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BY THE COMPTROLLER GENERAL

RELEASED

Report To The Congress

OF THE UNITED STATES

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The Effectiveness Of The Defense Contract Audit Agency Can Be Improved

This report on the Defense Contract Audit Agency is the fifth in a series of reports on Department of Defense audit organizations. The magnitude of the Agency's responsibility is reflected by the cost of Defense contracting--\$96 billion in fiscal 1977.

GAO reviewed the work of the Agency and found that often it is not given enough time to do an effective audit and sometimes is not allowed access to contractor records needed to perform an effective audit. Also, contracting officers frequently do not consider the Agency's findings when negotiating contract prices.

The report, which was made at the request of the Chairman, Subcommittee on Legislation and National Security, House Committee on Government Operations, makes several recommendations which should help the Agency to become more effective in its auditing role.



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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report, the fifth and final report of a series on Department of Defense audit activities, describes ways the Defense Contract Audit Agency can improve its contract auditing.

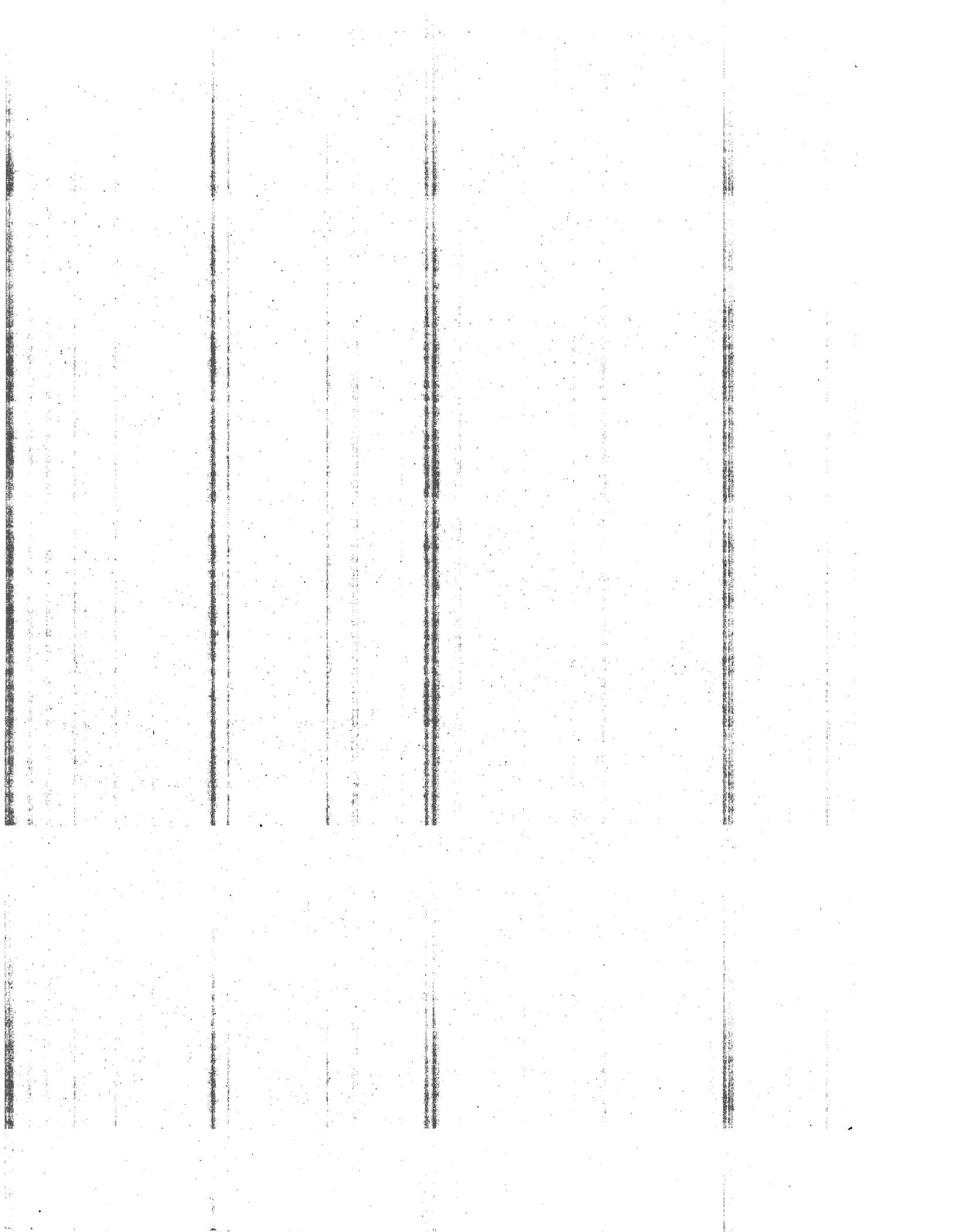
We made this review as part of our current effort to expand and strengthen audit activities in Government departments and agencies and also at the request of the Chairman, Subcommittee on Legislation and National Security, House Government Operations Committee. As requested by the Subcommittee Chairman, the report is being issued without agency comments.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Defense; and the Director, Defense Contract Audit Agency.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Thomas B. Atchafalua".

Comptroller General
of the United States



D I G E S T

The Defense Contract Audit Agency is the only Defense audit organization designated to perform audits of Defense contracts. The Agency's work is generally rated high by users of its products, but our review disclosed problems that occur using the Agency's work, and those problems tend to increase the cost of Government procurement. GAO found that:

--Contracting officers do not always use the work the Agency provides them with and when they do not, it often results in higher costs to the Government.

--The Agency has more work than it can do. This fact, coupled with time constraints imposed by contracting officers, sometimes leads to substandard work.

--Despite Government procurement regulations, the Defense Contract Audit Agency does not always have access to all of the contractor's records needed to make an effective audit.

--Defective pricing reviews, which we have found worthwhile, are given a low priority by the Agency.

--Contracting officers do not provide adequate feedback on DCAA reports to allow DCAA to improve its service, and DCAA does not adequately follow up on reports it issues.

Recommendations to the
Secretary of Defense

To promote better service by the Defense Contract Audit Agency and to promote better use of its audit findings by contracting officers, the Secretary of Defense should:

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(1) --Direct cognizant procurement management officials to begin to provide the kind of feedback information required by the Defense Acquisition Regulation and needed by contract auditors.

(2) --Direct the Director of the Agency to establish a more aggressive system of appropriate followup procedures, including phone contacts and personal visits, to obtain negotiation results.

(3) --Modify ~~its~~ existing policy and directive to require the reporting, through separate channels already established, of matters on which auditors and contracting officers disagree.

(4) --Direct the Agency to more faithfully follow its procedures for reporting significant matters and concurrently report these matters to internal audit organizations as they occur.

(5) Also, the Secretary of Defense should direct the Defense Contract Audit Agency to determine the thresholds for preaward audits at which it is cost effective to do preaward work in preference to other priority work the Agency has to do.

To allow the Defense Contract Audit Agency to have all the data it needs to do an effective job, we recommend that the Secretary of Defense:

(6) --Direct procurement management officials to conform to the current Defense Acquisition Regulation and established procedures and to provide the Agency with the opportunity to review unaudited and unsupported costs that were not available at the time of initial audit but were available prior to negotiation.

(7) --Direct procurement management officials to review the support they provide to the Agency when access to records problems are encountered and to aggressively conform to the Defense Acquisition Regulation in this regard.

(8) --Direct the Director of the Agency to cease entering into agreements with contractors for future access to needed contractor data.

(9) --Require procurement management officials to provide technical evaluations to the Agency for review and inclusion in their reports or as supplements to them.

II The Defense Contract Audit Agency gives low priority to defective pricing reviews of cost or pricing data submitted in proposals in accordance with Public Law 87-653. The Secretary of Defense should direct the Defense Contract Audit Agency to review its priorities to see if more work should be done in this audit area.

AGENCY COMMENTS

In accordance with the request of the Chairman, Subcommittee on Legislation and National Security, House Committee on Government Operations, we did not discuss the conclusions and recommendations in this report with officials of the Department of Defense.

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ABBREVIATIONS

DCAA	Defense Contract Audit Agency
DOD	Department of Defense
GAO	General Accounting Office

CHAPTER 1

INTRODUCTION

This is the fifth in a series of reports on the results of our reviews of audit organizations in the Department of Defense (DOD). This review was made at the request of the Chairman, Subcommittee on Legislation and National Security, House Committee on Government Operations.

HSE 01506

The Defense Contract Audit Agency (DCAA), established in 1965 under the direction and control of the Secretary of Defense ^{AGC 00473} 1/, is one of five professional audit organizations in the Department of Defense and the only one designated by the Department to perform audits of Defense contracts. Its responsibility is a significant one because of the magnitude of Defense contracting. In this respect, during fiscal 1976, Federal agencies awarded contracts and placed orders with contractors for over \$61 billion in supplies, services, and equipment. The major portion of this amount was spent by DOD and the military services. Earlier, we reported to the Congress (PSAD-77-60, Jan. 18, 1977) that procurement of 147 major defense systems acquisitions alone would cost about \$243 billion on completion.

During fiscal 1977, DCAA issued about 48,800 reports to DOD and civil agency contracting officers. DCAA evaluations and audits covered contract proposals totaling \$96 billion and cost reimbursement claims worth \$28 billion. The Agency reported taking exception to almost \$9 billion in proposed and claimed costs and reported net savings to the Government of \$2.1 billion.

DCAA's headquarters is located in Alexandria, Virginia. Its operations are performed at 6 regional offices and 373 field audit offices located throughout the United States and overseas. As of September 30, 1977, the agency had an assigned strength of 3,299, including 2,727 professional and 572 administrative staff members. As with all other Defense audit organizations, staffing levels in DCAA have gradually declined in the last several years while the Agency's budget and workload have gradually increased.

1/Recently, the Secretary delegated these responsibilities to the Assistant Secretary of Defense (Comptroller).

CONTRACT AND INTERNAL AUDITS
ARE SEPARATE FUNCTIONS IN DOD

DCAA has an audit role unlike the other four audit organizations in the Department of Defense. ^{1/} The other audit organizations are essentially internal audit agencies. The internal auditor's job is to independently and objectively analyze, review, and evaluate existing procedures and activities; to report on conditions found; and whenever deemed necessary, to recommend changes or other action for management and operating officials to consider. The scope of internal audit is to be unlimited and includes all department and agency program operations and activities.

Contract auditing as practiced in DOD is more specialized. The purpose of contract auditing is to help procurement and contract administration management achieve the objective of prudent contracting by providing them with financial information and advice on proposed or existing contracts and contractors, as appropriate. The contract audit agency's audit services are used in connection with the negotiation, administration, and settlement of contract payments or prices which are based on cost, both incurred and estimated, or on cost analysis. The Agency also provides contract audit services, on a reimbursable basis, to other Government agencies, such as the National Aeronautics and Space Administration and the Department of Transportation.

Prior to the creation of the Defense Contract Audit Agency in 1965, all contract auditing in DOD was performed by the military audit agencies. In the Air Force and Navy, internal audit and contract audit functions were a separate but integral part of the audit agencies of those services. In the Army, however, an integrated audit approach was used in which the agency audited both the contractor's records and the activities' and procurement management's use of audit reports. With the creation of DCAA, contract and internal audit functions were completely separated; the Agency was made explicitly responsible for contract audit. DCAA auditors are viewed both by procurement management and themselves as part of the procurement management team even though organizationally, they are a separate agency reporting to the Assistant Secretary of Defense (Comptroller). (See app. IV.)

^{1/}The Defense Audit Service and the Army, Navy, and Air Force Audit Agencies.

DCAA DOES SEVERAL KINDS OF REVIEWS

In carrying out its responsibilities, DCAA performs in five major audit areas:

- Preaward. Audits that are generally required by regulation if any contractor price proposal is valued at \$100,000 or more, based on cost or pricing data.
- Incurred costs. Reviews that are designed to assure procurement officials that costs incurred under and charged to specific contracts, as evidenced by contractor claim representations, are allowable, allocable, and reasonable.
- Defective pricing. Selective postaward reviews of contract actions made to ensure that accurate, complete, and current cost or pricing data were submitted by contractors in accordance with requirements of Public Law 87-653.
- Cost accounting standards. Audit activities required in connection with DOD implementation of standards promulgated by the Cost Accounting Standards Board established by Public Law 91-379.
- Special audits. Other efforts, such as equitable adjustment and progress payments, which are generally performed as a result of a specific request.

Within boundaries, the Agency is free to prescribe the scope of audit of a contractor's proposal. The Defense Acquisition Regulation provides that the contracting officer establish the due date for receipt of the auditor's report and allow as much time as possible for the audit work. The auditors may request additional time, but whether it is granted is at the discretion of the contracting officer. The regulation also provides that the audit scope of a contract proposal must be determined by, and is the responsibility of, the contract auditor, who must include in the audit report any areas selected by the contracting officer.

DCAA reports its audit results as "questioned costs," "unsupported costs," "cost avoidance," or "unresolved costs." Questioned costs are reported when the contract costs are not considered acceptable. Costs may be identified as unacceptable under the contract terms, statute, public policy, applicable Government regulations, or legal advice. Costs may also be questioned which, although not specifically unacceptable for

the above reasons, are determined to be unreasonable in amount, contrary to generally accepted accounting principles, not properly allowable to the contract, or contrary to technical and engineering advice.

The Agency reports "unsupported costs" when the contractor does not furnish sufficient documentary evidence to enable the auditor to reach a definitive conclusion. The Agency recommends a "cost avoidance" when needed improvements are perceived in the economy and efficiency of contractor operations. Finally, DCAA will report costs as unresolved when an audit conclusion cannot be reached by the due date because an assist audit by another agency office has not been received.

DCAA's direct audit effort is distributed approximately as indicated below.

Direct Contract Audit
Effort for FY 1977

<u>Category</u>	<u>Percent</u>
Preaward audits	44
Incurred cost audits	33
Cost accounting standards reviews	8
Special audits	7
Operational audits	6
Defective pricing	<u>2</u>
Total	<u>100</u>

DCAA'S WORK GENERALLY RATED
HIGH BUT SOME PROBLEMS EXIST

Much of DCAA's work is used by contracting officers, so we queried them and other users about their satisfaction or lack of satisfaction with DCAA's work. Seventy-two percent felt the audit reports were good, 21 percent felt they were fair, and 7 percent felt they were poor.

According to our review, less than half of the users are satisfied with the lack of timeliness of reports, a situation which most blame on heavy contract audit workload, lack of audit staff, and complexity of contractor accounting systems. Approximately two-thirds of the users are satisfied with the adequacy of support for the Agency's conclusions and recommendations, while one-third consider them to be marginal.

Although those who use DCAA's work rate it as reasonably effective overall, our review disclosed some problems in using it in the procurement process. These problems tend to increase Government procurement costs. The scope of our review did not permit us to estimate how much the costs increased, but, based on the cases we studied, we believe that the amount is sizable. Specifically, we found that:

- Contracting officers do not always use DCAA's work and when they do not, higher costs to the Government often result.
- DCAA has more work than it can do. This fact, coupled with time constraints imposed by contracting officers, sometimes leads to substandard work.
- Despite Government procurement regulations to the contrary, DCAA does not always get access to all of the contractor's records it needs to make an effective audit.
- Reviews of defective pricing which we have found worthwhile, are given a low priority by DCAA.

CHAPTER 2

CONTRACTING OFFICERS DO NOT ALWAYS USE

DCAA'S FINDINGS

Defense procurement policies require that contracting officers consider DCAA auditors' recommendations in the pricing actions of Defense contracts. We found a number of cases in which the record showed no indication that consideration was given to important DCAA audit recommendations that involved sizable sums of money. Unless the contracting officers use DCAA findings in the pricing process, DCAA's audit work is not effective and the Government is not likely to get the best prices for the items DOD buys.

EXAMPLES OF OCCASIONS DCAA'S WORK WAS NOT USED

Some examples follow of cases in which the record indicates that DCAA findings were not properly considered.

- In November 1973, prior to negotiations, contract auditors advised Air Force officials that, contrary to contract provisions, a contractor was charging prices for aircraft purchases that were \$1.5 million in excess of those charged to the contractor's most favored customers. Despite this information, the contracting officer negotiated the contract price without regard for the auditor's findings. Air Force officials met with contractor representatives after negotiation and award of the contract but determined that no further effort to obtain credits from the contractor would be made. The amounts negotiated totaled \$226.3 million. The contract auditors believed they had no further responsibility for following up on the contracting officer's actions and the matter was dropped. We reported the matter to the Secretary of Defense in December 1974, and in July 1976, the Air Force advised us that it had settled with the contractor for the cash amount of \$4.4 million.

