0	94.5
No	11.0	5.5
N/A	2.0	—
Total	201.0	100.0

QUESTION 57—*How often have reviews been made of the internal controls in the labor cost distribution area—individuals have advice and knowledge of job or account authorization on which they are working?*

	Count	%
>3 During Last FY	81.0	39.7
1–2 During Last FY	92.0	45.1
0 Lst Yr–> 1 Lst 3 FY	21.0	10.3
0 During Last 3 FY	10.0	4.9
Not Applicable	3.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	182.0	90.5
No	19.0	9.5
N/A	1.0	—
Total	202.0	100.0

QUESTION 58—*How often have reviews been made of the internal controls in the labor cost distribution area—all work orders are issued in writing?*

	Count	%
>3 During Last FY	60.0	31.1
1–2 During Last FY	79.0	40.9
0 Lst Yr–> 1 Lst 3 FY	22.0	11.4
0 During Last 3 FY	32.0	16.6
Not Applicable	14.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	152.0	80.4
No	37.0	19.6
N/A	13.0	—
Total	202.0	100.0

QUESTION 59—*How often have reviews been made of the internal controls in the labor cost distribution area—all work orders are adequately controlled?*

	Count	%
>3 During Last FY	56.0	29.3
1–2 During Last FY	71.0	37.2
0 Lst Yr–> 1 Lst 3 FY	23.0	12.0
0 During Last 3 FY	41.0	21.5
Not Applicable	15.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	140.0	74.9
No	47.0	25.1
N/A	14.0	—
Total	201.0	100.0

QUESTION 60—*How often have reviews been made of the internal controls in the labor cost distribution area—all overhead cost authorizations are clearly defined?*

	Count	%
>3 During Last FY	56.0	28.6
1–2 During Last FY	86.0	43.9
0 Lst Yr–> 1 Lst 3 FY	21.0	10.7
0 During Last 3 FY	33.0	16.8
Not Applicable	11.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	168.0	86.2
No	27.0	13.8
N/A	7.0	—
Total	202.0	100.0

QUESTION 61—*How often have reviews been made of the internal controls in the labor cost distribution area—accounting provision is made for employee "downtime"?*

	Count	%
>3 During Last FY	55.0	29.4
1–2 During Last FY	74.0	39.6
0 Lst Yr–> 1 Lst 3 FY	20.0	10.7
0 During Last 3 FY	38.0	20.3
Not Applicable	20.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	150.0	81.5
No	34.0	18.5
N/A	18.0	—
Total	202.0	100.0

QUESTION 62—*How often have reviews been made of the internal controls in the labor cost distribution area—"downtime" charges are separately identified?*

	Count	%
>3 During Last FY	55.0	29.4
1–2 During Last FY	70.0	37.4
0 Lst Yr–> 1 Lst 3 FY	18.0	9.6
0 During Last 3 FY	44.0	23.5
Not Applicable	20.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	150.0	82.0
No	33.0	18.0
N/A	19.0	—
Total	202.0	100.0

QUESTION 63—*How often have reviews been made of the internal controls in the labor cost distribution area—cost authorizations conform with company policy in regard to direct and indirect labor categories?*

	Cour	%
>3 During Last FY	74.0	36.8
1–2 During Last FY	79.0	39.3
0 Lst Yr–> 1 Lst 3 FY	19.0	9.4
0 During Last 3 FY	29.0	14.4
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	178.0	89.9
No	20.0	10.1
N/A	4.0	—
Total	202.0	100.0

QUESTION 64—*How often have reviews been made of the internal controls in the labor cost distribution area—periodic surprise physical floor checks are made of timekeeping and cost assignment practices?*

	Count	%
>3 During Last FY	92.0	45.1
1–2 During Last FY	72.0	35.3
0 Lst Yr–> 1 Lst 3 FY	10.0	4.9
0 During Last 3 FY	30.0	14.7
Not Applicable	3.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	175.0	87.5
No	25.0	12.5
N/A	2.0	—
Total	202.0	100.0

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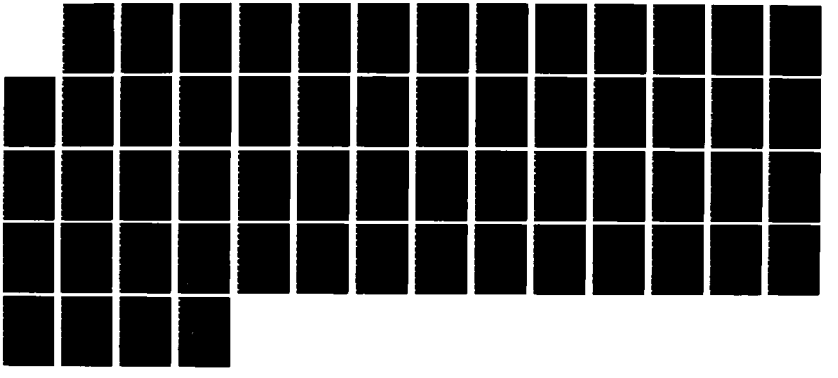

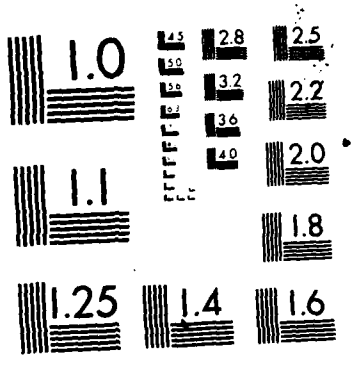

QUESTION 65—*How often have reviews been made of the internal controls in the labor cost distribution area—interviews of selected employees are undertaken?*

	Count	%
>3 During Last FY	80.0	40.6
1–2 During Last FY	78.0	39.6
0 Lst Yr–> 1 Lst 3 FY	13.0	6.6
0 During Last 3 FY	26.0	13.2
Not Applicable	10.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	176.0	91.2
No	17.0	8.8
N/A	9.0	—
Total	202.0	100.0

QUESTION 66—*How often have reviews of labor costs been made and compared with various controls, such as, actual vs. budgets by cost center?*

	Count	%
>3 During Last FY	43.0	21.4
1–2 During Last FY	59.0	29.4
0 Lst Yr–> 1 Lst 3 FY	18.0	8.9
0 During Last 3 FY	81.0	40.3
Not Applicable	5.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	122.0	61.6
No	76.0	38.4
N/A	4.0	—
Total	202.0	100.0

QUESTION 67—*How often have reviews of labor costs been made and compared with various controls, such as, individual indirect charges vs. budget amounts?*

	Count	%
>3 During Last FY	40.0	20.4
1–2 During Last FY	54.0	27.6
0 Lst Yr–> 1 Lst 3 FY	14.0	7.1
0 During Last 3 FY	88.0	44.9
Not Applicable	10.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	115.0	59.3
No	79.0	40.7
N/A	8.0	—
Total	202.0	100.0

QUESTION 68—*How often have reviews of labor costs been made and compared with various controls, such as, Independent Research and Development (IR&D) and Bid and Proposal (B&P) actuals vs. budgets?*

	Count	%
>3 During Last FY	44.0	22.3
1–2 During Last FY	70.0	35.5
0 Lst Yr–> 1 Lst 3 FY	11.0	5.6
0 During Last 3 FY	72.0	36.5
Not Applicable	10.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	130.0	66.3
No	66.0	33.7
N/A	7.0	—
Total	203.0	100.0

QUESTION 69—*How often have reviews of labor costs been made and compared with various controls, such as, audits designed to detect labor cost mischarging?*

	Count	%		PLANNED FOR FISCAL YEAR 1986	Count	%
>3 During Last FY	83.0	41.1	Yes		177.0	88.5
1–2 During Last FY	81.0	40.1	No		23.0	11.5
0 Lst Yr–> 1 Lst 3 FY	7.0	3.5	N/A		3.0	—
0 During Last 3 FY	31.0	15.3		Total	203.0	100.0
Not Applicable	4.0	—				
Total	206.0	100.0				

QUESTION 70—*How often have reviews been made of compensation plans requiring actuarial computations, including data submitted to actuaries and assumptions made?*

	Count	%		PLANNED FOR FISCAL YEAR 1986	Count	%
>3 During Last FY	19.0	13.1	Yes		86.0	61.9
1–2 During Last FY	56.0	38.6	No		53.0	38.1
0 Lst Yr–> 1 Lst 3 FY	7.0	4.8	N/A		64.0	—
0 During Last 3 FY	63.0	43.4		Total	203.0	100.0
Not Applicable	61.0	—				
Total	206.0	100.0				

QUESTION 71—*How often have reviews been made of "make or buy" practices?*

	Count	%		PLANNED FOR FISCAL YEAR 1986	Count	%
>3 During Last FY	21.0	11.2	Yes		96.0	51.3
1–2 During Last FY	56.0	29.9	No		91.0	48.7
0 Lst Yr–> 1 Lst 3 FY	27.0	14.4	N/A		17.0	—
0 During Last 3 FY	83.0	44.4		Total	204.0	100.0
Not Applicable	20.0	—				
Total	207.0	100.0				

QUESTION 72—*How often have reviews been made of the determination of material requirements?*

	Count	%		PLANNED FOR FISCAL YEAR 1986	Count	%
>3 During Last FY	27.0	14.0	Yes		115.0	60.2
1–2 During Last FY	80.0	41.7	No		75.0	39.3
0 Lst Yr–> 1 Lst 3 FY	27.0	14.0	N/A		14.0	—
0 During Last 3 FY	58.0	30.2		Total	204.0	100.0
Not Applicable	15.0	—				
Total	207.0	100.0				

QUESTION 73—*How often have reviews been made of the requisitioning procedures and authorities?*

	Count	%
>3 During Last FY	33.0	16.1
1–2 During Last FY	123.0	60.0
0 Lst Yr–> 1 Lst 3 FY	30.0	14.6
0 During Last 3 FY	19.0	9.3
Not Applicable	2.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	171.0	85.5
No	29.0	14.5
N/A	4.0	—
Total	204.0	100.0

QUESTION 74—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the current nature and adequacy of bidder's lists?*

	Count	%
>3 During Last FY	24.0	12.1
1–2 During Last FY	107.0	53.8
0 Lst Yr–> Lst 3 FY	33.0	16.6
0 During Last 3 FY	35.0	17.6
Not Applicable	8.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	142.0	72.8
No	53.0	27.2
N/A	8.0	—
Total	203.0	100.0

QUESTION 75—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the adequacy of the number of solicitations?*

	Count	%
>3 During Last FY	31.0	15.3
1–2 During Last FY	112.0	55.2
0 Lst Yr–> Lst 3 FY	39.0	19.2
0 During Last 3 FY	21.0	10.3
Not Applicable	4.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	160.0	80.8
No	38.0	19.2
N/A	5.0	—
Total	203.0	100.0

QUESTION 76—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the evaluation of bids?*

	Count	%
>3 During Last FY	33.0	16.3
1–2 During Last FY	111.0	55.0
0 Lst Yr–> Lst 3 FY	40.0	19.8
0 During Last 3 FY	18.0	8.9
Not Applicable	5.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	162.0	81.8
No	36.0	18.2
N/A	5.0	—
Total	203.0	100.0

QUESTION 77—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the treatment of bids by affiliates or subsidiaries?*

	Count	%
>3 During Last FY	20.0	11.8
1–2 During Last FY	74.0	43.5
0 Lst Yr–> Lst 3 FY	32.0	18.8
0 During Last 3 FY	44.0	25.9
Not Applicable	37.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	115.0	68.9
No	53.0	31.5
N/A	34.0	—
Total	202.0	100.0

QUESTION 78—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the evaluation or audit of subcontracts?*

	Count	%
>3 During Last FY	54.0	27.1
1–2 During Last FY	74.0	37.2
0 Lst Yr–> Lst 3 FY	25.0	12.6
0 During Last 3 FY	46.0	23.1
Not Applicable	7.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	144.0	73.5
No	52.0	26.5
N/A	7.0	—
Total	203.0	100.0

QUESTION 79—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the proper coding of purchase orders to identify the cost objectives to be charged (direct, indirect, inventory, government-owned)?*

	Count	%
>3 During Last FY	37.0	18.4
1–2 During Last FY	108.0	53.7
0 Lst Yr–>1 Lst 3 FY	29.0	14.4
0 During Last 3 FY	27.0	13.4
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	160.0	80.8
No	38.0	19.2
N/A	5.0	—
Total	203.0	100.0

QUESTION 80—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to the compliance with written policies explaining what types of activities are prohibited?*

	Count	%
>3 During Last FY	37.0	18.3
1–2 During Last FY	108.0	53.5
0 Lst Yr–>1 Lst 3 FY	31.0	15.3
0 During Last 3 FY	26.0	12.9
Not Applicable	5.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	161.0	81.3
No	37.0	18.7
N/A	5.0	—
Total	203.0	100.0

QUESTION 81—*How often are reviews made of adequacy of the purchasing policies and procedures with regard to any indications of improprieties in the procurement function, e.g., "bid matching" on awards to subsidiaries and other divisions, lowest bidder always being the same, any evidence of other than arm's length transactions?*

	Count	%
>3 During Last FY	31.0	15.1
1–2 During Last FY	100.0	48.8
0 Lst Yr–>1 Lst 3 FY	38.0	18.5
0 During Last 3 FY	36.0	17.6
Not Applicable	2.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	156.0	78.0
No	44.0	22.0
N/A	3.0	—
Total	203.0	100.0

QUESTION 82—*How frequently are examinations made to determine that there are criteria and procedures for returning or reworking defective materials?*

	Count	%
>3 During Last FY	8.0	4.1
1–2 During Last FY	104.0	53.3
0 Lst Yr–>1 Lst 3 FY	32.0	16.4
0 During Last 3 FY	51.0	26.2
Not Applicable	12.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	129.0	67.2
No	63.0	32.8
N/A	10.0	—
Total	202.0	100.0

QUESTION 83—*How frequently are examinations made to determine that all government-owned materials are separately stored, physically safeguarded, and independently accounted for?*

	Count	%
>3 During Last FY	27.0	13.8
1–2 During Last FY	94.0	48.2
0 Lst Yr–>1 Lst 3 FY	25.0	12.8
0 During Last 3 FY	49.0	25.1
Not Applicable	12.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	129.0	67.9
No	61.0	32.1
N/A	11.0	—
Total	201.0	100.0

QUESTION 84—*How frequently are examinations made to determine that materials are properly priced consistent with the company's inventory pricing policies?*

