

July 2008

# DCAA AUDITS

## Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated





Highlights of [GAO-08-857](#), a report to congressional addressees

### Why GAO Did This Study

The Defense Contract Audit Agency (DCAA) under the Department of Defense (DOD) Comptroller plays a critical role in contractor oversight by providing auditing, accounting, and financial advisory services in connection with DOD and other federal agency contracts and subcontracts. DCAA has elected to follow generally accepted government auditing standards (GAGAS). These standards provide guidelines to help government auditors maintain competence, integrity, objectivity, and independence in their work.

GAO investigated hotline complaints it received related to alleged failures to comply with GAGAS on 14 DCAA audits. Specifically, it was alleged that (1) working papers did not support reported opinions, (2) supervisors dropped findings and changed audit opinions without adequate evidence, and (3) sufficient work was not performed to support audit conclusions and opinions. GAO also investigated issues related to the quality of certain forward pricing reports.

GAO investigators interviewed over 50 individuals, reviewed the working papers and related documents for 14 audits issued from 2003 through 2007 by two DCAA field offices, and reviewed documentation on audit issues at a third DCAA office. GAO did not reperform the audits to validate the completeness and accuracy of DCAA's findings. DCAA did not agree with the "totality" of GAO's findings, but it did acknowledge shortcomings with some audits and agreed to take corrective action.

To view the full product, including the scope and methodology, click on [GAO-08-857](#). For more information, contact Gregory D. Kutz at (202) 512-6722 or [kutzg@gao.gov](mailto:kutzg@gao.gov).

## DCAA AUDITS

### Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated

#### What GAO Found

GAO substantiated the allegations. Although DCAA policy states that its audits are performed according to GAGAS, GAO found numerous examples where DCAA failed to comply with GAGAS. For example, contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions, and opinions of three audits—a serious independence issue. At two DCAA locations, GAO found evidence that (1) working papers did not support reported opinions, (2) DCAA supervisors dropped findings and changed audit opinions without adequate evidence for their changes, and (3) sufficient audit work was not performed to support audit opinions and conclusions. GAO also substantiated allegations of inadequate supervision of certain audits at a third DCAA location. The table below contains selected details about three cases GAO investigated.

**Selected Details of Audits GAO Investigated**

DOD contractor	Audit type	Significant case study issues
Major aerospace company (DCAA location 1)	Estimating system	<ul style="list-style-type: none"> <li>DCAA made an up-front agreement with the contractor to limit the scope of work and basis for audit opinion.</li> <li>Contractor was unable to develop compliant estimates, leading to a draft opinion of "inadequate in part."</li> <li>Contractor objected to draft findings, and DCAA management assigned a new supervisory auditor.</li> <li>Management threatened the senior auditor with personnel action if he did not delete findings from the report and change the draft audit opinion to "adequate."</li> </ul>
Company produces and supports military and satellite systems (DCAA location 2)	Billing system	<ul style="list-style-type: none"> <li>Draft audit report identified six significant deficiencies, one of which led the contractor to overbill the government by \$246,000 and another which may have led to \$3.5 million in overbillings.</li> <li>First supervisory auditor and auditor were replaced by other auditors who dropped the findings and changed the draft audit opinion from "inadequate," to "adequate."</li> <li>Sufficient testing was not performed to support an opinion that controls were adequate.</li> <li>DOD Inspector General recommended that DCAA rescind the final audit report. Over a year later, at the end of GAO's investigation, DCAA rescinded the final report.</li> </ul>
Major weapons system contractor (DCAA location 3)	Forward pricing	<ul style="list-style-type: none"> <li>Two supervisors responsible for 62 forward pricing audits of over \$6.4 billion in government contract negotiations did not review working papers before report issuance.</li> <li>Inexperienced trainee auditors were assigned to 18 of the 62 audits without proper supervision.</li> <li>An internal DCAA audit quality review found 28 systemic deficiencies in 9 of 11 selected forward pricing audits.</li> <li>The DCAA field office lost control of final working papers because trainee auditors did not always properly enter them in the electronic workpaper system.</li> </ul>

Source: GAO.

Throughout GAO's investigation, auditors at each of the three DCAA locations told us that the limited number of hours approved for their audits directly affected the sufficiency of audit testing. Moreover, during GAO's investigation, DCAA managers took actions against staff at two locations, attempting to intimidate auditors, prevent them from speaking with investigators, and creating a generally abusive work environment.

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## Abbreviations

ASBCA	Armed Services Board of Contract Appeals
BOE	basis of estimates
CAM	Contract Audit Manual
CAP	corrective action plan
CAS	Cost Accounting Standards
DCAA	Defense Contract Audit Agency
DCIS	Defense Criminal Investigative Service
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DOD	Department of Defense
DOD IG	DOD Office of Inspector General
ELC	expendable launch capacity
ELS	expendable launch services
FAO	field audit office
FAR	Federal Acquisition Regulation
FOB	free-on-board
G&A	general and administrative
GAGAS	generally accepted government auditing standards
GPS	global positioning system
IPT	integrated product team
RAM	regional audit manager
SMC	Space and Missile Systems Center

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United States Government Accountability Office  
Washington, DC 20548

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July 22, 2008

The Honorable Joseph I. Lieberman  
Chairman  
The Honorable Susan M. Collins  
Ranking Member  
Committee on Homeland Security  
and Governmental Affairs  
United States Senate

The Honorable Henry A. Waxman  
Chairman  
Committee on Oversight and Government Reform  
House of Representatives

Department of Defense (DOD) contract management has been included on our high-risk list since 1992, meaning that the government continues to be vulnerable to fraud, waste, abuse, and mismanagement in this area. In our most recent *High-Risk Series: An Update*,<sup>1</sup> we reported that DOD is not able to assure that it is using sound business practices to acquire the goods and services required to meet the needs of U.S. warfighters. Additionally, we reported that DOD has not always made sound use of various techniques to acquire goods and services, nor has it had a comprehensive plan to ensure that its workforce has the right skills and capabilities. Downsizing of contract oversight staff in the 1990s coupled with hundreds of billions of dollars in increased contract spending since 2000 has exacerbated the risks associated with DOD contract management.

The Defense Contract Audit Agency (DCAA), a defense agency supervised by the Office of the Under Secretary of Defense (Comptroller), plays a critical role in DOD contractor oversight by providing auditing, accounting, and financial advisory services in connection with the negotiation, administration, and settlement of contracts and subcontracts. DCAA also performs audit services for other federal agencies, as requested, on a fee-for-service basis. Although DCAA provides a range of services to contracting officers and other DOD officials, DCAA's primary

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<sup>1</sup>GAO, *High-Risk Series: An Update*, [GAO-07-310](#) (Washington, D.C.: January 2007).

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function is contract audit services. The *DCAA Contract Audit Manual* (CAM)<sup>2</sup> prescribes the standards, policies, and techniques to be followed by DCAA personnel in carrying out contract audits. DCAA contract audits are intended to be a key control to help assure that prices paid by the government for needed goods and services are fair and reasonable and that contractors are charging the government in accordance with applicable laws, regulations (e.g., Federal Acquisition Regulation (FAR) and Defense Federal Acquisition Regulation Supplement (DFARS), standards (e.g., Cost Accounting Standards (CAS)), and contract terms. DCAA also audits contractor-proposed estimates used to support contract negotiations and costs charged to the government. To determine the amount of testing on these proposal and cost-related audits, DCAA audits contractor controls in accounting, billing, estimating, and other key systems, and issues opinions on the adequacy of those control systems. For example, DCAA auditors may audit a contractor billing system to determine whether the contractor has adequate internal controls in place to assure that the government is being charged appropriately for the goods and services received. The results of billing system audits support decisions to approve contractors for direct-billing privileges, whereby the government pays contractors without prior review of invoices.

In performing its audits, DCAA states that it follows generally accepted government auditing standards (GAGAS).<sup>3</sup> These standards provide guidelines to help government auditors maintain competence, integrity, objectivity, and independence in their work and require that they obtain sufficient evidence to support audit conclusions and opinions. GAGAS apply to financial and performance audits and attestation engagements. Although DCAA refers to the assignments covered by our investigation as audits, most of them were performed as examination-level attestation engagements.<sup>4</sup> GAGAS covering examination-level engagements require that auditors perform sufficient testing to express an opinion on whether the subject matter, such as internal control, conforms with applicable

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<sup>2</sup>*DCAA Contract Audit Manual* (CAM), DCAAM 7640.1.

<sup>3</sup>GAO, *Government Auditing Standards: 2003 Revision*, [GAO-03-673G](#) (Washington, D.C.: June 2003). This was the version of GAGAS in effect at the time of all the DCAA audits that GAO investigated, except for the audit discussed in case 1. The version of GAGAS applicable to case 1 was the August 1999 revision.

<sup>4</sup>Certain assignments covered in case 8 were performed as agreed-upon procedures assignments. No opinion is issued on these types of assignments.

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criteria in all material respects.<sup>5</sup> GAGAS also require that an experienced auditor who is unfamiliar with the audit should be able to review the evidence in the audit documentation and come to the same conclusion as the original auditor.<sup>6</sup> According to GAGAS, supervisors should review and approve audit documentation before audit reports are issued.<sup>7</sup>

We investigated FraudNet hotline complaints and additional allegations and auditor concerns we received during our investigation related to alleged failures to comply with GAGAS on 14 DCAA audits at two DCAA locations in California. Specifically, DCAA auditors alleged that (1) the working papers did not support the reported opinions; (2) on certain audits, their supervisors personally changed (or directed others to change) draft audit conclusions without adequate audit evidence to support the changes; and (3) work performed on other audits was not sufficient to support the final audit opinions. Auditors noted that as a result of these practices, DCAA supervisors were issuing reports in which the audit documentation was not sufficient or it contradicted the final opinions or conclusions of the reports. During our investigation, we received additional allegations that raised concerns regarding the quality of forward pricing audit reports issued by a third DCAA field office in California. We investigated the allegations and concerns we received as 13 separate cases<sup>8</sup> to determine whether they could be substantiated.

In our case investigations, we conducted over 100 interviews of over 50 individuals and reviewed applicable CAM and relevant FAR, DFARS, and CAS requirements. We also obtained and reviewed the working papers related to the audits. We interviewed current and former DCAA auditors, supervisors, and managers who worked on the audits and interviewed DOD and other federal agency contracting officers. In assessing DCAA audits, we used GAGAS as our criteria. We learned that the DOD Office of Inspector General (DOD IG) was investigating the 10 audits noted in the original allegations we received. We therefore coordinated our work closely with DOD IG auditors and Defense Criminal Investigative Service (DCIS) investigators.<sup>9</sup> DOD IG's Office of Audit Policy and Oversight,

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<sup>5</sup>GAO-03-673G, § 6.02a.

<sup>6</sup>GAO-03-673G, § 6.22.

<sup>7</sup>GAO-03-673G, § 6.24e.

<sup>8</sup>We handled our investigation of 3 related audits of one contractor as one case.

<sup>9</sup>DCIS is a component of the DOD IG.

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which has oversight responsibility for DCAA, issued a memorandum to DCIS on its findings on January 24, 2007. We reviewed this memorandum and DCAA's response.

DCAA audit reports covered by our investigation were issued from 2003 through 2007. We did not reperform the audits to independently validate the completeness or accuracy of the findings contained in DCAA working papers. Where it was relevant to our investigation, we relied on the electronic date and name stamps on audit files to indicate when files were accessed and who accessed them. During our investigation, we noted a pattern of frequent management actions that served to intimidate the auditors and create an abusive environment at locations 1 and 2. As a result, some auditors were hesitant to speak to us. We performed our investigation from June 2006 through July 2008 in compliance with the standards for investigations prescribed by the President's Council for Integrity and Efficiency.

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## Summary of Investigation

We substantiated the allegations and auditor concerns made on each of the 13 cases we investigated, involving 14 audits and forward pricing audit issues related to seven contractors. In the 12 cases at locations 1 and 2, we substantiated the allegations and auditor concerns that (1) workpapers did not support reported opinions, (2) DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes, and (3) sufficient audit work was not performed to support audit opinions and conclusions. In addition, we also found that contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions, and opinions of some audits—a serious independence issue. We also substantiated allegations of problems with the audit environment and inadequate supervision of certain forward pricing audits at location 3. Moreover, during our investigation, DCAA managers took actions against their staff at two locations, attempting to intimidate auditors, discouraging them from speaking with our investigators, and creating a generally abusive work environment. DCAA states that its audits are performed according to GAGAS. However, in substantiating the allegations, we found numerous failures to comply with GAGAS. The working papers did not adequately support the final conclusion and opinion for any of the 14 audits we investigated. In many cases, supervisors changed audit opinions to indicate contractor controls or compliance with CAS was adequate when workpaper evidence indicated that significant deficiencies existed. We also found that in some cases, DCAA auditors did not perform sufficient work to support draft audit conclusions and their supervisors did not instruct or allow them to



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perform additional work before issuing final reports that concluded contractor controls or compliance with CAS were adequate. Two supervisors were responsible for the 12 audits we investigated at location 2, and 11 of these audits involved insufficient work to support the reported opinions. The following examples illustrate problems we found with audits at two DCAA locations:

- In conducting a 2002 audit related to a contractor estimating system, DCAA auditors reviewed draft basis of estimates (BOE) prepared by the contractor and advised the contractor on how to correct significant deficiencies. BOEs are the means for providing government contract officials with information critical to making contract pricing decisions. This process resulted from an up-front agreement between the DCAA Resident Auditor and the contractor—one of the top five government contractors based on contract dollar value—that limited the scope of work and established the basis for the audit opinion. According to the agreement, the contractor knew which BOEs would be selected for audit and the audit opinion would be based on the final, corrected BOEs after several DCAA reviews. Even with this BOE review effort, the auditors found that the contractor still could not produce compliant BOEs and labeled the estimating system “inadequate in part.” We found that enough evidence had been collected by the original supervisory auditor and senior auditor to support this opinion. However, after the contractor objected to draft findings and conclusions presented at the audit exit conference, the DCAA Resident Auditor replaced the original supervisory auditor assigned to this audit and threatened the senior auditor with personnel action if he did not change the summary workpaper and draft audit opinion. The second supervisory auditor issued the final report with an “adequate” opinion without documenting adequate support for the changes. This audit did not meet GAGAS for auditor objectivity and independence because of the up-front agreement, and it did not meet standards related to adequate support for audit opinions.
- The draft report for a 2005 billing system audit identified six significant deficiencies, one of which allowed the contractor to overbill the government by \$246,000 and another that may have led to \$3.5 million in overbillings. DCAA managers replaced the supervisory auditor and auditor, and the new staff worked together to modify working papers and change the draft audit opinion from “inadequate,” to “inadequate in part,” and, finally, to “adequate.” Sufficient testing was not documented to support this opinion. DOD IG concluded that DCAA should rescind the final report for this audit, but DCAA did not do so. As noted previously, billing system audits are conducted to assess contractor

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controls for assuring that charges to the government are appropriate and compliant and to support decisions on whether to approve contractors for direct billing. As a result of the 2005 audit, DCAA authorized this contractor for direct billing of its invoices without prior government review thereby providing quicker payments and improved cash flow to the contractor. On June 20, 2008, when we briefed DOD on the results of our investigation, DCAA advised us that a DCAA Western Region review of this audit in 2008 concluded that the \$3.5 million finding was based on a flawed audit procedure. As a result, it rescinded the audit report on May 22, 2008. However, DCAA officials said that they did not remove the contractor's direct-billing privileges because other audits did not identify billing problems.

- The draft report for a 2005 CAS 403<sup>10</sup> compliance audit requested by a Department of Energy administrative contracting officer (ACO) identified four deficiencies related to corporate cost allocations to government business segments. However, a DCAA supervisory auditor directed a member of her staff to write a “clean opinion” report in 1 day using “boilerplate” language and without reviewing the existing set of working papers developed by the original auditor. The supervisory auditor appropriately dropped two significant deficiencies from the draft report, but did not adequately document the changes in the workpapers. In addition, the supervisory auditor improperly referred two other significant deficiencies to another DCAA office that does not have audit jurisdiction, and therefore did not audit the contractor's corporate costs or CAS 403 compliance. The final opinion was later contradicted by a September 21, 2007, DCAA report that determined that this contractor was in fact not in compliance with CAS 403 during the period of this audit.

We also substantiated allegations that there were problems with the audit environment at a third DCAA location—a resident office responsible for audits of another of the five largest government contractors. For example, the two supervisors, who approved and signed 62 of the 113 audit reports performed at the Resident Office location,<sup>11</sup> said that trainees were

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<sup>10</sup>CAS 403 establishes criteria for allocation of the expenses of a home office to the segments of the organization.

<sup>11</sup>The two supervisors were responsible for all forward pricing audits at the Resident Office location. The remaining 51 of the 113 audits were performed by separate suboffice locations of the Resident Office and were signed by the supervisory auditors at those locations.

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assigned to complex forward pricing audits as their first assignments even though they had no institutional knowledge about the type of materials at risk of overcharges, how to look at related sources of information for cost comparisons, or how to complete the analysis of complex cost data required by FAR. The supervisors, who did not always have the benefit of experienced auditors to assist them in supervising the trainees, admitted that they generally did not review workpapers in final form until after reports were issued. Moreover, because the trainee auditors did not have an adequate understanding of DCAA's electronic workpaper filing system, they did not always enter completed workpapers in the system, resulting in a loss of control over official workpapers. In addition, one of the two supervisory auditors told us that contracting officers would sometimes tell auditors to issue proposal audit reports in as few as 20 days with whatever information the auditor had at that time and not to cite a scope limitation in the audit reports so that they could begin contract negotiations. If the available information was insufficient, GAGAS<sup>12</sup> would have required the auditors to report a scope limitation. Where scope limitations existed, but were not reported, the contracting officers could have negotiated contracts with insufficient information. Moreover, a 2006 DCAA Region quality review reported 28 systemic deficiencies on 9 of 11 forward pricing audits reviewed, including a lack of supervisory review of the audits. The problems at this location call into question the reliability of the 62 forward pricing audit reports issued by the two supervisors responsible for forward pricing audits at the Resident Office location from fiscal years 2004 through 2006, connected with over \$6.4 billion in government contract negotiations.

Throughout our investigation, auditors at each of the three DCAA locations told us that the limited number of hours approved for their audits and the number of audits required to be completed directly affected the sufficiency of audit testing. Noncompliance with GAGAS in the cases we investigated has had an unknown financial effect on the government. However, substandard audits do not provide assurance that billions of dollars in annual payments made to these contractors complied with FAR, CAS, or contract terms.