- In February 1978, we advised the Secretary of Defense that a Navy contracting officer had failed to follow the contract auditor's advice regarding the procurement of two submarine tenders. His failure to follow that advice resulted in a price increase of \$3.9 million in the contract target price. The contracting officer had not considered DCAA's recommendation even

though the contract auditors had based their recommendations on their recent experience in dealing with that contractor in constructing several vessels.

--In September 1976, DCAA issued a report disallowing \$145,000 claimed under a cost type contract. The contractor, a closely held corporation with only four stockholders who were all members of the same family, had claimed what DCAA called excessive and unreasonable pension and education expenses during a 2-year period. According to DCAA, the pension plan did not become effective until after the contractor received its first cost-plus-fixed-fee contract with the Government. The plan initially covered only the contractor and his wife who was not on the payroll until that year. Also compensation for the owners substantially increased coincident with the award of the first cost reimbursement contract. Public Law 93-406 required contractors to expand pension plans to 20 eligible employees, but the contractor modified the plan. He said that to continue the prior plan and extend it to additional employees would have resulted in increased contractor contributions and expense. Based on the new plan, DCAA determined that \$141,354 in pension costs and \$3,660 in tuition costs to send the contractor's daughter to law school should be disallowed. The contracting officer advised the Agency in a December 1977 letter that he would recommend that the costs be allowed because, in his opinion, the basis of unreasonableness and nonallowability of the costs could not be supported if the contractor appealed. DCAA advised us in 1978 that they had taken no action on the case but might in the future.

--As part of an overhead review, in fiscal 1977 contract auditors questioned the entire amount of project demonstration costs claimed by a contractor during calendar 1976. Even though the costs did not meet the basic requirements of the Defense Acquisition Regulation, an administrative contracting officer rejected DCAA's findings, basing his rejection on a precedent established by his predecessor. Agency officials said that this administrative contracting officer consistently rejects the Agency's questioned costs and in one case sustained the Agency on only 11.7 percent, or \$214,000 of a total of \$1.8 million, of questioned costs.

--As a result of one of our recommendations, the Navy asked DCAA to perform an audit to determine the extent

of pricing adjustments required on contracts because of problems with a contractor's price estimating system. The problems had been brought to the contracting officer's attention as far back as November 1973, and again in 1974, but the contracting officer, the only person who could have caused the contractor to take corrective action did not act on the Agency's reports. Following a review by us, the contracting officer asked the contract auditors to perform a series of reviews of defective pricing. The contract auditors identified 33 defective pricing situations covering contract efforts between 1977 and 1978 with recommended price adjustments of \$3 million. A total of 1,164 additional pricing actions, valued at \$750 million, still required review for activity during 1972 through 1977. As recently as 1978, DCAA reported that the contractor's price estimating system has still these same weaknesses, thus casting doubt on future contract costs or pricing data this contractor may submit.

--For several years the Air Force may have allowed a contractor to realize unusually high profits on the sale of aircraft to foreign governments because neither procurement nor administrative contract officials requested DCAA to perform cost or pricing reviews of the contractors' supporting data from 1967 to 1977. The Air Force contracted for aircraft sold to foreign governments using the contractor's catalog price. For at least part of this time the same procurement command would not accept catalog prices for U.S. Government purchases of the same aircraft and required the contractor to negotiate them. Contract auditors were aware that the contractor did not have sufficient data to support catalog prices for foreign sales of aircraft but they had not previously audited it. The basis for their decision was that the contracting officer did not request it and that it was the contract audit agency's unstated policy to audit only those proposals requested by contracting officers. That audit disclosed that for at least two foreign military sales catalog contracts the contractor realized unusually large profits--as high as 33 percent on a \$47 million contract.

We found no evidence that these matters were considered significant enough by the contract auditors to be referred to a higher level of management for resolution.

CONTRACTING OFFICERS DO NOT ALWAYS
USE DCAA FINDINGS

Since we were reviewing DCAA and were under time limitations, we did not fully explore the issue of why contracting officers do not always use DCAA findings. We are aware that in contract price negotiations, contracting officers frequently agree on a lump-sum price. To determine the exact amount of a price reduction that is attributable to DCAA's findings in these cases is not easy. Nonetheless, the DCAA findings, unless proved wrong represent costs either the Government should not have to pay or which the contractor should provide additional support for if they are to be allowed. We believe that proper discharge of the Government's funds requires that contracting officers report in each case precisely what disposition is made of DCAA findings. If they do not use them, they should be required to say why not. If they cannot state precisely how much of the costs were disallowed in the final lump-sum negotiation, they should be required to state what negotiation advantage came from using the auditors' findings. If this requirement were absolute, we believe that cases like those described above would be less likely to occur, and Defense procurement costs would be lowered.

As previously indicated, the Defense Procurement Regulation requires such disposition of DCAA auditors' findings, but as shown below in many cases the requirement was not honored.

ACTION TAKEN ON 22,500
AUDIT REPORTS IS UNKNOWN

As of June 30, 1978, the Agency listed about 22,500 reports on which either no action had been taken or the Agency was unaware of any action taken. These reports (1) questioned the reasonableness, allocability, and allowability of about \$10 billion, (2) reported costs of about \$5 billion that were not adequately supported by contractor records, and (3) recommended improvements in contractor operations that would trim contractor costs (which the Government ultimately pays) by about \$299 million. A schedule of the numbers of unresolved audit reports is shown on the next page.

Cost findings

<u>Fiscal year issued</u>	<u>Number of outstanding reports</u>	<u>Questioned</u>	<u>Unsupported</u>	<u>Avoidance</u>
		(millions)		
1978	11,670	\$4,835	\$2,928	\$171
1977	7,272	3,179	1,769	95
1976	2,709	1,406	425	27
1975	667	316	45	6
1974	129	88	9	-
1973 and before	<u>67</u>	<u>80</u>	<u>20</u>	<u>-</u>
Total	<u>22,514</u>	<u>\$9,904</u>	<u>\$5,196</u>	<u>\$299</u>

CONTRACTING OFFICERS DO NOT PROVIDE REQUIRED FEEDBACK

The Defense Acquisition Regulation requires contracting officers to furnish contract auditors with a price negotiation memorandum showing the disposition of preaward audit findings during contract negotiations. This feedback information is also required on the disposition of postaward audit findings of audits and on incurred costs including overhead. The information helps contract auditors determine whether and to what extent their findings were used so they may evaluate and improve their audit process as well as determine whether audit techniques and related reporting need revising. The information also brings any major differences or disagreements with contracting officials to the attention of top-level DOD and procurement management officials.

In many offices that we visited, the required feedback memorandums had not always been provided as required. In one office, 66 memorandums, or 33 percent of the reports, had not been received. In another office, the records showed that of 320 price proposal audits conducted in 1977, all requiring the memorandums, 139, or 43 percent, had never been received. In 55 percent of those not received, the auditors had questioned \$9 million in costs and had found about \$5 million in unsupported costs. One contract audit manager said that some feedback memorandums were still outstanding for fiscal 1976 and earlier years. He indicated that those outstanding for earlier years might never be received. In another office, 125 of 253 total reports made in 1977, or 49 percent of the cases, were still pending while 25 percent were still pending for 1976.

It is likely that most of the questioned and unsupported costs and other recommendations contained in the unresolved 22,500 contract audit reports have already been dealt with by contracting officers. It is also likely that some of the costs questioned and unsupported in those reports will have been sustained by contracting officers and that savings to the Government resulting from the negotiation process already have been achieved. However, because no feedback information has been received on those reports, and because only limited followup may have been performed, it is unknown whether the matters disclosed by DCAA received proper consideration. Moreover, since contract auditors do not know to what extent their recommendations have been followed, they cannot use this information to improve their audit techniques and responsiveness to contracting officer needs.

In some cases, this information will never be obtained and the answers to these questions never known. For example, while the Defense Acquisition Regulation requires Federal procurement officers to provide feedback, no similar requirements exist for industry procurement officials to furnish contract auditors with procurement negotiation memorandums. Contract auditors said that when they audit bid evaluations for private contractors, they never know how their findings were used because industry procurement officials do not routinely provide this data. The work performed by DCAA for private contractors is usually done at the request of a prime contractor's contracting officer when the prime contractor cannot otherwise gain access to a subcontractor's records.

Also, even when feedback is received it is sometimes useless to the contract auditor in determining which elements of costs questioned or unsupported were sustained by the contracting officer because some contracting officers do not give needed information about how useful the information was. When this happens, negotiated costs cannot be analyzed on a lineitem basis in subsequent post-award reviews of defective pricing since, according to contract auditors, contracting officials frequently negotiate on a bottom-line or total-cost basis. For example, we noted that one procurement negotiation memorandum did not itemize negotiated costs even though the contract auditors had questioned \$49,000 of a \$327,000 proposal. The memorandum showed only that the contract was negotiated for \$308,000. Costs were not itemized and the auditors could not relate their findings on questioned costs to the negotiation process or the results of that process.

Inadequate feedback is not limited to forward pricing work. Contract auditors do not always receive feedback on findings resulting from other kinds of work they do. For example, in conducting operations audits at a contractor's plant, the contract auditors took major exception to selected aspects of the contractor's operations. The auditors recommended cost avoidance measures which could have saved \$750,000. An additional \$55,000 could have been saved if the contractor had brought his ratio of senior engineers (80 percent) into line with the industry average (55 percent) for similar kinds of operations.

The contracting officer did not notify the contractor of the potential additional savings. However, the contractor did take action to implement the auditors' recommendations on cost avoidance. Also, during annual overhead audits of one contract, the audit office questioned \$432,000 of a contractor's legal fees as unallowable by current procurement regulations. The contracting officer negotiated away all but 24 percent of the questioned costs without explaining any details other than that additional information had been furnished by the contractor. In another case, the same negotiator reinstated \$57,000 in retroactive compensation to union members after the contract auditors questioned the costs. The negotiator did not explain this action.

Despite the importance of feedback information to the Defense Contract Audit Agency, to top level management, and to procurement management, the failure to provide this information is an old problem which still persists.

In 1967 we reported that contract auditors were not receiving necessary information on the usefulness of their audits in negotiations or on the ways their services could be more effective in future negotiations. An internal audit by DOD in 1969 disclosed a similar problem. The problem has still not been resolved.

DCAA'S FOLLOWUP SYSTEM
NEEDS IMPROVEMENT TOO

The Defense Contract Audit Agency has a major responsibility to help insure that appropriate management action is taken on its recommendations. To do this, the contract auditor must follow up on his reports and periodically apprise top management of the extent and adequacy of actions taken on his recommendations. We noted that here too a longstanding problem exists.

DCAA's followup system is operated by its field audit offices which are allowed to establish and implement their

own procedures within guidelines provided by Contract Audit Agency headquarters and regional offices. Consequently, no uniformly and aggressively applied system is in effect throughout the Agency. Generally, contract auditors in field audit offices should attempt to get feedback on their reports within a reasonable time as specified in their guidelines-- normally 45 days after report issuance or after negotiations in the case of preaward work. However, we noted that even though feedback documents had not been received, followup had not been made in many cases. In one contract audit region, there seemed to be a correlation between those offices with the largest number of feedback documents not received and a lack of aggressive followup. In this case, the field audit offices located in the region were 3 to 6 months late in following up on their reports. One branch office manager told us that followup has low priority in his office.

Some offices do not attempt to follow established followup procedures. Two offices we visited only perform their initial followup about 90 to 120 days after issuance on all outstanding reports regardless of negotiation dates. At these offices, it is possible that no followup action will be taken on a given report for almost 6 months after a report has been issued. At another office, we were told that followup was irregular because of staff shortages and higher priority work. At this office, 56 percent of the reports for which feedback had not been received showed no evidence that followup action had been taken within 3 months of the report date, and 27 percent showed no evidence of followup within 6 months of the report date.

Audit reports closed by estimating

In 1976, Defense Contract Audit Agency headquarters observed that some of its audit offices were deferring timely followup of forward pricing reports in deference to higher priority work. Recognizing the importance of obtaining feedback on their reports and the difficulties in getting it, contract audit management authorized offices to use estimates to close reports for which no feedback had been received. Estimates of audit savings were to be based on the best available information, including oral replies from contracting officers and past experience and relationships of proposed and negotiated prices. In some offices where a higher percentage of reports were closed by estimating, their estimating methods varied considerably among reports, and some reports were closed that did not comply with the Agency's estimating criteria.

At two offices in one region, we observed that over half of the audit reports with questioned costs were closed by

estimation--54 percent in one office and 52 percent in the other. One office took a conservative approach by estimating that contracting officers sustained \$1,000 on each audit report with questioned costs. The other office used a ratio of 1976 dollars sustained to all dollars questioned or unsupported under \$1 million. This estimating procedure was used even when feedback was received.

Forty-five of 148 reports at the first office and 3 of 65 reports at the other office were for other than forward pricing audits but were closed by estimating without regard to stated criteria. According to one Agency official, the procedures for high percentage estimating were used because attempts to obtain feedback memorandums were unsuccessful. He also said that the reported savings were conservatively stated for the year but that without feedback from procurement officials, the exact impact of the contract audit report on final negotiations cannot be judged.

One DCAA official told us that the Agency had once had an aggressive followup program which included phone calls and personal visits by staff and the procurement liaison auditor. The program was not very successful in getting the procurement negotiation memorandum and resulted in antagonizing the contracting officers. He said that the guidance that established the estimating procedures resulted in a less aggressive followup program. He also said that some contracting officers could be deliberately holding the price negotiation memorandums so that the Defense Contract Audit Agency could not evaluate their actions.

Differences between contracting officers and auditors rarely reported to higher levels

Defense had another procedure to promote the reporting of instances where significant amounts questioned by auditors were reinstated by contracting officers. Under this procedure, adopted in 1969, if the contracting officer reinstated or allowed amounts that DCAA auditors believed should not be allowed, the auditors could forward the matter to higher levels for consideration. This procedure was designed to afford high-level DOD officials an opportunity to consider differences between auditors and contracting officers both on large dollar amounts and on the implementation of important cost principles.

In October 1970, Deputy Secretary of Defense Packard issued a memorandum which changed the situation. In his memorandum he stated:

"We should avoid actions by auditors in their advisory capacity which appear to dispute or question specific decisions of contracting officers. I want our contracting people to exercise judgement in their day-to-day work. The escalation of possible disputes relative to specific decisions should be avoided. If, however, such decisions or judgements have general application and, in the professional opinion of the auditor, indicate a change or trend in pricing or costing policy, the auditors may, of course, transmit the appropriate information through audit command channels."

This memorandum relaxed the reporting procedures. DCAA still has procedures requiring contract auditors to report to contract audit headquarters cases in which cost items over \$25,000 (\$10,000 for certain incurred costs) were disapproved or questioned but were reinstated by contracting officers without mutual agreement on the principle involved. Although the procedures are contained in each contract auditor's comprehensive audit manual, they are not being aggressively followed.

We are not aware of any specific DOD regulations or instructions directing DCAA not to report matters of significance; even the Packard memorandum does not specifically preclude it. Nevertheless, in the year prior to its issuance, at least 31 such cases were referred to top-level managers in DOD. Since 1970, however, very few cases have been referred and only 16 were reported to higher levels between August 1974 and October 1977.

The need for the procedure was recently indicated by a DOD task force. In 1975, DOD established a task force to enhance the effectiveness of DOD safeguards against reimbursing Defense contractors for improper expenditures. Their final report issued in January 1976 contained a recommendation that procedures be initiated requiring the contract audit agency to report instances where significant amounts that were questioned or considered unallowable by auditors were reinstated or allowed by contracting officers. The procedures were designed to enhance audit effectiveness, provide appropriate internal controls within DOD, and help ensure that the Office of the Secretary and cognizant military department management were knowledgeable of significant costs questioned by auditors but allowed by contracting officers.

These procedures required DCAA to write special reports, eventually reaching the Office of the Secretary of Defense, on significant problem areas or controversial situations arising from contract audits. Significant problem areas or controversial situations were defined as (1) costs questioned exceeding \$100,000 or (2) costs allocable to Government contracts exceeding \$50,000 which are questioned by auditors but reinstated by contracting officers without mutual agreement on the principles involved or the underlying rationale. These dollar thresholds were not intended to preclude the reporting of lesser amounts of reinstatements involving significant cost principles or procurement policy. However, the task force recommendation was not implemented. Instead, the required reporting was to be provided through internal audit and through procurement management review teams who review the written results of contract negotiations.

