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To The President's Blue Ribbon Commission  
On Defense Management

We have completed our study of Government auditing and other oversight of defense contractors. Pursuant to our agreement dated December 16, 1985, the study consisted principally of field visits to 15 major defense contractors throughout the United States and interviews with several Government representatives. Each of the contractor and Government representatives with whom we met was helpful and we are appreciative of their cooperation and the courtesies extended to us.

The accompanying report sets forth our findings and recommendations. During the course of our work, we talked with many knowledgeable individuals and reviewed supporting documentation they made available to us. The recommendations contained in this report represent largely a composite of the principal recommendations and observations offered by the individual contractors and Government representatives with whom we visited. We evaluated all recommendations received, together with the related supporting data, and have included only those recommendations we consider to be reasonable and likely, if properly implemented, to improve the overall efficiency and effectiveness of the Government's auditing and other oversight of defense contractors.

We appreciate this opportunity to be of assistance to the President's Blue Ribbon Commission on Defense Management and would be pleased to meet with the Commission or its staff to further discuss our findings and recommendations.

Very truly yours,



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# I. EXECUTIVE SUMMARY

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## INTRODUCTION

This report presents the results of a study of government auditing and other oversight of defense contractors. The study is based principally on information obtained during field visits to 15 major defense contractors and interviews with several government representatives.

The results of the study indicate that duplication in the oversight process is extensive. Changes are clearly required to enhance efficiency and reduce costs to both contractors and the government. While the contractors expressed concern about this, each acknowledged the need for a reasonable level of auditing and other oversight in the procurement process and accepts that as a condition of doing business with the government.

## RESULTS OF CONTRACTOR FIELD VISITS

The major causes of duplicative, overlapping, or inefficient government auditing and other oversight noted during our study are:

### 1. Lack of Coordinated Government Approach to Oversight

The most serious issue we noted is an apparent lack of coordination and communication among, and occasionally within, responsible government agencies or organizations. This problem is so pervasive that it underlies, and may be a principal cause of, the other auditing and oversight problems identified by this study. The following appear to

be the principal reasons for this lack of coordination:

- An apparent reluctance by individual audit or oversight organizations to place reliance upon each other's work;
- An apparent unwillingness of organizations to share information;
- Lack of centralized oversight coordination;
- Inadequate advance planning by the agencies or organizations involved;
- Inconsistencies between agencies and organizations with respect to interpretations of contractual or other requirements and results of audits and reviews; and
- Lack of a clear definition of each agency's or organization's audit or oversight responsibilities.

### 2. Deterioration of the Contracting Officer's Authority

Deterioration of the contracting officer's authority as the government's team leader together with an apparent increase in the Defense Contract Audit Agency's (DCAA's) authority appears to be a principal cause of the duplication and inefficiency in the audit and oversight process. The contractors attribute much of this problem to Department of Defense (DoD) Directive 7640.2, which limits the contracting officer's authority to independently resolve DCAA audit recommendations and requires that deviations from those recommendations be justified by the contracting officer. Contractors see administrative contracting officers (ACOs) as reluctant to take a position contrary to DCAA because of concern about being subjected to

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criticism. The net effect of this situation is a procurement environment fraught with indecision, delays, and unnecessary and costly disputes.

### 3. The "Blanket" Approach to Audits and Oversight

The government appears unwilling in many cases to give adequate consideration to: (1) a contractor's past performance; (2) favorable results of prior and ongoing reviews of the contractor's operations and systems; and (3) cost/benefit analyses in determining the nature, timing, and extent of its audit or other oversight activities. In effect, the government seems to use very standardized or "blanket" approaches to many audit or oversight functions. The same procedures, tests, and reviews are performed year after year at each contractor location apparently without regard to the internal controls that are in place or the magnitude of the potential costs and benefits involved. It seems that the same work is performed irrespective of risk or the results of prior reviews.

### 4. Multiple Proposals and Other Delays in the Negotiation Process

The often lengthy time period that elapses between submission of a proposal and final agreement on price appears to be a significant factor contributing to duplicative or inefficient auditing and other oversight. In many cases, months may go by, during which time the government may change quantities or specifications, quotes may go "stale," labor rates may change, etc. These changes generally require that the contractor submit an updated proposal, and each updated proposal starts a new audit cycle in which the unchanged as well as the revised data are audited. The contractors surveyed indicated that the average proposal is updated three times. One contractor cited a proposal that was updated 15 times and another cited a recent procurement

that spanned a two year period from the date the proposal was submitted to negotiation of the final price. Situations such as these also create problems for contractors in their dealings with vendors and subcontractors and expose contractors to a greater risk of inadvertent defective pricing.