	Count	%
>3 During Last FY	23.0	12.7
1–2 During Last FY	92.0	50.8
0 Lst Yr–>1 Lst 3 FY	20.0	11.0
0 During Last 3 FY	46.0	25.4
Not Applicable	26.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	132.0	74.2
No	46.0	25.8
N/A	23.0	—
Total	201.0	100.0

QUESTION 85—*How frequently are examinations made to determine that transfers between cost objectives (e.g., contracts, projects, indirect expense accounts) are properly controlled and priced?*

	Count	%
>3 During Last FY	28.0	14.3
1–2 During Last FY	95.0	48.5
0 Lst Yr–>1 Lst 3 FY	23.0	11.7
0 During Last 3 FY	50.0	25.5
Not Applicable	11.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	151.0	78.6
No	41.0	21.4
N/A	9.0	—
Total	201.0	100.0

QUESTION 86—*How frequently are examinations made to determine that procedures for scrap, spoilage, and obsolescence are adequate and actually practiced?*

	Count	%
>3 During Last FY	20.0	10.7
1–2 During Last FY	95.0	50.8
0 Lst Yr–>1 Lst 3 FY	42.0	22.5
0 During Last 3 FY	30.0	16.0
Not Applicable	20.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	125.0	68.3
No	58.0	31.7
N/A	18.0	—
Total	201.0	100.0

QUESTION 87—*How frequently are examinations made to determine that the policies and procedures for costing intracompany transfers are consistent with government regulations?*

	Count	%
>3 During Last FY	21.0	11.1
1–2 During Last FY	71.0	37.6
0 Lst Yr–>1 Lst 3 FY	23.0	12.2
0 During Last 3 FY	74.0	39.1
Not Applicable	18.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	123.0	67.2
No	60.0	32.8
N/A	18.0	—
Total	201.0	100.0

QUESTION 88—*How frequently are examinations made to determine that where standard costs are used, variances are recorded properly and periodically adjusted in conformance with Cost Accounting Standard (CAS) 407 (use of standard cost for direct material and direct labor)?*

	Count	%
>3 During Last FY	9.0	10.8
1–2 During Last FY	27.0	32.5
0 Lst Yr–>1 Lst 3 FY	10.0	12.0
0 During Last 3 FY	37.0	44.6
Not Applicable	120.0	—
Total	203.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	53.0	60.9
No	34.0	39.1
N/A	116.0	—
Total	203.0	100.0

QUESTION 89—*How frequently are examinations made to determine that where catalog pricing is used for government contract work, the pertinent Federal Acquisition Regulation criteria are met?*

	Count	%
>3 During Last FY	29.0	23.6
1–2 During Last FY	35.0	28.5
0 Lst Yr–>1 Lst 3 FY	8.0	6.4
0 During Last 3 FY	51.0	41.5
Not Applicable	81.0	—
Total	204.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	65.0	50.9
No	55.0	41.1
N/A	82.0	—
Total	202.0	100.0

QUESTION 90—*How frequently are examinations made to determine that all government-related contract clauses are "flowed down" to subcontracts when appropriate?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	49.0	25.0	Yes	116.0	60.1
1–2 During Last FY	49.0	25.0	No	77.0	39.9
0 Lst Yr–>1 Lst 3 FY	30.0	15.3	N/A	11.0	—
0 During Last 3 FY	68.0	34.7			
Not Applicable	11.0	—	Total	204.0	100.0
Total	207.0	100.0			

QUESTION 91—*How frequently are examinations made to determine that audits of subcontractors are made, or arranged to be made, when required?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	51.0	26.0	Yes	134.0	69.1
1–2 During Last FY	72.0	36.7	No	60.0	30.9
0 Lst Yr–>1 Lst 3 FY	9.0	4.6	N/A	9.0	—
0 During Last 3 FY	64.0	32.7			
Not Applicable	11.0	—	Total	203.0	100.0
Total	207.0	100.0			

QUESTION 92—*How often are reviews made for compliance with public law 87-653 as amended (the Truth in Negotiations Act, 10 U.S.C. Section 2306 (F))?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	51.0	26.2	Yes	140.0	72.9
1–2 During Last FY	51.0	26.2	No	52.0	27.1
0 Lst Yr–>1 Lst 3 FY	25.0	12.7	N/A	11.0	—
0 During Last 3 FY	68.0	34.9			
Not Applicable	12.0	—	Total	203.0	100.0
Total	207.0	100.0			

QUESTION 93—*How often have reviews been made of the various levels of controls to assure that materials comply with all specifications on incoming material inspections?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	30.0	15.6	Yes	126.0	66.7
1–2 During Last FY	77.0	40.1	No	63.0	33.3
0 Lst Yr–>1 Lst 3 FY	34.0	17.7	N/A	14.0	—
0 During Last 3 FY	51.0	26.6			
Not Applicable	15.0	—	Total	203.0	100.0
Total	207.0	100.0			

QUESTION 94—*How often have reviews been made of the various levels of controls to assure that materials comply with all specifications on production line inspections?*

	Count	%
>3 During Last FY	27.0	15.5
1–2 During Last FY	60.0	34.5
0 Lst Yr–>1 Lst 3 FY	8.0	4.6
0 During Last 3 FY	79.0	45.4
Not Applicable	33.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	96.0	56.1
No	75.0	43.9
N/A	32.0	—
Total	203.0	100.0

QUESTION 95—*How often have reviews been made of the various levels of controls to assure that materials comply with all specifications on final shipments to assure that contract specifications have been met and that there are no material substitutions?*

	Count	%
>3 During Last FY	25.0	14.1
1-2 During Last FY	51.0	28.8
0 Lst Yr–>1 Lst 3 FY	4.0	2.3
0 During Last 3 FY	97.0	54.8
Not Applicable	30.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	85.0	48.8
No	89.0	51.2
N/A	29.0	—
Total	203.0	100.0

QUESTION 96—*How often have reviews been made of the various levels of controls to assure that materials comply with all specifications on products made by subcontractors?*

	Count	%
>3 During Last FY	23.0	12.3
1–2 During Last FY	55.0	29.4
0 Lst Yr–>1 Lst 3 FY	16.0	8.6
0 During Last 3 FY	93.0	49.7
Not Applicable	19.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	99.0	53.2
No	87.0	46.8
N/A	17.0	—
Total	203.0	100.0

QUESTION 97—*How often have reviews been made of the effectiveness of the estimating manual or other volume of instructions that establishes policies and procedures for developing and submitting cost and pricing data for government contracts?*

	Count	%
>3 During Last FY	25.0	12.5
1–2 During Last FY	72.0	36.2
0 Lst Yr–>1 Lst 3 FY	20.0	10.1
0 During Last 3 FY	82.0	41.2
Not Applicable	8.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	118.0	59.9
No	79.0	40.1
N/A	8.0	—
Total	205.0	100.0

QUESTION 98—*How often have reviews been made to determine that all essential skill mixes of the company's organization are contributing to the bid proposals?*

	Count	%
>3 During Last FY	24.0	12.2
1–2 During Last FY	57.0	28.9
0 Lst Yr–>1 Lst 3 FY	14.0	7.1
0 During Last 3 FY	102.0	51.8
Not Applicable	10.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	107.0	54.9
No	88.0	45.1
N/A	9.0	—
Total	204.0	100.0

QUESTION 99—*How often are reviews made to determine that the respective independent roles and responsibilities of individuals on the proposal team are clearly defined?*

	Count	%
>3 During Last FY	25.0	12.6
1–2 During Last FY	55.0	27.8
0 Lst Yr–>1 Lst 3 FY	12.0	6.1
0 During Last 3 FY	106.0	53.5
Not Applicable	9.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	101.0	52.1
No	93.0	47.9
N/A	10.0	—
Total	204.0	100.0

QUESTION 100—*How often are reviews made to determine that the contribution of each component member is supervised and reviewed by a responsible individual in the respective functional organizations, i.e., engineering, accounting?*

	Count	%
>3 During Last FY	29.0	14.6
1–2 During Last FY	41.0	20.6
0 Lst Yr–>1 Lst 3 FY	16.0	8.0
0 During Last 3 FY	113.0	56.8
Not Applicable	8.0	
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	98.0	49.7
No	99.0	50.3
N/A	7.0	—
Total	204.0	100.0

QUESTION 101—*How often are reviews made to determine that there are controls to assure that all factual data reasonably available are used in the proposal with regard to the data's currency, accuracy, and completeness?*

	Count	%
>3 During Last FY	36.0	17.9
1–2 During Last FY	51.0	25.4
0 Lst Yr–>1 Lst 3 FY	15.0	7.5
0 During Last 3 FY	99.0	49.2
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	112.0	56.3
No	87.0	43.7
N/A	5.0	—
Total	204.0	100.0

QUESTION 102—*How often are reviews made to determine that there are adequate procedures and clearly defined responsibilities for the various component organizations to update all data at the time of agreement of contract price with the government?*

	Count	%
>3 During Last FY	25.0	12.4
1–2 During Last FY	60.0	29.9
0 Lst Yr–>1 Lst 3 FY	23.0	11.4
0 During Last 3 FY	93.0	46.3
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	117.0	58.8
No	82.0	41.2
N/A	5.0	—
Total	204.0	100.0

QUESTION 103—*How often are reviews made to determine that there is adequate written evidence of negotiation results leading to the pricing of each negotiated government contract?*

	Count	%
>3 During Last FY	28.0	14.4
1–2 During Last FY	54.0	27.7
0 Lst Yr–>1 Lst 3 FY	15.0	7.7
0 During Last 3 FY	98.0	50.3
Not Applicable	12.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	113.0	58.5
No	80.0	41.5
N/A	11.0	—
Total	204.0	100.0

QUESTION 104—*How often have reviews been made of the accumulation of indirect costs to assure conformance with pertinent Cost Accounting Standards?*

	Count	%
>3 During Last FY	33.0	16.3
1–2 During Last FY	95.0	47.0
0 Lst Yr–>1 Lst 3 FY	22.0	10.9
0 During Last 3 FY	52.0	25.7
Not Applicable	5.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	158.0	78.2
No	44.0	21.8
N/A	3.0	—
Total	205.0	100.0

QUESTION 105—*How often have the allocation bases been reviewed for conformance with Cost Accounting Standards?*

	Count	%
>3 During Last FY	27.0	13.4
1–2 During Last FY	86.0	42.8
0 Lst Yr–>1 Lst 3 FY	20.0	10.0
0 During Last 3 FY	68.0	33.8
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	153.0	76.9
No	46.0	23.1
N/A	5.0	—
Total	204.0	100.0

QUESTION 106—*How often have reviews been made of the procedures in effect to assure that unallowable indirect costs under Federal Acquisition Regulation (FAR) Part 31 are separately maintained and not included in any representations to the government, in accordance with Cost Accounting Standard 405 (accounting for unallowable costs)?*

	Count	%
>3 During Last FY	42.0	20.6
1–2 During Last FY	107.0	52.5
0 Lst Yr–>1 Lst 3 FY	11.0	5.4
0 During Last 3 FY	44.0	21.6
Not Applicable	3.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	170.0	84.2
No	32.0	15.8
N/A	2.0	—
Total	204.0	100.0

QUESTION 107—*How often are reviews made of the latest Cost Accounting Standard disclosure statement to test adequacy and compliance?*

	Count	%
>3 During Last FY	26.0	13.1
1–2 During Last FY	86.0	43.4
0 Lst Yr–>1 Lst 3 FY	24.0	12.1
0 During Last 3 FY	62.0	31.3
Not Applicable	9.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	147.0	75.0
No	49.0	25.0
N/A	8.0	—
Total	204.0	100.0

QUESTION 108—*With regard to the "imputed cost of money invested in facilities," how often have examinations been made of the company's informal records and representations to the government to assure conformance with Cost Accounting Standard 414 (cost of money as an element of the cost of facilities capital)?*

	Count	%
>3 During Last FY	15.0	8.0
1–2 During Last FY	71.0	38.0
0 Lst Yr–>1 Lst 3 FY	16.0	8.6
0 During Last 3 FY	85.0	45.5
Not Applicable	20.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	98.0	52.7
No	88.0	47.3
N/A	18.0	—
Total	204.0	100.0

QUESTION 109—*With regard to the "imputed cost of money invested in facilities," how often have examinations been made of the company's informal records and representations to the government to assure conformance with Cost Accounting Standard 417 (cost of money as an element of the cost of capital under construction)?*

	Count	%
>3 During Last FY	11.0	6.5
1–2 During Last FY	60.0	35.7
0 Lst Yr–>1 Lst 3 FY	9.0	5.4
0 During Last 3 FY	88.0	52.4
Not Applicable	39.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	81.0	48.2
No	87.0	51.8
N/A	36.0	—
Total	204.0	100.0

QUESTION 110—*How often have reviews been made to establish that clearly defined instructions delineate the charges appropriate to the following classes of technical labor—cost objectives (contracts)?*

	Count	%
>3 During Last FY	43.0	21.3
1–2 During Last FY	93.0	46.0
0 Lst Yr–>1 Lst 3 FY	20.0	9.9
0 During Last 3 FY	46.0	22.8
Not Applicable	5.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	165.0	82.1
No	36.0	17.9
N/A	3.0	—
Total	204.0	100.0

QUESTION 111—*How often have reviews been made to establish that clearly defined instructions delineate the charges appropriate to the following classes of technical labor—Independent Research and Development (IR&D) and Bid and Proposal (B&P)?*

	Count	%
>3 During Last FY	36.0	18.2
1–2 During Last FY	89.0	44.9
0 Lst Yr–>1 Lst 3 FY	19.0	9.6
0 During Last 3 FY	54.0	27.3
Not Applicable	9.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	162.0	82.2
No	35.0	17.8
N/A	7.0	—
Total	204.0	100.0

QUESTION 112—*How often have reviews been made to establish that clearly defined instructions delineate the charges appropriate to the following classes of technical labor—indirect (overhead or G&A) accounts?*

	Count	%
>3 During Last FY	44.0	21.9
1–2 During Last FY	96.0	47.8
0 Lst Yr–>1 Lst 3 FY	24.0	11.9
0 During Last 3 FY	37.0	18.4
Not Applicable	6.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	175.0	87.9
No	24.0	12.1
N/A	4.0	—
Total	203.0	100.0

QUESTION 113—*How often have reviews been made to determine compliance with instructions on charging of technical labor?*

	Count	%
>3 During Last FY	54.0	26.9
1–2 During Last FY	89.0	44.3
0 Lst Yr–>1 Lst 3 FY	20.0	9.9
0 During Last 3 FY	38.0	18.9
Not Applicable	5.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	170.0	85.0
No	30.0	15.0
N/A	2.0	—
Total	202.0	100.0