The principle reason the task force recommendation was not accepted was the belief by major DOD staff elements that the auditor and contracting officer would be placed in an adversary position with the auditor second guessing the actions of contracting officers regarding costs. The overriding consensus in DOD appears to be that the contract auditors should not be delegated any responsibility for internal audit of the team effort and must not be placed in a position of reviewing and reporting on a client--the contracting officer. As a practical matter, we noted that neither internal auditors nor procurement review groups have been informed of the need to place more emphasis on reporting to higher DOD management those instances of significant differences between contract auditors and contracting officers. Instead, they were working under the assumption that their current procedures were adequate.

DOD, and consequently DCAA, considers procurement oversight to properly be the province of DOD internal audit organizations. DOD Instruction 7600.3, which implements the agency's charter, states in part:

"The contract auditor may provide assistance to the internal auditor where providing assistance does not conflict with his basic role of providing advisory services to contracting officers. Assistance requiring contract auditors to evaluate contracting officers' performance would not be appropriate whereas assistance requiring evaluation of contractors' performance may be appropriate."

OMB Circular A-73 sets the policies to be followed in the audit of Federal operations and programs by executive departments and establishments. The Circular requires Federal

agencies to coordinate and cooperate with each other in developing and implementing their individual audit plans.

Financial Management policy notwithstanding, DCAA officials said they do not refer specific problem areas to DOD internal audit groups because to do so would be a violation of their charter. They said that if internal auditors requested such information they would provide it as long as it did not conflict with their role of an advising service to the contracting officer.

CONCLUSION

We see no reason why contracting officers should not be held accountable for seeing that DCAA auditors' findings are properly considered in the contract pricing process. We believe that they should be required to report on what action they take on DCAA's findings and, to the extent possible, report on the price advantages secured because of the findings. When the DCAA findings are valid, the contracting officer is obligated to the Government and to the taxpayers to take full advantage of any findings that might result in a lower price. When the findings are shown to be inaccurate or questionable, the contracting officer should report this to DCAA so they can improve their service.

RECOMMENDATIONS

To promote better service by DCAA and to promote better use of DCAA audit findings by contracting officers, we recommend that the Secretary of Defense:

- Direct cognizant procurement management officials to begin to provide the kind of feedback information required by the Defense Acquisition Regulation and needed by contract auditors.
- Direct the Director of the Defense Contract Audit Agency to establish a more aggressive system of appropriate followup procedures, including phone contacts and personal visits to obtain negotiation results.
- Modify its existing policy and directive to require the reporting, through separate channels already established, of matters on which auditors and contracting officers disagree.
- Direct the Defense Contract Audit Agency to more faithfully follow its procedures for reporting significant matters and concurrently report these matters to internal audit organizations as they occur.

CHAPTER 3

TIME CONSTRAINTS AND EXCESSIVE WORKLOAD

RESULT IN SOME SUBSTANDARD AUDIT WORK

The Defense Acquisition Regulation requires contract auditors to treat contracting officers' requests as a signal to begin audit work. The regulations require the contracting officer to establish the dates for receipt of the auditor's report and in so doing, to allow as much time as possible for the audit work. The auditor may request additional time; however, approval is at the discretion of the contracting officer. The contract auditor is responsible for determining the overall scope and depth of audit within the time available and is also required to include in the scope any particular areas emphasized by the contracting officer. Approximately 44 percent of the Defense Contract Audit Agency's work is performed at the direct request of contract officers in support of and prior to negotiations.

The time allowed for preaward audit by contracting officers is often very short considering the work to be done. As a consequence, the agency has, in some instances, taken shortcuts which produced work that was incorrect or not as useful as it might have been.

Audit standards published by us make timeliness the second standard of reporting. The standard recognizes that, for maximum usefulness, an audit report must be as timely as possible. However, the standards also describe unreasonable time constraints as restricting the auditors and impinging on their ability to reach independent and objective opinions and conclusions. Where time constraints are justifiable and do limit the scope of an audit, the standards require that the limitation be identified in the auditors' report. DCAA's contract audit manual requires the same identification as well as appropriate comments on the limited scope.

EFFECTS OF AN INCREASING WORKLOAD

In the preaward contract audit area, workloads have been steadily increasing over the past years while staff time available for all kinds of contract audit work has been decreasing. Preaward work has always been emphasized, so the continued increase in preaward audit work has resulted in reduced coverage of postaward work, delays in performing contract settlement audits, and may be contributing to reduced quality of both contract audit work

and reporting. The amount of hours spent on the preaward workload varies from one contract audit office to another depending on governmental contract activity, but the trend is up. In one office, the situation was as follows:

<u>Fiscal year</u>	<u>Hours expended</u>	<u>Percent of total effort</u>
1975	16,275	37
1976	17,913	38
1977	22,474	44

In this office, the time spent for these reviews was in excess of time originally scheduled. The overall report for this office stated that 1977 was characterized by a constant scrambling for resources and reassessment of priorities due in large part to understated workload, particularly in the preaward area where the office audited over 5 times more dollars than planned. According to DCAA records, in this office the major casualty of the need for a shift in resources in this office was cost incurred (postaward) audits. The records also showed that the backlog of cost incurred audits had increased from an expected \$84 million to \$212 million. According to an administrative contracting officer, because of higher priority work, agency contract settlement audits are regularly received later than the standard 20-month period after the date of final acceptance for closing a contract. He said these delays tie up contractor funds and produce a number of contractor complaints. The Defense Contract Administration Service office for this region had formally complained to DCAA calling the situation untenable. One contract audit manager said that self-initiated work must often be interrupted to handle the press of request work. Another audit manager said that a review of defective pricing on a major contract that had experienced significant cost underruns was delayed for 4 months getting started by forward pricing requests.

The timeliness and quality of other contract audit work may also be affected by the pressures and the extent of the high priority preaward request audits. For example, in a defective pricing review of a large contract the Agency did not select a firm fixed-price subcontract for review negotiated for about \$1.1 million because it was not a major subcontract, even though it was negotiated for about \$1.1 million. The subcontractor experienced a cost under-run of almost \$372,000 or about 34 percent. A subsequent GAO review found defective pricing and recovered \$324,000.

The manager of the contract audit office in which this occurred said that, in this case, increased time demands led to reductions in the scope of some audit areas which may not have been critical to the overall audit of incurred costs. He said that if the time squeeze worsens, the point of unacceptable scope reductions may be reached.

SOME EXAMPLES OF AUDIT WORK
THAT WAS NOT FULLY SATISFACTORY

Many contract audit reports we reviewed contained mathematical errors, errors in judgment, or other deficiencies that, in our opinion, raised questions about the adequacy of some of DCAA's work. Most problems noted were minor, although some were significant showing both a lack of professional care and adequate supervision. We believe these problems may be symptomatic of a much larger problem--too much work with too little time and staff to accomplish it. Following are examples of these problems as noted in six offices that we visited. We do not consider these examples to be indicative of the level of work generally done but rather, we think they represent cases where their work was subpar.

--The contract auditors responding to a request for reimbursable audit assistance chose to review the requesting agency's internal audit reports to determine the adequacy of costs billed to the agency under a contract. The more appropriate choice for the contract auditors would have been to directly audit costs, using the internal auditors' work, when appropriate, to minimize their own effort. DCAA said it could not judge the adequacy of claimed costs because the contractor's internal audits were not conducted according to standards. The internal audits were redone but, according to contract auditors, they still did not conform to standards. Seventeen months after the request for audit and after 94 staff-days of contract audit work, the requesting agency still did not know whether billed costs amounting to \$8,161,187 were reasonable. Reviewing an internal auditor's work is a normal and acceptable prerequisite for determining the scope of audit work to be conducted. However, strict reliance on the work of others without verifying and testing that information is never an adequate substitute for audit work. However, in this case we believe that a better approach and one more in keeping with the kind of work requested would have been for DCAA to perform the analysis that was requested and then citing deficiencies noted in the internal audit work which prevented DCAA from

reducing its scope. The requesting agency commented that DCAA spent more time reviewing the internal audit effort than was spent making the original audits, and the review period was longer than the contracting period that was audited.

- Our review of the contract audit of a contractor's price proposal disclosed that under previous contracts the Government had allowed a contractor approximately 15 percent profit on Government-furnished material. The estimated profits paid to the contractor were between \$300,000 and \$500,000 annually. The contract auditors had never questioned this practice even though profit on Government-furnished material is not a normal Government policy. We brought this matter to the attention of the contract auditors who subsequently recommended that this Government-furnished material be non-profit bearing.
- In their review of a proposal for a cost-plus-fixed-fee contract for professional services, the contract auditors used incorrect data in computing base rates for staff-hours and salary escalation factors. This error caused the agency to incorrectly question the proposed prices for these items. The contract auditors agreed with our assessment and stated that the auditors do not want to spend much time on such small contracts and are willing to accept greater risk.
- The contract auditors reported that a contractor's firm-fixed-price proposal of \$4.8 million was understated by about \$226,000 because proposed labor costs were improperly escalated. Also, other costs applicable to overtime hours were omitted from cost factors applicable to overtime hours. The report was qualified because no technical evaluation was provided and because severe time limitations on completing the review that were imposed by the requestor prevented an indepth analysis of significant cost elements. We reviewed the audit report and supporting papers and found that (1) the auditor should have reported that the understated costs were \$488,000, or \$262,000 more than the \$226,000 reported, (2) the auditor failed to note that labor hours were understated, and (3) the report was not accomplished in accordance with agency requirements. Contractor cost awareness was a major factor in the award of this contract, but the auditors did not show that this contractor did not demonstrate full cost awareness. The auditor in charge concurred with our assessment and attributed the errors and oversights to insufficient time to do a proper analysis.

- Contract auditors had no findings on a review of a cost-plus-fixed-fee that was proposed for about \$212,000. However, our review showed that the reasonableness of the contractor's quotes for parts, labor rates, and payroll additive rates should have been questioned but were not. These matters were reviewed by the requestor's price analyst and a proposal reduction of about \$15,000 was accepted. An Agency supervisor agreed that the auditor should have looked at the adequacy of the prices quoted for parts, but the auditor probably did not have sufficient time to do so. The contract auditors did not qualify their report because their scope was reduced and time was limited.

- Our review of a DCAA audit of a \$3,983,000 firm-fixed-price proposal disclosed significant judgmental errors which caused their reported questioned costs to be greatly inflated. When we reviewed the contract auditor's files, we noted that an audit request from the prime contractor for this contract had shown a split purchase of units at 51/35 with 51 units coming from the prime contractor and 35 from the subcontractor. Without reference to that data, DCAA auditors performed the audit, arbitrarily basing their analysis on a 50/50 split and automatically questioning one-half of all costs, including support costs and all labor costs other than assembly, manufacturing, and inspection. Consequently, the auditors did not provide a clear, concise, or accurate analysis to the contracting officer. They questioned a total of \$1,075,000 in proposed costs when in fact they should have questioned only \$276,000--creating a 289-percent overstatement of questioned costs. We did not concur in their conclusions and recommendations. The resident auditor agreed with our findings.

- Our examination of a contract auditor's report showed that the auditors had failed to consider and evaluate all cost factors proposed by two offerers. As a result, if accepted, the high offerer rather than low offerer would have been selected. The contract auditor concurred with our findings and agreed that an additional \$85,000 in proposed costs should have been questioned during his evaluation.

The preceding examples were taken from reports prepared from preaward audits for contracting officers to use prior to contract negotiations. Preaward audit work is considered an essential part of the procurement process and is performed primarily to prevent negotiation of excessive contracts.

However, we noted similar kinds of problems with adequacy in postaudit work as illustrated by the following examples.

--Our review of a contract audit agency postaward audit showed that the auditor did not sufficiently support a conclusion that the contractor had submitted accurate, complete, and current cost or pricing data. The contract worth \$3.1 million was a fixed-price incentive contract on which there was an underrun of \$323,000, or 15 percent of negotiated costs in the area of labor, overhead, and general and administrative expenses. The postaward audit, or defective pricing review, was both insufficient and incomplete and misled the reader into believing that the auditor found the cost and pricing data to be accurate, current, and complete when it was not. The resident contract auditor agreed that not enough work had been done.

--Our examination of two postaward or defective pricing audits performed by one office showed that the contract auditor had not reviewed current data, did not review all cost elements, and did not establish sufficient support that there was no defective pricing for these contracts. Our review showed that one contract, a fixed-price incentive contract, was completed for an underrun of \$159,000, or about 11 percent of negotiated cost. This audit took 17 months to complete because of its low priority and because auditors had difficulty in obtaining needed contractor documentation. The resident auditor agreed that the contract auditors should have done more work on these assignments.

We noted that DCAA was well aware of and recognized the problem of inadequate quality of defective pricing work performed by its staff. In a staff review the Agency's own internal reviewers found weaknesses similar to those noted during our review.

PREAWARD DEMAND AUDITS
REDUCE COVERAGE IN OTHER AREAS

The high volume of preaward audit work may not only contribute to reduced quality of audit work, it can also severely affect the amount of coverage provided other important postaward audit work conducted by DCAA--in some cases needlessly.

Demand audits have priority

Estimating staffing needs to accomplish the audit workload at each field audit office begins several months prior

to the start of each fiscal year when DCAA headquarters asks in its program objective document for a requirement plan to be submitted. The Agency provides guidance for its regions and field audit offices in developing their resource requirements. The field audit offices estimate their staffing needs based on (1) annual dollar volume of contract cost subject to audit, (2) estimated number and value of proposals expected from contractors for the year; (3) established productivity rates (dollars audited per hour or number of hours per proposal), and (4) prior experience in auditing the contractor.

Using those factors each team estimates the number of audits or reviews it needs to do or wants to do as well as the time required to do them. This estimating is done for each type of DCAA audit activity--incurred costs, forward pricing, cost accounting standards, defective pricing, and other direct and indirect audit time. Team estimates are consolidated into a field audit office estimate and sent to the region where they are reviewed, adjusted, and consolidated into a regional request. Agency headquarters then approves a yearly authorized staffing level for the region, and the region allocates the staff to field audit offices. Finally, program plans for the year are prepared based on the staff allocation received. As a result, the original estimate of the audit work planned for field audit offices usually requires adjusting.

The results of the above process can be seen in the following table which compares field office estimates of audit staffing requirements, regional approved staffing requirements, and final allocation of staff to one region for fiscal 1978.

<u>Office</u>	<u>Field office estimate of requirements</u>	<u>Staff-years</u>		
		<u>Regional approved requirements</u>	<u>Headquarters allocation</u>	<u>Total reductions</u>
1	57	52	38	19
2	36	36	30	6
3	21	19	15	6
4	18	18	16	2
5	11	11	10	1
6	11	11	10	1
Other	<u>437</u>	<u>416</u>	<u>330</u>	<u>107</u>
Total	<u>591</u>	<u>563</u>	<u>449</u>	<u>142</u>

The above table shows that field offices had 142 less auditors available for audit in fiscal 1978 than they believed were needed to accomplish the estimated workload. As a result, many had to reduce audit coverage planned for the year. Most of the adjustments, 116 staff-years, were made to reduce incurred cost and cost accounting standards audits. Only 11 staff-years were dropped in the forward pricing area.

The demand or request audits, which include forward pricing proposals and special audits, have priority over other audit work in each agency region. Our review shows that the DCAA spent about 51 percent of their audit effort on priority audits in fiscal 1977. In several offices, we found that demand audits are not backlogged because of self-initiated work. Instead, other audits are often cancelled or deferred because of the high priority work.

Planned operations audits not completed
because of higher priority work

One office doing primarily reimbursable work for a non-defense agency over the past several years has planned to perform certain operations audits pursuant to discussions and coordination with the local civil agency audit office. However, for the most part the audits have been delayed or cancelled because of higher priority work. During the first half of fiscal 1978, the contract audit branch planned to start and complete four operational audits but two of the audits had not been started and two were still in process at the time of our review in May 1978. The audits had not been started because of higher priority work.

The branch manager told us that he had not been able to perform operations audits because of higher priority work and inadequate staffing. He said that the DCAA has not been responsive to his request for additional staff, as shown above by the reduction in staffing requested for fiscal 1978. Civil agency procurement and audit officials said that their main complaint about DCAA audits centered around the branch's failure to perform operational audits. According to these officials, the contract audit branch has continuously performed unproductive audits (e.g., floor checks) while operations audits with higher potential for Government savings have not been done. The civil agency internal auditor believes DCAA would be more effective if it realigned its audit priorities at this location. We noted with interest that the Defense Contract Audit Agency's work plan for fiscal 1977 directed that higher priority be given to planning, initiating, and completing operations audits,

and it suggested that priority be given to request audits second. Apparently, this has no visible effect on completing operations audits at this user activity.