During the DOD IG and GAO investigations, we identified a pattern of frequent management actions that served to intimidate the auditors and create an abusive environment at two of the three locations covered in our

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<sup>12</sup>[GAO-03-673G](#), § 6.27c.

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investigation. In this environment, some auditors were hesitant to speak to us even on a confidential basis. For example, supervisory auditors and the branch manager at one DCAA location we visited pressured auditors, including trainees who were in probationary status, to disclose to them what they told our investigators. Some probationary trainees told us this questioning made them feel pressured or uncomfortable. Further, we learned of verbal admonishments, reassignments, and threats of disciplinary action against auditors who raised questions about management guidance to omit their audit findings and change draft opinions or who spoke with or contacted our investigators, DOD investigators, or DOD contracting officials. We briefed cognizant DCAA Region and headquarters officials on the results of our investigation in February 2008 and reviewed additional documentation they provided. We briefed DOD officials on the results of our investigation on June 20 and 25, 2008.

On July 3, 2008, DCAA provided a written response to our corrective action briefing that stated that the 13 cases related to the three field audit offices (FAO) whose audits we investigated represent a very small portion of the audit work performed by these FAOs. DCAA stated that the three FAOs are currently operating at a satisfactory level of compliance with GAGAS. DCAA's response also stated that it did not agree with the "totality" of our overall conclusions. However, DCAA acknowledged that shortcomings existed in the working paper evidence and documentation to support the final audit conclusions in several of the assignments we investigated. DCAA's response noted that the rationale for dropping many of the significant deficiencies from audit reports was not adequately supported or documented and stated that DCAA has no evidence that the supervisors "willfully" removed findings from the audit reports. DCAA also acknowledged that in some cases, additional work should have been performed to support the final audit opinion. Finally, DCAA's response stated that DCAA found no evidence to support our conclusions that DCAA managers took actions against their staff at two locations, attempting to intimidate auditors, preventing them from speaking with investigators, and creating a generally abusive work environment because we had not provided them specific evidence. DCAA stated that we did not advise them of this problem during our investigation. We advised DCAA headquarters of our conclusions on management issues in February 2008. However, because of the fear of retaliation expressed by several individuals during our confidential interviews, we did not provide DCAA the names of individuals or specific incidents. DCAA indicated that it has begun actions to assess the existence of management abuse. We maintain our position on the results of our investigation of the 13 cases as well as

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the DCAA management issues at locations 1 and 2. A more detailed discussion of DCAA's response is presented in the Corrective Action Briefing section of this report. We also reflected DCAA actions, as appropriate, in the individual case summary discussions. DCAA's written response is reprinted in appendix I.

We plan to issue a separate report at the request of the Senate Committee on Homeland Security and Governmental Affairs concerning our broader audit of DCAA's overall organizational environment and quality control system and our review of selected audits performed by selected offices within DCAA's five regions. Our report will include recommendations for strengthening the overall contract audit environment and ensuring compliance with GAGAS.

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## Background

DCAA, reporting to the Office of the Under Secretary of Defense (Comptroller), consists of a headquarters office at Fort Belvoir, Virginia, and six major organizational components—a field detachment office, which handles audits of classified contracting activity, and five regional offices within the United States. The regional offices manage FAOs, which are identified as branch offices, resident offices, or suboffices. Resident offices are located at larger contractor facilities in order to facilitate DCAA audit work. In addition, regional office directors can establish suboffices as extensions of FAOs to provide contract audit services more economically. A suboffice depends on its parent FAO for release of audit reports and other administrative support. In total, there are more than 300 FAOs and suboffices throughout the United States and overseas.

DCAA plays a critical role in DOD contractor oversight by providing auditing, accounting, and financial advisory services in connection with the negotiation (i.e., procurement), administration, and settlement of contracts and subcontracts. DCAA also performs audit services for other federal agencies, as requested, on a fee-for-service basis. Although DCAA provides a range of services to contracting officers and other DOD officials, DCAA's primary function is contract audit services. Figure 1 provides a summary of audit activities by contract phase and event and notes the types of audit activities covered in our investigation.

**Figure 1: Relationship between Contract Phases, Contract Events, and DCAA Audit Activities**

Contract phases	Contract events	Audit activities ( 🔍 indicates audits covered by GAO's investigation)
<b>Negotiation phase</b>	Proposal Contract negotiations Contract award	<ul style="list-style-type: none"> <li>🔍 Full proposal</li> <li>🔍 Rate review</li> <li>Financial capability</li> <li>Pre-award accounting survey</li> <li>Initial disclosure statement review</li> <li>🔍 Other</li> </ul>
<b>Administrative phase</b>	Contract performance	<ul style="list-style-type: none"> <li>Provisional billing rates</li> <li>Progress payments (fixed price and fixed price incentive fee contracts only)</li> <li>Earned value management system (if required)</li> <li>Other requested special audits</li> <li>Annual incurred cost reviews (flexibly priced contracts only)</li> <li>🔍 Audits of contractor internal control systems</li> <li>🔍 Cost accounting standard (CAS) compliance</li> <li>Paid voucher reviews</li> <li>Overpayment review</li> </ul>
<b>Close out/termination phase</b>	Contract physically complete Contract closed	<ul style="list-style-type: none"> <li>Final price submissions (fixed price incentive fee contracts)</li> <li>Contract audit closing statement (cost type and time and materials contracts)</li> <li>Termination</li> </ul>

Source: GAO analysis of DCAA information.

According to DCAA data, in 1989, DCAA had almost 6,000 auditors on its staff. During fiscal year 2007, as a result of gradual downsizing, DCAA had about 3,500 auditors. According to the DCAA Director, DCAA's 3,500 auditors annually perform about 40,000 audits of approximately 10,000 contractors. In terms of organizational structure, teams of DCAA auditors typically report to supervisory auditors. Among many other duties, supervisory auditors are in charge of staffing audits and helping auditors manage the scope of their audits in compliance with DCAA policies and procedures. DCAA supervisory auditors review and approve audit plans and risk assessments, allocate audit hours at the beginning of an audit, and perform supervisory review and approval of summary workpapers and underlying workpapers, as appropriate, at the end of an audit. Supervisory auditors report to branch managers or resident auditors, who oversee the operations of their offices and manage the progress of all audits assigned to them. Branch managers and resident auditors also work with regional management staff, such as quality assurance managers, regional audit managers who oversee the work of multiple DCAA offices, and region directors.

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In accordance with GAGAS, the results of DCAA audits are issued in report form. For example, DCAA audits internal controls in key contractor accounting and management systems that have a significant effect on government contract costs. DCAA reports on those audits describe whether any significant deficiencies<sup>13</sup> were found in contractor internal controls and, if necessary, include recommendations to correct the deficiencies. DCAA may issue one of three opinions on a contractor's internal control system: "adequate," when no internal control deficiencies are found; "inadequate," when internal control deficiencies are so significant that the entire system is unreliable; or "inadequate in part," when deficiencies are found that affect parts of the system. There are no materiality criteria for determining whether significant deficiencies would result in a system being labeled inadequate in part versus inadequate. However, DCAA's CAM<sup>14</sup> states that "A deficiency is significant when the auditor believes that additional audit procedures are needed in related audits to protect the Government's interest because the contractor's internal controls are unlikely to accomplish specific control objectives." Contractors are required to take action to correct significant deficiencies. DCAA reports may also include suggestions for improvement where identified weaknesses are not considered significant deficiencies but still merit action by the contractor. Contractors are encouraged, though not required, to address suggestions for improvement, and suggestions for improvement do not affect the audit opinion. According to the policy in effect at the time DCAA issued its reports on all but one of the audits we investigated, if an audit report expressed an "adequate" opinion, supervisory auditors could issue the report under their own signature, if the branch manager or resident auditor delegated this authority to them. However, if an audit report expressed any opinion other than "adequate," a DCAA branch manager or resident auditor was required to sign the report.<sup>15</sup> In instances where the auditor determines that a contractor has an "inadequate in part" or "inadequate" internal control system, DCAA is required to perform a follow-up audit within 6 months to determine whether the contractor has fully implemented corrective actions.

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<sup>13</sup>DCAA auditors and workpaper documentation use the terms deficiency and significant deficiency interchangeably. For consistency, we use the term significant deficiency throughout this report.

<sup>14</sup>CAM 5-109d.

<sup>15</sup>DCAA Regulation 5600.1. On December 3, 2007, the DCAA Western Region changed its policy to require branch manager or resident auditor signature on all internal control audit reports. DCAA adopted this policy change agencywide on February 13, 2008.

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DCAA audit opinions provide support for granting contractors authorization to directly bill a federal agency and receive payment without prior review of invoices by the government. DCAA is the agent of the contracting officer for purposes of granting contractors direct-bill authorization.<sup>16</sup> If DCAA determines, based on its audit work, that a contractor should not be granted direct-bill authority, DCAA must review the contractor's invoices prior to payment.<sup>17</sup> DCAA's CAM states that to the extent appropriate, voucher (invoice) reviews based on judgmental sampling will be performed by clerical staff and requires the reviews to be completed within 5 business days.<sup>18</sup> DCAA forwards approved invoices to the federal agency payment office, and it returns invoices with errors or unallowable costs to the contractor for correction. Moreover, the results of DCAA internal control audits affect auditor decisions on the scope of work performed on future internal control audits and other DCAA cost-related audits. This is because the nature, extent, and timing of audit work are based on risk associated with significant deficiencies. For example, if controls for a particular system are deemed adequate, the level of testing on future audits will be decreased based on the assurance provided by adequate controls. Conversely, if a contractor's system is determined to be "inadequate" or "inadequate in part," the assessment of risk and the testing required would be increased because the controls do not provide reasonable assurance that data generated by the contractor's system are reliable.

Figure 2 summarizes the different DCAA audit opinions, the criteria for judging them, and the resultant actions for audits of contractor internal control systems and CAS compliance.

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<sup>16</sup>FAR 42.101 and DFARS 242.803.

<sup>17</sup>FAR 42.803(b); DFARS 242.803; and CAM 6-1007.

<sup>18</sup>CAM 6-1008.



**Figure 2: DCAA Internal Control and CAS Compliance Audit Opinions, Criteria, and Resultant Actions**

Risk	DCAA opinion	Criteria	Resultant actions
 Low	Adequate	No significant deficiencies	Report could be signed by supervisory auditor <sup>a</sup> Contractor can potentially directly bill the government Scope of future and concurrent audits of contractor may be narrowed
	Inadequate in part	One or more significant deficiencies that affect parts of the system	Field office manager or higher must sign report Contractor required to make improvements Follow-up testing within 6 months Expanded audit scopes on future and concurrent audits Contractor may not be authorized to directly bill (billing system audits only)
	Inadequate	One or more significant deficiencies that render the entire system unreliable	Field office manager or higher must sign report Contractor required to make improvements Follow-up testing within 6 months Expanded audit scopes on future and concurrent audits Contractor may not be authorized to directly bill (billing system audits only)

Source: GAO analysis of DCAA policy.

<sup>a</sup>On December 3, 2007, the DCAA Western Region changed its policy to require branch manager or resident auditor signature on all internal control audit reports. DCAA adopted this policy change agencywide on February 13, 2008.

Because DCAA audit opinions determine whether a contractor can directly bill the government and drive the nature and extent of testing on subsequent audits, it is essential that audit opinions be supported by sufficient testing.

## Questioned DCAA Audits Did Not Comply with GAGAS

We substantiated the allegations regarding the 13 cases at the three locations we investigated. Specifically, at two locations, we substantiated the allegations that DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes. In some cases, supervisors changed opinions in final audit reports without changing the underlying workpapers, resulting in opinions that contradicted the workpapers. We also found that even though some auditors believed that they had not performed sufficient work to support draft audit conclusions, their supervisors did not instruct or allow them to perform additional work before issuing final audit reports. At a third DCAA location, we substantiated allegations that there were problems with the audit environment. These problems included supervisors (1) assigning inexperienced trainees to forward pricing audits (i.e., more complex audits related to proposals for contract modifications) without proper supervision and (2) issuing forward pricing audit reports before

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audit work was completed. In addition, one DCAA supervisor noted problems with inadequate training of new auditors on the electronic audit documentation system that resulted in losing control over versions of the working papers as they were imported and exported from the system for review and revision. The problems at this location call into question the reliability of at least 62 forward pricing audit reports issued by the two supervisors responsible for forward pricing audits at this office from fiscal years 2004 through 2006, connected with over \$6.4 billion in government contract negotiations.

The DCAA audit reports we investigated all stated that they were performed in accordance with GAGAS. These standards are intended for use by government auditors to ensure that they maintain competence, integrity, objectivity, and independence in planning, conducting, and reporting their work and that auditors obtain sufficient evidence to support findings and conclusions. GAGAS pertain to auditors' professional qualifications and the quality of their work, the performance of fieldwork, and the characteristics of meaningful reporting. Adherence to GAGAS can help provide credibility of the information in audit reports so that it can be relied upon by users and decision makers. Among many key GAGAS requirements are the following:

- The audit organization and the individual auditor should be free both in fact and appearance from personal, external, and organizational impairments to independence.<sup>19</sup>
- Auditors should plan audit work, perform sufficient testing, and obtain sufficient evidence to express an opinion on the subject matter.<sup>20</sup>
- In making professional judgments, auditors should exercise reasonable care and diligence and observe the principle of serving the public interest and maintaining the highest degree of integrity, objectivity, and independence.<sup>21</sup>
- Documentation related to planning, conducting, and reporting on the engagement should contain sufficient information to enable an

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<sup>19</sup>GAO-03-673G, § 3.03.

<sup>20</sup>GAO-03-673G, §§ 6.02a, 6.04a, and 6.04b.

<sup>21</sup>GAO-03-673G, § 3.34.

experienced auditor with no previous connection to the engagement to determine that the evidence supports the auditor’s significant judgments and conclusions.<sup>22</sup>

- Audit staff should collectively possess technical knowledge, skills, and experience necessary to be competent for the type of work being performed and should be properly supervised.<sup>23</sup>

Despite DCAA’s statements that its reports are performed according to GAGAS, we found numerous failures to comply with GAGAS on the 13 cases we investigated. These problems are briefly summarized in table 1.

**Table 1: GAGAS Compliance Problems Associated with Hotline Case Investigations**

Case	Impairment to auditor independence	Working papers did not support reported opinions	Draft audit opinions changed without sufficient documentation	Auditor did not perform sufficient work to support conclusions	Significant problems
1	X	X	X		The DCAA resident office and contractor made an up-front agreement on audit scope, which had the effect of predetermining an “adequate” audit opinion.
2	X	X	X		Based on pressure from contractor and buying command to resolve CAS compliance issues and issue a favorable opinion, a DCAA region official directed the auditors not to include CAS compliance problems in the audit workpapers.
3		X	X	X	Branch manager and supervisory auditor terminated audit work and issued opinions without sufficient documentation based on their view that defective pricing did not exist on the related contracts.
4		X	X	X	Supervisory auditor dropped preliminary findings of deficiencies based on a flawed audit procedure instead of requiring auditors to perform sufficient testing to conclude on the adequacy of billing system controls.

<sup>22</sup> GAO-03-673G, § 6.22.

<sup>23</sup> GAO-03-673G, §§ 3.39 and 6.04a.

Case	Impairment to auditor independence	Working papers did not support reported opinions	Draft audit opinions changed without sufficient documentation	Auditor did not perform sufficient work to support conclusions	Significant problems
5		X	X	X	Auditor was excluded from exit conference, findings were dropped without adequate support, and supervisor made contradictory statements on her review of the audit.
6		X	X	X	Dropped findings on corporate accounting were referred to another FAO, which does not review corporate costs. Supervisor prepared and approved key working papers herself, without required supervisory review.
7		X	X	X	Supervisor directed another auditor to write a clean opinion report without reviewing the working papers. Supervisor then changed the working papers without support and referred two dropped findings to another FAO, which does not review corporate overhead allocations.
8	X	X		X	Inexperienced trainees assigned to complex forward pricing audits without proper supervision. Reports issued with unqualified opinions before supervisory review was completed due to pressure from contracting officers.
9		X		X	Significant deficiency and FAR noncompliance related to the lack of contractor job descriptions for executives not reported.
10		X		X	Significant deficiency related to subcontract management not reported.
11		X	X		Second auditor and supervisor dropped 6 of 10 significant deficiencies without adequate documentation to show that identified weaknesses were resolved.
12		X	X	X	Supervisor identified problems with test methodology but dropped findings instead of requiring tests to be reperformed.
13		X		X	Second auditor and supervisor deleted most audit steps and performed limited follow-up work that did not support the reported opinion of overall compliance with CAS.

Source: GAO analysis.

Our investigation found that contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions, and

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opinions of some audits—a serious independence issue (Cases 1, 2, and 8). In addition, we found problems with the adequacy of workpaper support for opinions in all 13 cases we investigated. Specifically, our investigation determined that working papers for 14 audits<sup>24</sup> at two DCAA locations (Cases 1 through 7 and 9 through 13) did not adequately support the final audit report opinions. The two supervisors responsible for 12 audits we investigated at location 2 did not ensure that sufficient work was performed to support audit conclusions and opinions for 11 of these audits. Further, all but two of the 12 audit reports were issued in the last 2 weeks of the fiscal year to meet performance metrics. The two remaining audits were issued by the end of the first quarter of the following fiscal year—also a performance metric. Finally, absent final supervisory review of forward pricing working papers prior to report issuance, there is no assurance that audit opinions in Case 8 were supported by sufficient audit evidence, as required by GAGAS.<sup>25</sup> In 9 of our 13 cases, a supervisory auditor or manager either changed or directed changes to be made to an auditor’s draft audit conclusions without adequate audit evidence to support the changes. In Case 6, the supervisory auditor prepared and reviewed her own working papers, which is also a GAGAS noncompliance. Moreover, in 9 of our 13 cases, the auditors did not perform sufficient work to support their draft conclusions, and the supervisory auditors failed to note that the work was insufficient or direct or authorize the auditors to perform additional audit procedures before issuing the final reports. On 10 audits, the original supervisor or auditor was reassigned and the new supervisor or auditor dropped findings and changed conclusions and opinions without adequate supporting documentation.

Throughout our investigation, auditors at each of the three DCAA locations told us that the limited number of hours approved for their audits directly affected the sufficiency of audit testing. At the third DCAA location we investigated, two former supervisory auditors told us that the volume of requests for the audits, short time frames demanded by customers for issuing reports to support contract negotiations (e.g., 20 to 30 days), and limited audit resources affected their ability to comply with GAGAS. Our review of DCAA performance data showed that DCAA measures audit efficiency and productivity as a factor of contract dollars audited divided by audit hours. In addition, because customer-requested assignments—such as forward pricing audits requested by contracting

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<sup>24</sup>Case 3 involved three related defective pricing audits at the same contractor.