QUESTION 114—*How often have reviews been made to assure that adjustments or cost transfers between final cost objectives are clearly explained, documented, and approved by a responsible company official?*

	Count	%
>3 During Last FY	44.0	21.7
1–2 During Last FY	91.0	44.8
0 Lst Yr–>1 Lst 3 FY	31.0	15.3
0 During Last 3 FY	37.0	18.2
Not Applicable	4.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	164.0	81.2
No	38.0	18.8
N/A	2.0	—
Total	204.0	100.0

QUESTION 115—*How often have reviews been made to test estimates of progress or of ultimate contract costs used in the determination of percentage complete?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	35.0	18.3	Yes	136.0	71.6
1–2 During Last FY	81.0	42.4	No	54.0	28.4
0 Lst Yr–>1 Lst 3 FY	30.0	15.7	N/A	14.0	—
0 During Last 3 FY	45.0	23.6	Total	204.0	100.0
Not Applicable	16.0	—			
Total	207.0	100.0			

QUESTION 116—*How often have tests been made of the support for cost estimates and revisions to cost estimates?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	39.0	19.2	Yes	142.0	70.6
1–2 During Last FY	87.0	42.9	No	59.0	29.4
0 Lst Yr–>1 Lst 3 FY	22.0	10.8	N/A	3.0	—
0 During Last 3 FY	55.0	27.1	Total	204.0	100.0
Not Applicable	4.0	—			
Total	207.0	100.0			

QUESTION 117—*How often are examinations made to determine the integrity of automated cost and financial application systems?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	37.0	18.3	Yes	164.0	82.0
1–2 During Last FY	105.0	52.0	No	36.0	18.0
0 Lst Yr–>1 Lst 3 FY	23.0	11.4	N/A	4.0	—
0 During Last 3 FY	37.0	18.3	Total	204.0	100.0
Not Applicable	5.0	—			
Total	207.0	100.0			

QUESTION 118—*If the percentage of completion method is used for recognizing revenue under government contracts, how often are reviews made of criteria necessary for applying this method?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	21.0	13.5	Yes	92.0	59.0
1–2 During Last FY	50.0	32.0	No	64.0	41.0
0 Lst Yr–>1 Lst 3 FY	19.0	12.2	N/A	48.0	—
0 During Last 3 FY	66.0	42.3	Total	204.0	100.0
Not Applicable	50.0	—			
Total	206.0	100.0			

QUESTION 119—*How often are tests made to assure validity of progress payment requests submitted to the government?*

	Count	%
>3 During Last FY	39.0	19.5
1–2 During Last FY	63.0	31.5
0 Lst Yr–>1 Lst 3 FY	39.0	19.5
0 During Last 3 FY	59.0	29.5
Not Applicable	7.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	129.0	65.5
No	68.0	34.5
N/A	6.0	—
Total	203.0	100.0

QUESTION 120—*How often are tests made to assure validity of public vouchers for reimbursements under government cost-type contracts?*

	Count	%
>3 During Last FY	38.0	19.5
1–2 During Last FY	62.0	31.8
0 Lst Yr–>1 Lst 3 FY	31.0	15.9
0 During Last 3 FY	64.0	32.8
Not Applicable	10.0	—
Total	205.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	116.0	60.4
No	76.0	39.6
N/A	12.0	—
Total	204.0	100.0

QUESTION 121—*How often are tests made to assure validity of the certificate required for various representations to the government (e.g., overhead, catalog pricing, cost and pricing data)?*

	Count	%
>3 During Last FY	30.0	14.8
1–2 During Last FY	66.0	32.5
0 Lst Yr–>1 Lst 3 FY	17.0	8.4
0 During Last 3 FY	90.0	44.3
Not Applicable	4.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	109.0	54.8
No	90.0	45.2
N/A	3.0	—
Total	202.0	100.0

QUESTION 122—*How often are tests made to assure validity of billings of employee rates on hourly rate and time and material contracts are in conformance with contract classifications?*

	Count	%
>3 During Last FY	24.0	13.4
1–2 During Last FY	49.0	27.4
0 Lst Yr–>1 Lst 3 FY	26.0	14.5
0 During Last 3 FY	80.0	44.7
Not Applicable	26.0	—
Total	205.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	95.0	53.7
No	82.0	46.3
N/A	25.0	—
Total	202.0	100.0

QUESTION 123—*How often are reviews made to assure adequate financial management control with regard to Limitations of Cost (LOC) clause in cost-type contracts?*

	Count	%
>3 During Last FY	28.0	14.9
1–2 During Last FY	51.0	27.1
0 Lst Yr–>1 Lst 3 FY	19.0	10.1
0 During Last 3 FY	90.0	47.9
Not Applicable	17.0	—
Total	205.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	97.0	51.1
No	93.0	48.9
N/A	14.0	—
Total	204.0	100.0

QUESTION 124—*How often are reviews made to assure adequate financial management control with regard to the non-incurrence of costs before official contract authorization is received?*

	Count	%
>3 During Last FY	53.0	26.6
1–2 During Last FY	56.0	28.1
0 Lst Yr–>1 Lst 3 FY	24.0	12.1
0 During Last 3 FY	66.0	33.2
Not Applicable	8.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	125.0	63.1
No	73.0	36.9
N/A	6.0	—
Total	204.0	100.0

QUESTION 125—*How often are reviews made to assure adequate financial management control with regard to contractual ceilings on overhead recovery?*

	Count	%
>3 During Last FY	31.0	17.0
1–2 During Last FY	55.0	30.2
0 Lst Yr–>1 Lst 3 FY	13.0	7.1
0 During Last 3 FY	83.0	45.6
Not Applicable	24.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	102.0	56.7
No	78.0	43.3
N/A	23.0	—
Total	203.0	100.0

QUESTION 126—*How often are reviews made to assure adequate financial management control with regard to advance agreements which limit recoveries for specified costs such as travel, Independent Research and Development (IR&D), and Bid and Proposal (B&P)?*

	Count	%
>3 During Last FY	34.0	17.9
1–2 During Last FY	64.0	33.7
0 Lst Yr–>1 Lst 3 FY	8.0	4.2
0 During Last 3 FY	84.0	44.2
Not Applicable	17.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	116.0	61.1
No	74.0	38.9
N/A	13.0	—
Total	203.0	100.0

QUESTION 127—*How often are reviews made to assure adequate financial management control with regard to ceiling prices on contracts?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	41.0	21.1	Yes	117.0	60.6
1–2 During Last FY	68.0	35.1	No	76.0	39.4
0 Lst Yr–>1 Lst 3 FY	20.0	10.3	N/A	9.0	—
0 During Last 3 FY	65.0	33.5	Total	202.0	100.0
Not Applicable	11.0	—			
Total	205.0	100.0			

QUESTION 128—*How often are reviews made to assure adequate financial management control with regard to the triggering of an Economic Price Adjustment (EPA) clause?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	26.0	14.9	Yes	81.0	46.6
1–2 During Last FY	41.0	23.6	No	93.0	53.4
0 Lst Yr–>1 Lst 3 FY	17.0	19.8	N/A	29.0	—
0 During Last 3 FY	90.0	51.7	Total	203.0	100.0
Not Applicable	33.0	—			
Total	207.0	100.0			

QUESTION 129—*How often have reviews been made to determine that company employees are informed of their responsibilities with respect to accuracy of time cards?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	80.0	39.4	Yes	170.0	85.0
1–2 During Last FY	75.0	36.9	No	30.0	15.0
0 Lst Yr–>1 Lst 3 FY	14.0	6.9	N/A	4.0	—
0 During Last 3 FY	34.0	16.7	Total	204.0	100.0
Not Applicable	4.0	—			
Total	207.0	100.0			

QUESTION 130—*How often have reviews been made to determine that company employees are informed of their responsibilities with respect to ethical practices required in the conduct of their functions?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	46.0	22.5	Yes	169.0	83.7
1–2 During Last FY	99.0	48.5	No	33.0	16.3
0 Lst Yr–>1 Lst 3 FY	15.0	7.4	N/A	2.0	—
0 During Last 3 FY	44.0	21.6	Total	204.0	100.0
Not Applicable	3.0	—			
Total	207.0	100.0			

QUESTION 131—*How often have reviews been made to determine that company employees are informed of their responsibilities with respect to laws and regulations relating to their duties, e.g., anti-kickback, price fixing, bribery?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	47.0	23.2	Yes	163.0	80.7
1–2 During Last FY	89.0	43.8	No	39.0	19.3
0 Lst Yr–>1 Lst 3 FY	18.0	8.9	N/A	2.0	—
0 During Last 3 FY	49.0	24.1	Total	204.0	100.0
Not Applicable	2.0	—			
Total	205.0	100.0			

QUESTION 132—*How often have reviews been made to determine that company employees are informed of their responsibilities with respect to certifications required in representations made to the government?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	52.0	25.6	Yes	139.0	69.2
1–2 During Last FY	62.0	30.5	No	62.0	30.8
0 Lst Yr–>1 Lst 3 FY	10.0	4.9	N/A	3.0	—
0 During Last 3 FY	79.0	38.9	Total	204.0	100.0
Not Applicable	4.0	—			
Total	207.0	100.0			

QUESTION 133—*How often have reviews been made to determine that company employees are informed of their responsibilities with respect to the need for complying with military security regulations?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	26.0	13.6	Yes	122.0	62.9
1–2 During Last FY	75.0	39.3	No	72.0	37.1
0 Lst Yr–>1 Lst 3 FY	12.0	6.3	N/A	10.0	—
0 During Last 3 FY	78.0	40.8	Total	204.0	100.0
Not Applicable	16.0	—			
Total	207.0	100.0			

QUESTION 134—*How often have tests been made to determine that training sessions are held to maintain the appropriate level of employee awareness of the sensitive items mentioned in questions 129 through 133?*

	Count	%		PLANNED FOR FISCAL YEAR 1986 Count	%
>3 During Last FY	24.0	11.9	Yes	130.0	67.7
1–2 During Last FY	82.0	40.8	No	62.0	32.3
0 Lst Yr–>1 Lst 3 FY	10.0	5.0	N/A	11.0	—
0 During Last 3 FY	85.0	42.3	Total	203.0	100.0
Not Applicable	6.0	—			
Total	207.0	100.0			

QUESTION 135—*How often have tests been made to determine that new employees are indoctrinated in these areas?*

	Count	%
>3 During Last FY	28.0	13.8
1–2 During Last FY	81.0	39.9
0 Lst Yr–>1 Lst 3 FY	12.0	5.9
0 During Last 3 FY	82.0	40.4
Not Applicable	4.0	—
Total	207.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	142.0	71.0
No	58.0	29.0
N/A	4.0	—
Total	204.0	100.0

QUESTION 136—*How often have tests been made to determine that written evidence is available to reflect such training?*

	Count	%
>3 During Last FY	18.0	9.5
1–2 During Last FY	52.0	27.5
0 Lst Yr–>1 Lst 3 FY	13.0	6.9
0 During Last 3 FY	106.0	56.1
Not Applicable	17.0	—
Total	206.0	100.0

PLANNED FOR FISCAL YEAR 1986

	Count	%
Yes	125.0	66.8
No	62.0	33.2
N/A	17.0	—
Total	204.0	100.0

QUESTION 137—*To what organizational level(s) are regular audit reports directed? (Circle all that apply.)*

	Count	%
Chief Executive Officer	74.0	36.1
Chief Financial Officer	152.0	74.1
Chief Operating Officer	100.0	48.8
All Levels Req'ng Act.	162.0	79.0
Other	63.0	30.7
Total Respondents	205.0	100.0
Total Responses	551.0	

QUESTION 138—*Are auditees permitted to respond to internal audit findings and recommendations?*

	Count	%
Yes	195.0	94.7
No	0.0	0.0
Other	11.0	5.3
Total	206.0	100.0

QUESTION 139—*Are time limits and follow-up procedures established for responses to audit findings and recommendations?*

	Count	%
Yes	199.0	96.6
No	4.0	1.9
Other	3.0	1.5
Total	206.0	100.0

QUESTION 140—*Who has the responsibility for follow-up on replies to internal audit reports?*

	Count	%
The Audit Group	157.0	76.6
Chief Financial Officer	15.0	7.3
Chief Executive Officer	4.0	2.0
Other	29.0	14.1
None	0.0	0.0
Total	205.0	100.0

QUESTION 141—*Who acts as mediator and decision maker if disagreement occurs between the audit report and the responsible entity?*

	Count	%
Above Ch. Exec. Officer	31.0	15.3
Chief Executive Officer	42.0	20.7
Chief Financial Officer	67.0	33.0
None	5.0	2.5
Other	58.0	28.6
Total	203.0	100.0

QUESTION 142—*To whom are the audit reports and supporting working papers and documents made available internally? (Circle all that are appropriate.)*

	Count	%
Audit Committee	94.0	46.1
All Levels of Management	63.0	30.9
All Super. Levels & Up	25.0	12.3
In-house Counsel	119.0	58.3
Corp. Int. Audit Staff	146.0	71.6
Other	74.0	36.3
Total Respondents	204.0	100.0
Total Responses	521.0	

QUESTION 143—*To which of the following external groups are audit reports available when requested? (Circle all that are appropriate.)*

	Count	%
Co.'s Outside CPAs	194.0	94.6
DCAA	137.0	66.8
IRS	42.0	20.5
SEC	14.0	6.8
Others	38.0	18.5
None	2.0	1.0
Total Respondents	205.0	100.0
Total Responses	427.0	

QUESTION 144—*External to the company, to whom are working papers and other documentary support made available when requested? (Circle all that are appropriate.)*

	Count	%
Co.'s Outside CPAs	184.0	89.8
DCAA	93.0	45.4
IRS	29.0	14.1
SEC	11.0	5.4
Others	35.0	17.1
None	10.0	4.9
Total Respondents	205.0	100.0
Total Responses	362.0	

QUESTION 145—*If an irregularity is detected by internal auditors, to whom is the finding disclosed? (Circle all that are appropriate.)*

	Count	%
Employees	39.0	19.0
The Resp. Supervisor	105.0	51.2
Higher Level Mgt.	164.0	80.0
In-house Counsel	136.0	66.3
Ext. Investigation	29.0	14.1
Audit Committee	76.0	37.1
Other	64.0	31.2
Total Respondents	205.0	100.0
Total Responses	613.0	

QUESTION 146—*To whom is the responsiblity for investigating suspected irregularities or violations of law normally assigned?*

	Count	%
Internal Audit Staff	15.0	7.4
Corp. Investigators & Auditors	84.0	41.2
Corp. Internal Auditors	24.0	11.8
In-house Counsel	50.0	24.5
External Counsel	0.0	0.0
Other	31.0	15.2
Total	204.0	100.0

QUESTION 147—*After examining the facts of a violation, whom does the company advise? (Circle all that are appropriate.)*

	Count	%
In-house Counsel	164.0	80.0
External Counsel	59.0	28.8
Government Agency	138.0	67.3
Other Authorities	54.0	26.3
Other	70.0	34.1
None of the Above	3.0	1.5
Total Respondents	205.0	100.0
Total Responses	488.0	

QUESTION 148—*Does the company have an officially appointed ombudsman?*

	Count	%
Yes	41.0	20.1
No	163.0	79.9
Total	204.0	100.0

QUESTION 149—*Does the company have a hot line for use by employees in reporting suspected improprieties?*

	Count	%
Yes	58.0	28.6
No	145.0	71.4
Total	203.0	100.0

QUESTION 150—*If the answer to question 149 is yes, are the allegations received over the hot line explored and investigated by any of the following? (Circle all that are appropriate.)*

	Count	%
Internal Audit	50.0	79.4
Ad Hoc Committee	19.0	30.2
In-house Counsel	51.0	81.0
Ombudsman	21.0	33.3
Other	35.0	55.6
Total Respondents	63.0	100.0
Total Responses	176.0	

APPENDIX D

Study of Government Audit and Other Oversight Activities Relating to Defense Contractors

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February 25, 1986

To The President's Blue Ribbon Commission
On Defense Management

We have completed our study of Government auditing and other oversight of defense contractors. Pursuant to our agreement dated December 16, 1985, the study consisted principally of field visits to 15 major defense contractors throughout the United States and interviews with several Government representatives. Each of the contractor and Government representatives with whom we met was helpful and we are appreciative of their cooperation and the courtesies extended to us.