Priority work can limit the ability of a field audit office to do other audits because, as illustrated, final staffing allocations are reduced significantly more for incurred cost audits than for the priority work. Consequently, the estimated audit workload (unaudited dollar backlog) can increase from year to year. For example, in one region, field audit offices initially planned to carry over about \$1.7 billion of unaudited costs from fiscal 1978 to fiscal 1979 but as a result of final staff allocations, the planned unaudited backlog increased to \$3.5 billion. We did not review or evaluate the unaudited backlog in sufficient depth to establish whether DCAA's workload estimates are valid. However, we have no reason to believe that they are grossly in error.

We also observed that some of the Defense Contract Audit Agency's field audit offices we visited had a high percentage of cost or pricing proposal audits where the proposed contract amounts were less than \$500,000. Additionally, many proposals in one region were for amounts less than required by the current Defense Acquisition Regulation for contracting officers to request Agency field audit pricing support (\$100,000 for fixed-price and \$250,000 for cost-type). The threshold amounts in the regulations are lower-limit guidelines, but to determine the reasonableness of the proposed cost or price--particularly for cost-type contracts--the contracting officer can waive an audit when information is already available.

The following table shows the number and percentage of cost or pricing proposals for less than \$500,000 as noted at four of six offices visited.

Office	Period	Total proposals in period	Up to \$250,000	\$250,000 to \$500,000	Total less than \$500,000	Percentage of proposals less than \$500,000
1	Sept. 1977	45	17	11	28	62
2	Sept. 1977	32	11	5	16	50
3	FY 1977	44	6	6	12	27
4	FY 1977	<u>76</u>	<u>12</u>	<u>9</u>	<u>21</u>	28
Total		<u>197</u>	<u>46</u>	<u>31</u>	<u>77</u>	39

One office used about 8 percent of the staff time devoted to proposal audits on the 12 proposals for less than \$500,000; 92 percent was spent on the remaining 32 proposals. The audit office used 300 staff-hours on the 12 proposals but only classified \$136,000 (\$126,000 on one proposal) as questioned costs. Net savings from this work was about \$5,000.

We believe that the time devoted to these proposals could have been used more productively on other audits such as the operations audits suggested by the requesting agency.

SUGGESTED WAYS CONTRACT AUDIT RESOURCES CAN BE BETTER UTILIZED

With the increasingly heavy workload and limited resources available to it, DOD and Defense Contract Audit Agency management officials should make every effort to use DCAA's staff as productively as possible. Contract auditors are now performing work which can be reassigned or even eliminated. If that work responsibility is changed, staff would be freed for more pressing work and able to be more responsive to the needs of management.

RAISE DOLLAR THRESHOLDS OF PROPOSAL AUDITS

The Defense Contract Audit Agency devotes a great deal of time and effort to the preaward audit function while yielding only minimal results when compared to their overall effort. At one of five regions we visited, dollar threshold audits requested for contracts starting at \$100,000 for firm-fixed price and at \$250,000 for all other proposals may be too low thus resulting in significant time being spent--33 percent of total time was spent for this kind of work in one office, which accounted for only two percent of total proposal costs examined.

The Defense Acquisition Regulation requires that contracting officers normally request audit input for proposals in excess of \$100,000 for firm-fixed-price and fixed-price with economic price adjustment contracts or in excess of \$250,000 for all other types of proposals when the proposal price will be based on cost or pricing data. This requirement is waived only if information already available to the contracting officer is adequate to determine the reasonableness of the proposed cost or price.

Using an arbitrary cutoff point of \$500,000, we analyzed proposal data for over and under this arbitrary ceiling in one regional contract audit office. The results of our

analysis show that during fiscal 1977, the regional office reviewed 4,144 proposals of which 2,474, or 60 percent, were under \$500,000. The time expended to audit proposals under \$500,000 was about 30 percent of the total direct proposal hours spent--73,465 of 244,442 hours. This effort accounted for 2.2 percent of the proposal dollars examined by DCAA, 1.3 percent of proposal costs questioned, and 2.3 percent of the proposal costs unsupported in the Agency's audit reports for fiscal 1977. The analysis included firm-fixed-price proposals as well as all other types reviewed.

Firm-fixed-price proposals accounted for most of the proposals reviewed under \$500,000--1,541 of 2,474 proposals. By excluding these proposals from the "under \$500,000" criteria, significant dispositions were still noted. For example, 12 percent of proposal time was spent on proposals under \$500,000. This effort accounted for .8 percent of the dollar examined, .4 percent of the costs questioned, and .08 percent of the costs unsupported in fiscal 1977.

Taken as a whole, the large number of contracts that fall below the \$500,000 threshold will undoubtedly result in significant savings. However, our analysis tends to show that by increasing the established parameters, DCAA staff could be used more effectively in other higher priority areas.

CONCLUSIONS

To improve DCAA's overall performance, we believe that action needs to be taken to provide DCAA auditors with more time to perform pricing reviews. Time devoted to the biggest problem area--preaward pricing reviews--would be better spent if the minimum dollar amount is raised for the contracts DCAA must audit. Our review was not extensive enough to identify precisely what dollar thresholds would be most productive, but we think such a review should be made.

RECOMMENDATION

We recommend that the Secretary of Defense direct the Defense Contract Audit Agency to determine the thresholds for preaward audits at which it is cost effective to do preaward work in preference to other priority work DCAA has to do.

CHAPTER 4

INFORMATION NEEDED TO CONDUCT

AUDITS IS NOT ALWAYS MADE AVAILABLE

Contrary to both DOD policy and regulations and to public law, contract auditors are not always provided with the information necessary to review contractor pricing proposals or contractor costs. Contract auditors are denied access to certain budgetary data of contractors, technical evaluations are not always provided by contracting officers, and contractors do not always submit complete, accurate, and current data in support of initial cost or pricing proposals. Consequently, contract auditors have had to qualify 1/ many of their audit reports, thereby making them less useful to contracting officers in the negotiation process.

ACCESS TO CONTRACTOR BUDGETARY DATA

Two Defense Department contractors have repeatedly denied access to DCAA auditors. As a result, contract auditors were not able to do their job effectively and had to qualify numerous reports. Also, contract auditors may have compounded the problem by entering into agreements which limited their own access to contractor data.

Since 1958, access to contractor budgetary data has been a source of disagreement between two contractors and the Government. Efforts to resolve the problem over the years culminated in a policy memorandum issued by DOD in 1973. The DOD policy clearly requires access to budgetary data because it can have an impact on incurred and estimated costs. Contractors agree to this access when they submit pricing proposals. Nevertheless, access to budgetary data continued to be a problem with these contractors and, DCAA has since entered into a memorandum of agreement defining, and thus limiting, the amount and kind of budgetary data both contractors agree to provide contract auditors.

Access problems require management attention

DOD regulations require procurement managers and contracting officers to assist the auditors in gaining access

1/Auditors indicate in their report that in evaluating any opinions given in the report the user must consider that they did not have access to all the data they needed to do this work properly.

to contractor records. However, during the period of controversy, procurement officials were of little help to the contract auditors even though they were repeatedly advised of the problems. One auditor said that no procurement contracting officer had provided him with assistance even though he had issued qualified reports explaining that the contract auditor could not fully evaluate specific contract proposals without access to contractor budgets. Also, one procurement contracting officer said he considered the records to be internal contractor documents that are not necessary for evaluating contractor proposals. Accordingly, he felt no need to address the issue.

We understand that the Defense Contract Audit Agency has entered into similar agreements with other Government contractors and that the agreements prescribe varying degrees of access to contractor records. For several reasons, we believe that the Agency should not have entered into agreements restricting the Government's and its own access to contractor books and records. Such agreements are not consistent with good auditing procedure and with the role of the Agency as the accounting and financial advisor to the Department of Defense on procurement matters. Further, in signing the agreements, the Agency may have precluded the rights of access to contracting officers in future dealings with the contractor as well as their own rights of access in future audits of contractor-supplied data. Agreements of this kind do not solve access to records problems as is demonstrated by the fact that the auditor, a party to one of the above agreements, continues to experience access to records problems after the agreement is signed.

In our opinion, access to contractor records is of vital interest to the contracting officer as the Government's representative in the procurement process. In fulfilling its prescribed duties, the Defense Contract Audit Agency has the responsibility as well as the right to unrestricted access to all data, including budgets, needed to analyze proposed and incurred contractor costs. When agreements restricting these rights have been entered into, the Government does not have the information that is available to the contractor and, therefore, is at a disadvantage in monitoring the contractor's costs.

The nature of these agreements becomes even more disturbing when one considers the case where up to 90 percent of the contractor's business is with the Government. Another case involves a major defense contractor operating a Government-owned plant with Government-owned equipment. In this case,

Government-guaranteed loans have been directly responsible for the contractor continuing in business. Under these types of circumstances, we find contractor denial of access and governmental agreement to the denial particularly difficult to understand.

ACCESS TO TECHNICAL EVALUATIONS
AND OTHER COST AND PRICING DATA

Contrary to the Defense Acquisition Regulation, contracting officers do not ensure that defense contract auditors are provided with technical evaluation and other cost and pricing data to enable them to consider and include the financial effects of the data in their reports. Consequently, procurement officials and other top-level managers in DOD have no assurance either that all audit findings in the financial area have been considered by contracting officers or that data that should have been audited actually was.

Technical evaluations not provided

Technical evaluations are the products of technical specialists who are members of the procurement officer's team. Among other things, they are responsible for reviewing such technical matters as the number of proposed hours required for a specific job or contract based on such things as shop practices, industrial engineering, time and motion factors, and the contractor plant organization and capabilities. Reports on technical evaluations are to be given to the contract auditors at least 5 days prior to the due date of an audit report. The auditor relies on those reports to price out any differences noted by the technical evaluator in the kinds and quantities of material, labor hours, and other factors. In the event technical evaluations are not available in time to be included in the auditor's report, the report must be qualified and the facts made known to the contracting officer.

In the vast majority of cases covered by our review, relatively few technical evaluations were made available to auditors in time to be reviewed and included in their reports. The problem is universal throughout the Defense Contract Audit Agency and is known to top-level DCAA management officials. The data is particularly needed for their evaluations when a proposal involves complex engineering functions of products for which no related historical cost experience is available. The data is also needed for analyzing patterns.

Contracting officers with whom we discussed the matter said that the evaluations are not furnished to contract auditors because, in their opinion, the evaluations are not

needed and because price analysts, also members of the procurement team, can put the results of the technical evaluations together with the audit to present to the contracting officer. We did not examine technical evaluations prepared outside of DCAA. Therefore, we were unable to determine the extent to which impairments to the Government have resulted from missing technical evaluations. However, we noted that of the reports reviewed in one DCAA regional office, an average of 83 percent had been qualified by the contract auditors. In another regional office, 19 of 25 field audit offices reported that they had difficulty in obtaining the evaluations and had been forced to qualify their reports. Nine of the 19 offices reported that their reports were qualified 80 to 95 percent of the time for failure to provide the evaluations.

In our opinion, technical evaluations should be provided to the contract auditors before completing their review to make sure that significant overstatements of costs are not overlooked by contracting officers or other procurement support staff.

CONTRACTORS SUBMIT UNSUPPORTED COST DATA
AS PART OF PROPOSAL PACKAGES

During fiscal 1978, the Defense Contract Audit Agency issued a large number of reports without reviewing the support for about \$3 billion in costs contained in contractors' proposals. These unsupported costs were then negotiated by contracting officers generally without benefit of review by auditors.

The Truth in Negotiations Act requires, with certain exceptions, that contractors submit cost or pricing data and certify as to their accuracy, completeness, and currency for the award of any negotiated contract expected to exceed \$100,000.

According to procurement and contract audit officials, one negotiating technique used by some contractors is to delay providing support for costs until time of negotiation. Normally, the contracting officer does not have time to adequately review the data or request the contract auditors to review it; consequently, some unallowable costs probably are included in the price. For instance:

- In one preaward audit, contract auditors reported unsupported costs of \$8.69 million or 13 percent of the contractor's total proposed costs. The auditors were never given the opportunity to audit these costs. Instead, the contracting officer said that they were reviewed by a procurement evaluation team which did not include auditors.

--In another review, contract auditors reported unsupported costs for engines and propellers in a contractor proposal. The Air Force accepted the costs without audit and without further support. The engines and propellers cost \$4 million, or 15.6 percent of the proposed \$25.8 million. Contract auditors said in their report that the contractor had negotiated commercial prices for the engines and propellers with a subcontractor but had done so without benefit of cost and pricing data as required by the Defense Acquisition Regulation. In a subsequent report on an Air Force direct-purchase proposal from this same engine manufacturer, contract auditors reported questioned and unresolved costs of \$8,415 in costs per engine.

In one pricing proposal we reviewed in one office, time constraints were wrongly cited as a contributing factor in not requiring an audit of unsupported costs. In this case, 10 months passed from the time the report was issued until negotiations began. Also in this case, \$3.9 million, or 28 percent of the costs, was cited by the auditors as unsupported.

In this office, only 5 percent of unsupported costs reported by auditors were sustained when negotiated by contracting officers while 53 percent of questioned costs cited in contract audit reports were sustained. We believe that a primary reason that contracting officers have not supported the auditors in this area is a lack of vigorous enforcement of the provisions of public laws and the Defense Acquisition Regulation. By requiring contractors to provide support for proposed costs and by allowing auditors to review that support, we believe that additional savings to the Government are possible.

If reviews of these unaudited costs had been made and if questioned costs from these reviews had been supported by contracting officers at about the same rate as its other questioned costs, we think that significant savings could have resulted. We estimate that in just one of 373 offices of the six DCAA regions, \$28 million could have been saved if a 20-percent rate of acceptance had been achieved for unsupported costs reported by contract auditors in 1977.

CONCLUSIONS

Contract auditors are not always provided with all the data they need to do an effective job. In some instances, a large amount of cost or pricing data submitted in proposals is not audited by the contract auditor which raises the possibility that significant savings that could have been achieved

from these audits were overlooked. Management attention to the access to records problems has not been sufficient. As a result, DCAA has had to enter into agreements with some contractors or into the management decisionmaking process--clearly responsibilities beyond the normal scope of the audit function whether it is internal, external, or other.

A large amount of unaudited costs are negotiated by contracting officers; a situation which poses additional questions about whether the Government's negotiating position has been adequately represented. The potential for overpayment of costs in these cases is substantial and, as illustrated in chapter 2, may never be discovered if appropriate reviews are not performed.

We believe that auditors can only do an effective job if they are privy to all data or allowed to audit all data available on a given subject. While audit techniques do exist which allow the auditor to choose which of the data available for audit is representative, failure to provide access to this data negates the validity of both the techniques and the audit. In these circumstances, DCAA's reports cannot provide an overall picture of the reasonableness and propriety of the contracts it reviews.

RECOMMENDATIONS

We recommend that the Secretary of Defense:

- Direct procurement management officials to conform to current Defense Acquisition Regulations and established procedures and to provide DCAA with the opportunity to review unaudited and unsupported costs that were not available at the time of initial audit but were available prior to negotiation.
- Direct procurement management officials to review the support they provide to DCAA when access to records problems are encountered and to aggressively conform to the Defense Acquisition Regulation in this regard.
- Direct the Director, DCAA to cease entering into agreements with contractors for future access to needed contractor data.
- Require procurement management officials to provide technical evaluations to DCAA for review and inclusion in their reports or as supplements to them.

CHAPTER 5

LOW PRIORITY GIVEN TO DEFECTIVE PRICING

REVIEWS SEEMS INAPPROPRIATE

The Defense Contract Audit Agency performs postaward reviews to determine if accurate, complete and current cost or pricing data were submitted by contractors in accordance with Public Law 87-653, the Truth In Negotiations Act of 1962. The Agency's level of effort in this area totals about 2 percent of direct time spent each year. Because of limited staffing available and an extremely large number of contracts (preaward proposals are also covered by Public Law 87-653), the Agency only emphasizes review of larger contracts and uses a matrix system to select contracts for review. Also, DCAA headquarters, in providing annual planning guidance, establishes the level of effort required for the defective pricing program. This required level has decreased from a level of about 5 percent to 2 percent of direct audit hours spent each year. The relatively low level of effort in this area is justified by DCAA on the basis that further expenditures are not warranted by past results.