<sup>25</sup>[GAO-03-673G](#), §§ 6.02a, 6.04a, and 6.04b.

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officers—which are referred to as demand work by DCAA, take priority, other work, such as internal control and CAS compliance audits, are often performed late in the year. Auditors told us that there is significant management pressure to complete these nondemand audits by the end of the fiscal year to meet FAO performance plans. To test this, we analyzed internal control audit reports issued in fiscal years 2005 and 2006 at the location associated with nine of the nondemand audits in our initial hotline complaint. We found that 92 percent (2005) and 83 percent (2006) of these reports were issued in the last 2 weeks of the fiscal year. These percentages are significantly higher than those for most other DCAA offices. DCAA Western Region officials also recognized that this office issued an unusually high number of reports at fiscal year-end.

Noncompliance with GAGAS in the cases we investigated has had an unknown financial effect on the government. Because DCAA auditors' limited work identified potential significant deficiencies in contractor systems and accounting practices that were not analyzed in sufficient detail to support reportable findings and recommendations for corrective action, reliance on data and information generated by the audited systems could put users and decision makers at risk. Because the DOD IG was concerned with the effect of certain noncompliance issues, in its January 24, 2007, memorandum of investigation, it concluded that the final reports associated with Cases 4, 5, and 9 should be rescinded. In making its determinations, the DOD IG stated that "the reports were not supported by the working papers, are still being used, and could have a negative effect on current actions involving the contractor." We agree with the DOD IG's position and advised DCAA of our same concern with the final report related to Case 13. The DCAA Western Region Director disagreed with the DOD IG's and our determinations. As a result, the systems and processes audited may have been relied on since the 2005 audits. After our briefings on the results of our investigation, DCAA's Western Region rescinded the reports associated with Cases 4 and 5. In addition, new audits were performed on Cases 7, 9, and 12 that identified numerous significant deficiencies and included "inadequate in part" opinions. The following table summarizes key details related to 8 of the 13 cases we investigated, which are explained in detail in the body of our report. We included 5 of the 10 cases we investigated at location 1 in the body of our report. The additional 5 cases are summarized in appendix II.

**Table 2: Summary of DCAA Case Studies GAO Investigated**

Case	Type of audit	Contractor	DCAA Location	Case details
1	Estimating system survey follow-on (2002)	Contractor A	Location 1 <sup>a</sup>	<ul style="list-style-type: none"> <li>• Purpose of audit was to review the corrective action plan (CAP) developed by Contractor A in response to prior findings of inadequate BOEs related to labor hours.</li> <li>• In the face of pressure from DOD's contracting community to approve Contractor A's estimating system, we found evidence that there was an up-front agreement between DCAA and Contractor A to limit the scope of work and basis for the audit opinion (a significant impairment of auditor independence).</li> <li>• Auditors found significant deficiencies with the CAP implementation plan, that is, the contractor could not develop compliant BOEs without DCAA's assistance at the initial, intermediate, and final stage of estimates.</li> <li>• Original supervisory auditor was reassigned; the resident auditor and new supervisory auditor directed the draft opinion be changed from "inadequate in part" to "adequate" after the contractor objected to DCAA draft findings and opinion.</li> <li>• The working papers did not contain audit evidence to support the change in opinion.</li> <li>• Field office management threatened the senior auditor with personnel action if he did not change the draft audit opinion to "adequate."</li> </ul>
2	Proposal audit (2006)	Contractor A	Location 1	<ul style="list-style-type: none"> <li>• Audit related to a revised proposal submitted after DCAA reported an adverse (inadequate) opinion on Contractor A's 2005 proposal.</li> <li>• At beginning of the audit, buying command and Contractor A officials met with a DCAA regional audit manager to determine how to resolve CAS compliance issues and obtain a favorable audit opinion.</li> <li>• Contractor A did not provide all cost information requested for audit.</li> <li>• Contrary to DCAA CAM guidance, the regional audit manager instructed auditors that they could not base an "adverse" (inadequate) audit opinion on the lack of information to audit certain costs.</li> <li>• On the basis of an "inadequate in part" opinion reported in May 2006, the buying command negotiated a \$967 million contract, which has grown to \$1.2 billion.</li> </ul>

Case	Type of audit	Contractor	DCAA Location	Case details
3	Three defective pricing audits (2004)	Contractor B	Location 2 <sup>b</sup>	<ul style="list-style-type: none"> <li>• Branch manager and supervisory auditor predetermined that there was no defective pricing; however, the auditor concluded that Contractor B's practice potentially constituted defective pricing and obtained technical guidance that specific contracts would need to be analyzed to make a determination. The branch manager disagreed.</li> <li>• Supervisory auditor and branch manager subsequently issued three reports stating that Contractor B's practice at three divisions did not constitute defective pricing.</li> <li>• Insufficient work was performed on these audits to come to any conclusion about defective pricing, and as a result, the final opinions on all three audit reports are not supported.</li> <li>• Absent DCAA audit support for defective pricing, the contracting officer pursued a CAS 405 noncompliance at three contractor divisions and recovered \$71,000.</li> <li>• At the end of our work, a settlement on a separate DCIS defective pricing case was being negotiated.</li> </ul>
4	Billing system (2005)	Contractor C	Location 2	<ul style="list-style-type: none"> <li>• Draft audit report identified six significant deficiencies, one of which led Contractor C to overbill the government by \$246,000 and another which potentially led to \$3.5 million in overbillings, but audit work was incomplete. The contractor had refunded the \$246,000.</li> <li>• The original auditor concluded that the \$3.5 million was for subcontractor costs improperly billed to the government. The supervisor deleted the finding based on a flawed audit procedure, but did not require additional testing.</li> <li>• First supervisory auditor and auditor were replaced after draft audit report was completed.</li> <li>• New auditor and supervisory auditor worked together to modify working papers and change the draft audit opinion from "inadequate," to "inadequate in part," and, finally, to "adequate."</li> <li>• Sufficient testing was not performed to determine if the contractor had systemic weaknesses or to support an opinion that contractor billing system controls were adequate.</li> <li>• On the basis of the "adequate" opinion, the FAO approved the contractor for direct billing.</li> <li>• DOD IG recommended that DCAA rescind the final report for this audit, but DCAA did not do so.</li> <li>• Following the briefing on our investigation, the DCAA Western Region rescinded the audit report on May 22, 2008.</li> </ul>



Case	Type of audit	Contractor	DCAA Location	Case details
5	Estimating system (2005)	Contractor C	Location 2	<ul style="list-style-type: none"> <li>Auditor identified five deficiencies and concluded the contractor's system was "inadequate in part."</li> <li>Auditor did not perform sufficient work to support some findings, but supervisory auditor did not direct the auditor to gather additional evidence.</li> <li>After consulting with the branch manager, the supervisory auditor modified documents and eliminated significant deficiencies, changing the draft audit opinion from "inadequate in part" to "adequate."</li> <li>Working papers did not properly document the reason for the change in opinion and therefore do not support the final opinion.</li> <li>DOD IG recommended that DCAA rescind the final report for this audit, but DCAA did not do so.</li> <li>On June 27, 2008, the DCAA Western Region informed us that it was rescinding this audit report.</li> </ul>
6	Accounting system (2005)	Contractor D	Location 2	<ul style="list-style-type: none"> <li>Auditor believed audit evidence related to a 24 percent error rate in a small sample of cost pools supported an "inadequate in part" opinion and suggested testing be expanded, but supervisory auditor disagreed.</li> <li>Auditor and supervisory auditor documented their disagreement in the working papers.</li> <li>Supervisory auditor subsequently modified documents to change the draft audit opinion from "inadequate in part" to "adequate" before issuing the final report.</li> <li>Certain final working papers were prepared and approved by the supervisory auditor.</li> <li>Branch manager and supervisory auditor determined that findings of corporate accounting problems should be referred to another FAO for future audit. However, the other FAO does not audit corporate costs.</li> <li>Working papers do not support the final opinion.</li> </ul>
7	Compliance, CAS 403 (2005)	Contractor D	Location 2	<ul style="list-style-type: none"> <li>Auditor identified four potential instances of noncompliance with CAS 403.</li> <li>Auditor was transferred to a different team before supervisory review of her working papers. Three months later, the supervisory auditor requested that another auditor write a "clean (adequate) opinion" report.</li> <li>Second auditor used "boilerplate" (i.e., standardized) language to write the final report and never reviewed the working papers.</li> <li>The supervisor correctly deleted two findings and referred two findings of corporate-level noncompliance to another FAO for future audit. The other FAO does not audit corporate-level costs.</li> <li>Working papers do not support the final "clean opinion," which was later contradicted by a September 21, 2007, DCAA report that determined that Contractor D was in fact not in compliance with CAS 403 during the period of this audit.</li> </ul>

Case	Type of audit	Contractor	DCAA Location	Case details
8	Forward pricing (2004 through 2006)	Contractor E	Location 3 <sup>c</sup>	<ul style="list-style-type: none"> <li>• Two Location 3 supervisors signed 62 of 113 forward pricing audits performed by the resident office related to Contractor E from 2004 through 2006.</li> <li>• Supervisors responsible for the 62 forward pricing audits admitted to us that they did not always have time to review working papers before report issuance.</li> <li>• According to the DCAA Region, inexperienced trainee auditors were assigned to 18 of the 62 audits. However, the region did not provide assignment documentation for the 62 audits.</li> <li>• An internal DCAA Region audit quality review found audits where the audit working papers did not support the final audit report, working paper files were lost, and working paper files were not archived in the DCAA-required time period.</li> <li>• The 62 forward pricing audits were connected with over \$6.4 billion in government contract negotiations.</li> </ul>

Source: GAO analysis.

<sup>a</sup>Location 1 is a DCAA resident office located at facilities run by one of the five largest DOD contractors (Contractor A). The audit in Case 1 was performed at a suboffice location and the audit in Case 2 was performed at the resident office.

<sup>b</sup>Location 2 is a DCAA branch office.

<sup>c</sup>Location 3 is a DCAA resident office located at facilities run by another of the five largest DOD contractors (Contractor E).

The following discussion summarizes our investigations of the above eight cases, including the allegations we received, and the details of the audits for seven cases at two DCAA locations; for Case 2, similar significant audit issues we identified in current GAO work; and for Case 8, the issues associated with the forward pricing audit environment at a third location; and the results of our investigation of each case.

### Case 1: 2002 Follow-on Survey of Contractor A's Estimating System

We investigated allegations that DCAA managers at a suboffice under location 1 engaged in an up-front agreement with Contractor A to provide an "adequate" audit opinion on a corrective action plan (CAP) developed by the contractor to correct weaknesses in its estimating system that DCAA had identified in two previous audits. According to the allegations, consonant with this up-front agreement, the working papers for this audit do not support the opinion because the DCAA resident auditor at location 1 directed the auditor to remove findings from the draft report. Contractor A is a major aerospace company that is among the five largest defense contractors in the United States. In calendar year 2006, Contractor A reported over \$61 billion in revenue. The resident office we investigated is located on the site of a wholly owned subsidiary of Contractor A; this

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subsidiary produces cost estimates for several major Air Force weapon systems.

#### Details of the Audit (Case 1)

In audit reports issued in September 2000 and September 2001, DCAA documented inadequacies in the estimating system Contractor A used to produce BOEs on labor hours related to support and maintenance of the major weapon systems manufactured at this California location. BOEs are critical because they define the purpose of contract estimates, the estimate scope, the basis for pricing, and other important factors that government contract managers must consider in making decisions on pricing contract work. As a result of these reports, the Defense Contract Management Agency (DCMA) downgraded Contractor A's estimating system rating from green (satisfactory) to yellow (marginal). As required by DCAA policy,<sup>26</sup> whenever at least one inadequacy is disclosed in an audit, the contractor must develop a CAP to address the deficiencies. Because of continuing problems with labor-hour estimates noted in the 2000 and 2001 DCAA reports, DOD established an integrated product team (IPT) to address the inadequacies. The IPT, which included DCMA contracting officials, Air Force acquisition officials, Contractor A management representatives, and DCAA auditors, was a key component of the contractor's CAP.

According to working papers we reviewed, at the time the audit of Contractor A's CAP was initiated in March 2002, there was an up-front agreement between the DCAA resident auditor and Contractor A officials that limited the audit scope and noted that the yet-to-be-performed CAP audit opinion would be based on final approved BOEs for labor hours in selected forward pricing proposals. This agreement had the effect of predetermining an "adequate" audit opinion. For example, under the agreement, Contractor A would provide BOEs to be audited for all proposals issued during March through June 2002. Thus, Contractor A knew in advance which proposals would be audited. Further, under the agreement, DCAA auditors would review Contractor A's BOE proposals at three phases and advise the contractor of needed corrections. According to the agreement, which was documented in a "letter of understanding" between DCAA and Contractor A, DCAA would only report on its audit results after reworking the BOE proposals and reaching agreement on them. This represented a significant deviation from DCAA audit procedures. According to the auditors, DCAA normally allows a contractor

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<sup>26</sup>CAM 5-1215a.

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to produce several final proposals through its estimating system before randomly selecting and reviewing proposals. Our interviews of DOD contracting officials and an Air Force buying command official revealed that there was pressure from the contracting community to approve Contractor A's estimating system.

In October 2002, DCAA auditors prepared a draft audit opinion of "inadequate in part." They found that Contractor A failed to adequately implement the CAP and that the contractor could not produce compliant BOEs even after they had been reviewed twice by DCAA auditors. In addition, they identified a risk of \$11 million in unsupported labor charges on the specific BOEs Contractor A had selected for them to review. Auditors explained that the effect of the unsupported labor charges could extend beyond the specific BOEs they reviewed and could affect all BOEs prepared over the next 3 to 4 years, until the next estimating system internal control audit is performed, if the problems were not corrected. A DCAA working paper showed that during an exit conference with Contractor A on September 13, 2002, the director of the contractor's estimating system stated that if the report was issued with an "inadequate in part" opinion he would "escalate" the issue "to the highest level possible" in the government and within his own company. He contended that the DCAA audit attempted to hold Contractor A to standards that were guidelines rather than requirements in the contractor's estimating system manual. However, our analysis of DCAA working papers showed that the contractor's estimating system manual was not FAR compliant,<sup>27</sup> which led to the disagreement.

In mid-January 2003, the resident auditor at this location reviewed the working papers for the CAP audit and, as documented in the working papers, demanded in several e-mail messages that the senior auditor make modifications that would support an "adequate" opinion. The senior auditor acquiesced and added a statement in certain key working papers, including the working paper summarizing the exit conference with Contractor A, stating that DCAA's understanding of the contractor's estimating system manual was "clarified." The statement concluded that the draft report findings were based on guidelines rather than requirements. The statement closed by noting, "In addition, the contractor has corrected the originally cited deficiency discussed in DCAA's prior audits due to the government's participation in the BOE IPT." On February

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<sup>27</sup>FAR 15.404-1, 15.407-3, and 15.407-5, table 15-2.

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Results of Investigation  
(Case 1)

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10, 2003, the new supervisory auditor issued a report stating that contractor's estimating system was adequate.

Our investigation substantiated the allegations. We determined that this audit did not comply with GAGAS because (1) the working papers did not support an "adequate" opinion, (2) the resident auditor directed the auditor to remove findings from the draft report without adequate supporting documentation, and (3) draft conclusions in the working papers were changed without adequate support. Moreover, the up-front agreement, which limited the scope of the audit and provided the basis for an "adequate" opinion, impaired the objectivity of the audit and posed a serious independence issue.<sup>28</sup> Our review of the audit workpapers showed that the DCAA auditors determined that the contractor's estimating system guidance was not FAR compliant; thus, the resident auditor's directions to add language to certain key working papers stating that Contractor A "clarified" its estimating system procedures misrepresented the condition of the contractor's estimating system and related controls. We found that the majority of the working papers were not revised to reflect an "adequate" opinion, and that enough evidence had been collected by the original supervisory auditor and senior auditor to support an "inadequate in part" opinion. For instance, the auditors identified a risk of \$11 million dollars in unsupported labor charges on the final BOEs. Further, the auditors told us that the risk to the government would be much greater than the \$11 million because once Contractor A's estimating system controls were deemed adequate, future proposals would receive less audit scrutiny.

According to the senior auditor whom we interviewed, he initially refused to make changes, but later did so after being pressured by the resident auditor who did not want this report to be inconsistent with recent proposal audit opinions. An Air Force procurement official who had worked closely with the auditors on reviewing the BOEs told us that he was aware that the resident auditor had threatened the senior auditor with personnel action if he did not change the workpapers. The Air Force official told us that he advised the DCAA senior auditor not to "lose his job" over the disagreement and to go ahead and make the changes to the working papers.

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<sup>28</sup>GAO, *Government Auditing Standards*, August 13, 1999, update, §§ 3.17a-b.

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Further, the Air Force procurement official involved in this case told us that while DCAA's CAP audit was ongoing, there was talk within DCMA of lowering the contractor's rating to red (unsatisfactory and unusable). He said that throughout the CAP process, Contractor A continued to deliver unsatisfactory BOEs that lacked information on scope, methodology, pricing estimates, and other critical elements. This official added that Contractor A was putting considerable pressure on the government to raise its estimating system rating to green despite these problems.

In November 2002, while the CAP audit was still in draft, the original supervisory auditor was promoted and reassigned to another DCAA audit, even though he requested that he be allowed to complete this audit beforehand. The resident auditor was subsequently transferred to the branch manager position at location 2. In her new position, this individual was in charge of managing the audits associated with Cases 3 through 7 and 9 through 13 (Case 8 occurred at a third DCAA office). Furthermore, Contractor A officials met with the Commander of DCMA and requested staffing changes in DCMA related to the audit.

In a January 2007 memorandum, the DOD IG also concluded that the working papers supported the original draft "inadequate in part" opinion on the contractor's estimating system, not the "adequate" opinion that was actually reported. On May 17, 2007, the second supervisory auditor, who had signed the audit report, prepared a Memorandum for the Record documenting her conclusions on the 2002 audit. Specifically, she stated that the draft "inadequate in part" opinion was based on draft BOEs, when the opinion should have only been based on the contractor's final certified BOEs, which she concluded were adequate. To support her opinion, the second supervisory auditor created a new workpaper on her analysis of the final, corrected BOEs that omitted the original analysis of BOEs at the initial and interim stages. The revised workpaper was consistent with the up-front agreement.