The accompanying report sets forth our findings and recommendations. During the course of our work, we talked with many knowledgeable individuals and reviewed supporting documentation they made available to us. The recommendations contained in this report represent largely a composite of the principal recommendations and observations offered by the individual contractors and Government representatives with whom we visited. We evaluated all recommendations received, together with the related supporting data, and have included only those recommendations we consider to be reasonable and likely, if properly implemented, to improve the overall efficiency and effectiveness of the Government's auditing and other oversight of defense contractors.

We appreciate this opportunity to be of assistance to the President's Blue Ribbon Commission on Defense Management and would be pleased to meet with the Commission or its staff to further discuss our findings and recommendations.

Very truly yours,

Arthur Andersen & Co.

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I. EXECUTIVE SUMMARY

INTRODUCTION

This report presents the results of a study of government auditing and other oversight of defense contractors. The study is based principally on information obtained during field visits to 15 major defense contractors and interviews with several government representatives.

The results of the study indicate that duplication in the oversight process is extensive. Changes are clearly required to enhance efficiency and reduce costs to both contractors and the government. While the contractors expressed concern about this, each acknowledged the need for a reasonable level of auditing and other oversight in the procurement process and accepts that as a condition of doing business with the government.

RESULTS OF CONTRACTOR FIELD VISITS

The major causes of duplicative, overlapping, or inefficient government auditing and other oversight noted during our study are:

1. Lack of Coordinated Government Approach to Oversight

The most serious issue we noted is an apparent lack of coordination and communication among, and occasionally within, responsible government agencies or organizations. This problem is so pervasive that it underlies, and may be a principal cause of, the other auditing and oversight problems identified by this study. The following appear to be the principal reasons for this lack of coordination:

- An apparent reluctance by individual audit or oversight organizations to place reliance upon each other's work;
- An apparent unwillingness of organizations to share information;
- Lack of centralized oversight coordination;
- Inadequate advance planning by the agencies or organizations involved;
- Inconsistencies between agencies and organizations with respect to interpretations of contractual or other requirements and results of audits and reviews; and
- Lack of a clear definition of each agency's or organization's audit or oversight responsibilities.

2. Deterioration of the Contracting Officer's Authority

Deterioration of the contracting officer's authority as the government's team leader together with an apparent increase in the Defense Contract Audit Agency's (DCAA's) authority appears to be a principal cause of the duplication and inefficiency in the audit and oversight process. The contractors attribute much of this problem to Department of Defense (DoD) Directive 7640.2, which limits the contracting officer's authority to independently resolve DCAA audit recommendations and requires that deviations from those recommendations be justified by the contracting officer. Contractors see administrative contracting officers (ACOs) as reluctant to take a position contrary to DCAA because of concern about being subjected to

criticism. The net effect of this situation is a procurement environment fraught with indecision, delays, and unnecessary and costly disputes.

3. The "Blanket" Approach to Audits and Oversight

The government appears unwilling in many cases to give adequate consideration to: (1) a contractor's past performance; (2) favorable results of prior and ongoing reviews of the contractor's operations and systems; and (3) cost/benefit analyses in determining the nature, timing, and extent of its audit or other oversight activities. In effect, the government seems to use very standardized or "blanket" approaches to many audit or oversight functions. The same procedures, tests, and reviews are performed year after year at each contractor location apparently without regard to the internal controls that are in place or the magnitude of the potential costs and benefits involved. It seems that the same work is performed irrespective of risk or the results of prior reviews.

4. Multiple Proposals and Other Delays in the Negotiation Process

The often lengthy time period that elapses between submission of a proposal and final agreement on price appears to be a significant factor contributing to duplicative or inefficient auditing and other oversight. In many cases, months may go by, during which time the government may change quantities or specifications, quotes may go "stale," labor rates may change, etc. These changes generally require that the contractor submit an updated proposal, and each updated proposal starts a new audit cycle in which the unchanged as well as the revised data are audited. The contractors surveyed indicated that the average proposal is updated three times. One contractor cited a proposal that was updated 15 times and another cited a recent procurement that spanned a two year period from the date the proposal was submitted to negotiation of the final price. Situations such as these also create problems for contractors in their dealings with vendors and subcontractors and expose contractors to a greater risk of inadvertent defective pricing.

5. Expanding Scope of DCAA Activities

DCAA's increasing involvement in nonfinancial areas such as operational auditing and compensation and insurance reviews appears to be contributing to overlap and duplication in the oversight process. The contractors noted that inefficiencies and increased costs resulting from this duplication of effort are compounded by what they perceive to be a lack of technical competence as well as a poor definition of objectives by DCAA personnel when performing work in nonfinancial areas. On the other hand, a DCAA representative indicated that as long as DCAA is responsible for evaluating the "reasonableness" of costs charged to the government, it is justified in reviewing and evaluating those aspects of a contractor's operations that may have a bearing on the reasonableness of its costs. In so doing, DCAA will seek the technical advice and assistance of other members of the procurement team as it deems appropriate. He noted, however, that there is a difference of opinion within DCAA as to its appropriate level of involvement in operational auditing.

6. Post-award Audits

Several contractors noted that the number and intensity of post-award audits conducted by the government has increased over the last two years and they see no relief in sight. Since the principal objective of these audits is to identify instances of defective pricing, contractors are compelled to devote significant resources to supporting the organizations performing these reviews to minimize misunderstandings and

erroneous conclusions which may lead to serious, though unwarranted, problems including suspension, debarment, and possibly criminal prosecution. In short, post-award audits are a time-consuming and costly exercise for most contractors and these problems are compounded by the introduction of duplication and inefficiency into the process.

PRINCIPAL LAWS AND REGULATIONS

The principal laws and regulations governing the audit and oversight process overlap in some respects as they relate to the designated functions and responsibilities of the primary agencies and organizations involved in the process; however, those laws and regulations do not appear to be a primary cause of duplication and inefficiency. In fact, the Federal Acquisition Regulation (FAR) and the DoD FAR supplement (DFARS) prescribe policies and procedures for coordinating and controlling DoD's activities in connection with field pricing support and monitoring contractors' costs, both of which are particularly relevant to the subject of this study. The problem appears to be that DoD is not following its own regulations, or at least these regulations are not operating effectively.

RECOMMENDATIONS AND COMMENTS

In view of our findings as summarized above, the following recommendations and comments are offered for the Commission's consideration:

1. The contracting officer's position as leader of the government's team in all dealings with the contractor should be reaffirmed. Strong leadership at the ACO and corporate administrative contracting officer (CACO) level is essential. Accordingly, the contracting officer should be responsible for, among other things, the determination of final overhead rates for all contractors (responsibility for which was recently given to DCAA) and for coordination of all auditing and other oversight activities at contractor locations. Further study is required to determine how best to implement this recommendation and the following should be among the points considered:

- The Inspector General (IG) and the military investigative services have certain oversight responsibilities that clearly require their independence from the contracting officer. While this independence should not be compromised, these organizations should be required to coordinate their activities with respect to individual contractors to the maximum extent possible. Consideration should therefore be given to establishing a formal mechanism within DoD for facilitating this coordination.
- DCAA's role in relation to the contracting officer should be more clearly defined. Irrespective of existing regulations that provide for DCAA to serve the contracting officer in an advisory capacity, our study indicates that DCAA has, in practice, assumed a role which has contributed to a diminution of the contracting officer's authority and his or her willingness to make independent decisions contrary to the recommendations of DCAA. In this connection, the appropriateness of DoD Directive 7640.2 should be reevaluated.
- Although we believe the principal laws and regulations mandating the activities of the major oversight organizations are not a primary cause of duplication and inefficiency, they may be a contributing factor. For example, DCAA's charter to review a contractor's "general business practices and procedures" as provided for in DoD Directive 5105.36 creates ample opportunity for DCAA's activities to overlap those of the Defense Contract Administration Services (DCAS), or one of the other oversight agencies. On the other hand, DCAS' responsibility for determining

"allowability of costs" appears to overlap DCAA's assigned responsibilities. DoD should consider clarifying the responsibilities of DCAA and the various contract administration organizations, particularly with respect to matters such as operational auditing and compensation and insurance reviews, which were frequently noted areas of concern to contractors. In this regard, FAR 42.302 specifically cites reviews of contractors' compensation structures and insurance plans as contract administration functions; however, DCAA perceives the need to delve into these areas to determine the reasonableness of compensation and insurance costs. This apparent conflict needs to be resolved. One solution may be to assign sole responsibility for all matters related to compensation and insurance, including reasonableness of the related costs, to a single DoD organization.

- Closely related to and perhaps inseparable from the need to clarify individual agency auditing and oversight responsibilities is the need to evaluate the day-to-day working relationships between auditing and other oversight organizations with particular emphasis on (1) the degree of reliance each places, or should place, on the work of the others; and (2) the extent to which the agencies share information. Several contractors cited the need for greater cooperation between government agencies in these respects as being essential to reducing duplication and inefficiency in the oversight process. Problems in these areas could be at least partially alleviated by requiring the establishment of a formal data base of contractor information under the control of either the local ACO or the CACO who, in connection with his or her responsibilities for coordinating all auditing and other oversight activities with respect to a contractor, would control the maintenance and distribution of all contractor related information and its distribution to the respective audit or other oversight agencies. The mechanics of this proposed process require further study.

2. Based on the results of this study, it appears that the requirements of DFARS Subparts 15.8 and 42.70 with respect to the conduct and coordination of DoD activities related to field pricing support and monitoring contractors' costs are not being followed, or at least they are not operating effectively. These requirements do, however, address many of the concerns expressed by the contractors surveyed. For example, they require DoD to give appropriate consideration to (a) the contractor's past performance; (b) effectiveness of the contractor's existing system of internal administrative and accounting controls; and (c) cost/benefit analyses in determining the nature, timing, and extent of audit or other review activities. DoD should assess the adequacy of its compliance with the provisions of DFARS Subparts 15.8 and 42.70 and take corrective action as necessary.

The policies, procedures, and practices of all auditing and other oversight agencies with respect to planning, organizing, and controlling their activities should be reevaluated. This reevaluation must give due consideration to the individual goals and charters of each of the agencies as well as the usefulness of their prescribed auditing and other oversight procedures. For example, the IG and the General Accounting Office (GAO) have different missions than do DCAA and DCAS. The principal purpose of this reevaluation would be to identify ways of improving the effectiveness of these organizations in achieving their objectives while minimizing the cost to the government and disruption to the contractor's operations. The latter problem, while of obvious concern to contractors, represents a substantial hidden cost to the government inasmuch as contractors have reportedly increased their staffs and incurred substantial amounts of other expenses in response to intensified oversight activities. These higher costs, in part, have been or will be

passed on to the government through higher contract prices. Further, duplicative and inefficient auditing and other oversight activity adds little, if anything, to the quality of the products being procured by the government, and may actually divert contractor attention from such critical matters.

3. DoD should reevaluate the negotiation process to identify ways of reducing the elapsed time between submission of contractors' proposals and final agreement on contract price. Delays in this process contribute to duplicative and inefficient auditing and other oversight because contractors are required to update their proposals on multiple occasions and each update starts a new audit cycle in which the unchanged as well as the changed data are audited. The following are some suggestions to expedite contract negotiations:

- The government should better define contract requirements before issuing a request for proposal. This is particularly true with respect to quantities which, if not well defined, may change several times and necessitate multiple subcontractor quotes which have to be obtained by the contractor and then audited or reviewed by the government.
- Government audits and reviews of updated proposals should be limited solely to the revised data submitted by contractors. Reauditing unchanged data is duplicative, inefficient, and generally unnecessary.
- Responsibility for the price analysis of a contractor's proposal should be centralized in one organization or agency. The individual(s) performing the analysis should be part of the government negotiation team so that his or her insight can be brought directly to bear during the negotiation process.
- The government's audits and reviews of both initial and updated proposals should be properly planned and coordinated to avoid duplication of effort between agencies. Greater reliance should be placed by the government on contractors' internal control systems where past history and other factors indicate such reliance is warranted.

4. DoD should reevaluate policies and practices with respect to postaward audits to ensure that (a) duplication between agencies and organizations in the performance of these audits is eliminated or minimized; (b) appropriate consideration is given to cost/benefit analyses in determining the nature, timing, and extent of such reviews; (c) appropriate consideration is given to the contractor's past performance and results of prior and ongoing audits and reviews; and (d) postaward reviews are completed on a timely basis, say within one year after contract award.

