Audit Report

OFFICE OF THE INSPECTOR GENERAL

INTRACOMPANY TRANSFERS BY DEFENSE CONTRACTORS

Report No. 96-041 December 11, 1995

Department of Defense

Additional Information and Copies

To obtain additional copies of this audit report, contact the Secondary Reports Distribution Unit of the Analysis, Planning, and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or FAX (703) 604-8932.

Suggestions for Audits

To suggest ideas for or to request future audits, contact the Planning and Coordination Branch of the Analysis, Planning, and Technical Support Directorate at (703) 604-8939 (DSN 664-8939) or FAX (703) 604-8932. Ideas and requests can also be mailed to:

Inspector General, Department of Defense
OAIG-AUD (ATTN: APTS Audit Suggestions)
400 Army Navy Drive (Room 801)
Arlington, Virginia 22202-2884

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@DODIG.OSD.MIL; or by writing the Defense Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

DCAA	Defense Contract Audit Agency
DPRO	Defense Plant Representative Office

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

Report No. 96-041 December 11, 1995

MEMORANDUM FOR DIRECTOR, DEFENSE PROCUREMENT
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit of Intracompany Transfers by Defense Contractors (Project No. 5CH-0048)

Introduction

We are providing this report for your information and use. The audit reviewed prices Defense contractors charged for intracompany transfers of materials, supplies, and services. The audit determined whether the intracompany transfers were in accordance with acquisition regulations and were properly reviewed by appropriate Government contracting personnel. Intracompany transfers are transfers of materials among a prime contractor's divisions, subsidiaries, or affiliates. Generally, the transfers should be sold or transferred at cost, with no added profit.

Audit Results

Our review of 11 Army, Navy, and Air Force contracts, currently valued at $8.2 billion, with intracompany transfers of at least $489 million, showed that contracting officers were taking appropriate measures to ensure that the prices charged for intracompany transfers were fair and reasonable. Also, Defense Plant Representative Offices (DPROs) and resident Defense Contract Audit Agency (DCAA) offices were using appropriate methods to administer and monitor intracompany transfer costs. Management controls applicable to the monitoring of intracompany transfers were deemed to be adequate in that no material weaknesses were identified.

Audit Objectives

The overall audit objective was to determine whether DoD contracting officers were taking adequate measures to provide reasonable assurance that the prices of intracompany transfers were fair and reasonable. The audit also evaluated the adequacy of applicable management controls established at DoD contract administration offices.

Scope and Methodology

Judgmental Selection. We judgmentally selected 11 significant DoD contracts for major weapon systems, research and development, and spare parts. The contracts were from Army, Navy, and Air Force major buying commands and were awarded between FYs 1989 and 1994. The contracts were valued at $8.2 billion. The contracts were selected based on the size and extent of the prime contractors' divisions, subsidiaries, or affiliates under a common control. Intracompany transfers were separately proposed for 9 of the 11 contracts reviewed. Intracompany transfers were proposed at a total of $489 million, which represented 6.6 percent of the total proposal cost for the 9 contracts. Enclosure 1 lists the 11 contracts and their values.

Selected intracompany transfers were reviewed to document contracting officer rationale in determining whether intracompany transfer prices were fair and reasonable. We also determined whether contracting officers properly utilized DCAA in evaluating the prices for intracompany transfers. We reviewed DPRO contract administration controls and related DCAA audit coverage over contractor intracompany transfer policies and procedures at five contractor locations.

Audit Period, Standards, and Locations. This program audit was performed from May through October 1995 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included such tests of management controls as were considered necessary. We did not rely on any computer-processed data or statistical sampling procedures to perform the audit. Enclosure 2 lists the organizations visited or contacted during the audit.

Management Control Program

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. We evaluated the adequacy of management control objectives and techniques used by contracting officers to monitor intracompany transfers. We did not assess the adequacy of management's self-evaluation of those controls.

Adequacy of Management Controls. Management controls applicable to the monitoring of intracompany transfers were deemed to be adequate in that we identified no material management control weaknesses.