Although the workpaper documentation clearly lays out the nature of the up-front agreement, DCAA disagrees that there was an up-front agreement. DCAA also stated that sufficient evidence was not collected by the original auditors to support the draft "inadequate in part" opinion. However, we found the workpaper evidence to be sufficient in this regard.

Further, because of the well-known history of improper practices by a senior Air Force acquisition official, we believe that the DCAA Resident Office should have increased its audit scrutiny during the 2002 estimating system follow-on audit. For example, in 1993, a senior Air Force

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acquisition official involved in procurements related to a company later acquired by Contractor A was investigated for involvement in a plan to speed up Air Force payments to that company. In 2000, during the earlier estimating system audit, the senior Air Force acquisition official sent the résumés of her daughter, a recent college graduate, and her daughter's fiancé, a published PhD aeronautical engineer, to Contractor A and both were hired. From 2000 through 2002, Contractor A was attempting to secure a \$24.5 billion contract with DOD related to major weapon systems covered by the Contractor A's same estimating system. During this period, while the same senior Air Force acquisition official was negotiating this contract on behalf of DOD, the official was simultaneously negotiating for a high-paying job for herself with Contractor A. After resolving the contract negotiations in Contractor A's favor, this official then retired from the Air Force and accepted a \$250,000 per year job with Contractor A, plus a \$50,000 signing bonus. She later pled guilty to 18 counts of conflict of interest violations. She received 9 months in jail, 7 months of halfway house/home confinement, and 150 hours of community service. Following this sequence of events, DCAA did not revisit the 2002 estimating system audit.

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## Case 2: Continuing Audit Issues with Contractor A Related to a 2006 DCAA Proposal Audit

A current GAO audit of a program to provide satellite launch capability identified audit issues that are similar to those involved in our investigation of the 2002 DCAA estimating system audit discussed in Case 1. Accordingly, we investigated issues related to (1) buying command and contractor pressure for a favorable audit opinion and (2) an unsupported change in the draft audit opinion directed by a DCAA Western Region official. DOD initiated the program in 1995 to develop a new generation of launch vehicles and provide assured, affordable access to space. The program was developed in three phases. The initial phase, low cost concept validation involved four separate \$30 million contracts and was completed in November 1996. The second phase involved two \$60 million contracts for preengineering and manufacturing. Phase three began in October 1998 with the award of two development agreements and two initial launch services contracts known as Buy 1 totaling more than \$3 billion. Additional launch service awards were made in Buy 2 and proposed in Buy 3. Buy 3 launch services awards are continuing. By mid-2004, program costs had increased by more than \$13 billion over the approved 2002 baseline estimate of \$18.8 billion, resulting from the failure of the commercial market to materialize and other factors. The cost increase led the Secretary of Defense to certify that the program was critical to national security and that the revised program cost estimates

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were reasonable. DOD's Selected Acquisition Report as of September 30, 2007, estimated total program acquisition costs at \$35.7 billion.

Contractor A was one of two government contractors selected to provide two families of launch vehicles for this program, each using common components and common infrastructure. To meet reductions in projected life cycle costs, the program was expected to capture at least 15 percent of the commercial market. However, Contractor A proceeded to develop launch capability based on 75 percent commercial participation—about 300 commercial launches compared to 100 government launches. Further, the contractor lacked negotiated contracts with interested private sector entities, primarily cell phone companies. During 1998 and 1999 the cell phone companies decided to use communication towers instead of space satellite technology, and nearly all of Contractor A's anticipated commercial business fell through, leaving Contractor A with excess capacity associated with the operation of only one of two production lines, excess equipment and materials, and a corresponding shortfall in revenue to cover the related costs. Contractor A and DCAA refer to the commercial losses included in Contractor A's cost estimates as "unabsorbed costs" and "over average" costs rather than identifying them specifically as losses.

In 2005, the government split the program into two efforts—expendable launch services (ELS) involving hardware (rockets) and expendable launch capability (ELC) involving support and maintenance. Up to this point, the government had actual cost data and pricing estimates on the cost to complete these efforts. Over \$2.5 billion had been recorded as acquisition cost of commercial-type items. Under the two efforts, the contract changed from coverage under FAR Part 12—Acquisition of Commercial Items—to FAR Part 15—Contracting by Negotiation. FAR Part 12 does not require contractors to submit cost or pricing data. FAR Part 15 places a higher burden on contractors for documenting costs and submitting cost or pricing data. ELS, which involved costs associated with construction of the production facility and associated tooling and equipment, involved firm, fixed-price contracts. ELC cost-type contracts covered launch operations, mission assurance, mission integration, supplier readiness, transportation, data reporting, unabsorbed program management and hardware support, and special studies to support launch requirements.



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In September 2006, we reported<sup>29</sup> that Office of the Secretary of Defense guidance states that commercial acquisition was not intended to allow military-unique items to be purchased commercially. Misclassification of items as commercial can leave the Air Force vulnerable to accepting prices that are not the best value for the department. When an item is designated as commercial, the Air Force should be able to determine if the price is reasonable on the basis of prices in the commercial market. If the Air Force designates an item as being commercial when it is not really available in the commercial market, this limits its ability to assess the reasonableness of the contractor's price because it might, especially in sole-source situations, have less information on prices to make its decision.

## Details of the Audit (Case 2)

The ELC proposal addressed in the May 8, 2006, DCAA audit report was a revision to the Buy 3 launch capability proposal<sup>30</sup> for which the DCAA resident office at location 1 had rendered an adverse opinion<sup>31</sup> in its July 29, 2005, audit report. On the revised \$1.1 billion proposal, the May 2006 DCAA audit report questioned about \$88.6 million<sup>32</sup> and found that another \$123.4 million in proposed costs was unsupported.<sup>33</sup> The audit report also included a qualification related to the Air Force's refusal to

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<sup>29</sup>GAO, *DOD Contracting: Efforts Needed to Address Air Force Commercial Acquisition Risk*, GAO-06-995 (Washington, D.C.: Sept. 29, 2006).

<sup>30</sup>The original Buy 3 launch capability proposal totaled nearly \$2.6 billion for the 3-year period from October 1, 2005, through September 30, 2008, and the revised proposal was reduced to a little over \$1.1 billion for the 2-year period from October 1, 2005, through September 30, 2007.

<sup>31</sup>CAM 9-212 explains the four types of audit opinions used in price proposal audit reports, including (1) an unqualified opinion (submitted cost or pricing data or cost information other than cost or pricing data are considered by the auditor to be adequate, acceptable, and in compliance with applicable FAR, DFARS, and CAS provisions); (2) a qualified opinion (cannot be issued when there are inadequacies with the cost or pricing data or cost information other than cost or pricing data, noncompliance with FAR, DFARS, and CAS provisions, or other problems not related to contractor actions or inactions), (3) an adverse opinion (used when there is denial of access to records or data having a significant effect on the examination, or when significant inadequacies or significant noncompliance requiring corrective action by the contractor prior to negotiation is noted); and (4) a disclaimer (when the auditor does not express an opinion on the cost or pricing data or information audited because the auditor has not performed an audit of sufficient scope to form an overall opinion).

<sup>32</sup>CAM 10-304.8b defines questioned costs as those amounts on which audit action has been completed and which are not considered acceptable as a contract cost.

<sup>33</sup>CAM 10-304.8c defines unsupported costs as costs for which a contractor does not furnish sufficient documentation to enable a definitive conclusion.

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provide DCAA auditors a copy of a technical evaluation on labor hours performed by DCMA to support the Buy 3 launch capability contract negotiation. As previously discussed, our investigation of Case 1 determined that Contractor A had uncorrected estimating system deficiencies related to labor-hour estimates, which could affect contract negotiations on future proposals. In addition, the workpapers documented the auditors' concerns that they were unable to evaluate the extent to which the contractor included costs related to lost commercial business in the ELC Buy 3 proposal because Contractor A did not provide all requested cost information. On April 28, 2006, the auditors submitted their draft report with an inadequate (meaning adverse) opinion for review. The final report issued on May 8, 2006, included an "inadequate in part" opinion.

## Results of Investigation (Case 2)

Our interviews of DCAA auditors, review of DCAA workpapers, and analysis of related documentation on meetings and briefings obtained during our investigation substantiated concerns about (1) buying command and contractor pressure for a favorable audit opinion and (2) an unsupported change in the draft audit opinion that was directed by DCAA Western Region officials. Contractor A's noncompliance with CAS was viewed by the Space and Missile Systems Center (SMC)—the Air Force buying command—and DCMA as an obstacle to awarding the revised Buy 3 launch capability contract. Documentation of meetings between SMC, DCMA, and the DCAA regional audit manager (RAM) noted discussions on how to resolve CAS issues so that the buying command would be in the best position to negotiate the ELC contract without CAS impediments. Air Force legal counsel had previously instructed the buying command that it could not negotiate this ELC contract if DCAA issued an adverse audit opinion. According to documentation by SMC and DCMA officials on meetings held in December 2005 at the beginning of the ELC Buy 3 proposal audit, a senior buying command official stated that "CAS waivers [were] being considered to overcome DCAA's documented, adverse opinions on the Expendable Launch Capabilities (ELC) and the Expendable Launch Services (ELS) proposals." However, the official also noted that the "SMC proposed CAS waiver appears to be politically unacceptable in Washington, DC at this time." The official asked "[Contractor A], DCAA, DCMA, and SMC to reevaluate their respective positions to determine if there is some material way of overcoming the CAS Waiver challenges facing the Government and [Contractor A]." The meeting documentation revealed that a Contractor A official had stated that he considered the 15-year duration of Lot 1 to be discretionary and a reasonable way to conduct business. The official stated that that he did not believe that his company had violated the CAS. The DCAA RAM agreed

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to revisit DCAA's position on CAS issues and provide a "recommendation to withdraw CAS 406/411 [noncompliance issues]" by January 15, 2006 or shortly thereafter." When we asked the former RAM what was recommended, the former RAM explained that after observing Contractor A's "accounting demo" (demonstration), she had concluded that there were no CAS 406 or other CAS compliance issues. We do not consider an accounting demonstration to represent sufficient audit evidence without independent testing and confirmation. Further, our review of the audit workpapers revealed that Contractor A provided bulk cost data and bulk allocations to the auditors without necessary detail to trace costs to program components or contracts.

DCAA's audit workpapers did not contain evidence of CAS compliance issues. The auditors told us that they were instructed by the RAM not to document CAS compliance issues in the workpapers. Further, other related documentation, including DCAA briefing documents and documentation of various meetings, showed that CAS compliance continued to be a significant issue. For example, although CAS 406 requires contractors to account for costs by annual periods,<sup>34</sup> Contractor A used a lot costing methodology that covered multiple years.<sup>35</sup> According to the auditors and our review of Contractor A's lot cost accounting definition, Contractor A's cost accounting for Lot 1 initially covered 2 years in 1997, but was extended to cover 15 years by 2005. In addition, Contractor A's Lot 1 costs consisted of all production and launch capability costs to place a satellite in orbit, including a combination of costs and estimates for past and future years as well as costs for more than one contract (i.e., launch capability and launch services), which is a

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<sup>34</sup>FAR 9904.406.40a states that a contractor is to use a fiscal year as its cost accounting period except as provided in 9904.406.50(d) when the government agrees that a contractor may use a fixed annual period other than a fiscal year.

<sup>35</sup>Our review of DCAA documentation on meetings with the contractor identified Contractor A's definition of its lot accounting methodology. Contractor A defines lot accounting as synonymous with lot costing and states that its use of lot costing is a method of accounting that is applicable to products manufactured for delivery under multiple production-type contracts over multiple years. Under lot accounting, direct charge costs and associated indirect expense allocations are accumulated and charged to units or contracts at the average cost determined for the production lot. A lot consists of the total estimated number of units (accounting quantity) of a product to be produced in a continuing, long-term production effort for delivery under existing and anticipated contracts. To establish the average cost to be assigned from inventory to individual units or contracts under lot accounting, the number of units to be produced in a lot is established as the denominator, and the total cost estimated to complete the units in the lot is established as the numerator. Contractor A's definition referred specifically to the program in Case 2.

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noncompliance with cost allocation guidance in CAS 418.<sup>36</sup> Documentation of meetings with the Air Force, Contractor A, and the DCAA RAM also indicated concerns about compliance with CAS 411, which provides guidance on accounting for material inventory costs.<sup>37</sup> During meetings with DCAA auditors, a senior Contractor A official and an Air Force buying command official verbally confirmed that Lot 1 costs included the period of time during which Contractor A was incurring costs to gear up for a “robust commercial market.”

According to the auditors, based on fixed costs of \$600 million annually for ELC launch support and the limited number of launches, average launch costs had significantly increased. DCAA briefing documents showed that to address this problem, Contractor A used lot costing as a means of spreading costs over the 15-year period in Lot 1 and increased the estimated number of government launches to 32 launches using 42 common booster cores (rockets). One DCAA briefing document described this gradual reduction in costs over the 15-year period in Lot 1 as the wedge. The wedge includes unabsorbed costs, also referred to as over average costs, related to contractor commercial business losses. A wedge diagram showed declining costs per launch as additional government launches were projected and the time frame for accomplishing the launches stretched over several additional years based on Contractor A’s lot-costing methodology. For example, the wedge diagram showed 4 launches from 1998 through 2005, with an additional 28 launches projected through 2011. Because only 4 launches were accomplished in the first 7 years, the auditors considered the 28 estimated launches to be unrealistic. As of June 2008, only 1 additional government launch had been conducted.

The auditors completed the workpapers and prepared a draft audit report on April 28, 2006. The audit workpapers showed that on that date, the RAM advised the resident auditor (FAO manager) at location 1 that DCAA “did not have an authoritative basis (such as allocability) to question the entire wedge.” However, the workpapers also showed numerous auditor requests for cost information and meetings with contractor officials to

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<sup>36</sup>FAR 9904.418.20 states the purpose of CAS 418, which is to provide for consistent determination of direct and indirect costs and accumulation of indirect costs and provide guidance on selection of allocation measures between an indirect cost pool and cost objectives.

<sup>37</sup>FAR 9904.411 states the purpose of CAS 411, which is to provide criteria for accounting for the acquisition costs of material and the consistent measurement and assignment of costs to cost objectives, including direct and indirect cost allocations (CAS 411.40).

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request and discuss cost information. At the end of the audit, the workpapers indicated that Contractor A had not responded to several requests for information that would have helped the auditors identify costs related to lost commercial business. For example, Contractor A did not provide information on the cost of excess and obsolete materials, excess production facility capacity, and excess equipment. The audit findings on five significant issues/qualifications and access to records problems in the ELC Buy 3 proposal audit meet DCAA's criteria for an adverse (inadequate) opinion,<sup>38</sup> particularly the criteria related to the lack of access to key records and related cost documentation.

DCAA disagreed that the audit opinion was influenced by pressure from the contractor and the buying command. DCAA also stated that there is no evidence in the workpapers that the RAM directed the draft opinion to be changed from "inadequate" to "inadequate in part." However, according to the auditors, on April 28, 2006, the RAM directed the DCAA resident auditor to change the draft audit opinion on cost and pricing data from "inadequate" (adverse) to "inadequate in part" and add language to the report stating, "However, we consider it a procurement decision as to whether or not payment of these costs will further the objective to maintain Assured Access to Space as a vital national security interest." DCAA also stated that Contractor A did not have CAS and FAR compliance issues related to the 2006 proposal. However, the opinion paragraph makes reference to CAS and FAR noncompliance, although the referenced pages of the report do not discuss any CAS noncompliance. Further, although DCAA stated that the contractor did not substantively use lot costing in the 2006 proposal, this is not supported by the audit documentation or subsequent documentation on meetings related to approval of advance agreements related to the proposal, which were approved in November 2006. The final "inadequate in part" audit opinion allowed the Air Force to negotiate the contract. Following the report, on June 1, 2006, DOD approved a \$967.8 million contract for Buy 3 launch capability for the period October 1, 2005, through September 30, 2007. The contract has since grown to over \$1.2 billion.

During this audit, Contractor A was the subject of a well-publicized investigation of industrial espionage related to contract competition that was ongoing during the 2005 ELC Buy 3 proposal audit. Therefore, we would have expected DCAA to have been skeptical of contractor

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<sup>38</sup>CAM 9-212 and 9-213.

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accounting practices and related assertions. During the investigation, the government charged Contractor A with hiring an engineer from a competing firm in 1996 and agreeing to provide pay raises in exchange for proprietary documents that later favorably aided Contractor A in contract negotiations during the development phase of the program. The theft of proprietary documents was identified in June 1999. An investigation ensued and the two former Contractor A managers—the engineer and his recruiting manager—were charged with conspiring to steal trade secrets concerning a multibillion-dollar rocket program. According to the civil settlement agreement entered on June 30, 2006, Contractor A did not admit liability, and agreed to settle the matter. Under the settlement agreement, Contractor A agreed to pay the government \$565 million, withdraw any unallowable costs previously submitted to the government, and provide cognizant contracting officers or their designated representatives with a fiscal year schedule of all incurred costs excluded, withdrawn, or adjusted as a result of the settlement agreement. Costs that do not comply with CAS and FAR are generally unallowable. The government also divided future launches between Contractor A and the other contractor.

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### Case 3: Three 2004 Defective Pricing Audits of Contractor B

We investigated allegations that the working papers for audits of three Contractor B divisions do not support the opinions because the DCAA branch manager and a supervisory auditor improperly made an advance determination that defective pricing did not exist based on their interpretation of one of the five defective pricing criteria. The audits, which were reported in a series of three reports (one on each of the contractor's Southern California divisions), were intended to determine whether Contractor B's method of charging transportation costs at three of its divisions from July 1998 through July 2003 constituted defective pricing. Contractor B is a service, engineering, and technology development company with 57,000 employees in locations around the world. Contractor B's three Southern California divisions provide fuel systems, aerospace control systems, and military support services. DCAA reported that these three divisions had about \$429 million in government sales in fiscal year 2004.

#### Details of the Audits (Case 3)

A defective pricing audit of Contractor B was initiated in September 2003 at the request of DCMA to resolve an issue that began in 1998. On July 13, 1998, Contractor B sent DCMA a letter stating that it would no longer use

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government shipping and would pay its own transportation costs instead. At that time, the contractor included its free-on-board (FOB)-origin<sup>39</sup> freight costs in its material overhead pool, a practice that would inflate overhead and violate FAR if the contractor continued it while paying its own freight costs. FAR<sup>40</sup> requires that such costs be billed as direct expenses. Given this fact, at an August 6, 1998, meeting, DCMA requested that the contractor provide a revised accounting disclosure statement. Contractor B agreed to revise its disclosure statement, but through July 2003, Contractor B's disclosure statement continued to show that it was including FOB-origin shipping costs in the material overhead pool, in violation of FAR. It was not until nearly 5 years after these events that a DCMA ACO realized that the company continued to include FOB-origin shipping costs in its material overhead pool. The ACO sent a letter to Contractor B notifying it that it was violating FAR and CAS.<sup>41</sup> In response to the letter, Contractor B revised its practice and agreed to bill shipping costs directly as required by FAR.