5. The general relationship between contractors and the government needs to be improved for the benefit of the procurement process. While this situation will be difficult to resolve, the following general recommendations may prove helpful:

- Individual contractor and government personnel should strive for a relationship characterized by a "healthy skepticism" rather than animosity and antagonism.
- Every effort should be made by both contractors and the government to improve their communication and reduce the level of "gamesmanship" in their dealings with each other.
- The government must be careful not to foster the perspective among contractors that it believes every contractor intentionally engages in cost mischarging, defective pricing, and other such practices.
- The government needs to closely monitor the scope of its audits and other oversight activities to ensure that the work is properly planned, its personnel are technically competent for their assigned tasks, and duplication and inefficiency are minimized.

6. There should be a moratorium on the issuance of new procurement laws and

regulations affecting defense contractors for a period of perhaps two years until the prudence and effectiveness of present and proposed rules and regulations can be fully evaluated.

7. The basic framework of the entire auditing and oversight process should be reevaluated with a view toward establishing a system by which contractors are classified according to specified and measurable criteria for the purpose of determining the extent to which they will be subject to government oversight. Under this system, the government would adjust the scope of its oversight activities for individual contractors to respond to the level of risk identified. While conceptually this recommendation is reminiscent of the now defunct Contractor Weighted Average Share in Cost Risk (CWAS) concept, we are not suggesting that the proposed system be an exact replica of that concept. Instead, we recommend that DoD, or preferably a joint task force comprised of DoD and industry personnel, take a "fresh look" at possible methods of categorizing or "qualifying" contractors.

We recognize this recommendation will be difficult to implement. Major challenges to implementation will relate to the definition, application, and monitoring of compliance with the qualification criteria. The initial classification of contractors will be particularly difficult. Moreover, many of the matters discussed elsewhere in this report will impact on the feasibility of the recommendation. However, given the extensive overlap, duplication, and inefficiency present in the auditing and oversight process today, this fundamental change is worthy of consideration.

II. OBJECTIVE AND CONDUCT OF THE STUDY

STUDY OBJECTIVE

The objective of this study was to assist the President's Blue Ribbon Commission on Defense Management in determining whether and to what extent government auditing and other oversight of defense contractors is operating effectively or is duplicative or inefficient. In particular, the Commission requested our conclusions concerning the appropriateness of the overall design of current government auditing and other oversight efforts, and the prudence, utility, and necessity of any duplication identified.

CONDUCT OF THE STUDY

Overview

The study was divided into two basic projects which were performed concurrently. The principal project consisted of (1) evaluating information obtained during field visits to a limited number of defense contractors located throughout the United States, and (2) interviews with Department of Defense (DoD) personnel representing the contract administration function, including the Defense Contract Administration Services (DCAS), the Defense Contract Audit Agency (DCAA), and the Inspector General (IG). The second project consisted of a review of the principal laws and regulations mandating government auditing and oversight processes to identify areas, if any, of potential duplication or overlap.

Contractor Field Visits

Sixteen contractors were invited to participate in the study, one of which declined. The contractors were selected judgmentally and represent companies performing substantial work for the Army, Navy, Air Force, Marines, and Defense Logistics Agency. The chairman or president of the parent company of each contractor received a letter from the chairman of the Commission soliciting the contractor's participation in the study. Upon the contractor's agreement to participate, designated contractor personnel were contacted by a representative of Arthur Andersen & Co., the purpose of the study was further explained, and a field visit was scheduled. We requested that each contractor be prepared to discuss the nature and extent of their government auditing and other oversight activities during at least the prior 18 months and their recommendations for improving the oversight process.

As a condition precedent to contractor participation in the survey, and pursuant to our agreement with the Commission, individual contractor responses will be kept confidential. Accordingly, neither the Commission nor its staff have been informed of those individual responses and this report is written so as to preserve that confidentiality.

III. FINDINGS AND RECOMMENDATIONS

INTRODUCTION

This section describes in more detail the findings and recommendations summarized in Section I. Because the principal objective of the study was to determine whether and to what extent current government auditing and other oversight processes are operating efficiently, the results of our contractor field visits are presented first and are followed by a discussion of the principal laws and regulations governing those processes. Finally, the recommendations resulting from the study are presented for the Commission's consideration.

RESULTS OF CONTRACTOR FIELD VISITS

Overview

Our study indicates that all of the 15 contractors surveyed have been subject to duplicative, overlapping, and inefficient government auditing and oversight activities. The amount of duplication and overlap varies from contractor to contractor. While most matters of concern relate to DCAA, DCAS, and the procuring agencies, several instances were noted of apparent duplication and inefficiency involving the IG and the General Accounting Office (GAO). Changes are clearly required to enhance efficiency and reduce costs to both contractors and the government.

Each contractor surveyed acknowledged the need for a reasonable level of auditing and oversight in the procurement process and accepts that as a condition of doing business with the government. However, the overwhelming consensus of the contractors was that the conduct of the process must be improved for the sake of both contractors and the government. They feel the current auditing and oversight activities add little value to the procurement process and, in fact, unnecessarily add to the cost of procurement. The principal problem areas we noted are described below, together with some specific examples of duplication, overlap, and inefficiency cited by the contractors participating in the study.

Lack of a Coordinated Government Approach to Oversight

The most serious issue we noted is the apparent lack of coordination and communication among, and occasionally within, responsible government agencies or organizations. This problem appears to be so pervasive that it underlies, and may be a principal cause of, many of the other auditing and oversight problems cited by the contractors and discussed later in this report. The following are some of the examples cited by contractors as indicative of poor coordination and communication in the government's conduct of its audit and oversight activities.

> DCAS and DCAA periodically review the contractor's data processing systems. The reviews are performed separately and appear to the contractor not to be coordinated. Further, the contractor has noted what appears to be outright animosity between the two agencies. The contractor estimates that 70 to 80 percent of the information requested during these reviews is duplicative. Representatives of both agencies request copies of the same data and the contractor believes the volume of information it is required to provide is usually more than could ever be assimilated by the auditor.
>
> The contractor also noted that separate

cost reviews were recently performed by both DCAA and a "should-cost team" from one of the procuring agencies and that the same records were reviewed by both groups. The contractor perceives these reviews as indicative of poor communication and lack of coordination among agencies, particularly since the procuring organization is presumably the ultimate user of the information.

The Defense Logistics Agency (DLA) requires the contractor's spare parts proposals to be evaluated on a "line-item" basis to ensure "unit price integrity." DCAA has taken exception to the use of this technique. Consequently, the contractor had to alter its estimating techniques and is now required to prepare and support its spare parts proposals in two different ways solely to satisfy the conflicting requirements of these two agencies.

The contractor noted that even though the administrative contracting officer (ACO) reviews its purchasing system on a quarterly basis, DCAA recently performed a comprehensive review of the contractor's purchasing system. During the seven month period DCAA required to complete its review, the quarterly reviews by the ACO continued. Just prior to our field visit, the contractor was notified that still another agency will review its purchasing system. The contractor believes this latter review was requested by the ACO but DCAA's review was done independently without coordination through the ACO and, consequently, was at least partially duplicative and inefficient.

The contractor has received government requests for data related to over 1300 spare parts since the beginning of 1985. The requests have come from several agencies or organizations and many of the requests have been duplicative. The contractor estimates that the cost of responding to all of these requests has exceeded $1,000,000. In the process, the contractor's staff assigned to respond to spare parts investigations grew from 24 people in January 1985 to 43 people in October 1985.

The contractor also identified 11 separate reviews of its personnel and administration functions over a two year period by at least nine different agencies or organizations. The timing of these reviews was largely overlapping and the organizations performing the reviews frequently requested the same data.

Both the Defense Investigative Service (DIS) and the National Security Agency (NSA) perform security audits at the contractor's plants. If DIS begins its audit shortly after NSA has completed its work, DIS accepts the results of the NSA review. In contrast, NSA refuses to rely on the work of DIS and reaudits the contractor, even if DIS has just recently completed its work.

Further, the contractor noted that the Defense Contract Administrative Services Management Area and the Small Business Administration both perform a "Small Business/Minority Business Compliance Review" every year at every plant even though the procedures at each plant are the same. The contractor considers these reviews to be inefficient from both its own and the government's perspective, as well as at least partially duplicative of the work performed by the Defense Contract Administrative Services Region (DCASR) during its annual review of the contractor's procurement system.

One of the military services performed a "should-cost review" that covered several aspects of the contractor's operations, including compensation, data processing, and plant rearrangement. With respect to

compensation, the review duplicated a compensation review performed less than a year earlier by DCASR. In the data processing area, the review duplicated work performed in other DCASR reviews, including several studies of equipment cost and utilization.

One contractor has been visited by more than 20 fact finding and "should-cost review" teams in connection with one program during an 18 month period. In total, these reviews involved over 200 visitors to the contractor's plant for an average of five days at a time. In total, during this same 18 month period, government personnel involved in auditing and other oversight activity, excluding the 200 resident government audit personnel, spent over 70,000 man-days at the contractor's plant.

The buying organization and a prime contractor conducted a joint contractor operations review (COR) at the contractor's plant. The COR duplicated a "pre-COR" previously conducted independently by the prime contractor, as well as product control center reviews conducted on an ongoing basis by the plant ACO. The contractor observed that neither the buying organization nor the prime contractor was interested in the results of the ACO's reviews. Further, it appeared to the contractor that the ACO was really the subject of the review, yet the contractor was required to provide substantial personnel support which was very disruptive to its operations.

These examples summarize representative problems attributed by contractors to the lack of coordination between government agencies and organizations involved in the audit and oversight process. The principal reasons for this lack of coordination appear to be:

An apparent reluctance by individual audit or oversight organizations to place reliance upon each other's work;

An apparent unwillingness of organizations to share information;

Lack of centralized oversight coordination (see comments below regarding the role of the contracting officer);

Inadequate advance planning by the agencies or organizations involved;

Inconsistencies between agencies and organizations with respect to interpretations of contractual or other requirements and results of audits and reviews; and

Lack of a clear definition of each agency's or organization's audit or oversight responsibilities.

Deterioration of the Contracting Officer's Authority

Deterioration of the contracting officer's authority as the government's team leader together with an apparent increase in DCAA's authority appears to be a principal cause of the duplication and inefficiency in the audit and oversight process. There is a perception among contractors that DCAA is marching to its own drummer, who may or may not be playing the same tune as the rest of the government. The contractors believe that the principal cause of this problem is DoD Directive 7640.2, dated December 29, 1982, which limits the contracting officer's authority to independently resolve DCAA audit recommendations and requires that deviations from those recommendations be justified by the contracting officer. Contractors believe that the practical, though perhaps not intended, result of Directive 7640.2, has been a change in the role of DCAA auditor from adviser to decision maker and negotiator. In this latter role, contractors see DCAA as generally inflexible and ACOs as reluctant to take a position contrary to DCAA because of concern about being subjected to criticism. The net effect of this situation is a procurement environment fraught with indecision, delays, and unnecessary and costly disputes.

A DCAS representative also saw the changing role of the contracting officer vis-a-vis DCAA as a problem. He noted that, at times, contracting officers simply find it easier to "go along" with DCAA than to challenge the auditor's position. This is precisely the perception that many contractors have of the contracting officer in today's environment.

This same individual noted that DCAA is a vital member of the contracting officer's team; however, DCAA's changing role is eroding the effectiveness of that team. He cited as an example DCAA's recently acquired authority to determine final overhead rates for all contractors. He considers this change to be counterproductive because it takes authority away from the team, which he believes can do a more effective job than DCAA can do alone.

In contrast, while acknowledging that the contracting officer's authority has indeed deteriorated over the past few years, a DCAA representative noted that the shift in power was principally from the ACO at the plant level to higher level management in the government procurement organization and not to DCAA. He stated that ACOs are now more accountable to the management of their own organization and, accordingly, they have to do a better job than they did in the past of justifying their decisions. Thus, in his view, it is now more difficult for the ACO to simply accept the contractor's position on a particular matter just because it is the easiest thing to do.

This same individual stated that DCAA should be under no constraint as to what it can say or challenge. He noted that DCAA's purpose is not to support the ACO's procurement objectives, but rather to protect the taxpayers' dollars. Accordingly, he sees DCAA as having to be "independent" from both contractors and contracting officers. If the two opposing government views presented above are truly representative of the philosophies of DCAA and the government's procurement organizations, it is not difficult to see how internal disagreements, "turf battles," and lack of communication can occur, and how this can lead to the lack of coordination and efficiency in the audit and oversight process experienced by the contractors we surveyed.

The "Blanket" Approach to Audits and Oversight

The government appears unwilling in many cases to give adequate consideration to: (1) a contractor's past performance; (2) results of prior and ongoing reviews of the contractor's operations and systems; and (3) cost/benefit analyses in determining the nature, timing, and extent of its audit or other oversight activities. In effect, the government seems to use very standardized or "blanket" approaches to many audit or oversight functions. The same procedures, tests, and reviews are performed year after year at each contractor location, apparently without regard to the internal controls that are in place or the magnitude of the potential costs and benefits involved. It seems that the same work is performed irrespective of risk or the results of prior reviews. Some contractors believe that once issues such as spare parts pricing or quality control are identified as problems at one or a few contractors, the government tends to overreact and other contractors are subjected to intensified and repetitive reviews that are unwarranted in their circumstances. The following are some of the examples cited by the contractors we surveyed:

> With respect to major program proposals, each year's program "buy" is looked at as if it were a new program. The government audits or reviews each of the contractor's proposals from "ground zero" rather than focusing solely on program changes between years. The contractor considers this process to be duplicative and inefficient because its estimating and procurement systems are under constant review by the government throughout the year and comparable historical data are readily available.

Both DCAS and DCAA perform complete audits of the contractor's quality control, government property, and cost schedule control systems each year. The contractor feels the government is unwilling to adjust its audit scopes in consideration of prior favorable audit results and, consequently, the government audits systems that have been operating effectively for several years in the same manner and with the same intensity that it audits new systems. The contractor perceives this as costly and inefficient to the government and clearly disruptive to its own operations.

During an 18 month period, the contractor estimates that it spent approximately 9,600 man-hours responding to 120 DCAA audit reports which, when settled, had no cost impact. The contractor considers this indicative of the DCAA's failure to give adequate attention to cost/benefit considerations in planning and performing its work.

The contractor noted that when spare parts pricing became a "hot topic," the DCAA, GAO, and IG each conducted separate reviews of its basic ordering agreement for spares. The contractor considers the reviews to be clearly duplicative and questions why they were performed since it had no history of spare parts overpricing.