### 5. Expanding Scope of DCAA Activities

DCAA's increasing involvement in nonfinancial areas such as operational auditing and compensation and insurance reviews appears to be contributing to overlap and duplication in the oversight process. The contractors noted that inefficiencies and increased costs resulting from this duplication of effort are compounded by what they perceive to be a lack of technical competence as well as a poor definition of objectives by DCAA personnel when performing work in nonfinancial areas. On the other hand, a DCAA representative indicated that as long as DCAA is responsible for evaluating the "reasonableness" of costs charged to the government, it is justified in reviewing and evaluating those aspects of a contractor's operations that may have a bearing on the reasonableness of its costs. In so doing, DCAA will seek the technical advice and assistance of other members of the procurement team as it deems appropriate. He noted, however, that there is a difference of opinion within DCAA as to its appropriate level of involvement in operational auditing.

### 6. Post-award Audits

Several contractors noted that the number and intensity of post-award audits conducted by the government has increased over the last two years and they see no relief in sight. Since the principal objective of these audits is to identify instances of defective pricing, contractors are compelled to devote significant resources to supporting the organizations performing these reviews to minimize misunderstandings and

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erroneous conclusions which may lead to serious, though unwarranted, problems including suspension, debarment, and possibly criminal prosecution. In short, post-award audits are a time-consuming and costly exercise for most contractors and these problems are compounded by the introduction of duplication and inefficiency into the process.

## PRINCIPAL LAWS AND REGULATIONS

The principal laws and regulations governing the audit and oversight process overlap in some respects as they relate to the designated functions and responsibilities of the primary agencies and organizations involved in the process; however, those laws and regulations do not appear to be a primary cause of duplication and inefficiency. In fact, the Federal Acquisition Regulation (FAR) and the DoD FAR supplement (DFARS) prescribe policies and procedures for coordinating and controlling DoD's activities in connection with field pricing support and monitoring contractors' costs, both of which are particularly relevant to the subject of this study. The problem appears to be that DoD is not following its own regulations, or at least these regulations are not operating effectively.

## RECOMMENDATIONS AND COMMENTS

In view of our findings as summarized above, the following recommendations and comments are offered for the Commission's consideration:

1. The contracting officer's position as leader of the government's team in all dealings with the contractor should be reaffirmed. Strong leadership at the ACO and corporate administrative contracting officer (CACO) level is essential. Accordingly, the contracting officer should be responsible for, among other things, the determination of final overhead rates

for all contractors (responsibility for which was recently given to DCAA) and for coordination of all auditing and other oversight activities at contractor locations. Further study is required to determine how best to implement this recommendation and the following should be among the points considered:

- The Inspector General (IG) and the military investigative services have certain oversight responsibilities that clearly require their independence from the contracting officer. While this independence should not be compromised, these organizations should be required to coordinate their activities with respect to individual contractors to the maximum extent possible. Consideration should therefore be given to establishing a formal mechanism within DoD for facilitating this coordination.
- DCAA's role in relation to the contracting officer should be more clearly defined. Irrespective of existing regulations that provide for DCAA to serve the contracting officer in an advisory capacity, our study indicates that DCAA has, in practice, assumed a role which has contributed to a diminution of the contracting officer's authority and his or her willingness to make independent decisions contrary to the recommendations of DCAA. In this connection, the appropriateness of DoD Directive 7640.2 should be reevaluated.
- Although we believe the principal laws and regulations mandating the activities of the major oversight organizations are not a primary cause of duplication and inefficiency, they may be a contributing factor. For example, DCAA's charter to review a contractor's "general business practices and procedures" as provided for in DoD Directive 5105.36 creates ample opportunity for DCAA's activities to overlap those of the Defense Contract Administration Services (DCAS), or one of the other oversight agencies. On the other hand, DCAS' responsibility for determining

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“allowability of costs” appears to overlap DCAA’s assigned responsibilities. DoD should consider clarifying the responsibilities of DCAA and the various contract administration organizations, particularly with respect to matters such as operational auditing and compensation and insurance reviews, which were frequently noted areas of concern to contractors. In this regard, FAR 42.302 specifically cites reviews of contractors’ compensation structures and insurance plans as contract administration functions; however, DCAA perceives the need to delve into these areas to determine the reasonableness of compensation and insurance costs. This apparent conflict needs to be resolved. One solution may be to assign sole responsibility for all matters related to compensation and insurance, including reasonableness of the related costs, to a single DoD organization.

- Closely related to and perhaps inseparable from the need to clarify individual agency auditing and oversight responsibilities is the need to evaluate the day-to-day working relationships between auditing and other oversight organizations with particular emphasis on (1) the degree of reliance each places, or should place, on the work of the others; and (2) the extent to which the agencies share information. Several contractors cited the need for greater cooperation between government agencies in these respects as being essential to reducing duplication and inefficiency in the oversight process. Problems in these areas could be at least partially alleviated by requiring the establishment of a formal data base of contractor information under the control of either the local ACO or the CACO who, in connection with his or her responsibilities for coordinating all auditing and other oversight activities with respect to a contractor, would control the maintenance and distribution of all contractor related information and its distribution to the respective audit or other oversight agencies.

The mechanics of this proposed process require further study.