DCAA'S DEFECTIVE PRICING EFFORT IS VERY LIMITED

Guidance from DCAA headquarters calls for defective pricing audits of all firm-fixed-price contracts over \$10 million. An exception is made in the case of major contractors who have demonstrated that they may be relied upon to submit well-prepared, well-supported price proposals. Major contractors are those with an annual dollar volume of \$30 million or more or with 5,000 staff-hours of direct audit effort required.

Using DCAA's matrix, review is required of only 10 percent of firm-fixed-price contracts between \$1 million and \$10 million which are performed by major contractors known to be "careless or less proficient in proposal preparation" or by non-major contractors. The required percentage drops to 5 percent for major contractors who have "fairly reliable" procedures and control but whose proposal preparation is "less than adequate." For firm-fixed-price contracts under \$1 million the number to be audited is left to the judgment of the field audit office managers. This is also true for other types of contracts (for example, fixed-price-incentive, cost-plus-incentive fee) under \$10 million. For these types of contracts over \$10 million, requirements call for 50-percent review, except in the case of contractors known to be "careless or less proficient in proposal preparation," in which case, all contracts must be reviewed.

The contract auditor in charge of postaward reviews at one resident office said that his office had almost \$3 billion in contracts subject to defective pricing review. He said it would take 5,500 audit-hours in fiscal 1978 to do the 65 audits needed to keep current. He said that plans called for only 1,200 hours. He told us that a contract with an overrun or with an underrun of less than 5 percent or less than \$1 million is excluded from review. A supervisory auditor at this office said that in fiscal 1978 the office would examine only 14 contracts totaling \$517 million out of a possible 792 contracts totaling \$3 billion. Contracts audited in this office in fiscal 1977 and 1976 totaled \$158,345,000 and \$353,945,000, respectively.

Although it performed 320 preaward price evaluations in fiscal 1977, the resident officer performed only two defective pricing reviews, which represented less than 1 percent of the audit-hours expended by this office during the year.

DCAA STATES THAT RESULTS DO
NOT WARRANT GREATER EFFORT

Nationally, DCAA questioned only \$22 million or .18 percent of \$12 billion costs examined in defective pricing reviews in fiscal 1977. In defective pricing reviews at one residency, the auditors questioned 6.4 percent of fiscal 1977 costs examined; and 7.7 percent in 1976 costs. A branch office questioned no costs out of \$910,000 in fiscal 1976 and \$30,695,000 in fiscal 1977 that were examined during defective pricing reviews. The 1975 annual report for this office stated that defective pricing reviews were not productive and appeared to follow a general trend. The relatively low level of effort in this area is justified by DCAA on the basis that further expenditures are not warranted by past results.

Out of the \$22 million questioned by DCAA in fiscal 1977, only \$4 million was sustained by contracting officers. One manager said that DCAA generally sustains about 10 cents for every \$1.00 questioned. He explained that three elements are necessary for a finding of defective pricing:

- Pricing data was defective as of the date of certification.
- The defects were not disclosed to the contracting officer.
- The defective data was relied on by the contracting officer in agreeing to a price.

He said that the first two elements are sufficient for DCAA to issue a defective pricing report; the amount claimed would be established by substituting the correct data for the defective data. He pointed out, however, that the item for which cost data was defective usually was only a part of a larger cost item (for example, direct labor materials) which was directly negotiated. He said the contracting officer, under present procedures, must determine to what extent he would have adjusted the price negotiated if he had known of the defective data. A contract is eligible for defective pricing review until 3 years after final payment has been made. Thus, a sustained finding of defective pricing may be dependent on the contracting officer's memory of negotiations conducted several years and hundreds of contracts before. The Defense Acquisition Regulation, however, state as follows:

"In establishing that the defective data caused an increase in the contract price, the contracting officer is not expected to reconstruct the negotiation by speculating as to what would have been the mental attitudes of the negotiating parties if the correct data had been submitted at the time of agreement on price. In the absence of evidence to the contrary, the natural and probable consequence of defective data is an increase in the contract price in the amount of the defect plus related burden and profit or fee; therefore, unless there is a clear indication that the defective data was not used, or was not relied upon, the contract price should be reduced in that amount."

The amount to be recovered must either be negotiated by the contracting officer with the contractor, or the Government must resort to legal actions. Such negotiations further reduce actual costs recovered. For example, a recent GAO defective-pricing estimate of about \$7.9 million met with the contractor's denial of defective pricing. The difference was settled by the contracting officer for about \$3.9 million--roughly half the original findings. We believe that in this case, the contracting officer decided to settle at a reduced amount rather than take the case to court. However, contract clauses required by the Defense Acquisition Regulation basically provide that the contract price shall be reduced whenever the contracting officer determines that the contract price was increased by a significant amount because of defective cost or pricing data.

In cases where contract price adjustments that are recommended in defective pricing audit reports are not accepted by the contracting officers, a report is required by DCAA. However, the report is required only if the principle involved is not mutually agreed upon, or if the underlying rationale is not known, and if the amount reinstated exceeds \$25,000. The unwillingness of DCAA to challenge or report questionable actions or decisions of contracting officers is discussed in chapter 2.

WE DO NOT AGREE

We do not agree with DCAA's contention that defective pricing reviews are not justified in relation to the results obtained. We recently published a report (PSAD-77-91, Apr. 11, 1977) in which our reviews of 28 noncompetitive prime contracts and subcontracts totaling about \$400 million indicated that they were overpriced by about \$22 million. Just one of these contracts, a prime contract for \$3.6 million, was overstated by the contractor by \$986,000 because his proposal was not based on accurate, complete, and current cost or pricing data.

There is a connection between the preaward audit of proposals and subsequent defective pricing reviews conducted by DCAA. In responding to our review of one contract, an Agency regional manager said that the scope of the preaward audit of a contract in which we found defective pricing had been curtailed because of limited time allowed by a purchasing office to complete it. In this case, we reported that the Agency had failed to adequately warn the purchasing office that audit results might be affected by time constraints. Corrective action was taken by DCAA in this case.

In another case we noted that neither a preaward audit nor a defective pricing review was conducted. We subsequently reported that this contract, issued by the Air Force for F-16 program procurements worth \$1.5 billion, was not submitted with current, accurate, and complete data. As a result, the contract was overpriced by \$20.5 million.

Even though these are only two examples of the kinds of findings we have reported in the past, we do not consider them insignificant. We believe that DCAA places too little importance on this kind of review.

We believe that if effectively done, these audits are very worthwhile and serve as a check on whether the price negotiations were effective in ferreting out over-priced items.

The Defense Contract Audit Agency is aware that its own efforts in this area need improvement. In February 1977 Agency internal reviewers noted that:

- The quality of these audits were less than adequate at the majority of field audit offices visited.
- Audits were curtailed based on inappropriate comparisons of actual and certified costs.
- Contract universes were incomplete and poorly maintained at many audit offices.
- Many contracts were dropped from consideration for future review by audit offices.
- Backlogs of defective pricing audits were increasing.

CONCLUSION

We believe defective pricing reviews are an important part of the procurement process. They serve to provide a good review of the effectiveness of the use of cost data in establishing contract prices. Also, our own experience indicates that such audits are cost effective. Accordingly, we believe DCAA needs to reconsider its allocation of time to this work.

RECOMMENDATION

We recommend that the Secretary of Defense direct DCAA to review its priorities to see if more work should be done in this audit area.

CHAPTER 6

SCOPE OF REVIEW

We made our review at Defense Contract Audit Agency headquarters, Cameron Station, Alexandria, Virginia, and at field audit offices in five of the six DCAA regions. A list of the locations visited during our review is included in appendix I. The review, made from February 1978 to September 1978, covered selected aspects of DCAA's contract audit activities.

We reviewed the organization and operations of the Agency in relation to our audit standards and the Office of Management and Budget circular requirement, which set forth policies to be followed in auditing Federal operations and programs.

Our examination did not include all aspects of the Defense Contract Audit Agency's operations. Rather, we concentrated our efforts on those areas requested by the Chairman, Subcommittee on Legislation and National Security, House Government Operations Committee. Particular emphasis was given to organizational structure, independence, and reporting levels, and included a review of procedures for followup on unresolved items.

We also made a reliability assessment of the Agency's management information system and conducted a users survey of over 1,000 procurement and administrative contracting officers to determine their satisfaction with DCAA services.

DEFENSE CONTRACT AUDIT AGENCYOFFICES VISITEDAtlanta Region

Atlanta Regional Office	Marietta, Ga.
Atlanta Branch Office	Atlanta, Ga.
Kennedy Space Center Branch Office	Kennedy Space Center, Fla.
Resident Office, Lockheed-Georgia Co.	Marietta, Ga.
Resident Office, Honeywell, Inc.	St. Petersburg, Fla.
Resident Office, Harris Corp.	Melbourne, Fla.
Huntsville Branch Office	Huntsville, Ala.

Boston Region

Boston Regional Office	Waltham, Mass.
Bridgeport Branch Office	Bridgeport, Mass.
Northeast Branch Office	Waltham, Mass.
Resident Office, Massachusetts Institute of Technology	Cambridge, Mass.
Resident Office, GTE Sylvania, Inc.	Needham Heights, Mass.
Resident Office, Sanders Assoc.	Nashua, N.H.
Resident Office, Grumman Aerospace Corp.	Bethpage, N.Y.

Los Angeles Region

Los Angeles Regional Office	Los Angeles, Calif.
Los Angeles Branch Office	Inglewood, Calif.
Resident Office, McDonnell Douglas Corp.	Long Beach, Calif.

San Francisco Region

San Francisco Regional Office	San Francisco, Calif.
Seattle Branch Office	Seattle, Wash.
Resident Office, The Boeing Co.	Seattle, Wash.
St. Louis Branch Office	St. Louis, Mo.
Resident Office, McDonnell Douglas Corp.	St. Louis, Mo.

Philadelphia Region

Philadelphia Regional Office	Philadelphia, Pa.
Philadelphia Branch Office	Philadelphia, Pa.

DCAA Headquarters

	Alexandria, Va.
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(with changes thru 7/14/72
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ASD(C)

Department of Defense Directive

SUBJECT Defense Contract Audit Agency

Reference: DoD Directive 7600.2, "Department of Defense
Audit Policies," August 19, 1965

I. GENERAL

A. Pursuant to authority vested in the Secretary of Defense, a Defense Contract Audit Agency is hereby established as an agency of the Department of Defense under the direction, authority, and control of the Secretary of Defense and in accordance with Department of Defense policies, directives, and instructions.

B. No separate contract audit organization independent of the Defense Contract Audit Agency shall be established in the Department of Defense.

II. ORGANIZATION

A. The Defense Contract Audit Agency shall consist of:

1. A Director, a Deputy Director, a headquarters establishment, and such subordinate field audit offices as may be established by the Director, Defense Contract Audit Agency, for the accomplishment of the Defense Contract Audit Agency mission. Field audit offices will include district/regional, branch, procurement liaison, contractor residency, and contract audit coordination offices.

2. Such other subordinate offices or establishments and activities as are herein or may be hereafter specifically assigned to the Defense Contract Audit Agency by the Secretary of Defense.

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B. The chain of command shall run from the Secretary of Defense to the Director, Defense Contract Audit Agency.

III. SCOPE AND DEFINITIONS

A. The Defense Contract Audit Agency operations will be conducted on a world-wide basis.

B. Contract audit is defined as the professional auditing service provided by the Defense Contract Audit Agency to all elements of the Department of Defense, and to other Governmental agencies as appropriate, which will permit the Defense Contract Audit Agency to meet the responsibilities and perform the functions enumerated in Sections V, and VI. of this Directive.

IV. PURPOSE

The purpose of contract auditing is to assist in achieving the objective of prudent contracting by providing those responsible for procurement and contract administration with financial information and advice on proposed or existing contracts and contractors, as appropriate. Audit services of the Defense Contract Audit Agency shall be utilized by procurement and contract administration activities to the extent appropriate in connection with the negotiation, administration, and settlement of contract payments or prices which are based on cost (incurred or estimated), or on cost analysis.

~~* -V.-----DEFENSE CONTRACT AUDIT ADVISORY COUNCIL-----*~~

~~* A:-- To advise the Secretary of Defense in the direction and control of the Defense Contract Audit Agency, a Defense Contract Audit Advisory Council is hereby established with membership as follows:-- The Deputy Secretary of Defense, Chairman; The Assistant Secretary of Defense (Comptroller), Alternate Chairman; The Assistant Secretary of Defense (Installations & Logistics); The Assistant Secretaries of the Military Departments (Financial Management) and (Installations & Logistics); The Director, Defense Supply Agency; and the Deputy Director, Contract Administration Services, Defense Supply Agency.--*~~

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- * ~~B. -- The Defense Contract Audit Advisory Council will be~~ *
- * ~~furnished an appropriate report at least twice a year by the~~ *
- * ~~Director, Defense Contract Audit Agency.~~ *

- * ~~C. -- The Council will also be available for consultation with~~ *
- * ~~the Director, Defense Contract Audit Agency, on such matters as~~ *
- * ~~he or any member of the Council may bring before it. It will meet~~ *
- * ~~as regularly as necessary but not less frequently than semiannually.~~ *

- * ~~D. -- The Assistant Secretary of Defense (Comptroller) will~~ *
- * ~~provide for furnishing Executive Secretarial services to the Council.~~ *

V. RESPONSIBILITIES

The Defense Contract Audit Agency, under the direction and operational control of its Director shall be responsible for:

A. Performing all necessary contract audit for the Department of Defense and providing accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. These services will be provided in connection with negotiation, administration, and settlement of contracts and subcontracts.

B. Providing contract audit service to other Government agencies as may be appropriate.

VI. FUNCTIONS

Under its Director, the Defense Contract Audit Agency will perform the following functions:

A. Audit, examine and/or review contractors' and sub-contractors' accounts, records, documents, and other evidence; systems of internal control; accounting, costing, and general business practices and procedures; to the extent and in whatever manner is considered necessary to permit proper performance of the other functions described in B through J below.

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B. Examine reimbursement vouchers received directly from contractors, under cost-type contracts, transmitting those vouchers approved for payment to the cognizant Disbursing Officer and issuing DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with a copy to the cognizant contracting officer, with respect to costs claimed but not considered allowable. Where the contractor disagrees with a suspension or disallowance action by DCAA, and the difference cannot be resolved, the contractor may appeal in writing to the Administrative Contracting Officer (ACO) who will make his determination in writing. In addition, the contracting officer may direct the issuance of DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with respect to any cost which he has reason to believe should be suspended or disapproved.

C. Provide advice and recommendations to procurement and contract administration personnel on:

1. Acceptability of costs incurred under redeterminable, incentive and similar type contracts.

2. Acceptability of incurred costs and estimates of cost to be incurred as represented by contractors incident to the award, negotiation, modification, change, administration, termination, or settlement of contracts.

3. Adequacy of financial or accounting aspects of contract provisions.

4. Adequacy of contractors' accounting and financial management systems, adequacy of contractors' estimating procedures and adequacy of property controls.

D. Assist responsible procurement or contract administration activities in their surveys of the purchasing-procurement systems of major contractors.

E. Direct audit reports to the Government management level having authority and responsibility to take action on the audit findings and recommendations.

F. Cooperate with other appropriate Department of Defense components on reviews, audits, analyses, or inquiries involving

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contractors' financial position or financial and accounting policies, procedures, or practices.

G. Establish and maintain liaison auditors as appropriate at major procuring and contract administration offices.

H. Review General Accounting Office reports and proposed responses thereto which involve significant contract or contractor activities for the purpose of assuring the validity of appropriate pertinent facts contained therein.

I. In an advisory capacity, attend and participate, as appropriate, in contract negotiation and other meetings where contract cost matters, audit reports, or related financial matters are under consideration.

J. Provide assistance, as requested in the development of procurement policies and regulations.

VII. AUTHORITY

To discharge the responsibilities of the Agency, the Director, Defense Contract Audit Agency, or his designees, are specifically delegated authority to:

A. Have free and unrestricted access to and direct communication with all elements of the Department of Defense and other executive departments and agencies as necessary.

B. Operate and control all organizations, activities, and resources assigned or attached to the Defense Contract Audit Agency.

C. Establish Defense Contract Audit Agency facilities using wherever feasible, appropriate established physical facilities of the military departments or the Defense Supply Agency.

D. Obtain such information from any component of the Department of Defense as may be necessary for the performance of Defense Contract Audit Agency functions.

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E. Centralize or consolidate the functions for which Defense Contract Audit Agency is responsible to the extent the Director deems feasible and desirable in consonance with the aims of maximum over-all efficiency, economy, and effectiveness.