A government task force reviewing spare parts pricing required the contractor to call a three hour meeting with approximately 20 government and contractor personnel present to discuss potential questions involving less than $30,000. The contractor considered this disruptive, a waste of its own and the government's time, and a matter that could easily have been handled by letter or telephone, particularly in light of the amounts involved.

Multiple Proposals and Other Delays in the Negotiation Process

The often lengthy time period that elapses between submission of a proposal and final agreement on price appears to be a significant factor contributing to duplicative or inefficient auditing and oversight. In many cases, months may go by during which time the government may change quantities or specifications, quotes may go "stale," labor rates may change, etc. These changes generally require that the contractor submit an updated proposal and each updated proposal seems to start a new audit cycle in which the unchanged as well as the revised data are audited. The contractors surveyed indicated that the average proposal is updated three times. One contractor cited a proposal that was updated 15 times and another cited a recent procurement that spanned a two year period from the date the proposal was submitted to negotiation of the final price.

Revising, resubmitting, and auditing the same basic proposal three, four, or more times is inefficient and costly to the government and the contractor. It also creates problems for the contractor in its dealings with vendors and subcontractors and exposes the contractor to a greater risk of inadvertent defective pricing. One contractor commented that it had, in effect, been told by subcontractors asked to submit proposals, "When you and the government get serious, we'll get serious."

Contractors believe the number of required changes to proposals could be minimized, and the lag time between proposal submission and agreement on price reduced, if the government better defined the product or service in the original specifications and contract documents. In addition, other inefficiencies and problems exist which contribute to costly and disruptive delays in the negotiation process. The following are two examples:

The contractor does business with many subcontractors. Approximately 20 of

these subcontractors are also competitors of the contractor and thus do not permit the prime contractor to audit their proposals (i.e., they consider their cost and pricing data to be proprietary). Although the ACO is well aware of this situation, the contractor is continually required to go through a series of time-consuming steps before the ACO requests DCAA to perform the audits.

The contractor's proposals are reviewed by a DCAS pricing analyst who provides an analysis to the procuring agency for use in negotiation. The procuring agency's pricing analyst must then "get up to speed" on the details of the proposal and, even after supposedly doing so, is generally unable to make independent negotiation decisions without extensive telephone consultations with the DCAS pricing analyst who reviewed the proposal initially. The contractor perceives this review process as duplicative and costly and believes that either DCAS or the procuring agency, but not both, should be responsible for price analysis of proposals.

Expanding Scope of DCAA Activities

DCAA's increasing involvement in nonfinancial areas such as operational auditing and compensation and insurance reviews appears to be contributing to overlap and duplication in the oversight process. The contractors noted that inefficiencies and increased costs resulting from this duplication of effort are compounded by what they perceive to be a lack of technical competence as well as a poor definition of objectives by DCAA personnel when performing work in nonfinancial areas. On the other hand, a DCAA representative indicated that as long as DCAA is responsible for evaluating the "reasonableness" of costs charged to the government, it is justified in reviewing and evaluating those aspects of a contractor's operations that may have a bearing on the reasonableness of its costs. In so doing, DCAA will seek the technical advice and assistance of other members of the procurement team as it deems appropriate. However, he noted that there is a difference of opinion within DCAA as to its appropriate level of involvement in operational auditing. In this regard, he described a proposed approach under which DCAA would conduct "probe" reviews to identify areas where a full-scale operational audit would be cost beneficial. The contractor would then be responsible for completing the audit and submitting the results to DCAA and the ACO as a condition for receiving future contracts. The following are examples of situations in which the apparent expansion of DCAA's activities into nonfinancial areas has contributed to duplication and inefficiency:

DCAS and DCAA both evaluate items such as production rates, yield factors, and learning curve assumptions supporting the contractor's pricing proposals. The contractor believes that DCAS has demonstrated greater expertise in these judgmental and operational areas and that DCAA's review of these items is of no value to the contractor or the government. This same contractor noted that it had recently installed "state of the art" computer systems in certain nonfinancial areas of its operations. Nevertheless, shortly thereafter, DCAA performed reviews of those systems to see if potential cost savings were available. No meaningful suggestions or benefits were derived from the review and, given the advanced technology of the systems, the contractor considered the entire process a waste of its time as well as the government's.

DCAA has started performing audits of the contractor's procedures related to maintenance and calibration of test equipment and the repair, rework, and

replacement of "nonperforming" material. Aside from questioning the DCAA's technical competence in this area, the contractor considers the entire process duplicative and a waste of time because there are approximately 50 resident DCAS personnel at the contractor's plant who review and monitor the same systems and procedures on virtually a daily basis.

DCAS and DCAA both performed audits of the contractor's insurance and retirement plans. The contractor observed that DCAS personnel were generally more knowledgeable in these areas than the typical DCAA auditor. This duplication of effort reduced the efficiency of the entire process because the contractor was required to reconcile differences between the costs questioned by the two agencies.

Post-award Audits

Several contractors noted that the number and intensity of post-award audits conducted by the government has increased over the last two years and they see no relief in sight. Since the principal objective of these audits is to identify instances of defective pricing, contractors are compelled to devote significant resources to supporting the organizations performing these reviews to minimize misunderstandings and erroneous conclusions that may lead to serious, though unwarranted, problems including suspension, debarment, and possibly criminal prosecution. In short, post-award audits are a time consuming and costly exercise for most contractors to go through, and these problems are compounded by the introduction of duplication and inefficiency into the process. The following are three examples cited by the contractors we surveyed:

The contractor received 283 multi-item requests for data in connection with post-award audits conducted by DCAA during a recent 18 month period. During that time DCAA conducted post-award audits on 36 different contracts. This represents a significant increase in activity over the previous 18 month period and the contractor attributes the increase in large measure to allegations by the IG and others that insufficient post-award audits had been performed in the past. The contractor believes that there is little relationship between DCAA's findings and the extensive effort expended by both the contractor and the government.

During the past five years, the contractor has undergone between 20 and 25 post-award audits each year. Since 1978 only one defective pricing issue of relatively minor amount has been identified. Despite the favorable results, the contractor has been advised that the number of post-award audits to be performed in 1986 will nearly double.

The contractor considers post-award audits to be extremely time consuming and disruptive. The government typically reviews contracts one or two years after completion. The audits require the contractor to locate and produce a variety of old records, many of which are in storage and not easily accessible. Five out of 10 post-award reviews currently in process relate to contracts that are five years old or older. The contractor has had no defective pricing problems in recent years and it feels the level of government activity is unreasonable and unwarranted in view of its past performance.

PRINCIPAL LAWS AND REGULATIONS MANDATING THE GOVERNMENT AUDIT AND OVERSIGHT PROCESS

Overview

The laws and regulations governing federal contracting are extensive and complex. This

study is not intended to include a comprehensive analysis of the legislative and regulatory history of the contracting process. Instead, our objective is to highlight the principal laws and regulations which significantly and directly affect the government's auditing and other oversight of defense contractors on a day-to-day basis, and to identify areas in which those laws and regulations may contribute to overlap and duplication. We approach this task first from the perspective of the functions and responsibilities of the primary agencies and organizations involved in the audit and oversight process. We then focus on several key provisions of the Federal Acquisition Regulation (FAR) that seem particularly relevant to the issues addressed in this study. Finally we offer some observations on the relationship of those laws and regulations to the overlap and duplication in the process as described by the contractors we surveyed.

Government Auditing and Other Oversight Agencies

The principal organizations responsible for DoD auditing and oversight activities include DCAA, DCAS, DoD–IG, and GAO. Each of these organizations was established at a different time and assigned certain responsibilities and functions. The following is a brief discussion of those functions.

Defense Contract Audit Agency

DCAA is a separate agency of DoD under the direction, authority, and control of the Assistant Secretary of Defense (Comptroller). It was established by DoD Directive 5105.36, dated June 9, 1965. That Directive was replaced on June 8, 1978, by a new Directive, also identified as 5105.36, which describes the DCAA's mission as follows:

> 1. Perform all necessary contract audit for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. These services will be provided in connection with negotiation, administration, and settlement of contracts and subcontracts.
> 2. Provide contract audit services to other Government agencies as appropriate.

Directive 5105.36 also describes DCAA's responsibilities and functions and provides, in part, that the Director of DCAA shall:

> 1. Organize, direct, and manage the DCAA and all resources assigned to the DCAA.
> 2. Assist in achieving the objective of prudent contracting by providing DoD officials responsible for procurement and contract administration with financial information and advice on proposed or existing contracts and contractors, as appropriate.
> 3. Audit, examine and/or review contractors' and subcontractors' accounts, records, documents, and other evidence; systems of internal control; accounting, costing, and general business practices and procedures; to the extent and in whatever manner is considered necessary to permit proper performance of the other functions described in 4 through 12 below.
> 4. Examine reimbursement vouchers received directly from contractors . . .
> 5. Provide advice and recommendations to procurement and contract administration personnel on:
>
> a. Acceptability of costs incurred under redeterminable, incentive, and similar type contracts.
>
> b. Acceptability of incurred costs and estimates of cost to be incurred as represented by contractors . . .
>
> c. Adequacy of financial or accounting aspects of contract provisions.
>
> d. Adequacy of contractors' accounting and financial management systems, adequacy of contractors' estimating procedures, and adequacy of property controls.

6. Assist responsible procurement or contract administration activities in their surveys of the purchasing-procurement systems of major contractors.
7. Direct audit reports to the Government management level having authority and responsibility to take action on the audit findings and recommendations.
8. Cooperate with other appropriate Department of Defense components on reviews, audits, analyses, or inquiries involving contractors' financial position or financial and accounting policies, procedures, or practices.
9. Establish and maintain liaison auditors as appropriate at major procuring and contract administration offices.
10. Review General Accounting Office reports and proposed responses thereto which involve significant contract or contractor activities for the purpose of assuring the validity of appropriate pertinent facts contained therein.
11. In an advisory capacity, attend and participate, as appropriate, in contract negotiation and other meetings [in] which contract cost matters, audit reports, or related financial matters are under consideration.
12. Provide assistance, as requested, in the development of procurement policies and regulations.
13. Perform such other functions as the Assistant Secretary of Defense (Comptroller) may from time to time prescribe.

With respect to DCAA's relationship to other components of DoD, Directive 5105.36 provides that:

1. In the performance of his functions, the Director, DCAA shall:
a. Maintain appropriate liaison with other components of the DoD, other agencies of the Executive Branch, and the General Accounting Office for the exchange of information and programs in the field of assigned responsibilities.
b. Make full use of established facilities. . .
c. The military departments and other DoD components shall provide support, within their respective fields of responsibility, to the Director, DCAA to assist in carrying out the assigned responsibilities and functions of the Agency. . .
2. Procurement and contract administration activities of the DoD components shall utilize audit services of the DCAA to the extent appropriate in connection with the negotiation, administration, and settlement of contract payments and prices which are based on cost (incurred or estimated), or on cost analysis.

Defense Contract Administration Services

DCAS is part of the Defense Logistics Agency (DLA), which was established by DoD Directive 5105.22 dated January 5, 1977. That Directive was replaced on June 8, 1978, by a new Directive also identified as 5105.22. This Directive, with attachments, is 21 pages long and describes numerous functions to be performed by the Director, DLA. DCAS is not specifically mentioned in the Directive but information provided to us by a DCAS representative during the course of this study summarizes DCAS' mission as follows:

To assure contractor compliance with cost, delivery, technical, quality, and other terms of the contract;
To accept products on behalf of the government; and
To pay the contractor.

As indicated by the first of the above points, contract administration is a major responsibility of DCAS. DCAS, together with its plant representative offices (DCASPRO), is responsible for administering contracts at all but approximately 40 defense contractor locations where that function is performed principally by the military services, for example, Air Force Plant Representative Offices (AFPRO); Navy Plant Representative Offices (NAVPRO); and

Army Plant Representative Offices (ARPRO). These organizations are referred to collectively in this report as ACOs.

Directive 5105.22 describes contract administration as including:

> . . . plant clearance, utilization and disposal of contract inventories, administration of government furnished property, financial analysis, review of contractor management systems, price and cost analysis (excluding examination of contractor's financial records), convenience termination settlements, small business and economic utilization, negotiation of contract changes pursuant to the changes clause, determination of allowability of cost, and such other functions as are delegated.

Contract administration duties are also enumerated in Subpart 42.3 of the FAR. In total, the FAR and the DoD FAR Supplement (DFARS) describe more than 70 functions that are the responsibility of the cognizant contract administration office (CAO) or that may be performed by the CAO if authorized by the procuring organization.

Inspector General

Public Law 95-452, "Inspector General Act of 1978" (the Act) established Offices of Inspector General (OIG) within 12 federal civilian agencies. For reasons beyond the scope of this study, an OIG for DoD was initially not established. The purpose of the OIG as stated in the Act is as follows:

> 1. To conduct and supervise audits and investigations relating to programs and operations of the Department of Agriculture, the Department of Commerce, the Department of Housing and Urban Development, the Department of Interior, the Department of Labor, the Department of Transportation, the Community Services Administration, the Environmental Protection Agency, the General Services Administration, the National Aeronautics and Space Administration, the Small Business Administration, and the Veterans' Administration;
> 2. To provide leadership and coordination and recommend policies for activities designed (a) to promote economy, efficiency, and effectiveness in the administration of, and (b) to prevent and detect fraud and abuse in, such programs and operations; and
> 3. To provide a means for keeping the head of the establishment and the Congress *fully and currently informed about* problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action.

The 1983 Defense Authorization Act (Public Law 97-252) provided for establishment of the DoD-IG. By design, the DoD-IG is independent from the agency it monitors. In addition to those duties and responsibilities included in the Act, the DoD-IG is empowered under Public Law 97-252 Title XI of the United States Code, Section 1117(c) to:

> 1. Be the principal adviser to the Secretary of Defense for matters relating to the prevention and detection of fraud, waste and abuse in the programs and operations of the department;
> 2. Initiate, conduct, and supervise such audits and investigations in the Department of Defense (including military departments) that the Inspector General considers appropriate;
> 3. Provide policy direction for audits and investigations relating to fraud, waste and abuse, and program effectiveness;
> 4. Investigate fraud, waste and abuse uncovered as a result of other contract and internal audits, as the Inspector General considers appropriate;
> 5. Develop policy, monitor and evaluate program performance, and provide guidance with respect to all department activities relating to criminal investigation programs;

6. Monitor and evaluate the adherence of department auditors to internal audit, contract audit, and internal review principles, policies and procedures;
7. Develop policy, evaluate program performance, and monitor actions taken by all components of the department in response to contract audits, internal audits, internal review reports, and audits conducted by the Comptroller General of the United States;
8. Request assistance as needed from other audit, inspection, and investigative units of the Department of Defense (including military departments); and
9. Give particular regard to the activities of the internal audit inspection and investigative units of the military department with a view toward avoiding duplication and ensuring effective coordination and cooperation.