According to the workpapers, the specific objective of the audit was to determine whether Contractor B's practice of including transportation costs in the material-handling overhead pool for about 5 years—from July 1998 through July 2003—constituted systemic defective pricing. The audit focused on three Southern California divisions of Contractor B and consequently resulted in three separate audit assignments—one for each division. The auditor and supervisory auditor both concluded that defective pricing existed and documented this conclusion in the working papers. However, while the audit was still ongoing, the resident auditor discussed in Case 1 was assigned to be branch manager at this location. According to the auditor, the new branch manager then assigned a new supervisory auditor.<sup>42</sup> The branch manager conferred with the new supervisory auditor and determined that defective pricing did not exist. The supervisory auditor subsequently issued three reports on September 28, 2004, stating that defective pricing did not exist at each of three

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<sup>39</sup>FOB-origin is used to describe a shipment in which the buyer of the goods—in this case, the government—assumes risk of loss for the goods at the point of shipment. It is contrasted with FOB-destination, in which the buyer does not assume this risk until receipt of the goods.

<sup>40</sup>FAR § 47.104-2(b).

<sup>41</sup>CAS 405—Expressly Unallowable Costs.

<sup>42</sup>This supervisory auditor subsequently managed the audits associated with Cases 5, 6, 7, 9, and 12.

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Southern California divisions of Contractor B. Because DCAA determined that Contractor B's FAR and CAS noncompliance did not constitute defective pricing, no cost impact was assessed by DCAA, and DCAA did not audit the other 10 contractor divisions with regard to defective pricing.

DCAA's CAM<sup>43</sup> cites five criteria that must be met in order to make a determination of defective pricing.<sup>44</sup> For example, the auditor must be able to show that the government was not aware of the defective pricing and its significance. The auditor must also show that the defective pricing caused an increase in government expenditures on an actual contract. The only documentation provided in the working papers to support the conclusion that defective pricing did not exist was a memorandum written by the supervisory auditor on the same day the reports were issued. The memorandum states that the five criteria for defective pricing were not met in this case because the government was aware of Contractor B's practice of including shipping costs in the material overhead pool and its significance. However, the supervisory auditor included no evidence to support this assertion, and as explained below, our review of DCAA documentation did not find sufficient evidence of knowledge by the government during contract negotiations.

## Results of Investigation (Case 3)

Our investigation substantiated the allegations that a DCAA branch manager and a supervisory auditor improperly made an advance determination that defective pricing did not exist based on their interpretation of one of the five defective pricing criteria. We determined that the three defective pricing reports did not comply with GAGAS<sup>45</sup> because sufficient evidence was not obtained to support the conclusion that defective pricing did not occur. Although the contractor's

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<sup>43</sup>CAM 14-102b.

<sup>44</sup>CAM 14-102a states that defective pricing occurs when a contractor does not submit or disclose to the government cost or pricing data that are accurate, complete, and current prior to reaching a price agreement. Generally, the auditor establishes the existence of defective pricing in a postaward audit by examining and analyzing the records and data available to the contractor as of the date of prime contract price agreement and comparing them with the submitted cost or pricing data. Defective pricing occurs when a contractor does not submit or disclose to the Government cost or pricing data that is accurate, complete, and current prior to reaching a price agreement. Generally, the auditor establishes the existence of defective pricing in a postaward audit by examining and analyzing the records and data available to the contractor as of the date of prime contract price agreement and comparing them with the submitted cost or pricing data.

<sup>45</sup>[GAO-03-673G](#), § 6.02a and 6.04b.



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noncompliant practice was disclosed, under case law<sup>46</sup> the disclosure must be obvious to the government during actual contract negotiations. According to our interviews with the ACO and our review of the workpapers, the ACO was not aware of the FAR noncompliance for 5 years, and DCAA's audits conducted up to that point did not report the noncompliance. Therefore, in order to make a determination of defective pricing, the auditor would have had to review all contracts containing the FOB-origin clause and show that the defective pricing caused an increase in the contract prices. However, there was no evidence of such a review in the working papers. Consequently, the working papers do not support the opinion and the draft conclusions in the working papers were changed without adequate documentation. However, because the branch manager and supervisory auditor predetermined that defective pricing did not exist, they chose not to pursue a review of contracts with an FOB-origin clause. In addition, to document this unsupported determination, the auditor, under the branch manager's and second supervisor's direction, changed the draft conclusions in the working papers.

Without DCAA audit support for defective pricing, the contracting officer instead pursued a CAS 405 noncompliance for improper recording of FOB-origin costs in the material overhead pool. DCAA policy<sup>47</sup> supports pursuing defective pricing issues under CAS when applicable because CAS provide for greater recovery by the government. For example, CAS allow for consistent recovery across all contracts while defective pricing is pursued under specific individual contracts. After considerable communication between DCMA, DCAA, and the contractor, in July 2007, DCMA sent Contractor B a letter offering to settle with the three Southern California divisions for \$71,000, and the contractor subsequently refunded the government that amount. DCAA officials advised us that they will notify cognizant DCAA offices of other contractor segments for follow-up on this issue.

In addition to our investigation of the allegations surrounding this defective pricing audit, DCIS pursued a criminal investigation of potential defective pricing by the same contractor. This defective pricing issue

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<sup>46</sup>The Armed Services Board of Contract Appeals (ASBCA) has held that disclosure to the government can be adequate if relevant cost or pricing data are made available to a person who participates in negotiations and if the significance of those data should be "obvious" to that person. (ASBCA Nos. 50447, 50448, 50449, Aug. 29, 2000.)

<sup>47</sup>CAM 14-120.2.

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related to the contractor negotiating a firm, fixed-price contract with the intent to manufacture F-18 parts. Instead, another DCAA auditor found that the contractor had purchased the parts from a vendor at a lesser cost and did not remit the savings to the government. When faced with legal action on this defective pricing allegation, the contractor agreed to settle with the government. At the time we issued this report, a settlement agreement was under negotiation.

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#### Case 4: 2005 Billing System Audit of Contractor C

We investigated allegations that the working papers for this audit do not support the opinion because a DCAA supervisory auditor (1) removed some draft findings from the report without adequate support and (2) evidence of deficiencies documented in the working papers was not reported. The objective of a billing system audit is to evaluate the contractor's adequacy of and compliance with billing system internal controls. Those controls should provide reasonable assurance that billings applicable to government contracts are prepared in accordance with applicable laws, regulations, and contract terms, and that material misstatements are prevented, or detected and corrected, in a timely manner.<sup>48</sup> Contractor C produces and supports military display systems, global positioning systems (GPS), and satellite communications systems. DCAA reported that for calendar year 2004, Contractor C generated sales of over \$99 million, including \$92 million from DOD contracts.

#### Details of the Audit (Case 4)

The first auditor on this engagement completed her working papers, summary of audit findings and results, and draft audit report on June 23, 2005. The draft report included six significant system deficiencies and an "inadequate" opinion on the contractor's billing system controls. For example, the auditor identified about \$3.5 million in potential overbillings for unallowable costs. The auditor wrote an explanatory note that these billings were for subcontract claims that the contractor had not paid within 90 days, and that the contractor admitted to including these charges in its billings to the government even though the contractor had never actually paid the subcontractors who performed the work. FAR precludes including such costs in billings to the government.<sup>49</sup> However, the auditor did not include sufficient working paper support to show that the \$3.5 million that the contractor owed its subcontractor was over 90 days delinquent or that it had been included in billings to the government. In

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<sup>48</sup>CAM 5-1104a-b.

<sup>49</sup>FAR 32.504(b).

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addition, the auditor identified about \$246,000 in billings in excess of contract ceilings or funding limits. Although the contractor eventually reimbursed the government for this amount, the auditor noted that a lack of policies and procedures in this area could constitute a significant deficiency. Contractors are required to have policies and procedures to detect and correct overbillings.<sup>50</sup> After submitting her workpapers for review, in July 2005, the first auditor was transferred to a DCAA office in Europe. According to the original acting supervisor, because he was too busy to review the working papers, the audit was transferred to a different supervisory auditor on July 26, 2005. Workpaper documentation showed that several days later, the new supervisory auditor<sup>51</sup> reviewed and approved the working papers that supported four of the six significant deficiencies identified by the auditor, including the \$3.5 million and \$246,000 overbillings.<sup>52</sup> The new supervisory auditor then requested that a second auditor review the first auditor's findings.

In August and September 2005, the second auditor, with review and approval by the supervisory auditor, changed several working papers and removed the original six significant system deficiencies from the draft report. In the interim, on August 22, 2005, the supervisory auditor signed off on a draft report with an "inadequate in part" opinion and three significant deficiencies: (1) failure to monitor and adjust indirect billing rates, (2) billing of \$246,000 in excess of contract cost ceilings, and (3) inadequate policies and procedures to ensure that billings comply with applicable regulations and contract provisions. Under DCAA policy, a branch manager was required to sign an audit report with significant deficiencies. Although we could not find any documentation of the branch manager's review of this draft report or of a branch manager decision regarding the final audit opinion, the draft opinion was changed. On September 15, 2005, the supervisory auditor signed and issued the final report with all deficiencies removed and an "adequate" opinion. We found no documented reason for the supervisory auditor's reversal of her decision on the "inadequate in part" opinion that she had approved earlier.

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<sup>50</sup>FAR 52.216-7e and FAR 42.704 (b) and (c).

<sup>51</sup>This supervisory auditor also managed the audits associated with cases 9, 10, and 13.

<sup>52</sup>One of the other two originally documented deficiencies had been reviewed by the original acting supervisor as part of the risk assessment process. The other documented deficiency was not approved by a supervisor at that time.

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## Results of Investigation (Case 4)

Our investigation substantiated the allegations. We determined that this audit did not comply with GAGAS<sup>53</sup> because the working papers did not support an “adequate” opinion and the draft conclusions in the working papers were changed without adequate support. Moreover, four of the six significant deficiencies were adequately supported in the working papers but were not reported. For example, according to the supervisory auditor on this audit, the finding of \$246,000 in overbillings due to exceeding contract limits was dropped because it was “insignificant” and because the contractor had identified and repaid the amount. However, the working papers show that at least two of the overbillings were identified by the government, not the contractor. In addition, the original working papers and the results of a prior audit explained that the billing personnel did not have correct information on contract terms, including cost ceilings, indicating a systemic internal control weakness. This was not addressed in the revised working papers or the final audit report. For the other two of the six findings, neither the original auditor’s nor the final working papers supported a determination of whether a finding existed. For example, regarding the \$3.5 million overbilling reported by the first auditor, neither the first auditor nor the second auditor performed sufficient work to determine whether the contractor adhered to FAR requirements to only bill subcontract costs that the contractor had paid in a timely manner. The first auditor documented this potential finding in March 2005. Despite the magnitude of this finding, however, no one reviewed the first auditor’s support until late the following July, although this supervisor was aware of the auditor’s findings. By the time the supervisor’s review took place, the first auditor was working in Europe. Neither the second supervisor nor the second auditor asked the first auditor for support of her finding. Instead, the finding was dropped without working paper support.

In its January 2007 memorandum, the DOD IG concluded that the working papers for this audit supported, at best, an “inadequate in part” opinion and that reliance on data and information generated by these systems puts users and decision makers at risk. Therefore, the DOD IG recommended that DCAA rescind this audit report, gather and evaluate additional evidence, determine the appropriate conclusion, and reissue the report. DCAA stood by its findings and did not rescind the report. According to the DOD IG memorandum, the unsupported “adequate” opinion on this report may have resulted in narrowed audit scopes for other concurrent audits. Moreover, on the basis of the “adequate” audit opinion on its billing

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<sup>53</sup> [GAO-03-673G](#), §§ 6.02a, 6.04b, and 6.22.

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system controls, DCAA authorized Contractor C to bill the government directly—without review of its invoices prior to payment—for the first time. Officials at the DCAA Western Region told us that as a nonmajor contractor, Contractor C was not required to undergo a billing system audit. We acknowledge this point. However, because the branch office performed an audit and issued a report with an “adequate” opinion on the contractor’s billing system, it must have adequate support for that opinion per GAGAS. In this case, the workpapers did not support an adequate opinion. On September 16, 2005, the day after the audit report was issued with an adequate opinion, Contractor C was approved for direct billing. However, based on work paper evidence of significant deficiencies, the contractor should not have been eligible for direct-billing privileges.

In response to our investigation, the DCAA Western Region Deputy Director stated that both auditors had used the wrong contractor report for their test work. On May 22, 2008, DCAA rescinded the audit report and notified the ACO that the report could no longer be relied upon for any matters relating to the contractor. However, DCAA did not revoke Contractor C’s direct-billing privileges, stating that subsequent paid-voucher audits did not identify billing problems. In addition, the Deputy Director advised us that as a result of our findings on inadequate supervisory review, the region established a policy to require supervisory auditors to review audit sampling plans at the time they approve the audit risk assessment.

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### Case 5: 2005 Estimating System Audit of Contractor C

We investigated allegations that the working papers for this audit do not support the opinion because a DCAA supervisory auditor removed audit findings from the draft report. As an estimating system audit, this audit was intended to determine whether the contractor’s method of estimating costs for contract proposals was adequate. As discussed above, Contractor C produces and supports military display systems, global positioning systems (GPS), and satellite communications systems. DCAA reported that for calendar year 2004, Contractor C generated sales of over \$99 million, including \$92 million from DOD contracts.

#### Details of the Audit (Case 5)

On August 9, 2005, the auditor tested six contract proposals from Contractor C. He found errors on two of the six proposals related to FAR

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noncompliance.<sup>54</sup> For these two proposals, the auditor documented that cost analyses were not performed before contract negotiation, BOEs were not signed by a reviewer, and there was no consolidated bill of materials. These were noted as three separate significant deficiencies. The auditor also performed additional testing on the BOEs and found that Contractor C did not provide its estimating methodology when submitting its BOEs. Moreover, for four of the six proposals the auditor reviewed, he documented that he was unable to determine what methodology Contractor C used to estimate labor hours. This was noted as a fourth significant deficiency. Finally, the auditor documented a “lack of use of historical experience” in the estimating process, noting that he could not find any instance in which the contractor used historical incurred-cost records to develop estimates. He also noted that engineers did not have access to historical cost data when determining their estimates of engineering hours. This was originally listed as a fifth significant deficiency. The auditor concluded that Contractor C’s estimating system had five significant deficiencies and was “inadequate in part.” The deficiencies were reported in the following order: (1) failure to perform cost analyses on subcontracts greater than \$550,000 prior to award of the prime contract, (2) lack of an estimating methodology; (3) lack of additional review of estimated engineering hours, (4) lack of the use of historical experience, and (5) failure to provide a consolidated bill of material.

The draft report and working papers were forwarded to the supervisory auditor (the same person as the replacement supervisor in Case 3) for review throughout August and September 2005. Upon her initial review, the supervisory auditor approved the “inadequate in part” opinion and four of the five deficiencies, deleting the finding of a lack of an estimating system methodology. Then on September 23, 2005, she submitted the working papers to the branch manager for review. The branch manager told us that “after taking one look at the working papers” she felt the supervisory auditor needed to review the auditor’s support for the audit findings.

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<sup>54</sup>FAR 15.403-4(b) requires contractors to provide support for estimates, including cost and pricing data and a certification from the contractor that those data are accurate, complete, and current. FAR 15, table 15-2, provides instructions for submitting pricing proposals, to include judgmental factors, mathematical methods, and, depending on the system, support for labor, materials, and other costs.

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Following the branch manager's review, the supervisory auditor reviewed the working papers again. During her final review, the supervisory auditor revised several working papers and signed one revised working paper herself as the preparer and reviewer, a noncompliance with GAGAS.<sup>55</sup> Regarding significant deficiencies one, three, and five, the supervisor noted that they were suggestions for improvement rather than significant deficiencies, and edited the auditor's summary of test results to conclude that the findings "do not appear to be systemic problems as they were limited occurrences in our sample." Although audit work was based on a small judgmental sample, the supervisory auditor did not explain why she considered deficiencies in three of six sample items to be insignificant or why she summarily concluded that there was no systemic problem without additional test work to determine the extent of the deficiencies. In our judgment, to determine whether the errors were systemic, the supervisory auditor should have instructed the auditor to expand his testing and perform additional work. The supervisory auditor deleted the second and fourth deficiencies entirely. Regarding the second deficiency, the supervisory auditor wrote a comment that the contractor told her that although the estimating methodology details were not in the BOEs, they were documented with the contractor's supporting documentation. However, the supervisory auditor did not review or request that the auditor review this additional documentation to test the contractor's assertion. This should have been done in order to verify the contractor's statements. The supervisor did not initially document why she deleted the fourth deficiency. However, in a Memorandum for the Record dated May 21, 2007, the supervisor stated that the auditor was "probably not qualified to judge" the basis for using historical engineering hours, and that the auditor's working papers were not sufficient to support this finding. If the supervisor was correct about the auditor's qualifications to do this work, she should have increased her supervisory guidance or requested assistance from a technical expert.<sup>56</sup> However, our investigation determined that the auditor was an experienced senior contract auditor who was subsequently detailed to DCAA location 3 to help provide needed experience to assist that resident office with its forward pricing proposal audits. Further, there was no evidence in the working papers that a technical expert who would be qualified to judge the basis for using historical engineering hours was consulted on this audit. The supervisor's

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<sup>55</sup> GAO-03-673G, § 6.24e.

<sup>56</sup> GAO-03-673G, §§ 6.39 and 6.04a.

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rationale for dropping the fourth finding is not supported by factual evidence.

On September 23, 2006, the supervisory auditor held an exit conference with Contractor C's pricing manager without the auditor's presence. A record of the meeting shows that the supervisory auditor told the pricing manager that the final report would include several suggestions for improvement. On September 25, 2005, the supervisory auditor transmitted suggestions for improvement via e-mail to the pricing manager. After receiving the suggestions for improvement, on September 29, 2005, the pricing manager told DCAA he had to take care of a family emergency and requested that DCAA wait for his response. However, DCAA issued the report with the suggestions for improvement before the pricing manager returned.