VIII. RELATIONSHIPS

A. In the performance of his functions, the Director, Defense Contract Audit Agency shall:

*	1. - Consult with the Defense Contract Audit Advisory	*
*	Council to assure that the Council has adequate knowledge of	*
*	Defense Contract Audit Agency plans for accomplishing its	*
*	Defense Contract Audit Agency mission in support of programs	*
*	to be carried on by the military departments, Defense Supply	*
*	Agency, and other defense agencies.	*

1. Maintain appropriate liaison with other components of the Department of Defense, other agencies of the Executive Branch, and the General Accounting Office for the exchange of information and programs in the field of assigned responsibilities

2. Make use of existing Department of Defense facilities and services, wherever practicable to achieve maximum efficiency and economy.

B. Primary staff supervision shall be provided to the Director, Defense Contract Audit Agency, on behalf of the Secretary of Defense, by the Assistant Secretary of Defense (Comptroller), who will prescribe principles and policies to be followed in connection with technical, organization, and administrative matters related to contract audit.

C. The military departments and other Department of Defense components shall provide support, within their respective fields of responsibility, to the Director, Defense Contract Audit Agency to assist in carrying out the assigned responsibilities and functions of the Agency. Programming, budgeting and financing for such support will be in accordance with policies and procedures prescribed by the Assistant Secretary of Defense (Comptroller).

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IX. ADMINISTRATION

A. The Director shall be appointed by the Secretary of Defense.

B. The Deputy Director will be a qualified civilian and appointed by the Secretary of Defense.

C. The transfer of manpower authorizations to Defense Contract Audit Agency from other DoD components will be in accordance with established policies and procedures.

D. The appointment of other personnel to the Agency will be subject to the approval of the Director, Defense Contract Audit Agency. Regional managers will be qualified civilians.

E. The Defense Contract Audit Agency will be authorized such personnel, facilities, funds, and other administrative support as the Secretary of Defense deems necessary for the performance of its function. In this connection, programming, budgeting, financing, accounting, and reporting activities of the Defense Contract Audit Agency will be in accordance with policies and procedures established by the Assistant Secretary of Defense (Comptroller).

X. IMPLEMENTATION

The Director, Defense Contract Audit Agency will assume assigned responsibility and functions of the Agency in accordance with the schedule to be approved by the Secretary of Defense.

XI. EFFECTIVE DATE

This Directive is effective upon publication. Whenever the Defense Contract Audit Agency assumes responsibility for the function assigned to it under the terms of this Directive, all components of the Department of Defense will review their existing directives, instructions, and regulations for conformity, make necessary changes thereto within 90 days, and notify the Assistant Secretary of Defense (Comptroller) when the changes are completed.

*

*


Secretary of Defense

**Inclosure
Delegation of Authority**

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DELEGATIONS OF AUTHORITY

1. Pursuant to the authority vested in the Secretary of Defense, the Director, Defense Contract Audit Agency, or, in the absence of the Director, the person acting for him is hereby delegated, subject to the direction, authority, and control of the Secretary of Defense, and in accordance with Department of Defense policies, directives, and instructions, and pertinent OSD regulations, authority as required in the administration and operation of DCAA to:

a. Exercise the powers vested in the Secretary of Defense by Section 3101 of Title 5, U.S.C. and Section 302 of Title 5, U.S.C. pertaining to the employment, direction and general administration of DCAA civilian personnel.

b. Fix rates of pay for wage board employees exempted from the Classification Act by 5 U.S.C. 5102(c)(7) of that Act on the basis of rates established under the Coordinated Federal Wage System. DCAA, in fixing such rates, shall follow the wage schedule established by DoD Wage Fixing Authority.

c. Establish such advisory committees and employ such part-time advisers as approved by the Secretary of Defense for the performance of DCAA functions pursuant to the provisions of 10 U.S.C. 173, 5 U.S.C. 3109(b), and the Agreement between the DoD and the Civil Service Commission on employment of experts and consultants, dated July 22, 1959.

d. Administer oaths of office incident to entrance into the Executive Branch of the Federal Government or any other oath required by law in connection with employment therein, in accordance with the provisions of the Act of June 26, 1943, as amended, 5 U.S.C. 2903(b) and designate in writing, as may be necessary, officers and employees of DCAA to perform this function

e. Establish a DCAA Incentive Awards Board and pay cash awards to and incur necessary expenses for the honorary recognition of civilian employees of the Government whose suggestions, inventions, superior accomplishments, or other personal

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efforts, including special acts or services, benefit or affect DCAA or its subordinate activities in accordance with the provisions of the Act of September 1, 1954, as amended, 5 U. S. C. 4503 and Civil Service Regulations.

f. In accordance with the provisions of the Act of August 26, 1950, as amended (5 U. S. C. 7532); Executive Order 10450, dated April 27, 1953, as amended; and DoD Directive 5210.7, dated September 2, 1966 (as revised):

- (1) Designate any position in DCAA as a "sensitive" position;
- (2) Authorize, in case of an emergency, the appointment of a person to a sensitive position in the Agency for a limited period of time for whom a full field investigation or other appropriate investigation, including the National Agency Check, has not been completed; and
- (3) Authorize the suspension, but not to terminate the services of an employee in the interest of national security in positions within DCAA.

g. Clear DCAA personnel and such other individuals as may be appropriate for access to classified Defense material and information in accordance with the provisions of DoD Directive 5210.8, dated 15 February 1962, "Policy on Investigation and Clearance of Department of Defense Personnel for Access to Classified Defense Information," and of Executive Order 11652, dated March 8, 1972.

h. Act as agent for the collection and payment of employment taxes imposed by Chapter 21 of the Internal Revenue Code of 1954 and, as such agent, make all determinations and certifications required or provided for under Section 3122 of the Internal Revenue Code of 1954 and Section 205(p)(1) and (2) of the Social Security Act, as amended (42 U. S. C. 405(p)(1) and (2)) with respect to DCAA employees.

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i. Authorize and approve overtime work for DCAA civilian officers and employees in accordance with the provisions of Section 550.1 of the Civil Service Regulations.

j. Authorize and approve:

(1) Travel for DCAA civilian officers and employees in accordance with the Joint Travel Regulations, Volume 2.

(2) Temporary duty travel only for military personnel assigned or detailed to DCAA in accordance with Joint Travel Regulations, Volume 1.

(3) Invitational travel to persons serving without compensation whose consultive, advisory, or other highly specialized technical services are required in a capacity that is directly related to or in connection with DCAA activities, pursuant to the provisions of Section 5 of the Administrative Expenses Act of 1946, as amended (5 U. S. C. 5703).

k. Approve the expenditure of funds available for travel by military personnel assigned or detailed to DCAA for expenses incident to attendance at meetings of technical, scientific, professional or other similar organizations in such instances where the approval of the Secretary of Defense or his designee is required by law (37 U. S. C. 412). This authority cannot be redelegated.

l. Develop, establish, and maintain an active and continuing Records Management Program, pursuant to the provisions of Section 506(b) of the Federal Records Act of 1950 (44 U. S. C. 3102).

m. Establish and use Imprest Funds for making small purchases of material and services other than personal for DCAA when it is determined more advantageous and consistent with the best interests of the Government, in accordance with the provisions of DoD Instruction 7280.1, dated August 24, 1970, and the Joint Regulation of the General Services Administration -- Treasury Department -- General Accounting Office, entitled "For Small Purchases Utilizing Imprest Funds."

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n. Authorize the publication of advertisements, notices, or proposals in newspapers, magazines, or other public periodicals as required for the effective administration and operation of DCAA (44 U.S.C. 3702).

o. (1) Establish and maintain appropriate Property Accounts for DCAA.

(2) Appoint Boards of Survey, approve reports of survey, relieve personal liability, and drop accountability for DCAA property contained in the authorized Property Accounts that has been lost, damaged, stolen, destroyed, or otherwise rendered unserviceable, in accordance with applicable laws and regulations.

p. Promulgate the necessary security regulations for the protection of property and places under the jurisdiction of the Director, Defense Contract Audit Agency, pursuant to paragraph III. A. and V. B. of DoD Directive 5200.8, dated August 20, 1954.

q. Establish and maintain, for the functions assigned, an appropriate publications system for the promulgation of regulations, instructions, and reference documents, and changes thereto, pursuant to the policies and procedures prescribed in DoD Directive 5025.1, dated March 7, 1961.

r. Enter into support and service agreements with the military departments, other DoD agencies, or other Government agencies as required for the effective performance of responsibilities and functions assigned to DCAA.

2. The Director, Defense Contract Audit Agency, may redelegate these authorities, as appropriate, and in writing, except as otherwise specifically indicated above or as otherwise provided by law or regulation.

3. This delegation of authorities is effective immediately.



NUMBER 7600.3
DATE January 4, 1974

ASD(Comp)

Department of Defense Instruction

SUBJECT

Internal Audit in the Department of Defense

- Refs:
- (a) DoD Directive 7600.2, "Department of Defense Audit Policies," August 19, 1965
 - (b) DoD Instruction 7600.3, "Internal Audit in the Department of Defense," May 25, 1968 (hereby cancelled)
 - (c) DoD Instruction 2010.1, "Support of International Military Activities," July 23, 1973
 - (d) DoD Instruction 7600.5, "Internal Audit Staff Development Programs; Qualifications and Supervisory Structure," January 4, 1974
 - (e) ASD(Comp) memorandum, "Interface Between Contract Audit and Internal Audit," December 26, 1966 (hereby cancelled)
 - (f) ASD(Comp) memorandum, "Internal Audit Reports," June 20, 1967 (hereby cancelled)
 - (g) General Services Administration Federal Management Circular 73-2, "Audit of Federal Operations and Programs by Executive Branch Agencies," September 27, 1973
 - (h) Standards for Audit of Governmental Organizations, Programs, Activities and Functions issued by the Comptroller General of the United States, June 1972

I. PURPOSE

- A. This Instruction reissues reference (b) to update the policies concerning organization, responsibilities and mission with respect to internal audit in the Department of Defense under the provision of reference (a).
- B. Expanded guidance is provided with respect to the coordination between the central internal audit organizations and between the internal audit organizations and the Defense Contract Audit Agency; the exchange of technical information; and the receptiveness and utilization of internal audit results. Also, applicability of this Instruction is extended to the audit organizations of the Military Exchange Systems.

II. APPLICABILITY

The general provisions of this Instruction apply to all the DoD Components. The provisions relating to management and performance of the internal audit function apply to the DoD Components authorized to have an internal audit organization (i.e., the Office of the Secretary of Defense, the Military Departments, and the Defense Supply Agency) and to other DoD Components to the extent specified herein.

III. ORGANIZATION FOR INTERNAL AUDITA. Office of the Secretary of Defense

1. Internal audit functions at this level will be accomplished by the Office of the Assistant Secretary of Defense (Comptroller).
2. Policy, coordination, evaluation and operating audit functions relating to internal audit activities throughout the Department of Defense will be the responsibility of the Deputy Assistant Secretary (Audit).
 - a. Policy, coordination and evaluation functions include, but are not limited to:
 - (1) Development of policies, plans and procedural guidance with respect to internal audit.
 - (2) Analysis and evaluation (through observation of audit operations at headquarters and field offices, or otherwise) of internal audit organizations and operations including audit programs, schedules, and reports.
 - (3) Coordination of audit matters within the Department of Defense and with outside agencies such as the General Accounting Office.
 - (4) Dissemination of Defense Component audit findings and recommendations to interested elements within the Office of the Secretary of Defense, and obtaining statements of action taken on audit recommendations upon request by OSD offices or as deemed appropriate.
 - b. Operating audit functions include, but are not limited to, the following:
 - (1) Perform internal audits and provide audit service to the Office of the Secretary of Defense, the Organization of the Joint Chiefs of Staff, and other DoD Components, as assigned.
 - (2) Develop, plan, perform, and/or direct performance of DoD-wide audits of the Military Assistance Program and of other selected areas and functions.
 - (3) Plan, perform, and/or direct performance of special audits or audit surveys of selected areas within the Department of Defense as requested or as deemed appropriate.

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B. Military Departments and Defense Supply Agency

1. All internal audit responsibilities (subject to the provisions of III.A. and III.G. of this Instruction), continental United States and overseas, shall be carried out by a single internal audit organization in each Military Department and in the Defense Supply Agency in order to assure independence and to avoid duplication.
2. The head of the central audit organization in each DoD Component will be responsible to the Comptroller of the DoD Component. However, in each DoD Component, administrative arrangements shall provide for direct channels of communication to higher levels as prescribed in reference (a).
3. Field offices may be established as necessary to carry out effectively the mission of the audit organization. The field organization may include resident auditors at installations or command headquarters where the volume of audit work or the need for particularly prompt audit service warrant. Such field offices will be a part of the central audit organization and will be under the administrative and technical command and control of the head of the central organization.

C. Defense Agencies Not Authorized to Have an Internal Audit Organization. All internal audit responsibilities for the Defense Advanced Research Projects Agency, Defense Civil Preparedness Agency, Defense Communications Agency, Defense Contract Audit Agency, Defense Intelligence Agency, Defense Investigative Service, Defense Mapping Agency, Defense Nuclear Agency, Defense Security Assistance Agency, National Security Agency, and for such other Defense Agencies as may be designated, will be carried out by the Office of the Assistant Secretary of Defense (Comptroller).

D. Executive Agent Assignments. Joint Defense offices or activities for which a Military Department or Defense Agency is assigned as executive agent will be audited by the Defense audit organization which has audit cognizance of the executive agent, if not otherwise prescribed.

E. Unified and Specified Commands

1. Internal audit of the headquarters of unified and specified commands (including headquarters of subordinate unified commands) will be the responsibility of the Office of the Assistant Secretary of Defense (Comptroller). In carrying out this responsibility, the Assistant Secretary of Defense (Comptroller) may obtain assistance from the audit organizations of the DoD Components in accordance with III.A.1. of reference (a).

2. Internal audit cognizance of the Military Department Components of unified, specified and subordinate unified commands rests with the respective Military Department audit organizations.

F. International Military Activities

1. DoD Instruction 2010.1 (reference (c)) assigns responsibilities and establishes methods for providing budgetary, financial, logistical, and administrative support by agencies of the Department of Defense to international military activities. The functions prescribed therein will be audited, as appropriate, by the Defense audit organization which has audit cognizance of the DoD Component assigned responsibility for national support.
2. Internal audit of the U.S. elements of international military activities, wherever appropriate in accordance with international agreements, will be the responsibility of the Office of the Assistant Secretary of Defense (Comptroller), with assistance, as appropriate, from the audit organization which has audit cognizance of the DoD Component assigned responsibility for national support.

G. Other Audit-Type Activities at Various Management Levels

1. Audits of Nonappropriated Funds

- a. General. As stated in reference (a), no internal audit groups are authorized to be established (independent of authorized central audit organizations) at any management level, except that a DoD Component may delegate responsibility for performing certain audits of nonappropriated fund activities to lower levels. When this responsibility is assigned to commanders at lower levels, performance will be subject to the technical guidance, surveillance and review of the cognizant central audit organization.

b. Military Exchange Systems

- (1) All internal audit responsibilities within a military exchange system, continental United States or overseas, shall be carried out by a single exchange audit organization to assure independence and to avoid duplication. To provide an adequate degree of independence, the head of each exchange audit organization should be responsible to the highest practical

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organizational level, preferably to the commander or to a principal official reporting directly to the commander. Field offices may be established as necessary to carry out effectively the mission of the audit organization. Such field offices will be a part of the central exchange audit organization and will be under the administrative and technical control of the head of the exchange audit organization. To the extent feasible within resource availability and other priorities, exchange audit organizations and central audit organizations of the DoD Components shall arrange to perform assist audits for one another wherever economy, efficiency or more effective audit coverage will result.

- (2) Internal audits of the exchanges (including field locations) shall be conducted in accordance with the provisions of this Instruction with regard to internal audit responsibilities, mission, and scope (Section IV.); receptiveness and utilization of internal audit (Section V.); personnel (Section VII.A.); audit frequency (Section VII.C.); audit approach (Section VII.D.); audit reports (Section VII.E.); management requested audits (Section VII.F.); and audits within combat theaters (Section VII.G.). These provisions may be revised upon approval by the Assistant Secretary of Defense (Comptroller) to provide for differences in the size, organization and mission of the exchange audit organizations.