General Accounting Office

The GAO was created by the Budget & Accounting Act of 1921. It is under the control of the Comptroller General, a constitutional appointment made by the President, and serves as an agent of Congress. The GAO is an independent organization.

Title 31 of the United States Code, Section 712, describes the Comptroller General's responsibilities with respect to investigating the use of public money as follows:

1. Investigate all matters related to the receipt, disbursement, and use of public money;
2. Estimate the cost to the United States Government of complying with each restriction on expenditures of a specific appropriation in a general appropriation law and report each estimate to Congress with recommendations the Comptroller General considers desirable;
3. Analyze expenditures of each executive agency the Comptroller General believes will help Congress decide whether public money has been used and expended economically and efficiently;
4. Make an investigation and report ordered by either House of Congress or a committee of Congress having jurisdiction over revenue, appropriations, or expenditures; and
5. Give a committee of Congress having jurisdiction over revenue, appropriations, or expenditures the help and information the committee requests.

Federal Acquisition Regulation

The two procedural statutes underlying federal contracting activity are the Armed Services Procurement Act of 1947 and the Federal Property and Administrative Services Act of 1949. The statutes contain detailed requirements for awarding of contracts but provide little guidance regarding contract administration.

The principal source of guidance with respect to contract administration is the FAR. The FAR, together with agency supplemental regulations, replaced the Federal Procurement Regulation System, the Defense Acquisition Regulation, and the NASA Procurement Regulation for all solicitations issued after April 1, 1984. It is the primary regulation for use by all federal executive agencies in their acquisition of supplies and services with appropriated funds.

The following paragraphs highlight several key provisions of the FAR that are particularly relevant to the matters encompassed by our study. The thrust of the discussion is upon contract administration as described in FAR Part 42. However, we note that FAR Part 15, which deals with contracting by negotiation, contains guidance with respect to proposal analysis; FAR Part 31 addresses cost allowability; and FAR 52.214-26, 52.215-1 and 52.215-2 contain the clauses granting the government the right to audit or examine contractors' records. While questions regarding cost allowability and government access to records may impair the efficiency of the oversight process, DFARS 15.805-5 is particularly pertinent to this study, as it deals with coordination of the

government's field pricing support activities.

DFARS 15.805-5(c)(1)(70)(A) states, in part, that, "The Plant Rep/ACO is the team manager for all PCO requests for field pricing support." DFARS 15.805-5(d) and (e) acknowledge the importance of coordination and the need for contract auditors to consider their past experiences with a contractor, as well as the effectiveness of the contractor's procedures and controls, in determining the scopes of their audits. Specifically, they provide as follows:

> (d) The efforts of all field pricing support team members are complementary, advisory and also offer an excellent check and balance of the various analyses imperative to the PCO's final pricing decision. Therefore, it is essential that there be close understanding, cooperation and communication to ensure the exchange of information of mutual interest during the period of analysis. While they shall review the data concurrently when possible, each shall render his services within his own area of responsibility. For example, on quantitative factors (such as labor hours), the auditor may find it necessary to compare proposed hours with hours actually expended on the same or similar products in the past as reflected on the cost records of the contractor. From this information he can often project trend data. The technical specialist may also analyze the proposed hours on the basis of his knowledge of such things as shop practices, industrial engineering, time and motion factors, and the contractor's plant organization and capabilities. The interchange of this information will not only prevent duplication but will assure adequate and complementary analysis.
>
> (e) The terms "audit review" and "audit" refer to examinations by contract auditors of contractors' statements of actual or estimated costs to the extent deemed appropriate by the auditors in the light of their experience with contractors and relying upon their appraisals of the effectiveness of contractors' policies, procedures, controls, and practices. Such audit reviews or audits may consist of desk reviews, test checks of a limited number of transactions, or examinations in depth, at the discretion of the auditor. The contract auditor is responsible for submission of information and advice, based on his analysis of the contractor's books and accounting records or other related data, as to the acceptability of the contractor's incurred and estimated costs.

Turning now to contract administration, FAR Part 42 prescribes general policies and procedures for performing contract administration functions and related audit services. As noted above in connection with our discussion of DCAS' responsibilities, Subpart 42.3 of the FAR and DFARS identifies more than 70 functions comprising contract administration. Also described elsewhere in Part 42 are general policies and procedures for performing those contract administration functions and related audit services. FAR 42.1 deals with interagency contract administration and audit services. FAR 42.100 describes the scope of that subpart as follows:

> This subpart prescribes policies and procedures for obtaining and providing interagency contract administration and audit services in order to (a) provide specialized assistance through field offices located at or near contractors' establishments, (b) avoid or eliminate overlapping and duplication of government effort, and (c) provide more consistent treatment of contractors.

In connection with the providing of interagency services, FAR 42.101(b) prescribes the following policy:

> Multiple reviews, inspections, and examinations of a contractor or subcontractor by several agencies

involving the same practices, operations, or functions shall be eliminated to the maximum practicable extent through the use of cross-servicing arrangements.

With respect to procedures for implementing this policy, FAR 42.102(d) and (e) provide as follows:

> (d) Contract administration and audit services will be performed using the procedures of the servicing agency unless formal agreements between agencies provide otherwise.
>
> (e) Both the requesting and servicing activities are responsible for prudent use of the services provided under either formal or informal interagency cross-servicing arrangements. When it is appropriate, servicing activities shall counsel requesting agencies or contracting offices concerning the desirability and practicality of relaxing or waiving controls and surveillance that may not be necessary to ensure satisfactory contract performance.

Thus, the FAR requires the government to plan and conduct its contract administration and related audit activities in a manner that will avoid or at least minimize overlap, duplication, and inefficiency. The DFARS gives further recognition to the importance of coordination and efficiency in the contract administration function. DFARS Subpart 42.70 deals with the government's monitoring of contractors' costs, a subject that is particularly relevant to the issues addressed in this study. DFARS 42.7000 describes the scope of that subpart as follows:

> This subpart sets forth guidelines for monitoring the policies, procedures, and practices used by contractors to control direct and indirect costs related to government business. These procedures are intended to eliminate duplication in monitoring contractors' costs.

DFARS 42.7002 goes on to provide that:

> A formal program of government monitoring of contractor policies, procedures, and practices to control costs should be conducted at:
>
> (a) All major contractor locations where—
>
> (1) Sales to the government are expected to exceed $50 million during the contractor's next fiscal year on other than firm-fixed price and fixed-price-with-escalation contracts;
>
> (2) The government's share of indirect costs for such sales is at least 50 percent of the total of such indirect costs; and
>
> (3) A contract administration office has been established at the location.
>
> (b) Other critical locations with significant government business where specifically directed by the HCA. . .

DFARS 42.7003 provides for a member of the contract administration office (CAO) cognizant of a contractor location meeting the above requirements to be designated as the Cost Monitoring Coordinator (CMC). The CMC may be the ACO or any other staff member whose normal function entails evaluation of contractor performance.

DFARS 42.7004 describes the responsibilities of the CMC. For the sake of brevity, each of those responsibilities is not specifically cited here. However, subparagraphs (b)(1), (b)(3), and (c) are of particular interest to this study. These subparagraphs provide as follows:

> (b) The CMC shall be responsible for:
>
> (1) Preparing and maintaining an annual consolidated written plan and schedule for reviewing contractor operations from coordinated long-range plans established by each team member including the DCAA auditor. This composite plan and schedule

will assure cost monitoring responsibilities are being fully implemented and that the technical and professional expertise of various organizational units of the CAO are used without duplication of effort or skills.

(3) Coordinating the cost monitoring efforts of the CAO with those of the DCAA auditor. . . .

(c) The plan required by (b)(1) above must be tailored to the contractor, taking into account the extent of competition in awarded contracts, the contractor's operating methods, the nature of work being done, procurement cycle stage, business and industry practices, types of contracts involved, degree of technical and financial risk, ratio of Government commercial work, and extent that performance efficiencies have been previously demonstrated. The plan should stress the importance of anticipating potential problems and provide a means of calling them to the attention of the contractor at an early stage so that preventive action can be taken. Reviews required by this supplement and the contracting officer must be included in the plan.

DCAA's responsibilities in connection with the contract administration process are described as follows in DFARS 42.7005:

> DCAA audit offices are responsible for performing all necessary contract audit for DoD and providing accounting financial advisory service regarding contracts and subcontracts to all DoD components responsible for procurement and contract administration. The auditor is responsible for submitting information and advice based on his analysis of the contractor's financial and accounting records or other related data as to the acceptability of the contractor's incurred and estimated costs, as well as for reviewing the financial and accounting aspects of the contractor's cost control systems. The auditor is also responsible for performing that part of reviews and such analysis which requires access to the contractor's financial and accounting records supporting proposed costs or pricing data. This does not preclude the Program Manager, PCO, Plant Rep/ACO, or their technical representatives from requesting any data from, or reviewing records of, the contractor (such as CSCS/C data, lists of labor operations, process sheets, etc.) necessary to the discharge of their responsibilities. The CAO will utilize the auditor's services whenever such expertise is needed, particularly regarding the contractor's financial management reports, books, and records.

DFARS 42.7006(a) sets forth procedures for selecting contractor operations for review and provides, in pertinent part, as follows:

> It is not possible to review all elements of a contractor's entire operation each year. Therefore, the CMC, together with the auditor, is to select for review those operations that have the greatest potential for charging government contracts with significant amounts of unacceptable costs. To select these cost-risk areas on a sound and orderly basis, an overview must first be obtained of the contractor's entire operation. Before the beginning of each government fiscal year, the CMC should arrange for a joint meeting between CAO, DCAA, and other directly interested government representatives to coordinate selection of the areas to be reviewed during the coming year.

DFARS 42.7006(a)(1) through (9) lists some of the data to be used by the government in selecting the contractor operations to be reviewed. Subparagraph (a)(5) is of particular relevance as it relates to the concern expressed by many of the contractors surveyed that the government does not give adequate consideration to the favorable results of prior audits or reviews in determining the scope of its auditing and other oversight activities. That

subparagraph requires the following data to be used in the selection process:

> A complete list of recent reviews and audits performed by CAO, the DCAA, and other government representatives that would affect the selection of areas to be reviewed in the current year. This listing should show outstanding weaknesses and deficiencies in the contractor's operations (CAO responsibility).

DFARS 42.7006(b), (c), and (d) set forth the procedures for planning contractor reviews, joint CAO-DCAA reviews, and reporting the results of reviews. With respect to planning, subparagraph (b) provides as follows:

> The primary purpose of the joint meeting described above is to develop a mutually acceptable annual plan for reviewing the contractor's operation. The plan should provide coverage for each significant operational area of the contractor over a period of two to three years and should be modified to reflect any changed conditions during subsequent meetings. The schedule and resource limitations of participating organizations will be considered in preparing the annual plan. The plan will identify the organizations having the primary responsibility for performing the reviews:
>
> (1) The CAO will review the technical aspects of contractor operations requiring minimal or no access to contractors' financial and accounting records and will sign reports on these reviews;
>
> (2) DCAA will review the financial and accounting aspects of contractor operations requiring minimal or no technical considerations and will sign reports on these reviews;
>
> (3) The CAO and DCAA will jointly perform reviews requiring significant CAO and DCAA expertise. Reports resulting from these reviews will be signed by the heads of the respective local organizations.
>
> Some operations reviews such as the purchasing (CAO) and estimating system reviews (DCAA) are assigned to the responsible reviewing organization. These assignments will continue to be recognized. All others will be performed according to the above criteria. The annual plan will be formally approved by heads of the local CAO and the DCAA resident offices.

DFARS 42.7006(c) discusses joint CAO-DCAA reviews and describes the objectives of such reviews as being:

> (i) To optimize the utilization of DCAA-CAO personnel in performing selected operations reviews; and
>
> (ii) To generate joint reports of the reviews that contain findings, conclusions, and recommendations mutually agreed upon by the DCAA auditor and the CAO to improve the effectiveness and economy of contractor operations.

Finally, subparagraph (d) discusses the disposition of reports that result from the above-described government reviews as follows:

> All reports prepared separately or jointly by DCAA or CAS personnel will be forwarded through the ACO to the contractor. While these review reports are advisory to the ACO, the ACO has responsibility to assure that (i) appropriate recognition is given to the results of such reviews in any contract negotiations and (ii) the contractor implements appropriate corrective actions. In event of any dispute with the contractor, the ACO has the ultimate responsibility and authority to effect final settlement [DAC 48-6, 6/15/84].

This last provision of DFARS Subpart 42.70 regarding the ACO's role in effecting final settlements relates to one of the principal concerns expressed by contractors — namely, the apparent erosion of the ACO's authority in

that respect. At the heart of this concern is DoD Directive 7640.2, which imposes certain requirements on contracting officers in connection with the resolution of DCAA audit recommendations. That Directive provides, in pertinent part, as follows:

> ***Resolution of Contract Audit Report Recommendations***
>
> a. From the time of audit report receipt to the time of final disposition of the audit report, there shall be continuous communication between the auditor and the contracting officer. When the contracting officer's proposed disposition of contract audit report recommendations differs from the contract auditor's report recommendations, and the criteria set forth below are met, the contracting officer's proposed disposition shall be brought promptly to the attention of a designated independent senior acquisition official or board (DISAO) for review. Each DoD acquisition component shall designate a DISAO at each appropriate organizational level who shall review the referred proposed disposition on the following:
>
> (1) All audit reports covering estimating system surveys, accounting system reviews, internal control reviews, defective pricing reviews, cost accounting standards noncompliance reviews, and operations audits.
>
> (2) Audit reports covering incurred costs, settlement of indirect cost rates, final pricings, terminations, equitable adjustment claims, hardship claims, and escalation claims if total costs questioned equal $50,000 or more and differences between the contracting officer and auditor total at least 5 percent of questioned costs.
>
> (3) Prenegotiation objectives for forward pricing actions when questioned costs total at least $500,000 and unresolved differences between the auditor and contracting officer total at least 5 percent of the total questioned costs.
>
> b. Existing acquisition review boards or panels, at appropriate organizational levels, may be designated to perform these functions provided they possess enough independence to conduct an impartial review. The DISAO will receive for review, along with other technical materials, the contract auditor's report. The DISAO shall give careful consideration to recommendations of the auditors, as well as the recommendations rendered by the other members of the contracting officer's team, in reviewing the position of the contracting officer. The DISAO shall provide the contracting officer, with a copy to the contract auditor, a clear, written recommendation concerning all matters subject to review.