2. Based on the results of this study, it appears that the requirements of DFARS Subparts 15.8 and 42.70 with respect to the conduct and coordination of DoD activities related to field pricing support and monitoring contractors’ costs are not being followed, or at least they are not operating effectively. These requirements do, however, address many of the concerns expressed by the contractors surveyed. For example, they require DoD to give appropriate consideration to (a) the contractor’s past performance; (b) effectiveness of the contractor’s existing system of internal administrative and accounting controls; and (c) cost/benefit analyses in determining the nature, timing, and extent of audit or other review activities. DoD should assess the adequacy of its compliance with the provisions of DFARS Subparts 15.8 and 42.70 and take corrective action as necessary.

The policies, procedures, and practices of all auditing and other oversight agencies with respect to planning, organizing, and controlling their activities should be reevaluated. This reevaluation must give due consideration to the individual goals and charters of each of the agencies as well as the usefulness of their prescribed auditing and other oversight procedures. For example, the IG and the General Accounting Office (GAO) have different missions than do DCAA and DCAS. The principal purpose of this reevaluation would be to identify ways of improving the effectiveness of these organizations in achieving their objectives while minimizing the cost to the government and disruption to the contractor’s operations. The latter problem, while of obvious concern to contractors, represents a substantial hidden cost to the government inasmuch as contractors have reportedly increased their staffs and incurred substantial amounts of other expenses in response to intensified oversight activities. These higher costs, in part, have been or will be

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passed on to the government through higher contract prices. Further, duplicative and inefficient auditing and other oversight activity adds little, if anything, to the quality of the products being procured by the government, and may actually divert contractor attention from such critical matters.

3. DoD should reevaluate the negotiation process to identify ways of reducing the elapsed time between submission of contractors' proposals and final agreement on contract price. Delays in this process contribute to duplicative and inefficient auditing and other oversight because contractors are required to update their proposals on multiple occasions and each update starts a new audit cycle in which the unchanged as well as the changed data are audited. The following are some suggestions to expedite contract negotiations:

- The government should better define contract requirements before issuing a request for proposal. This is particularly true with respect to quantities which, if not well defined, may change several times and necessitate multiple subcontractor quotes which have to be obtained by the contractor and then audited or reviewed by the government.
- Government audits and reviews of updated proposals should be limited solely to the revised data submitted by contractors. Reauditing unchanged data is duplicative, inefficient, and generally unnecessary.
- Responsibility for the price analysis of a contractor's proposal should be centralized in one organization or agency. The individual(s) performing the analysis should be part of the government negotiation team so that his or her insight can be brought directly to bear during the negotiation process.
- The government's audits and reviews of both initial and updated proposals should be properly planned and coordinated to avoid duplication of effort between agencies. Greater reliance should be placed by the

government on contractors' internal control systems where past history and other factors indicate such reliance is warranted.

4. DoD should reevaluate policies and practices with respect to postaward audits to ensure that (a) duplication between agencies and organizations in the performance of these audits is eliminated or minimized; (b) appropriate consideration is given to cost/benefit analyses in determining the nature, timing, and extent of such reviews; (c) appropriate consideration is given to the contractor's past performance and results of prior and ongoing audits and reviews; and (d) postaward reviews are completed on a timely basis, say within one year after contract award.

5. The general relationship between contractors and the government needs to be improved for the benefit of the procurement process. While this situation will be difficult to resolve, the following general recommendations may prove helpful:

- Individual contractor and government personnel should strive for a relationship characterized by a "healthy skepticism" rather than animosity and antagonism.
- Every effort should be made by both contractors and the government to improve their communication and reduce the level of "gamesmanship" in their dealings with each other.
- The government must be careful not to foster the perspective among contractors that it believes every contractor intentionally engages in cost mischarging, defective pricing, and other such practices.
- The government needs to closely monitor the scope of its audits and other oversight activities to ensure that the work is properly planned, its personnel are technically competent for their assigned tasks, and duplication and inefficiency are minimized.

6. There should be a moratorium on the issuance of new procurement laws and

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regulations affecting defense contractors for a period of perhaps two years until the prudence and effectiveness of present and proposed rules and regulations can be fully evaluated.

7. The basic framework of the entire auditing and oversight process should be reevaluated with a view toward establishing a system by which contractors are classified according to specified and measurable criteria for the purpose of determining the extent to which they will be subject to government oversight. Under this system, the government would adjust the scope of its oversight activities for individual contractors to respond to the level of risk identified. While conceptually this recommendation is reminiscent of the now defunct Contractor Weighted Average Share in Cost Risk (CWAS) concept, we are not

suggesting that the proposed system be an exact replica of that concept. Instead, we recommend that DoD, or preferably a joint task force comprised of DoD and industry personnel, take a "fresh look" at possible methods of categorizing or "qualifying" contractors.

We recognize this recommendation will be difficult to implement. Major challenges to implementation will relate to the definition, application, and monitoring of compliance with the qualification criteria. The initial classification of contractors will be particularly difficult. Moreover, many of the matters discussed elsewhere in this report will impact on the feasibility of the recommendation. However, given the extensive overlap, duplication, and inefficiency present in the auditing and oversight process today, this fundamental change is worthy of consideration.