According to the auditor, his supervisor told him that the branch manager did not agree with the first and fifth deficiencies (lack of timely cost analysis and lack of bill of material), but that the branch manager did agree with the fourth deficiency (failure to use historical experience) and that the opinion would remain "inadequate in part." On September 29, 2005, the auditor documented his disagreement with the decision on the first and fifth deficiencies in the working papers.

On September 30, 2005, DCAA issued its estimating system audit report with an "adequate" opinion and suggestions for improvement related to three of the five significant deficiencies the auditor identified originally (late cost analysis on subcontracts, lack of review of engineering hours, and failure to consistently provide consolidated bills of material). The auditor told us that he was surprised by the final opinion. He told us that the fourth deficiency (failure to use historical experience) represented, in his view, the greatest risk to the government of all his findings. In particular, DFARS<sup>57</sup> specifies that the failure to ensure that historical data is available to, and utilized by, cost estimators where appropriate is an indicator of a potentially significant estimating system deficiency.

## Results of Investigation (Case 5)

Our investigation substantiated the allegations. We determined that this audit did not comply with GAGAS because the working papers did not support the "adequate" opinion that was issued on the last day of fiscal year 2005, and the draft conclusions in the working papers were changed

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<sup>57</sup>DFARS 15.407-5-70(d)(3)(i).



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without adequate documentation. Further, some of the original auditor's findings were not adequately supported in the working papers, but the supervisory auditor dropped the findings or concluded that they were insignificant without appropriate support for her position in the working papers. In its January 2007 memorandum, the DOD IG recommended that DCAA rescind this audit report, gather and evaluate additional evidence, determine the appropriate conclusion, and reissue the report. DCAA stood by its findings and did not rescind the report. In addition, on May 21, 2007, the supervisory auditor prepared a Memorandum for the Record documenting her conclusions on the first, fourth, and fifth deficiencies, but not the second and third deficiencies. In this memorandum, the supervisor included supporting documentation that was not considered at the time the audit was performed and reviewed, and the supervisor made several statements that contradicted her judgments as documented during the performance and review of the audit.

DCAA Western Region officials told us that the findings related to Contractor C not performing cost analysis on subcontracts greater than \$550,000 were justifiably dropped because subsequent analysis showed that this requirement was met. Western Region officials also stated that Contractor C used parametric estimating techniques to determine the number and type of spare parts and, therefore, would not be required to have a bill of materials. However, FAR does not preclude use of a bill of materials when parametric estimating is used. Further, historical experience on repairs could serve as a basis for a bill of materials. Although the officials stated that they believe the reported opinion is correct, they did not validate Contractor C's estimating methodology or address Contractor C's failure to use historical experience, which is a significant estimating deficiency. As a result, the change to an "adequate" opinion was not supported. On June 27, 2008, a DCAA Western Region official informed us that after further review, DCAA had rescinded this report and notified the ACO that the report could no longer be relied upon for any matters relating to the contractor.

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## Case 6: 2005 Accounting System Audit of Contractor D

This audit was requested by a Department of Energy ACO. We investigated allegations that the working papers for this audit do not support the opinion because (1) sufficient work was not performed to support the audit opinion and (2) a DCAA supervisory auditor<sup>58</sup> removed audit findings from the draft report without adequate support. According to the allegation, the working papers support an “inadequate in part” opinion on Contractor D’s accounting system and related controls. Contractor D is a publicly traded engineering, construction, maintenance, and project management company. Contractor D has provided temporary housing to victims of Hurricane Katrina and performed work in Iraq and Afghanistan. For calendar year 2006, Contractor D reported over \$14 billion in revenue, including \$2.9 billion in revenue from government business.

### Details of the Audit (Case 6)

While performing this work, the auditor (the same auditor as in Case 3) identified costs that were misallocated among the contractor’s directly allocated corporate expense pools. The auditor reviewed \$203,263 in transactions from the contractor’s population of about \$11 million in directly allocated expense pools. The auditor found that \$47,955 (i.e., about 24 percent) of the reviewed costs were corporate-level direct charges that were miscoded and should have been passed directly to federal government business units, but were instead charged to the contractor’s federal services segment, which serves as an administrative office for the federal government business units. In this situation, the federal services segment costs would be inflated. The auditor also noted that the federal services segment was adding on a general and administrative (G&A) overhead expense as the direct costs were passed through it. The inflated federal services segment costs, combined with the added G&A expenses, would serve to inflate costs to the government overall. The auditor identified a 100 percent error rate for miscoding in two of the pools and high error rates in two other pools. Even though the auditor identified no errors in certain material cost pools, the testing performed was very limited. For example, the information technology pool contained \$2,772,630 in allocated costs, but the auditor only reviewed \$81 in costs allocated to this pool and did not find any errors. The auditor said that she asked the supervisory auditor to allow her to perform further transaction testing, but her request was denied. No further testing is documented in the working papers.

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<sup>58</sup>The supervisor for this audit was the same supervisory auditor in Cases 5, 7, 9, and 12 and the replacement supervisor in Case 3.

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On September 4, 2005, the auditor submitted her working papers and draft report to the supervisory auditor. The draft report concluded that the contractor's accounting system was "inadequate in part." Working papers indicate that the supervisory auditor initially concurred with the auditor's opinion. However, when the supervisory auditor discussed the findings with the branch manager at this location, the branch manager stated that she did not understand how the findings constituted an "inadequate in part" opinion and suggested that the issue be referred to a different DCAA office. The supervisory auditor subsequently agreed with the branch manager. At a September 26, 2005, meeting, the branch manager and supervisory auditor questioned the auditor about whether the miscoded costs were material and recommended that the issue be referred to a different DCAA office with audit responsibility for Contractor D's federal services business segments. The auditor disagreed with the supervisory auditor and branch manager. In accordance with DCAA policy, the auditor documented her disagreement in the working papers. The supervisory auditor also documented her disagreement with the auditor.

On September 28, 2005, the supervisory auditor revised the auditor's summary working papers to state that the contractor's accounting system was "adequate" and to cite one suggestion for improvement. The supervisory auditor signed these working papers as both the preparer and reviewer. To justify the position that the miscoded costs were not material, the supervisory auditor told us that the \$47,955 in miscoded costs was immaterial in relation to the contractor's approximately \$1.05 billion in total G&A overhead costs. The supervisory auditor also told us that testing of transactions in the two pools containing the majority of directly allocated costs—the real estate pool and the information technology pool—had not found any errors. The report was issued on September 29, 2005, with an "adequate" opinion and one suggestion for improvement. The report included as a suggestion for improvement that relevant Contractor D employees receive additional training on the allocation of corporate direct costs to the benefiting segments. The branch manager also told us that her office had referred the miscoding errors to the DCAA office responsible for auditing Contractor D's federal services segment.

## Results of Investigation (Case 6)

Our investigation substantiated the allegations. We determined that the audit did not comply with GAGAS<sup>59</sup> because the working papers did not contain sufficient audit evidence to support an "adequate" opinion and the

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<sup>59</sup>GAO-03-673G, § 6.22.

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draft conclusions in the working papers were changed without adequate supporting documentation. Our investigation found that the supervisory auditor made an incorrect determination that the nearly \$48,000 in miscoded costs did not provide evidence of a material weakness. In fact, it represented a significant percentage (24 percent) of the costs that were tested. However, because additional testing was not performed, the full extent of misallocated costs is unknown. Test work in the real estate and information technology cost pools was also too limited to conclude that miscoding errors did not exist in those pools. Further, the supervisor's comparison of the misallocated direct expenses to the G&A cost base, representing indirect costs, is not relevant. Moreover, the working papers that summarized the final audit findings and conclusion were prepared and reviewed by the supervisory auditor. In order to comply with GAGAS,<sup>60</sup> evidence of supervisory review—for example, by the branch manager—should have been documented in the working paper files.

Further, the referral of the corporate-level misallocations to the branch office responsible for Contractor D's federal services segments was not appropriate and did not address the underlying concerns with the corporate accounting system. DCAA Western Region officials told us that the other DCAA branch office had audited corporate costs during its most recent incurred cost audits of Contractor D's federal services segment, and provided us with the related audit reports, in which that branch office questioned 100 percent of one of the corporate cost pools (legal expenses). However, the branch manager at the other DCAA office told us that his office only audited the federal services segments' portion of the corporate costs, not the entire pools, and that his office does not review corporate cost allocations. DCAA agreed that the working papers do not adequately document the issues associated with the "miscoded" costs. DCAA advised us that a separate assignment has been established to test the contractor's internal controls related to the proper coding of corporate costs.

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<sup>60</sup>GAO-03-673G, § 6.24e.

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Our review of the audit workpapers and interviews with the supervisory auditor identified two qui tam<sup>61</sup> cases involving allegations that Contractor D had improperly charged government business segments for corporate G&A overhead and various unallowed costs. Based on this history of overcharging corporate overhead to the government, we would have expected the auditors to assess risk as high and increase testing. The first qui tam case, filed in December 1997, alleged that unallocable indirect costs incurred by a Contractor D division for 1995 through 1997 were charged to government contracts in violation of applicable FAR and CAS requirements and the False Claims Act. Contractor D denied the allegations, but agreed to settle the case for \$8.2 million. The second qui tam case filed in March 2000 involved similar allegations, specifically, that Contractor D knowingly misrepresented costs of an accounting system conversion and improperly allocated a disproportionate share of general and administrative costs, capital facilities interest rate, executive and management bonuses, computer network costs, and certain unallowable cost, including lobbying, international sales, and luxury items, to government contracts. This case was settled in October 2005 for \$12.4 million.

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#### Case 7: 2005 CAS 403 Compliance Audit of Contractor D

We investigated allegations that the working papers for this audit do not support the opinion because a DCAA supervisory auditor removed audit findings from the draft report and asked another auditor to write a “clean (adequate) opinion” report. The purpose of the audit was to determine whether Contractor D’s corporate office was in compliance with CAS 403 requirements regarding allocation of home-office expenses from January 1, 2004, through September 15, 2005. Contractor D is a publicly traded engineering, construction, maintenance, and project management company. Contractor D has provided temporary housing to victims of Hurricane Katrina and performed work in Iraq and Afghanistan. For calendar year 2006, Contractor D reported over \$14 billion in revenue, including \$2.9 billion in revenue from government business.

#### Details of the Audit (Case 7)

This audit also was requested by the Department of Energy ACO. From June 28, 2005, through approximately September 15, 2005, the same

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<sup>61</sup>The False Claims Act (31 U.S.C. §§ 3729-3733) establishes civil penalties against persons who commit certain acts, for example, knowingly presenting a false or fraudulent claim for payment to the United States. In addition to the Attorney General, private persons may enforce the False Claims Act in a qui tam action and be paid a percentage of the proceeds of such the action or settlement. 31 U.S.C. § 3730 (b), (d).

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auditor as in Case 6 performed this audit under the supervision of the same supervisory auditor from Case 6. According to the audit working papers, the auditor originally identified six potential instances of noncompliance with CAS 403. On the basis of our review of the working papers and our discussions with the auditor, we determined that two findings were substantially the same as others and did not warrant presentation as separate findings. The four key findings related to (1) allocation of Group Executive—Government Services costs, (2) misallocated corporate expenses, (3) add-on of G&A pass-through expenses after directly allocating costs,<sup>62</sup> and (4) allocation basis for liability insurance. The auditor was assigned to another team before she could complete the audit and transferred the working papers to the supervisory auditor on October 3, 2005, for her review. The supervisory auditor subsequently reviewed the working papers and partially documented her disagreement with the auditor’s work, but no additional audit work was performed.

- The auditor documented that the contractor incorrectly used the three-factor formula to allocate Group Executive—Government Services costs home-office expenses. The auditor concluded that this was a noncompliance with CAS 403,<sup>63</sup> because such costs are homogeneous costs, which are required to be allocated using a causal or beneficial relationship instead of using a three-factor formula. The supervisory auditor disagreed and eliminated this finding.
- The auditor believed that Contractor D was not in compliance with CAS 403<sup>64</sup> because it improperly allocated corporate charges that benefited other nongovernment business units to its federal services segment. According to the working papers, the DCAA branch office provided an audit lead on this issue via e-mail to a different DCAA office with responsibility for auditing this contractor’s federal services segment costs on September 6, 2005, for follow-up. The supervisory auditor used this referral as justification for eliminating the finding from the final report, stating in the working papers that it was not within the scope of the audit to pursue the potentially misallocated expenses. This was similar to the referral of two findings in Case 6.

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<sup>62</sup>The second and third findings noted were also identified during the accounting system audit discussed in Case 5.

<sup>63</sup>CAS 403-40(b)(3).

<sup>64</sup>CAS 403-40(a)(1).

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- The auditor believed that corporate project costs related to certain government business units had been inflated, in noncompliance with CAS 403.<sup>65</sup> The auditor explained in her working papers that Contractor D passed these costs through its federal services home office, which improperly added G&A expenses. The supervisory auditor disagreed and eliminated this finding. The supervisory auditor also referred this finding to the other DCAA office noted in Case 6 to determine the cost impact, if any.
  - The auditor believed that the contractor's use of a total labor dollar base to allocate General Liability and Excess/Umbrella Liability Insurance did not comply with CAS 403,<sup>66</sup> because the allocation base should have been based on both payroll and revenue dollars. The supervisory auditor disagreed and eliminated this finding without documenting the reason for doing so.

In addition to providing inadequate documentation to justify the elimination of the draft audit findings, the supervisory auditor did not provide documentation in the workpapers to show that she discussed her disagreement on these findings with the auditor as required by the CAM.<sup>67</sup> Instead, nearly 3 months after the auditor submitted the working papers for review, on December 30, 2005, the supervisory auditor asked another auditor to write a "clean opinion" report for this audit using "boilerplate" (i.e., standardized) language. The second auditor was the same individual as the acting supervisor in Case 4. According to the second auditor, the supervisory auditor asked him to use boilerplate language because she sought to issue the report the same day. The second auditor told us that he did not review the audit working papers because he had "too much work" on the day the supervisory auditor wanted to issue the report. The final report was issued on December 30, 2005, and stated that the contractor complied with CAS 403 in all material respects. The original auditor told us that she did not learn the report had been issued until she was contacted by a Department of Energy procurement official in February 2006. The procurement official was aware of the original preliminary findings of noncompliance and wondered why they had been removed from the final report.

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<sup>65</sup>Ibid.

<sup>66</sup>CAS 403-40(b)(4).

<sup>67</sup>CAM 4-403f(2).

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## Results of Investigation (Case 7)

Our investigation substantiated the allegations. We confirmed that another auditor wrote the “clean” opinion report without looking at the supporting working papers. We also determined that this report did not comply with GAGAS<sup>68</sup> because the working papers did not support the reported adequate opinion that Contractor D was in compliance with CAS 403, and the draft conclusions in the working papers were changed by the supervisory auditor without adequate audit evidence. We concluded that the supervisory auditor was correct in eliminating the first finding related to the contractor’s use of the three-factor formula for allocating corporate expenses to the federal services group and the fourth finding related to the allocation base for liability insurance cost. However, despite the claims of the supervisory auditor, we determined that referring the potential deficiencies related to misallocated costs (findings two and three) to a different DCAA office was not appropriate. These findings indicated corporate-level CAS 403 noncompliances related to misallocations of home-office expenses. The branch manager of the FAO to which these issues were referred told us that his office does not audit corporate costs of this contractor. Therefore, the corporate-level CAS 403 noncompliance issues were not fully audited by either office. Moreover, by asking an auditor who was unfamiliar with the work to write a “clean opinion” in 1 day using boilerplate language and without reviewing the working papers or obtaining additional audit support, the supervisory auditor deviated significantly from GAGAS requirements for performing sufficient testing and obtaining sufficient audit evidence to express an opinion and support conclusions.<sup>69</sup> The supervisory auditor later explained her reasons for disagreement with the original auditor’s findings more fully in a May 21, 2007, Memorandum for the Record. The explanation in the memorandum was similar to the explanation given by the DCAA Western Region on July 27, 2007, in its response to the DOD IG findings. The supervisory auditor’s memorandum presented the rationale noted above for transferring corporate cost allocation issues to another FAO that we determined does not review corporate cost allocations, and it contained several errors and miscalculations related to the basis for allocating liability insurance costs.

While conducting our investigation, we learned that DCAA contradicted its 2005 “clean opinion” of Contractor D’s compliance with CAS 403 in a report issued on September 21, 2007. This report expressed the opinion that Contractor D was, in fact, not in compliance with CAS 403 from

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<sup>68</sup> GAO-03-673G, § 6.22.

<sup>69</sup> GAO-03-673G, §§ 6.02a, 6.04b, and 6.22.



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January 1, 2004, through December 31, 2004, part of the time period covered by the “clean” opinion reported in 2005. The basis for noncompliance identified in the 2007 report was not mentioned in the 2005 audit working papers. The noncompliance related to an “uplift” in costs for doing work in the Iraq war zone, which affected Contractor D’s labor allocation base. DCAA Western Region officials stated that at the time the 2005 audit was being performed, Iraq work was “ballooning” at DCAA, but DCAA often did not have much information available on increased costs associated with this work. In addition, during 2005, Contractor D was in the process of settling a qui tam suit related to misallocations of costs, including CAS 403 noncompliance. The contractor had also settled a similar qui tam suit in 2001. Until the second qui tam suit was settled, Contractor D was under a “suspension of administrative process” under which its incurred cost claims could not be audited. However, the FAO did not include a cautionary note in the audit report that other information could become available when ongoing issues are resolved that could affect the audit opinion, and the report did not include a discussion of a scope limitation related to insufficient documentation on war-related costs.

In response to our corrective action briefing, DCAA agreed that the working papers do not fully explain the supervisor’s rationale for eliminating some of the auditor’s draft findings. However, DCAA disagreed with our position that two findings should not have been referred to the other DCAA office. DCAA also disagreed that the audit report should have included a scope limitation for the lack of incurred cost proposals and the ongoing qui tam investigation. However, DCAA stated that during discussions with us and the DOD IG during the past several months a number of questions were raised regarding the accounting methodology at both the corporate office and the federal services group regarding corporate cost allocations. As a result, DCAA said it has expanded the scope of the 2008 CAS 403 compliance audit to thoroughly address these questions.

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### Case 8: 2004–2006 Forward Pricing Audits of Contractor E

We investigated allegations of problems with the audit environment at this resident office—location 3. Specifically, we received allegations that this resident office was issuing audit reports before work was completed. In addition, the two forward pricing audit supervisors at location 3 told us that inexperienced trainees were being assigned to complex forward pricing (proposal) audits without proper supervision, and one supervisor noted problems that resulted in losing control over the audit workpapers. Although these audits were not part of our original investigation, a DCAA employee came forward while we were conducting our work and alerted

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us to this issue. We investigated the complaints by interviewing the two supervisory auditors, both of whom retired from DCAA in early 2007, who had supervised 62 forward pricing audits at this location from fiscal year 2004 through 2006. We also reviewed documentation relevant to the case. The forward pricing audits in question were related to Contractor E, a publicly traded company that designs government business and defense weapons systems. For calendar year 2006, the contractor reported that the division under which this California office is grouped generated about \$5.28 billion in revenue from government sales. Contractor E is one of the five largest DOD defense contractors in terms of contract dollars.