2. The broad usage of the terms "audit" and "auditing" covers a variety of activities, some of which do not constitute internal audit as prescribed herein and consequently are not intended to be covered by this Instruction. These are as follows:

- a. Administrative examinations or "audits" of transactions, vouchers, etc., which are a part of the regular operations constituting a normal element of internal control.
- b. Inspections and investigations performed by Inspector General and Procurement Management Review Program personnel in accordance with their normally assigned responsibilities. However, close coordination should be maintained between the audit and inspection organizations to exchange information where appropriate, and to avoid duplication of effort.

- c. Technical surveys and inspections performed by personnel of the offices of the various staff elements in accordance with their normally assigned responsibilities.
- d. Internal Review at Lower Echelons. Management at lower echelons is not precluded from establishing groups which, while not performing independent or comprehensive audits, would serve as "trouble shooters" who may make special analyses in controller and other areas and assist in correcting deficiencies which are revealed by audits, reports, analyses, observations or other means. In authorizing such internal review activities at any echelon, care should be exercised to assure avoidance of duplication of internal audit functions as defined below which are assigned to the centralized audit organizations.

IV. INTERNAL AUDIT RESPONSIBILITIES, MISSION AND SCOPE

- A. The purpose of internal audit is to lead to action which will improve the operations of the Department of Defense. It is the independent review and evaluation of the effectiveness and efficiency with which managerial responsibilities are being carried out. It is an independent appraisal activity for the review of financial, operational, and support activities as a basis for protective and constructive service to management. Internal audit review and appraisal covers functions, organizations, systems, procedures, practices and transactions, records and documentation of all kinds. It is directed toward determining that management controls, practices and procedures at all levels are adequate in concept and effective in application and that they provide for adequate financial integrity and effective utilization of resources available. It is a managerial control which functions by measuring and evaluating effectiveness of other controls.
- B. Subject to the authority, direction, and control of their superiors, the heads of Defense internal audit organizations will develop and execute plans, policies, procedures, and programs necessary to discharge internal audit responsibilities.
- C. To accomplish the overall objective of assisting management at all levels in achieving efficient and effective administration, audit activities of Defense audit organizations will include the following:
 1. Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls.

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2. Examining and appraising the adequacy and effectiveness of policies, systems, procedures, records, and reports relating to programming, budgeting, accounting, procurement, supply, financial or business transactions of all kinds, and other operations having an impact on the expenditure of funds, utilization of resources, or accomplishment of management objectives.
 3. Appraising performance under, and ascertaining the extent of compliance with, established policies, procedures, regulations, laws, etc.
 4. Ascertaining whether resources (funds, personnel, material and other property) are properly justified, utilized, accounted for, disposed of, and safeguarded from loss.
 5. Ascertaining the reliability of accounting and other data and reports developed within the DoD Components and the need for, timeliness, and usefulness thereof.
 6. Disclosing inefficiency, waste and other improper conditions and practices.
 7. Reporting the facts ascertained and making recommendations in connection therewith to appropriate levels of management.
- D. Internal audit is a staff function which, to operate effectively, must be completely independent of line operations. The internal auditor's responsibility is to examine, observe, review, and evaluate the policies, systems, and procedures, and the performance thereunder, respecting all aspects of management for the purpose of reporting findings and making recommendations for corrective action to management. The existence of an internal audit staff in no way relieves other personnel of duties and responsibilities assigned to them. Full responsibility is vested in the DoD Components and the various commands therein for proper management; for protection and use of assets under their control; for compliance with directives from higher authority; and for the accuracy, propriety, legality, and reliability of their actions.
- E. While the scope of internal audit responsibility is broad, it does not include criticism of management decisions based upon after-the-fact substitution of the auditor's judgment for that of responsible management. Most management decisions involve risk and uncertainty. Thus, the fact that later events prove the decision to be wrong is not, taken by itself, a subject for audit reporting. It becomes a subject, however, when the decision indicates

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inefficient operations, inadequate procedures, or other deficiencies, the reporting of which would lead to future improvements in systems or procedures, or avoidance of errors. The following are illustrative:

1. Erroneous decisions made on the basis of incorrect or incomplete data because of deficiencies in the information system.
 2. Erroneous decisions arising from failure to consider data which were readily available at the time the decision was made.
 3. Decisions resulting in actions which were contrary to law, policy or regulations.
- F. The internal auditor does not have the authority to make changes, nor to order changes made, in the procedures or operations of the activities audited. The internal auditor is not responsible for developing systems, methods, and procedures, nor for the performance of duties constituting a part of regular line operations. Such responsibilities would tend to give him a biased viewpoint when, in the course of his audits, he would be required to appraise his own work. However, the auditor may call attention to problem areas with respect to any of these matters and provide advisory assistance to system development personnel particularly with respect to such aspects as internal controls and audit trails. The auditor, based upon his independent examinations, reviews, and appraisals, provides an advisory service and makes recommendations to management for improvements and for the correction of deficiencies. It is the responsibility of management to determine what action will be taken and to give the required corrective orders. This, however, does not relieve the audit staff of the responsibility for following up on recommendations to determine whether they were given adequate consideration and that management's orders to accomplish changes and correct deficiencies were effectuated.

V. RECEPTIVENESS AND UTILIZATION OF INTERNAL AUDIT BY DOD COMPONENTS

- A. DoD Components will recognize, support, and utilize audit functions and results and establish appropriate arrangements to assure positive action on audit findings and recommendations as prescribed in III.C. of DoD Directive 7600.2, reference (a).
- * B. Followup systems shall be established to ensure that *
 * appropriate management action is taken to correct *
 * existing deficiencies and to prevent their recurrence. *
- * 1. Special attention shall be given to audit recommenda- *
 * tions involving potential tangible savings of a signi- *
 * ficant amount. (Any potential savings of \$100,000 or *
 * more will automatically be considered significant.) *
- * 2. For this purpose, tangible savings are those which *
 * are reasonably measurable and can be tracked to re- *
 * duced requirements for resources (from what otherwise *
 * would be required in terms of funds, personnel or *
 * materiel) for the particular function or functions *
 * involved. *

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- * 3. Audit reports should specifically identify functions or *
* activities where tangible savings can be achieved and show *
* the estimated monetary impact of the audit recommendations. *
- * C. Followup systems shall include the following: *
- * 1. Written statements, within a reasonable time period, by *
* management officials responsible for the audited activity. *
- * a. These statements should express concurrence or non- *
* concurrence in each audit finding and recommendation. *
- * b. Where concurrence is indicated, the management comments *
* shall describe the corrective actions which have been *
* taken or planned and the estimated dates for completion *
* of the planned actions. *
- * c. Where the actions will be taken over an extended period *
* of time, suspense dates should be established for com- *
* pletion of major segments of the plan. *
- * d. Where management nonconcurrs in any findings and recom- *
* mendations, the management comments shall include a *
* statement of the reasons for nonconcurrence. *
- * e. If appropriate, management officials may propose alter- *
* native methods for accomplishing desired improvements. *
- * 2. Management comments submitted in accordance with C.1. above *
* shall be evaluated by responsible management officials and *
* by the cognizant internal audit organization. *
- * a. Evaluations should consider whether corrective action *
* taken or proposed is adequate and timely and whether *
* savings are achieved where possible. *
- * b. Where the parties responsible for evaluating responses *
* and involved management cannot reach agreement, procedures *
* shall be established for referring significant matters *
* to higher authority for resolution. *
- * 3. An independent office shall be assigned responsibility for *
* monitoring action taken on audit reports to assure proper *
* disposition of audit findings and recommendations. *
- * a. This office should be at a sufficiently high level to *
* provide authority needed to adequately perform this *
* function. *
- * b. While it is preferable that this function not be assigned *
* to the central internal audit organization, this may be *
* necessary in some circumstances for administrative reasons. *
- * c. The office responsible for monitoring action on audit *
* reports will maintain time schedules for responding to *
* and acting on recommendations, keep a record of the *
* disposition of recommendations, and submit periodic reports *
* to top management officials on its activities identifying *
* problem areas needing management attention. *
- * 4. The followup system shall include subsequent reviews on a *
* selected basis by the central internal audit organization and *
* other review organizations as necessary to assure that cor- *
* rective actions reported have actually been taken and savings *

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- * achieved where possible. In selecting cases for follow-up reviews, special attention will be given to audit recommendations involving significant potential savings. *
- * D. Command replies, statements of action taken or position statements on audit findings and recommendations will be furnished the Office of the Secretary of Defense when specifically requested by the Office of the Assistant Secretary of Defense (Comptroller). *
- * E. As a supplement to DoD Component followup systems, a limited number of the more significant audit reports will be selected for attention of the Secretary of Defense. The Office of the Assistant Secretary of Defense (Comptroller) shall: *
1. Review audit reports issued by the DoD Components and select certain reports or findings therefrom for special attention based on significance and/or special interest evidenced by OSD management officials.
 2. Request the head of the DoD Component or element having primary responsibility for the matters involved in each report to submit, within a specified time, an official position statement on the report including information on action taken or proposed with respect to the audit findings and recommendations.
 3. Arrange for evaluation of the position statement by appropriate OSD offices and submit the report, position statement and OSD evaluation to the Secretary of Defense with appropriate recommendations regarding any further actions required.
 4. Monitor followup actions directed by the Secretary or otherwise indicated to be necessary.
- * F. Arrangements for followup by DoD Components on audit reports issued by the Office of the Assistant Secretary of Defense (Comptroller) will be consistent with procedures prescribed by the Assistant Secretary of Defense (Comptroller) in separate instructions. *

VI. RELATIONSHIP WITH THE GENERAL ACCOUNTING OFFICE

- A. As an agent of the legislative branch of the Government, the Comptroller General has been given extremely broad statutory authority to review the activities of executive agencies. The scope and extent of detailed examination work performed by General Accounting Office representatives are governed by the adequacy and effectiveness of an agency's internal controls, including internal audit. This principle is set forth in Section 117(a) of the Accounting and Auditing Act of 1950 (31 USC 67) which, in part, provides: "...In the determination of auditing procedures to be followed and the extent of examination of vouchers and other documents, the Comptroller General shall give due regard to generally accepted principles of auditing, including

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- consideration of the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices of the respective agencies."
- B. As the nature, quality, and scope of the audits performed by Defense auditors are important considerations affecting the manner in which the General Accounting Office discharges its audit responsibilities, it is desirable that that office be kept fully apprised of Department of Defense audit activities. Consultation between audit representatives of the Department of Defense and the General Accounting Office on auditing programs, procedures, methods, and techniques will promote a better understanding of each other's objectives and should prove beneficial in improving the overall audit program. Close coordination of audit plans and schedules will serve to reduce unnecessary duplication of audit effort by the General Accounting Office.
- C. Consultations with General Accounting Office representatives on basic audit policies and other audit matters which affect or are of interest and concern to the Department of Defense as a whole should be coordinated with the Deputy Assistant Secretary (Audit), Office of the Assistant Secretary of Defense (Comptroller). This is not to be interpreted as a restriction on the Defense audit organizations consulting directly with General Accounting Office representatives, but is to assure that major audit matters are brought to the attention of all concerned within the Department of Defense.
- D. The Defense internal audit organizations should make maximum use of GAO reports as a means of constantly improving the breadth, scope, and coverage of their own audit programs. These reports should be reviewed and action taken as necessary to assure that problem areas reported by GAO are provided appropriate internal audit coverage.

VII. OTHER AUDIT POLICIES

It is essential for maximum audit effectiveness that all levels of operations be subject to audit review and appraisal in an integrated, coordinated, and comprehensive manner. This requires a highly competent, independent audit staff fully cognizant of the responsibility it has to furnish objective audit service to all levels of management. In order to accomplish audit objectives effectively and efficiently, the following general policies will apply:

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A. Personnel

1. The central audit organizations of the DoD Components and the exchange audit organizations will establish, within available financial and other resources, recruiting, training, and career development programs necessary to develop and maintain a competent and effective professional audit staff. All such programs will be coordinated with the Office of the Assistant Secretary of Defense (Comptroller) to assure that joint programs are conducted to the maximum feasible extent. These programs and audit staff qualifications and supervisory structure shall conform to the provisions of DoD Instruction 7600.5, reference (d). Upon approval by the Assistant Secretary of Defense (Comptroller), the standards in reference (d) may be modified to accommodate differences in the organization, mission and personnel systems of the exchanges.
2. Where an internal audit organization assigns auditors to an installation or command headquarters on a continuous basis, provision shall be made for rotation of the resident auditor-in-charge no less frequently than every five years. Exceptions to this frequency of rotation may be made under compelling circumstances. A practice of rotating resident staff auditors on the same basis is encouraged to the extent feasible.

B. Audit Coordination Among Defense Audit Organizations

1. Audit of Joint Agencies or Activities. Joint agencies or activities, not specifically covered heretofore, involving two or more DoD Components will be assigned to one Defense audit organization for audit. Assignments will be made by the Assistant Secretary of Defense (Comptroller). Any activities of this type not under any audit cognizance, or subject to audit by two or more Defense audit organizations, will be reported to the Assistant Secretary of Defense (Comptroller) for internal audit assignment.
2. Coordination with the Defense Contract Audit Agency (DCAA)
 - a. When internal audits require verification of contractor data or records at contractors' plants, the internal audit organization normally should obtain fact-finding assistance from the Defense Contract Audit Agency.

- b. The contract auditor may provide assistance to the internal auditor where providing assistance does not conflict with his basic role of providing advisory services to contracting officers. Assistance requiring contract auditors to evaluate contracting officers' performance would not be appropriate; whereas assistance requiring evaluation of contractors' performance may be appropriate.
- c. Internal auditors are not normally precluded from reviewing contractors' books and records when DCAA acknowledges that it cannot provide the assistance required because (1) the assistance requested concerns matters beyond the proper role of DCAA, (2) the provision of the assistance would impede the prompt execution of DCAA's primary role of providing accounting and financial management advisory services regarding contracts and subcontracts to all DoD Components, or (3) the provision or scheduling of assistance would result in undue delays or inefficiencies in the accomplishment of internal audit objectives. In such cases, arrangements for access will be made through contract administration channels, and be in accordance with contractual provisions. If the data or information required by the internal auditor are not available in contract audit files, he will obtain contract audit assistance when feasible and mutually agreeable, or be afforded access to those contractor records necessary to complete properly the internal audit functions either in conjunction with contract auditors or independently.
- d. Contract audit working papers, reports and files will be made available to and will be used to the maximum practicable extent by internal auditors in the internal audit of the procurement, contract administration or related functions.
- e. Arrangements for access to contract audit files will be made between field offices of the Defense internal audit organizations and the Defense Contract Audit Agency.
- f. Internal auditors will advise cognizant contract audit field offices in advance of their entry into a contractor location involving access to contractor personnel or records.

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- g. In certain instances, contract audits involve work at a Defense installation or remote location where the nature of the work, proximity of an internal audit office, or other factors make it more practical or economical for the contract auditor to obtain assistance from an internal auditor. Such cross-service audit assistance is encouraged.

3. Coordination of Internal Audits

- a. Internal audit organizations shall arrange to perform complete or assist audits for one another whenever economy, efficiency, or more effective audit coverage will result. Factors to be considered include the geographical location of audit offices, nature and type of audit work required, availability of qualified personnel, etc. Each audit organization should be alert particularly to request assist audits, as necessary, where effective audit coverage of a program or function involves matters which extend across departmental and agency organizational boundaries. Assist audit arrangements should be worked out between the Defense audit organizations with assistance, as necessary, from the Office of the Assistant Secretary of Defense (Comptroller).
- b. In some instances, one department or agency has overall management responsibility for a given program and performance of certain support functions is assigned to one or more of the other departments or agencies. An example is where one DoD Component has management and ownership responsibilities for inventories which are in the custody of other components. Effective audit of total program responsibilities in such situations requires a coordinated audit approach which provides for concurrent coverage of the functions performed by the program manager and the functions performed by the other DoD Component. In such cases, the audit agency cognizant of the program manager is responsible for planning the required audits. Performance will be accomplished with the use of appropriate assistance by the audit organizations cognizant of the DoD Components providing support. Requests for assistance should be furnished sufficiently in advance so the assisting audit organizations can incorporate the workload in their annual audit programs. The audit organizations cognizant of the component's

providing support will be responsible normally for audit of those functions performed by their DoD Component. The assisting audit organization will cooperate with the audit organization cognizant of the program manager to the extent feasible within resource availability and priorities, in working out mutually acceptable arrangements for:

- (1) Providing assistance in developing the audit program including access to their components' facilities as necessary for survey work and monitoring the overall audit.
- (2) Arranging the frequency, timing, and approaches of the audits.
- (3) Conducting the audits in accordance with the program prescribed.
- (4) Furnishing copies of their audit reports to the audit organization cognizant of the program manager.