Observations

The laws and regulations discussed above are duplicative and overlapping in some respects as they relate to the designated functions and responsibilities of the primary agencies and organizations involved in the oversight process. However, the significance of this must be evaluated from at least two perspectives.

First, the GAO and IG are principally overseers of the government's internal organization and operations. The GAO is an agent of Congress with a broad mandate to audit or investigate expenditures of the Executive Branch and its agencies, including the DoD. The DoD-IG is also empowered to audit or investigate programs and operations of the DoD. Both organizations may audit or review contractors' records. The significance of the GAO/IG relationship to the matters considered by this study relates not so much to their designated responsibilities as to how those responsibilities are discharged. For example, the contractors surveyed generally acknowledged the validity of the functions assigned to the GAO and IG by law; however, several of them expressed concern about unnecessary disruptions to their operations

when they perceived that the principal objective of a GAO or IG review was to evaluate the internal operating effectiveness and performance of DoD organizations such as the DCASPRO or DCAA. Further, the contractors felt that even when they were the focus of a GAO or IG review, those organizations should have coordinated these activities more closely with DCAA and the ACO to avoid duplication and inefficiencies in the process.

Second, although the responsibilities assigned to the contract administration function and DCAA as outlined in DoD Directives 5105.22 and 5105.36, respectively, appear to be duplicative or overlapping in certain respects (e.g., DCAA's responsibility to examine or review contractors' and subcontractors' "general business practices and procedures" and DCAS' responsibility for "review of contractor management systems"), the FAR prescribes policies and procedures that require communication and coordination between the DCAA and the ACO, or his or her designee, for the purpose of avoiding duplication and inefficiency that might occur. Thus, when considered together, the regulations governing the relationship between the contract audit and administration functions are not a primary cause of the overlap and duplication cited by the contractors we surveyed. Instead, the problem appears to be largely due to the government's failure to coordinate and conduct its audit and oversight activities in accordance with its own regulations.

RECOMMENDATIONS AND COMMENTS

It is clear from the contractors surveyed that they are greatly concerned about the escalating and intensifying level of government auditing and other oversight activities. They foresee the duplication and inefficiency as continuing or escalating unless some fundamental changes and improvements are made to the system. We agree. On the other hand, in evaluating the nature and extent of those changes, contractors need to assess their own practices to ensure that they are making every reasonable effort to facilitate the required improvements. For example, one government representative noted that contractors' concerns regarding duplicative and inefficient auditing and other oversight are often due to poor communication and misunderstandings within the contractors' own organizations. He noted that requests for documents and other information by individuals representing two or more agencies may be construed by contractors as being duplicative or otherwise inappropriate when, in reality, the questions and objectives of the individuals concerned are truly different. He noted that the entrance conferences should be utilized by contractors to clarify objectives and resolve potential problems, and that the matters covered in those conferences should be better communicated to the appropriate elements of the contractor's organization to minimize misunderstandings.

The problem is a difficult one to resolve and human nature will be a critical factor. Long-standing habits, rivalries, and feelings of mistrust between government personnel and between the government and contractors, will have to be overcome. Ultimately, any concrete improvement in the system will be a function of the individuals, both contractor and government personnel, who are involved in the procurement process. It is with this perspective that the potential benefits of our recommendations must be evaluated.

The following recommendations and comments are offered for the Commission's consideration.

1. The contracting officer's position as leader of the government's team in all dealings with the contractor should be reaffirmed. Strong leadership at the ACO and corporate administrative contracting officer (CACO) level is essential. Accordingly, the contracting

officer should be responsible for, among other things, the determination of final overhead rates for all contractors (responsibility for which was recently given to DCAA) and for coordination of all auditing and other oversight activities at contractor locations. This recommendation is easier to make in theory than it will be to implement in practice. However, our study clearly indicates that lack of coordination between responsible agencies and organizations is one of the principal causes of duplicative and inefficient auditing and other oversight by the government. Further study is required to determine how best to implement this recommendation and the following should be among the points considered:

- The IG and the military investigative services have certain oversight responsibilities that clearly require their independence from the contracting officer. While this independence should not be compromised, these organizations should be required to coordinate their activities with respect to individual contractors to the maximum extent possible. Consideration should therefore be given to establishing a formal mechanism within DoD for facilitating this coordination.

- DCAA's role in relation to the contracting officer should be more clearly defined. Irrespective of existing regulations that provide for DCAA to serve the contracting officer in an advisory capacity, our study indicates that DCAA has, in practice, assumed a role that has contributed to a diminution of the contracting officer's authority and his or her willingness to make independent decisions in some matters.

  In this connection, the appropriateness of DoD Directive 7640.2 should be reevaluated. While contracting officers must be held accountable for their actions, their primary concern should be to ensure that the government's procurement objective is achieved on time and at a fair and reasonable price. This requires the contracting officer to evaluate data obtained from a number of sources, not just DCAA. By requiring the contracting officer to justify proposed deviations from DCAA's recommendations, Directive 7640.2 has clearly increased the influence of DCAA in relation to the other members of the procurement team and appears to have placed contracting officers on the defensive. This defensive posture is inconsistent and irreconcilable with the contracting officer's position as leader of the government's team.

- Although we believe that the principal laws and regulations mandating the activities of the major oversight organizations are not a primary cause of duplication and inefficiency, they may be a contributing factor. For example, DCAA's charter to review a contractor's "general business practices and procedures" as provided for in DoD Directive 5105.36 creates ample opportunity for DCAA's activities to overlap those of DCAS or one of the other oversight agencies. On the other hand, DCAS' responsibility for determining "allowability of costs" appears to overlap DCAA's assigned responsibilities. DoD should consider clarifying the responsibilities of DCAA and the various contract administration organizations, particularly with respect to matters such as operational auditing and compensation and insurance reviews which were frequently noted areas of concern to contractors. In this regard, FAR 42.302 specifically cites reviews of contractors' compensation structures and insurance plans as contract administration functions; however, DCAA perceives the need to delve into these areas to determine the reasonableness of compensation and insurance costs. This apparent conflict

needs to be resolved. One solution may be to assign sole responsibility for all matters related to compensation and insurance, including reasonableness of the related costs, to a single DoD organization.

- Closely related to and perhaps inseparable from the need to clarify individual agency auditing and oversight responsibilities is the need to evaluate the day-to-day working relationships between auditing and other oversight organizations with particular emphasis on (1) the degree of reliance each places, or should place, on the work of the others; and (2) the extent to which the agencies share information. Several contractors cited the need for greater cooperation between government agencies in these respects as being essential to reducing duplication and inefficiency in the oversight process. This is a troublesome area to evaluate because it is difficult for contractors to truly know how much "behind the scenes" communication and reliance occurs between agencies.

  With respect to the sharing of information between agencies, the problem appears to be at least twofold. First, in some instances there is simply a blatant refusal by one group to share data with another. For example, one contractor stated that DCAS is not willing to share its compensation data base with other agencies. This example is probably indicative of the ongoing "turf battle" between DCAA and DCAS as described above with respect to which agency is responsible for compensation reviews.

  Second, the problem may, as was suggested by one contractor, simply be due to a poor or inefficient government system of filing and controlling data provided by the contractor, which results in government personnel finding it more convenient to require the contractor to produce the same data two, three, or more times (generally at different dates), than to rummage through masses of poorly or inappropriately organized data already in its possession. Whatever the reason, the problem could be at least partially alleviated by requiring the establishment of a formal data base of contractor information under the control of either the local ACO or the CACO who, in connection with his or her responsibilities for coordinating all auditing and other oversight activities with respect to the contractor, would control the maintenance and distribution of all contractor-related information and its distribution to the respective audit or other oversight agencies. The mechanics of this proposed process require further study.

2. Based on the results of this study, it appears that the requirements of DFARS Subparts 15.8 and 42.70 with respect to the conduct and coordination of DoD activities related to field pricing support and monitoring contractors' costs are not being followed, or at least they are not operating effectively. These requirements do, however, address many of the concerns expressed by the contractors surveyed. For example, they require DoD to give appropriate consideration to (a) the contractor's past performance; (b) effectiveness of the contractor's existing system of internal administrative and accounting controls; and (c) cost/benefit analyses in determining the nature, timing, and extent of audit or other review activities. DoD should assess the adequacy of its compliance with the provisions of DFARS Subparts 15.8 and 42.70 and take corrective action as necessary.

The policies, procedures, and practices of all auditing and other oversight agencies with respect to planning, organizing, and controlling their activities should be reevaluated. This reevaluation must give due consideration to the individual goals and charters of each of the agencies as well as the usefulness of their prescribed auditing and other oversight

procedures. For example, the IG and GAO have different missions than do DCAA and DCAS. The principal purpose of this reevaluation would be to identify ways of improving the effectiveness of these organizations in achieving their objectives while minimizing the cost to the government and disruption to the contractor's operations. The latter problem, while of obvious concern to contractors, represents a substantial hidden cost to the government inasmuch as contractors have reportedly increased their staffs and incurred substantial amounts of other expenses in response to intensified oversight activities. These higher costs, in part, have been or will be passed on to the government through higher contract prices. Further, duplicative and inefficient auditing and other oversight activity adds little, if anything, to the quality of the products being procured by the government, and may actually divert contractor attention from such critical matters.

3. DoD should reevaluate the negotiation process to identify ways of reducing the elapsed time between submission of contractors' proposal and final agreement on contract price. Delays in this process contribute to duplicative and inefficient auditing and other oversight because contractors are required to update their proposals on multiple occasions and each update starts a new audit cycle in which the unchanged as well as the changed data are audited. The following are some suggestions to expedite contract negotiations.

- The government should better define contract requirements before issuing a request for proposal. This is particularly true with respect to quantities which, if not well defined, may change several times and necessitate multiple subcontractor quotes which have to be obtained by the contractor and then audited or reviewed by the government.

- Government audits and reviews of updated proposals should be limited solely to the revised data submitted by contractors. Reauditing of unchanged data is duplicative, inefficient, and generally unnecessary.

  Responsibility for the price analysis of a contractor's proposal should be centralized in one organization or agency. The individual(s) performing the analysis should be part of the government negotiation team so that their insight can be brought directly to bear during the negotiation process.

- The government's audits and reviews of both initial and updated proposals should be properly planned and coordinated to avoid duplication of effort between agencies. Greater reliance should be placed by the government on contractors' internal control systems where past history and other factors indicate such reliance is warranted.

4. DoD should reevaluate policies and practices with respect to post-award audits to ensure that (a) duplication between agencies and organizations in the performance of these audits is eliminated or minimized; (b) appropriate consideration is given to cost-benefit analyses in determining the nature, timing, and extent of such reviews; (c) appropriate consideration is given to the contractor's past performance and results of prior and ongoing audits and reviews; and (d) post-award reviews are completed on a timely basis.

We believe that duplication and inefficiency in the conduct of post-award reviews could be reduced if the government performed them within perhaps one year after contract award. Almost all information required for the government to complete a post-award audit is available at the time of contract award. Consequently, it is less disruptive to the contractor for the government to perform post-award audits shortly after contract award, rather

than wait until several years "down the road" when relevant data are less likely to be as readily available. Further, the sooner post-award audits are performed, the less likely it is that changes in the contractor's accounting system that might complicate the audit process will have occurred. Also details of the negotiation process will be fresh in the minds of government and contractor personnel who participated in the process, and those individuals are more likely to be available during the postaward audit to resolve questions as they arise. The result would be a cost savings for both the contractor and government.

5. The general relationship between contractors and the government's representatives needs to be improved for the benefit of the procurement process. Several contractors expressed concern over the seemingly adversarial posture DCAA takes toward contractors and fear that the adversarial relationship will increase as DCAA is granted new rights and powers, (e.g., subpoena power and sole responsibility for determination of final indirect cost rates). While there may be some merit in these concerns, it must be recognized that given the nature of its role (i.e., auditor, watchdog, etc.) DCAA's perspective will always be perceived as adversarial to some degree.

While this situation will be difficult to resolve, the following general recommendations may prove helpful:

- Individual contractor and government personnel should strive for a relationship characterized by a "healthy skepticism" rather than animosity and antagonism.

- Every effort should be made by both contractors and the government to improve their communication and reduce the level of "gamesmanship" in their dealings with each other.

- The government must be careful not to foster the perspective among contractors that it believes every contractor intentionally engages in cost mischarging, defective pricing, and other such practices.

- The government needs to closely monitor the scope of its audits and other oversight activities to ensure that the work is properly planned, its personnel are technically competent for their assigned tasks, and duplication and inefficiency is minimized.

6. There should be a moratorium on the issuance of new procurement laws and regulations affecting defense contractors for a period of perhaps two years, until the prudence and effectiveness of present and proposed rules and regulations can be fully evaluated. Contractors are overburdened by a maze of regulations that are costly to comply with and that add little or no value to the products they produce for the government. Further, contractors generally feel that the government is engaging in "micromanagement" of their operations and that the resulting overemphasis on compliance with detailed rules and regulations has contributed to duplication and inefficiency and detracted from the achievement of what should be the government's principal objective—namely, the procurement of the highest quality products at fair and reasonable prices.

7. The basic framework of the entire auditing and oversight process should be reevaluated with a view toward establishing a system by which contractors are classified according to specified and measurable criteria for the purpose of determining the extent to which they will be subject to government oversight. Under this system, the government would adjust the scope of its oversight activities for individual contractors to respond to the level of risk identified. While conceptually this recommendation is reminiscent of the now defunct Contractor Weighted Average Share in Cost Risk (CWAS) concept, we are not

suggesting that the proposed system be an exact replica of that concept. Instead, we recommend that DoD, or preferably a joint task force comprised of DoD and industry personnel, take a "fresh look" at possible methods of categorizing or "qualifying" contractors on the basis of a variety of factors including, but not necessarily limited to, past performance, quality of systems and internal controls, as well as types of contracts, volume of commercial business, etc.

We recognize this recommendation will be difficult to implement. Major challenges to implementation will relate to the definition, application, and monitoring of compliance with the qualification criteria. The initial classification of contractors will be particularly difficult. Moreover, many of the matters discussed elsewhere in this report will impact the feasibility of the recommendation. However, given the extensive overlap, duplication, and inefficiency present in the auditing and oversight process today, this fundamental change is worthy of consideration.

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