#### Details of the Audit (Case 8)

During fiscal years 2004 through 2006, the DCAA resident office and its suboffices issued 113 reports on forward pricing audits<sup>70</sup> related to Contractor E. Of the 113 forward pricing audits, 62 audits were led by the two supervisory auditors assigned to the resident office location. Forward pricing audits are important because they affect how much the government pays for goods and services. They are complex engagements, requiring the auditor to have years of contract auditing experience and a proficient understanding of CAS, FAR requirements for cost and price analysis, unallowable costs, and details of the contractor's industry. For example, the auditor must know the types of materials at risk of overcharges and how to look at related sources of information for cost comparisons.

Newly hired trainee auditors are required to take extensive in-house DCAA training. Within the first 2 months of being hired, trainees spend 2 weeks at DCAA's Defense Contract Audit Institute in Memphis, Tennessee,<sup>71</sup> where they receive mandatory new-hire technical indoctrination training. This training covers topics such as ethics, contract auditing procedures, and unallowable costs under FAR Part 31. Six months after the indoctrination training, new hires may begin taking other courses, such as intermediate contract auditing. In addition, trainees take online computer managed training library courses. DCAA's practice is to use senior

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<sup>70</sup>As defined in CAM 9-001, forward pricing audits involve the evaluation of cost elements used in contractor estimates supporting price proposals in connection with the award, administration, modification, and repricing of government contracts. Although DCAA generally uses the term audits, it performed some of these forward pricing assignments as examination-level attestation engagements and others as agreed-upon procedures assignments. No opinion is issued on agreed-upon procedures work.

<sup>71</sup>According to DCAA headquarters officials, the Defense Contract Audit Institute is registered with the National Association of State Boards of Accountancy.

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auditors as advisors or mentors to trainees and to assign trainees to work with journey-level auditors (generally grade GS-12) who are to assist supervisors with on-the-job training and development of new hires. On-the-job training plays a large role in trainee development.

As a part of their initial training, new hires are also instructed on the purpose and use of DCAA's Audit Planning and Performance System (APPS). APPS operates as a stand-alone system at each FAO and is used to store workpapers for ongoing audits. Workpapers are exported as auditors need to work on them and then imported so that supervisors can export them for review. When audits are completed, DCAA policy requires the workpapers to be archived in the Integrated Recorded Information Management System within 10 days.

## Results of Investigation (Case 8)

Our investigation substantiated the allegations. DCAA partially agreed with our findings, as noted in the following discussion.

- **Workpaper review.** The two supervisors, who approved and signed 62 of the 113 forward pricing reports issued by this resident office during fiscal years 2004 through 2006, admitted that they generally did not review workpapers in final form until after reports were issued. According to GAGAS, working papers should contain evidence of supervisory review prior to report issuance.<sup>72</sup> The DCAA Western Region Quality Assurance Manager told us that errors had been identified on some of these reports after they were issued. DCAA agreed that the two supervisors did not always properly review the working papers prior to report issuance. When the new FAO manager became aware of this practice, she counseled one supervisor to discontinue this practice immediately (although he retired 3 days later). The FAO manager followed up with an e-mail to the entire staff that this practice was not acceptable. The second supervisor has since retired.
- **Assignment of trainees to complex audits without adequate expertise.** Trainee auditors were assigned to complex forward pricing audits as one of their first assignments because management believed that information on labor and overhead rates was available and that these audits were straightforward. However, one former supervisory auditor pointed out that the trainees had no institutional knowledge about the types of materials at risk of overcharges, how to look at

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<sup>72</sup>GAO-03-673G, § 6.24e.

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related sources of information for cost comparisons, or how to complete the analysis of complex cost data required by FAR.<sup>73</sup> The two former supervisors told us that trainee auditors assigned to them had only worked for DCAA for a few months and that they lacked the experience needed to perform these audits. For example, the trainees were not capable of discerning whether (1) materials identified in proposals were appropriate for the product being developed, (2) contractor personnel assigned to projects had the right skills to perform the required work, and (3) estimates submitted met relevant FAR requirements.

DCAA did not agree that auditor trainees were assigned to complex forward pricing audits without requisite skills. DCAA stated that during their first year, trainees have up to 300 training hours to apply directly to audits to ensure that they spend an adequate amount of time on audits. Based on our investigation, the 300 hours is on-the-job training hours that are allowed in addition to planned audit hours on particular assignments. This does not mean that trainees always receive on-the-job training. For example, trainees and supervisors that we interviewed during our investigation at locations 2 and 3 told us that DCAA classroom training is high level and does not provide insights or expertise needed to perform all the technical aspects of various contractor audits. To provide on-the-job guidance, location 2 had provided increased supervision for trainees by assigning them to one supervisor with responsibility for trainees and also assigning a senior-level auditor to work with them on their audit assignments. One of the former supervisory auditors at location 3 told us that there is disconnect between DCAA training and what trainee auditors are required to do on the job. The former supervisor told us that at one point when she was acting supervisor at the resident office, she was “tasked with training seven new hires working on seven separate projects and this was not possible.” The other former supervisor told us “the lack of experience of these auditors and the pressure to complete the proposal audits in limited time was ridiculous.”

DCAA also stated that trainee auditors worked on 18 of the 62 assignments, and that several of these assignments were not complex based on audit scope and dollar amount. However, the summary-level documentation that DCAA provided was incomplete, and we have not

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<sup>73</sup>FAR 15.404-1, 15.407-3, and 15.407-5, table 15-2.

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seen or reviewed the underlying supporting documentation. Further, while we recognize that some types of audits, such as forward pricing rate agreements, pose less risk than other audits, we do not agree with DCAA that as a general matter cost-type audits are not inherently less risky because, unlike a fixed-price contract where the government has agreed to pay an established amount, the government agrees to pay all reasonable and allocable costs the contractor incurs during contract performance.

- **Lack of proper supervision and review of work.** Our investigation determined that supervisors did not always have the benefit of experienced journey-level auditors to assist them in supervising the trainees. As a result, supervisors were overwhelmed by their dual responsibility for supervising numerous trainees and completing forward pricing audits within 20 to 30 days to meet time frames for contract negotiations. Further, supervisors did not always review audit work performed by senior auditors that they trusted. GAGAS state that assistants shall be properly supervised.<sup>74</sup>
- **Lack of understanding of the electronic workpaper system.** One former supervisor told us that newly hired auditors and administrative staff did not have an adequate understanding of DCAA's electronic workpaper filing systems. The former supervisor explained that APPS training on the automated workpaper system for trainee auditors sometimes would be delayed for 3 to 4 months in order to focus on getting the audits done. He said this lack of understanding contributed to the resident office losing control of audit documentation. For example, trainees would export audit workpaper sets to document their work and forget to import them or they would duplicate the files and then forget which version was updated. In this environment, workpapers did not always get imported and some were lost and had to be recreated later.

With regard to late filing of audit documentation for completed audits, one former supervisory auditor told us that the resident office administrative employee responsible for archiving workpaper sets for completed audits did not always do so. The former supervisor also told us that during 2006, this resident office worked with the Western Region to reconcile completed audit workpaper sets to final, archived files for fiscal years 2004 through 2006. According to the former

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<sup>74</sup>GAO-03-673G, §§ 3.39 and 6.04a.

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supervisor, there were about 20 to 30 audits going back to 2004 that were not closed out properly. He said that there was significant improvement during 2006, but there were still some problems. GAGAS state that auditors should collectively possess adequate professional competence for the tasks required and assistants shall be properly supervised, and that audit organizations need to adequately safeguard audit documentation associated with any engagement.<sup>75</sup>

DCAA disagreed with our conclusion that trainee auditors had an inadequate understanding of the electronic workpaper system. In addition, DCAA Western Region officials stated that they provided us with results of quarterly reconciliations for 2006 and 2007 that showed no more than seven assignments per quarter had not been filed timely. However, the period identified in the allegations covered fiscal years 2004 through 2006. Documentation provided by DCAA Western Region officials showed that 6 of 520 total audits issued by the resident office had not yet been archived. The officials did not discuss or provide documentation for audits that were archived in fiscal years 2004 and 2005. However, based on the limited number of assignments that had not been archived at the end of fiscal year 2006, we concluded that this problem had been addressed.

- **Pressure to complete audits in short time frames.** Moreover, two former supervisory auditors told us that the volume of requests for the audits, short time frames demanded by customers for issuing reports to support contract negotiations (e.g., 20 to 30 days), and limited resources affected their ability to comply with GAGAS. Both former supervisors told us that the failure to issue forward pricing audit reports on time would have negatively affected their performance appraisals. They told us that they retired from DCAA in 2007 because they no longer wanted to face the risk associated with performing forward pricing audits in this environment.

Productivity rate, or contract dollars audited per hour, is a leading metric DCAA uses to measure the efficiency of its audits. DCAA supervisory auditors at this location told us that pressure to meet this metric drives down the amount of time spent auditing, compromises audit quality, and increases the risk of financial harm to the government. Auditors said that they felt pressure to complete forward

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<sup>75</sup>GAO-03-673G, §§ 3.39, 6.04a, and 6.26.

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pricing audits because (1) contracting officers require short turnaround, generally 30 days, to meet contract negotiation time frames and (2) DCAA considers meeting customer requirements to be a top priority. The supervisory auditors said that this does not provide sufficient time for them to complete all the required audit steps. Moreover, one supervisor told us that contracting officers would sometimes tell auditors to issue proposal audit reports in as few as 20 days with whatever information the auditor had at that time, and the contracting officers would then begin contract negotiations. The contracting officers would ask the auditors not to cite a scope limitation in the audit reports, as required by GAGAS,<sup>76</sup> because they could not use such a report in contract negotiations. Yielding to contracting officer pressure to limit audit scope without proper disclosure is an impairment to auditor independence. As a result, the contracting officers could be negotiating contracts with insufficient information to support the associated rates. The problems at this location call into question the reliability of at least the 62 forward pricing audits reports signed by the two supervisory auditors at this office from fiscal years 2004 through 2006, which were related to pricing proposals totaling over \$6.4 billion.

DCAA commented that its agencywide goal is to issue forward pricing audits in an average of 30 days in order to support the procuring community with timely audits. Further, DCAA stated that although the supervisors may have felt pressure to issue forward pricing audits in 20 to 30 days, 5 of the 18 audits were issued in 30 or more days. DCAA officials stated that executive management continually stresses that management should provide auditors the appropriate time for completing the audit in accordance with GAGAS and the goal does not mean that all audits must be issued within 30 days.

We also learned that in preparation for a DOD IG audit quality review at the resident office, the DCAA Western Region performed a quality review of selected audits performed by this resident office to assess its vulnerability and to take any needed corrective actions before the upcoming DOD IG review.<sup>77</sup> The Western Region's quality assurance manager and the resident auditor told us that the quality review had found

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<sup>76</sup>GAO-03-673G, § 6.27c.

<sup>77</sup>This is not the same review as discussed in the DOD IG's January 24, 2007, memorandum of investigation.

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“a few” errors in issued forward pricing audit reports. Our review of the Western Region’s quality assurance report showed that the Western Region reported 28 total systemic weaknesses in 9 of 11 selected forward pricing audits performed by the resident office in fiscal year 2006. Identified systemic deficiencies included

- no documentation of supervisory review, or supervisory review comments were not addressed until after report issuance;
- audit criteria not included in the audit documentation;
- no draft report in the working papers, or draft reports not sufficiently cross-referenced to working papers; and
- no documentation of approved extensions for audit report issuance dates.

The issues identified in the Western Region’s quality review demonstrate noncompliance with several GAGAS standards, which state that assistants shall be properly supervised, suitable criteria must be available to users of the engagement, audit documentation should support the audit conclusions, and audit documentation should contain evidence of supervisory review before report issuance.<sup>78</sup>

DCAA does not agree that the quality review identified systemic deficiencies in forward pricing audits most of which relate to GAGAS noncompliance and stated that our conclusion overstates the results of the review. DCAA noted that the review disclosed that the overall compliance rate for forward pricing audits was 93 percent based on “yes” and “no” responses to over 1,000 questions. We disagree with DCAA’s review methodology, which formed the basis for DCAA’s conclusions. For example, because the design of questionnaires and tabulations of “yes” and “no” responses can bias the results, we analyzed the individual findings of systemic deficiencies that were documented in the DCAA quality review report. Our analysis showed that the review identified a total of 28 systemic deficiencies, including one or more systemic deficiencies on 9 of the 11 audits reviewed. Of the 28 systemic deficiencies, 23 related to the allegations we investigated.

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<sup>78</sup>GAO-03-673G, §§ 6.04a, 6.03, 6.22, and 6.24e.



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DCAA management noted that since fiscal year 2006 they have taken several steps to address the issues noted above. For example, after a Western Region quality assurance review found that audit reports at this location were being issued without proper workpaper review, the resident auditor counseled the two supervisory auditors and sent a notice to audit personnel that this practice was not acceptable. In addition, the Western Region began temporarily assigning more experienced auditors from other field offices to work at this location. Further, Western Region officials acknowledged that there was a period of time when working papers were not being archived timely. The officials told us that they made improvements and now have effective controls in place.

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## DCAA Management Actions Intimidated Auditors, Impaired Some Audits, and Created a Generally Abusive Environment

During the DOD IG and GAO investigations, we documented a pattern of frequent management actions that served to intimidate some of the auditors and create an abusive environment at two of the three locations covered in our investigation—locations 1 and 2. These actions were documented in e-mail guidance from the Western Region and FAO managers and supervisors, instructions at staff meetings, and meetings with individuals. Our review of the documentation and interviews with numerous current and former auditors, supervisors, and managers concluded that they set an authoritative and abusive tone in which several auditors told us they preferred to speak with us on a confidential basis without their management or supervisors present. A few auditors were hesitant to speak with us even on a confidential basis. Examples of specific management actions include the following:

- We learned of reassignments of auditors and were told of verbal admonishments and threats of disciplinary action against auditors who raised questions about management guidance or who spoke with or contacted GAO, contracting officers, or investigators within DOD without prior management approval. As a result, at least two DCAA auditors have filed complaints as whistleblowers with the Office of Special Counsel.
- During one of the audits we investigated, a field office manager threatened a senior auditor with personnel action if he did not change a draft audit opinion to “adequate.” An Air Force official, who was aware of this situation, told us that he advised the auditor to make the requested changes rather than risk losing his job.
- During the DOD IG investigation, management provided notices to auditors regarding release of audit information to outside parties. For

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example, we were told that management at one FAO instructed auditors not to provide any internal documents to investigative units. Management at this location also advised auditors in staff meetings that they could be suspended or terminated for speaking ill of the agency or making false accusations against a coworker or speaking ill of a coworker. This guidance was perceived by some audit staff as including submission of hotline referrals and discussions with investigators.

- During our on-site interviews, management at all three locations required documentation requested by GAO to be provided through them. This is a normal management procedure to ensure the consistency and accuracy of information provided to outside parties. However, at one location, some auditors were permitted to give us information directly while others were required to submit information through their management. At two locations, several auditors indicated that they wanted to provide us certain information, but they were afraid of reprisals if their management learned they had done so.
- After our investigative interviews, supervisory auditors and the branch manager at one location asked some of the auditors, including trainees who were in probationary positions, to disclose to them what they told us. Some of the probationary trainees told us that this questioning made them feel pressured or uncomfortable.
- Excessive written documentation was required following some auditor meetings with our auditors and investigators. Although DCAA's CAM requires that contacts with GAO and other outside parties be documented to keep management informed, we learned of examples where auditors had been required to write memorandums up to 30 pages in length to document the details of their discussions. The requirement to document discussions with GAO discouraged some auditors from talking to us because it affected time frames for completing their audit assignments. For example, one auditor had to stay late on a Friday and use personal time to meet this requirement. The auditor was subsequently told that his shorter memorandum was sufficient.

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## Corrective Action Briefing and Agency Response

On June 20, and 25, 2008, we briefed DCAA and DOD on the results of our investigation. On July 3, 2008, DCAA provided a response to our briefing that stated that the three FAOs whose audits we investigated are currently operating at a satisfactory level of compliance with GAGAS. DCAA's response also stated that it did not agree with the "totality" of our overall conclusions. However, DCAA acknowledged that shortcomings existed in

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the working paper evidence and documentation to support the final audit conclusions in several of the assignments we investigated. DCAA's response noted that the rationale for dropping many of the significant deficiencies from audit reports was not adequately supported or documented and stated that DCAA has no evidence that the supervisor "willfully" removed findings from the audit reports. DCAA also acknowledged that in some cases additional work should have been performed to support the final audit opinion. In response to our investigation, DCAA rescinded audit reports related to Cases 4 and 5, and removed one contractor's authority to directly bill the government without review of invoices prior to payment (Case 11). In addition, DCAA performed new audits related to several of our cases. New audits related to Cases 7, 9, and 12 overturned previously reported "adequate" opinions by reporting "inadequate in part opinions," and noting several significant deficiencies. According to DCAA officials a new audit related to Case 13 validated the earlier unsupported "adequate" opinion. We did not review the support for the new audits. For Cases 3, 6, and 10, DCAA officials told us that although work paper documentation could have been better, they believe that the reported opinions are correct. GAGAS<sup>79</sup> require that opinions rendered for these types of attestation engagements (assessments of contractor controls and compliance with CAS) be supported by sufficient testing and workpaper documentation.

DCAA officials did not agree with our conclusions on Cases 1, 2, and 8. For example, DCAA officials did not agree that the audit in Case 1 was based on an up-front agreement. However, the workpaper documentation of the audit entrance conference and the "letter of understanding" sent to the contractor a few days later are clear evidence that there was an agreement between DCAA and the contractor on scope of work at the beginning of the audit that gave the contractor advance notice of the BOEs that would be covered in the estimating system audit. Further, the agreement that DCAA auditors would review BOEs at three phases, provide corrections, and base the audit opinion on the final, corrected BOEs served as an agreement on the basis for the audit opinion.

With regard to Case 2, documentary evidence obtained from multiple sources, including the contractor's own definition of lot costing, substantiated that the cost and pricing data provided in the contractor's ELC proposal did not comply with CAS. Further, documentation by

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<sup>79</sup>GAO-03-673G, §§ 6.02a and 6.22.