If circumstances exist which make it impracticable for an audit organization to provide appropriate audit assistance with respect to activities under its cognizance for an audit such as described above, then the audit organization will coordinate access to these activities for the audit organization cognizant of the program manager to perform the audits deemed necessary. In the event that disputes arise with respect to the audits described above that cannot be resolved within the DoD Components involved, they will be referred to the Assistant Secretary of Defense (Comptroller) for resolution.

4. Exchange of Technical Information

- a. In order to facilitate audit coordination where desirable and to assure that each audit organization has knowledge of, and access to, technical developments within the other audit organizations, there should be a free and direct interchange of copies of audit programs, instructions, and other material relating to audit methods and techniques, as well as representative audit reports.

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- b. As a minimum, the following types of material will be exchanged among the headquarters offices of the audit organizations:
- (1) Instructions and other audit agency issuances, as defined in Section X.B. herein, which implement DoD policy directives and instructions.
 - (2) Information relating to audit of automatic data processing systems and equipment including retrieval software, data banks, automatic data processing (ADP) audit programs, and techniques for making greater use of ADP to assist audit performance.
 - (3) Internal audit reports where findings or recommendations directly or indirectly impact upon or make reference to another DoD department or agency. This includes sending the Defense Contract Audit Agency a copy of audit reports which impact upon or make reference to that agency or contractors it audits in any substantive manner.
 - (4) Annual internal audit plans which contain data on audit priorities, areas of emphasis and major audits. Firm plans and schedules will be exchanged as soon as issued by each audit organization which normally will be on or before the first day of the fiscal year. In addition, tentative data should be exchanged during the audit planning and scheduling process. Since this process extends normally from six to twelve months prior to the beginning of the fiscal year, target dates of December 15 and March 31 of each year are prescribed for exchange of tentative planning information.

C. Audit Frequency

1. General

- a. Regulations of DoD Components prescribing rigid requirements for periodic audits of given activities or functions should be held to a minimum. Audit emphasis should be placed where need exists. In selecting areas and functions for concentrated audit coverage and in determining the extent of

audit tests, a high degree of judgment is required to assure that limited audit resources are applied in the most productive manner. However, proper management of the audit program by the audit organizations requires systematic advance planning of audit schedules in consideration of total audit workload and reasonable audit frequencies. To provide for reasonably consistent audit coverage throughout the Department of Defense, the standards set forth in 2 below, are prescribed.

- b. In consonance with the foregoing, the biennial frequency standard specified below is to be construed as a desirable objective, rather than as a mandatory requirement. It is recognized that slippage in achieving this frequency with available or attainable audit resources may occur as a result of higher priority audit requirements (1) imposed by OSD or departmental/agency management officials, or (2) determined by audit officials in accordance with policy guidance, set forth below in VII.D.2., concerning integrated-type audits of selected organizations, programs, systems and functions. A reasonable portion of audit resources should be directed to audits of this type in addition to, or coordinated with, cyclic coverage of individual installations or activities.

2. Standards

- a. Installations or activities (entities) performing significant responsibilities should be scheduled for comprehensive audit coverage on the basis of a normal cycle of two years. Significance should be judged in terms of such factors as mission and resources managed or controlled. In general, the performance (to other than a minor degree) of one or any combination of functions such as, but not limited to, the following should be deemed to warrant biennial audit coverage:

- (1) Supply Management (including inventory management)
- (2) Procurement
- (3) Contract Administration
- (4) Depot Maintenance
- (5) Depot Supply Operations
- (6) Centralized Accounting or Disbursing
- (7) Industrial Fund Operations
- (8) Research and Development

The major functions of the entity should be provided comprehensive coverage on a biennial basis whether the audit is performed on a periodic basis (mobile auditors) or on a continuous basis (resident auditors).

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- b. Entities or individual functions of an entity may be audited more frequently than biennially if conditions disclosed by a previous audit, the sensitive nature of the functions performed, management requests, or other circumstances, indicate more frequent coverage to be necessary.
- c. Entities which do not merit comprehensive audit coverage on a biennial basis by reason of their small size or mission may be audited on a less frequent basis or be exempted from regular audit coverage. However, such entities should be surveyed at least every four years to determine whether their exemption from biennial coverage should be continued.
- d. Each internal audit organization shall maintain an inventory of all entities under its audit cognizance. For those entities identified as subject to biennial audit coverage, the inventory, as a minimum, shall show the name and location, the date of the last audit and the direct man-hours expended, and an updated estimate of the direct man-hours required. For those entities identified as exempt from biennial audit coverage, the inventory, as a minimum, shall show the name and location, the date of the last audit or survey, the direct man-hours expended, and the scheduled date for the next audit or survey.

D. Audit Approach

1. In accordance with the concept of internal audit expressed herein, internal audit activities should be directed toward identifying, reporting, and making appropriate recommendations regarding conditions that cause or contribute to inefficient operations, deficiencies, and errors of omission or commission. Of primary concern is the prevention of deficiencies; of secondary concern is the detection of deficiencies and errors which occurred in the past. Detailed examination of transactions and supporting documents will be limited to that deemed necessary based upon appraisal of the adequacy of systems, procedures, and internal controls.
2. Audit coverage, from the standpoint of both depth and scope, should place emphasis on significant management areas and operational functions including such areas as determination of requirements, programming, budgeting, procurement, inventory management, and utilization of resources, as well as the accounting and reporting areas. The audit organizations should program and perform-

audits of selected areas on an integrated basis which permits across-the-board appraisal of organizations, programs, systems, and functions.

3. Contrary to the concept of external auditing in the commercial sense, the internal auditor's examination ordinarily is not conducted for the principal purpose of certifying to the reliability of financial statements produced within the organization. The principal purpose is rather to appraise the effectiveness of management. If the management controls and accounting system are operating effectively, reliance generally can be placed on the financial statements produced.

E. Audit Reports

1. Objective and complete reporting of all pertinent and significant facts to appropriate management levels is the keystone of the internal audit function. Anything less than complete integrity and full disclosure of significant matters in audit reporting destroys the value of the audit service to management. As a corollary, reported findings must be adequately supported and presented in proper perspective to convey their impact and significance. This places a heavy responsibility on audit management to insure the maintenance of professional standards of conduct, judgment, and objectivity. Each audit organization shall maintain audit report review procedures which meet the standards set forth below.
 - a. Each audit report will be reviewed, before release in final form, by at least one supervisory level within the audit organization above that of the individual responsible for performing the audit.
 - b. Review procedures will be designed to provide assurance that:
 - (1) All significant audit findings are included in the audit report.
 - (2) Findings are fully developed and logically and factually supported.
 - (3) Impact, significance and underlying causes of deficiencies are identified to the extent feasible.
 - (4) Recommendations are constructive, meaningful and supported by the findings.

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- (5) Lengthy reports include a summary highlighting the principal findings and recommendations in a manner which describes their significance for the benefit of top-management officials.
 - (6) Appropriate comments from the audited activity have been included in the report (see VII.E.3).
 - (7) Auditors who drafted the report are informed of substantial changes made during the review process and the reasons for the changes.
- c. Review procedures shall also provide for review at the audit organization headquarters or at the highest field supervisory level, prior to release of audit reports, of findings involving significant matters which may extend beyond the audited activity or are highly sensitive. These include findings that:
- (1) Involve nonconurrence at the entity being audited.
 - (2) Have a potential impact at organizational levels above that of the audited activity.
 - (3) Involve apparent fraud, defalcation, or malfeasance.
 - (4) Are concerned with apparent violations of Sections 3678 or 3679 of the Revised Statutes.
 - (5) Are concerned with problem areas which may affect similar command functions or activities at other bases or installations.
- d. Supervisory reviews or inspections of audit field offices performed by headquarters or intermediate headquarters offices shall include sufficient post reviews of working papers, draft and final reports to assure understanding of and compliance with the procedures outlined above.
2. Reports of audit will be directed to the management level having the authority and responsibility to assure that appropriate action is taken on the findings and recommendations contained therein. Consistent with the concept of centralized internal audit and the obligation to serve all management levels, it is essential that significant matters be reported to top levels of management. Significance should be judged in consideration of the extent of a given deficiency or pattern of

deficiencies, sensitivity or criticality of the matter, and/or the degree of management attention required to effectuate corrective action. Reporting to top management should be in the form most appropriate in the circumstances, which may be regular reports of audit, special reports, or summary reports. Matters reported may represent especially significant findings resulting from an individual audit, or significant patterns or trends apparent from summarizing the results of a number of individual audits.

3. Report drafts normally will be submitted to audited organizations for comment. Comments received normally will be included in the reports verbatim provided the comments are pertinent. Exceptionally lengthy or immaterial comments may be paraphrased with the key points highlighted. Where appropriate, auditors' views on the comments should be included. Exceptions may be made at the discretion of a DoD Component for audit reports issued to levels below the departmental or agency headquarters level, or where following the prescribed procedure would unduly delay issuance of the audit report.
4. Copies of audit reports and summaries thereof issued to command or staff elements at the departmental or agency headquarters level shall be distributed to the Office of the Assistant Secretary of Defense (Comptroller) promptly upon issuance. Copies of audit reports issued to lower echelons need be furnished to representatives of the Office of the Assistant Secretary of Defense (Comptroller) upon specific request only.

F. Management Requests for Audit Service. Requests by management officials at all levels for specific audit work should be accommodated to the greatest extent practicable in consideration of audit priorities and available audit resources. However, no arrangements should be entered into which would have the effect of diluting the independence or objectivity of the audit work or restricting the proper distribution of reports thereon. In all cases, the distribution to be given audit reports shall be determined by the cognizant audit organization based on the policies contained herein, particularly in VII.E.2.

G. Internal Audits Within Combat Theaters

1. As stated in III.B.1 of DoD Directive 7600.2, all organizational components and levels of operations will be subject to independent and comprehensive audit review and appraisal. This applies within combat theaters to

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the extent that carrying out the audit functions will not interfere with combat operations nor obstruct United States purposes.

2. Upon the outbreak of hostilities in any area or in emergency situations where outbreak of hostilities appears imminent, regularly scheduled audits may be temporarily suspended by the theater commander, departmental or higher authority. Notification of any such suspensions will be furnished promptly to the Assistant Secretary of Defense (Comptroller). However, in any area where this has been done, the situation will be reviewed at least every six months by responsible departmental or higher authority, and normal audits will be resumed, after coordination with the theater commander, to the extent this can be done without interfering with combat operations. Suspension of audits within a combat area for a period in excess of one year must be approved by the Assistant Secretary of Defense (Comptroller). Normally, such approval will be given only when conditions are so unstable and lines between actual combat operations and support operations are so fluid and undefined that effective audits cannot be made or the attempt to audit would interfere with combat operations or obstruct United States purposes.
3. Audits within combat theaters will emphasize the adequacy and effectiveness of the support furnished combat forces and the controls in being to prevent unauthorized diversion of equipment, supplies or other resources. Functions to be covered, to the extent feasible, include logistics functions (e.g., supply, procurement, maintenance, construction, etc.), assistance to foreign military forces, and administrative support activities. Normally, no attempt will be made to extend audit coverage to units actually engaged in combat, unless specifically requested by local or higher level commanders.

VIII. Audit Policies Promulgated by the General Services Administration (GSA)

GSA Federal Management Circular 73-2, reference (g), sets forth policies to be followed in the audit of Federal operations and programs by executive departments and establishments. It includes a provision that the Standards for Audit of Governmental Organizations, Programs, Activities and Functions issued by the Comptroller General of the United States, reference (h), will be the basic criteria on which audit coverage and operations are based. The policies prescribed in this Instruction are consistent with, and implement, reference (g).

IX. CANCELLATION

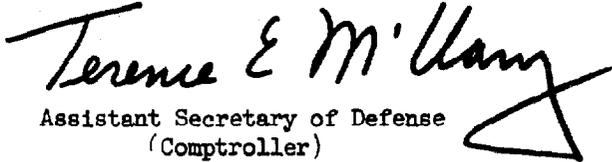
References (b), (e) and (f) are hereby superseded and cancelled.

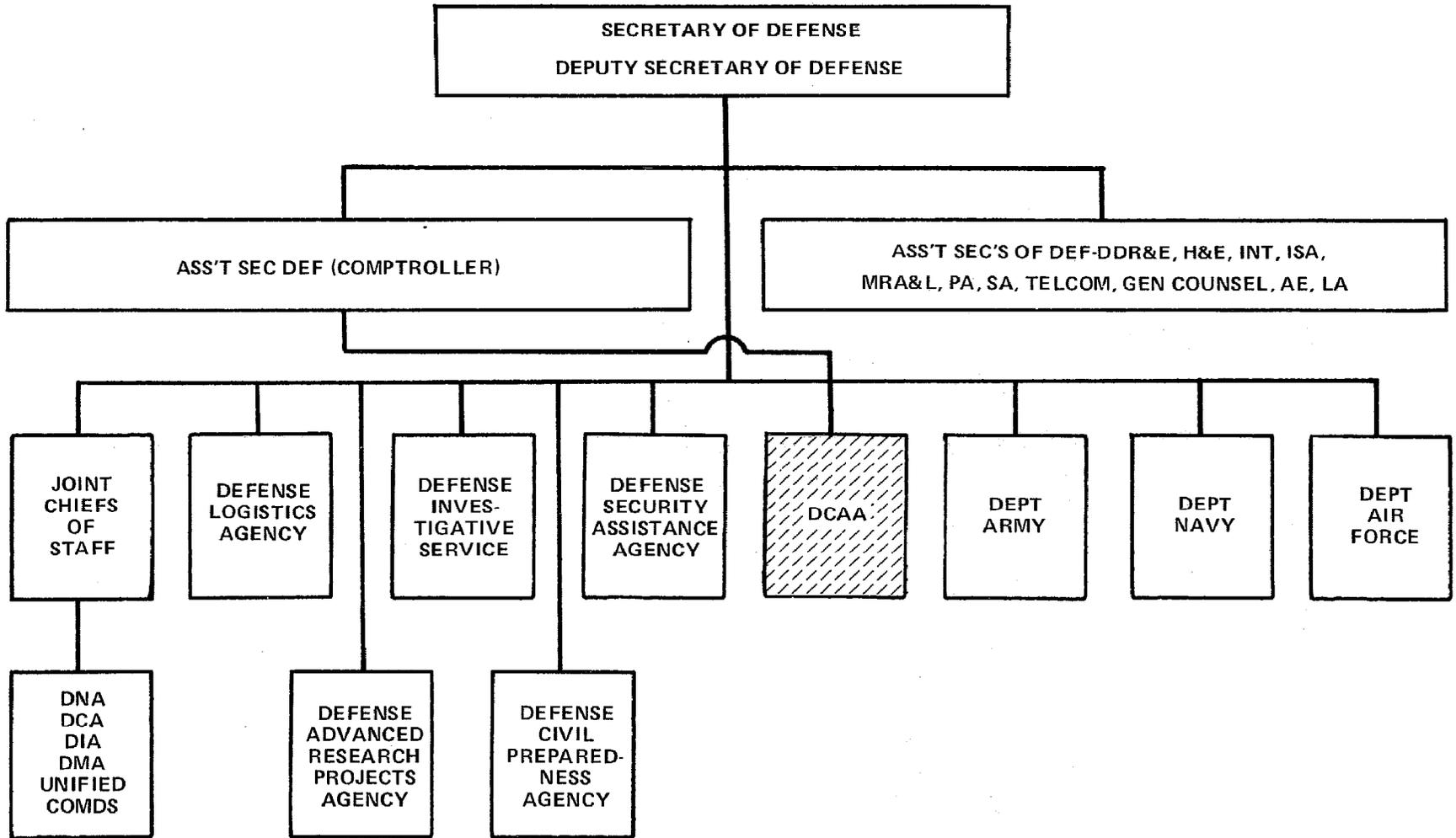
X. IMPLEMENTATION

- A. Each DoD Component shall take action to assure that its policies and procedures are consistent with this Instruction.
- B. Two copies of implementing instructions shall be furnished to the Deputy Assistant Secretary of Defense (Audit), OASD (Comptroller), within three (3) months from the date hereof. Copies of subsequent changes to the implementing instructions shall be furnished when issued. Implementing instructions should be construed to include copies of audit instructions, regulations, bulletins, manuals, programs, etc., issued by the headquarters of the Defense internal audit organizations.

XI. EFFECTIVE DATE

This Instruction is effective immediately.


Assistant Secretary of Defense
(Comptroller)



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