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multiple sources of meetings between SMC, the Air Force buying command; DCMA; DCAA; and the contractor evidenced pressure to resolve CAS compliance issues and obtain a favorable audit opinion so that the ELC contract could be awarded. The former DCAA RAM told us that she concluded that there were no CAS compliance issues based on a contractor accounting demonstration. However, the former RAM did not provide any evidence that the contractor's assertion was independently tested and confirmed. Further, DCAA auditors told us that the DCAA RAM instructed them not to include documentation on CAS compliance issues in the audit workpapers and directed the resident auditor to change the opinion in the draft report.

DCAA partially concurred with our conclusions on Case 8, involving forward pricing issues at a third DCAA location. DCAA agreed that the two former supervisory auditors did not always properly review the working papers prior to report issuance. DCAA disagreed that the forward pricing proposal audits were complex, but did not provide sufficient documentation to support its position. DCAA also stated, but did not provide adequate documentation to support its position, that trainees worked on 18 of the 62 forward pricing audits. Further, although DCAA noted that other auditors charged time to some of the assignments the trainees worked on, DCAA did not provide evidence that the other individuals performed a supervisory role. Finally, DCAA's assertion that the Western Region's quality review of forward pricing audits at location 3 found a 93 percent compliance rate and that the systemic deficiencies did not represent noncompliance with GAGAS is based on a flawed methodology. This methodology involved "yes" and "no" responses to over 1,000 questions. Because questionnaire design can bias study results, we analyzed the specific findings of systemic deficiencies that were documented in the DCAA quality review report. Our analysis showed that the review identified a total of 28 systemic deficiencies, including one or more systemic deficiencies on 9 of the 11 audits reviewed. Of the 28 systemic deficiencies, 23 related to the allegations we investigated, most of which were GAGAS noncompliance issues.

Finally, DCAA management stated that they found no evidence to support our conclusions that DCAA managers at locations 1 and 2 took actions against their staff that created a generally abusive work environment. DCAA management's response stated that we did not provide their management with specific evidence or notify DCAA headquarters of this problem during our investigation. Our conclusions are based on numerous confidential interviews of numerous DCAA auditors and supervisors as well as e-mail documentation. Several statements made during our

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interviews were corroborated by other interviewees as well as e-mail communication. We advised DCAA headquarters of our conclusions in February 2008. Because of the fear of retaliation expressed by several interviewees, we have not provided DCAA with names of individuals or specific incidents. DCAA indicated that it has begun actions to assess the existence of management abuse.

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## Conclusions

In the cases we investigated, pressure from the contracting community and buying commands for favorable opinions to support contract negotiations impaired the independence of three audits involving two of the five largest government contractors. In addition, DCAA management pressure to (1) complete audit work on time in order to meet performance metrics and (2) report favorable opinions so that work could be reduced on future audits and contractors could be approved for direct-billing privileges led the three DCAA FAOs to take inappropriate short cuts—ultimately resulting in noncompliance with GAGAS and internal DCAA CAM guidance. Although it is important for DCAA to issue products in a timely manner, the only way for auditors to determine whether “prices paid by the government for needed goods and services are fair and reasonable” is by performing sufficient audit work to determine the adequacy of contractor systems and related controls, and contractors’ compliance with laws, regulations, CAS, and contract terms. Further, it is important that managers and supervisory auditors at the three locations we investigated work with their audit staff to foster a productive, professional relationship and ensure that auditors have the appropriate training, knowledge, and experience.

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We are sending copies of this report to interested congressional committees, the Secretary of Defense, the Under Secretary of Defense (Comptroller), the Under Secretary of Defense for Logistics and Materiel Readiness, the Secretary of the Army, the Secretary of the Navy, the Secretary of the Air Force, the Director DCAA, the Director of DCMA, and the Director of the Office of Management and Budget. We will make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

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If you or your staff have any questions concerning this report, please contact Gregory D. Kutz, Managing Director, Forensic Audits and Special Investigations, at (202) 512-6722 or [kutzg@gao.gov](mailto:kutzg@gao.gov) or McCoy Williams, Managing Director, Financial Management and Assurance, at (202) 512-2600 or [williamsm1@gao.gov](mailto:williamsm1@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report are acknowledged in appendix III.



Gregory D. Kutz  
Managing Director  
Forensic Audits and Special Investigations



McCoy Williams  
Managing Director  
Financial Management and Assurance

# Appendix I: Comments from the Department of Defense



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

OFFICE OF THE DIRECTOR

July 11, 2008

Mr. Gregory Kutz,  
Managing Director for Forensic Audits  
and Special Investigations  
U.S. Government Accountability Office (GAO)  
441 G. St., NW  
Washington, DC 20548

SUBJECT: Response to GAO Correction Action Briefing of June 20 and 25, 2008 on GAO  
Investigation of Hotline Allegations Regarding Certain Defense Contract Audit  
Agency (DCAA) Audits (Code 195132)

Dear Mr. Kutz:

This is the Department of Defense (DoD) response to the GAO corrective action briefing, GAO Investigations of Hotline Allegations Regarding Certain DCAA Audits, dated June 20, 2008 (195132).

Thank you for the opportunity to respond to the subject briefings provided by the GAO. This response is being submitted without the opportunity for DCAA to review the draft report as the GAO has denied DoD a copy of the report. However, we have been permitted to submit our July 3, 2008, written comments in response to the GAO briefing of June 20, 2008, provided the response is redacted for For Official Use Only data. As a result, enclosed is DCAA's previous response appropriately redacted. We request DCAA comments be included as part of GAO's final report.

As discussed with you on July 7, 2008, although we do not concur with the totality of the GAO's overall conclusions, DCAA has taken prompt and immediate action to correct the issues and is committed to promptly addressing any remaining significant issues identified by the GAO. We believe the three field audit offices at issue are currently operating at a satisfactory level of compliance with Generally Accepted Government Auditing Standards.

Regarding the GAO's finding that "DCAA managers took actions against their staff that hindered their investigations and creating a generally abusive work environment," we were provided no facts that support this conclusion. As I discussed with you on July 7, 2008, in order to properly address this management issue, we request that the GAO provide the specific facts supporting this finding. Please be assured that DCAA is committed to supporting any GAO review or investigation and is prepared to take the necessary actions to address and resolve the findings.

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**Appendix I: Comments from the  
Department of Defense**

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Mr. Gregory Kutz  
SUBJECT: Response to GAO Correction Action Briefing of June 20 and 25, 2008 on GAO  
Investigation of Hotline Allegations Regarding Certain Defense Contract Audit Agency  
(DCAA) Audits (Code 195132)

Any questions regarding this memorandum should be directed to the undersigned at  
(703) 767-3200.

Sincerely,

  
April G. Stephenson  
Director

Enclosure:  
DCAA Policy and Plans' Response to GAO Corrective Action Briefing (Project No. 195132)



**Appendix I: Comments from the  
Department of Defense**

**Document redacted on 7/9/08 to remove FOUO data and markings. For  
unredacted copy, contact DCAA, Policy and Plans Directorate.**



**DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BEL VOIR, VA 22060-6219**

IN REPLY REFER TO

PQA 225.4 (GAO 195132)

July 3, 2008

Mr. Gregory Kutz,  
Managing Director for Forensic Audits  
and Special Investigations  
Government Accountability Office (GAO)  
441 G. St., NW  
Washington, DC 20548

**SUBJECT:** Response to GAO Correction Action Briefing of June 20 and 25, 2008 on GAO  
Investigation of Hotline Allegations Regarding Certain Defense Contract Audit  
Agency (DCAA) Audits (Code 195132)

Dear Mr. Kutz:

Thank you for the opportunity to respond to the subject briefings and talking points provided by the GAO. This response is being submitted without the opportunity for DCAA to review the draft report. DoD has requested a copy of the draft report to ensure our comments are responsive to the issues presented by the GAO, however, the GAO has denied DoD a copy of the report. Please be assured that based on the briefings provided and information shared throughout the review, DCAA has taken prompt and immediate action to correct the issues and is committed to promptly addressing any remaining significant issues identified by the GAO.

We believe the three field audit offices (FAOs) at issue are currently operating at a satisfactory level of compliance with GAGAS. For example, in FY 2008 the DCAA Headquarters Quality Assurance Division performed PCIE-based reviews of internal control audits at [REDACTED] and [REDACTED] Resident Offices and found those offices to be operating at a satisfactory level of compliance with GAGAS.

The GAO briefings relate to a two-year investigation of hotline complaints about certain audits at three DCAA southern California field audit offices (FAO). The subject briefings did not contain any recommendations. Our comments and positions relating to the GAO conclusions and findings are summarized below and detailed by GAO case number in the enclosed memorandum, dated July 3, 2008, from the Regional Director, Western Region.

The GAO states that it substantiated hotline complaints relating to certain assignments that alleged (1) DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes, (2) sufficient audit work was not performed to support audit opinions and conclusions, and (3) inadequate supervision existed of certain forward pricing

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**Appendix I: Comments from the  
Department of Defense**

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PQA 225.4 (GAO 195132)

July 3, 2008

SUBJECT: Response to GAO Correction Action Briefing of June 20 and 25, 2008 on GAO  
Investigation of Hotline Allegations Regarding Certain Defense Contract Audit Agency  
(DCAA) Audits (Code 195132)

audits. The GAO also concluded that during the audits as well as during the GAO and DODIG investigations, DCAA managers took actions against their staff that hindered their investigations and created a generally abusive work environment.

We do not concur with the totality of the GAO's overall conclusions. However, we do acknowledge that shortcomings existed in the working paper evidence and documentation to support the final audit conclusions in several of the reviewed assignments. We found in many of the cases cited by the GAO, the deficiencies originally cited by the DCAA auditor (that the GAO contends were dropped) were not supported with sufficient evidence required by the auditing standards. We have no evidence that the supervisor willfully removed findings from the audit reports. We acknowledge that in some cases additional work should have been performed to support the final audit opinion. As detailed in the enclosed memorandum, we have taken the necessary actions to correct these deficiencies to protect the Government's interests (e.g., perform additional audit work to support audit opinion).

In addition to the actions noted in the enclosed response from the Western Region, it should be noted that DCAA Headquarters has taken subsequent actions that relates to the performance of internal control audits. In February 2008, DCAA revised its DCAA Regulation 5600.1, Delegation of Signature Authority for Audit Reports and Other Audit Related Documents, to require FAO managers to sign all internal control audit reports. Previously, FAO managers could delegate this responsibility to supervisors. Many of the assignments reviewed by the GAO were internal control audit reports signed by the supervisor.

We found no evidence to support the GAO's conclusions that "DCAA managers took actions against their staff that hindered their investigations and creating a generally abusive work environment." The GAO has not provided any evidence to support these assertions and did not notify DCAA Headquarters during the investigations that its review was being "hindered." DCAA is committed to supporting any GAO review or investigation and is prepared to take the necessary actions once apprized by the GAO of the factual information supporting its statements. In the interim, due to the significance of these alleged issues, DCAA has already commenced actions to assess the existence of an "abusive work environment." These actions will include a management visit to the Western Region by the Director, DCAA within the next two months.

In summary, although we don't agree with the totality of the GAO's conclusions, we appreciate the GAO identifying certain shortcomings with these 13 cases. We would like to point out that these 13 assignments represent a very small portion of the audit work performed by these FAOs. For the three offices involved in this investigation, the FAOs completed over 2800 assignments from Fiscal Years 2005 through 2007. As stated above, we believe the three field audit offices (FAOs) are currently operating at a satisfactory level of compliance with GAGAS.

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**Appendix I: Comments from the  
Department of Defense**

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PQA 225.4 (GAO 195132)

July 3, 2008

SUBJECT: Response to GAO Correction Action Briefing of June 20 and 25, 2008 on GAO  
Investigation of Hotline Allegations Regarding Certain Defense Contract Audit Agency  
(DCAA) Audits (Code 195132)

Any questions regarding this memorandum should be directed to the undersigned at  
(703) 767-3280.

Sincerely,

/s/

Kenneth J. Saccoccia  
Assistant Director  
Policy and Plans Directorate

Enclosure:

Western Region's response to GAO Corrective Action Briefing (Project No. 195132)

# Appendix II: Additional Investigative Case Study Results

Table 3 provides details of the additional five case studies we examined from location 2, a Defense Contract Audit Agency (DCAA) branch office in Southern California. As with the five cases discussed in the body of this report, none of these audits complied with generally accepted government auditing standards (GAGAS). We found that reported opinions were not supported because findings of significant deficiencies were dropped or downgraded to suggestions for improvement without audit evidence, or the work performed was not sufficient to support the reported opinion. For example, on the audit of Contractor F's billing system, which was reviewed and approved by Western Region management, we found a lack of audit evidence to support dropping six of eight findings of significant deficiencies. Further, although the branch office reported an "inadequate in part opinion," it used the audit as support for maintaining this contractor's direct-billing privileges. The branch office justification for maintaining Contractor F's direct-billing status was not supported given the significant deficiencies that were identified but not reported. As a result of this decision, the government was put at risk of paying Contractor F for overbilled amounts with no government review of its invoices prior to payment. On March 12, 2008, after we met with Western Region officials on this issue, the branch office rescinded Contractor F's direct-billing privileges.

**Table 3: Additional Case Studies of DCAA Audits at Location 2**

Case	Type of audit	Contractor	Case details
9	Compensation system (2005)	Contractor D	<ul style="list-style-type: none"> <li>• Three different auditors worked on this audit.</li> <li>• Original auditor did not follow DCAA guidance when developing audit plan and was reassigned after audit work began.</li> <li>• Second auditor was inexperienced and noted in her working papers that she was "floundering" and could not finish the audit by the September 30, 2005, deadline.</li> <li>• Third auditor was assigned 10 calendar days before the audit was due to be completed.</li> <li>• Although audit was issued with an "adequate" opinion, insufficient work was performed on this audit and, therefore, working papers do not support the final opinion.</li> <li>• Significant system deficiencies noted in the working papers were not reported.</li> <li>• The Department of Defense Office of Inspector General recommended that DCAA rescind the final report for this audit, but DCAA did not do so. Instead, DCAA initiated another audit during 2007.</li> <li>• DCAA agreed with our finding that this audit did not include sufficient testing of executive compensation. In June 2008, the branch office issued a new audit report on Contractor D's compensation system which identified seven significant deficiencies and an "inadequate in part" opinion.</li> <li>• DCAA stated that it is currently assessing the impact of these deficiencies in current incurred cost audits.</li> </ul>

**Appendix II: Additional  
Investigative Case Study  
Results**

<b>Case</b>	<b>Type of audit</b>	<b>Contractor</b>	<b>Case details</b>
10	Purchasing system (2005)	Contractor F	<ul style="list-style-type: none"> <li>• Auditor found that the contractor was not fulfilling its Federal Acquisition Regulation-related obligations to ensure that subcontractors' cost claims were audited.</li> <li>• This issue was not reported as a significant deficiency in the contractor's purchasing system. The opinion on the system was "adequate."</li> <li>• The working papers did not include sufficient evidence to support the final opinion. DCAA relied on a 2004 Defense Contract Management Agency (DCMA) review in which the conclusions were based word for word on the contractor's response to a questionnaire without independent testing of controls.</li> <li>• DCAA stated that the overall opinion was not based on DCMA's review. However, DCAA stated that it will address the issue of the contractor's procedures for ensuring subcontract audits are performed during the next purchasing system audit, which is expected to be completed by December 30, 2008.</li> </ul>
11	Billing system (2006)	Contractor F	<ul style="list-style-type: none"> <li>• The branch manager allowed the original auditor to work on this audit after being assured that the auditors would help the contractor correct billing system deficiencies during the performance of the audit.</li> <li>• After the original auditor identified 10 significant billing system deficiencies, the branch manager removed her from the audit and assigned a second auditor to the audit.</li> <li>• With approval by the field audit office (FAO) and region management, the second auditor dropped 8 of the 10 significant deficiencies and reported 1 significant deficiency and one suggestion to improve the system. The final opinion was "inadequate in part."</li> <li>• Six of the findings were dropped without adequate support, including a finding that certain contract terms were violated and a finding that the contractor did not audit subcontract costs.</li> <li>• Despite issuing an "inadequate in part" opinion, the FAO decided to retain the contractor's direct-billing privileges. After we brought this to the attention of region officials, the FAO rescinded the contractor's direct-billing status.</li> <li>• DCAA did not agree with our finding that the working papers did not contain adequate support for dropping six draft findings of significant deficiencies.</li> </ul>
12	Labor floor check (2005)	Contractor C	<ul style="list-style-type: none"> <li>• Auditor performed sampling to determine whether sufficient controls over employee time cards existed.</li> <li>• Although the work was based on a limited judgmental sample, the auditor found three errors out of 18 employee time cards tested and concluded that controls over time cards were inadequate.</li> <li>• Supervisory auditor initially agreed with the findings, but later modified working papers to change the draft audit conclusion from "certain labor practices require corrective actions" to "no significant deficiencies."</li> <li>• Working papers did not properly document the reason for the change in conclusion and therefore, do not support the reported conclusion.</li> <li>• Supervisory auditor later stated that the initial sampling plan was flawed, but eliminated the deficiency finding rather than asking the auditor to redo the work.</li> <li>• On April 9, 2008, DCAA issued a new labor floor check audit for this contractor that identified eight significant deficiencies and concluded that corrective actions were needed in the contractor's labor accounting system.</li> </ul>

**Appendix II: Additional  
Investigative Case Study  
Results**

<b>Case</b>	<b>Type of audit</b>	<b>Contractor</b>	<b>Case details</b>
13	Compliance, Cost Accounting Standard (CAS) 418 (2006)	Contractor G	<ul style="list-style-type: none"> <li>• After original auditor was transferred to another audit, a second auditor significantly limited the scope of the audit with supervisory approval, deleting most of the standard audit steps.</li> <li>• Second auditor performed very limited testing and relied on contractor assertions with little or no independent verification.</li> <li>• Supervisory auditor approved issuance of the final audit with an opinion that the contractor complied with CAS 418 in all material respects.</li> <li>• Insufficient work was performed on this audit and therefore the scope of work and the working paper documentation does not support the opinion.</li> <li>• Region officials acknowledged that work was insufficient and stated that another CAS 418 audit has been initiated; however, DCAA did not rescind the misleading report.</li> <li>• On June 25, 2008, DCAA officials told us that the new CAS 418 audit was completed with an “adequate” opinion.</li> </ul>

Source: GAO analysis.

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# Appendix III: GAO Contacts and Staff Acknowledgments

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## GAO Contacts

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