Prior Audits and Other Reviews

No comprehensive audits of intracompany transfers had been performed during the last 5 years. DCAA had performed numerous audits and assist audits of intracompany transfers in the areas of preaward reviews, incurred costs, and defective pricing. The results of those audits are summarized in our discussion.

Audit Background

Intracompany Transfers. An intracompany transfer is any transfer of materials, supplies, or services among an organization's commonly controlled divisions, subsidiaries, or affiliates. According to Federal Acquisition Regulation 31.205-26(e), "Material Costs," the cost for the transfer should be determined on the basis of cost incurred. The intracompany transfer price may include profit when the established practice of the transferring organization is to price intracompany transfers at other than cost. The price must be based either on an established catalog or market price of commercial items sold in substantial quantities or on adequate competition. Additionally, the price must not exceed that charged to the company's most favored customer under comparable conditions.

Make-or-Buy Programs. Defense contractors normally propose intracompany work as part of their make-or-buy programs. Purchases by a contractor from one of its divisions, subsidiaries, or affiliates may be classified in the make-or-buy program as either "make" or "buy," depending on the circumstances. When reimbursement to the division, subsidiary, or affiliate is on a cost basis, the purchase is a make. When reimbursement is based on a competitive price, the purchase is a buy.

Discussion

Contracting Officer Analysis of Intracompany Transfer Proposals. Contracting officers were taking appropriate measures to ensure that the prices charged for intracompany transfers were fair and reasonable. Contracting officers used assist audits of intracompany transfers in conjunction with price and cost analyses to determine fair and reasonable pricing. Results of cost and price analyses and assist audits were included in negotiation file documentation of intracompany transfers.

Government Administration of Intracompany Transfers. DPRO administrative contracting officers are responsible for Government oversight and analyses of contractor plant intracompany policies and procedures. All five DPROs reviewed used either contractor purchasing system reviews, cost estimating system reviews, or DCAA oversight to ensure that intracompany transfers were properly priced.

The contractor purchasing system reviews examined intracompany transfers and contractor make-or-buy programs. For example, the Defense Contract Management Area Operations Atlanta, Georgia, with DCAA assistance, performed contractor purchasing system reviews on a 3-year cycle of the United Technologies Corporation Pratt and Whitney Government Engine Business. The contractor purchasing system reviews disclosed that the Pratt and Whitney cost accounting department did not receive current, accurate, and complete information concerning receipt of parts when intracompany work orders were supplemented. The contractor corrected the problem through a change in its policies and procedures.

The cost estimating system reviews also examined intracompany transfers. An estimating system review performed by the DPRO at Hughes Missile Systems Company disclosed that the contractor overstated general and administrative expenses and profit by including the cost of money on intracompany transfers. Federal Acquisition Regulation 31.205-10, "Cost of Money," states that cost of money is an imputed cost, determined by applying a cost-of-money rate to facilities capital employed in contract performance. Hughes Missile Systems Company has disagreed with the DPRO findings and defended its accounting practice. DCAA recommended that DoD contracting offices exclude cost of money from profit calculations.

DCAA Support of Intracompany Transfers. DCAA adequately evaluated intracompany work at all locations reviewed. The contracting officers requested and used DCAA audits of proposed intracompany transfers to determine price reasonableness for eight of the nine contracts with separate intracompany transfer cost and pricing data. For the remaining contract, the contracting officer relied on an in-house cost analysis of the intracompany proposal to determine price reasonableness.

DCAA performed audits of intracompany transfer proposals as assist audits for incorporation into the audit of the prime contractor. For example, DCAA audited four McDonnell Douglas Corporation intracompany proposals, each from a separate division, in support of the negotiation of Air Force contract F33657-92-C-2102 for F-15E aircraft. The intracompany audits were the primary basis for a negotiated reduction of 9.4 percent on proposed intracompany work orders on the Air Force contract.

DCAA adequately supported DPRO oversight of intracompany transfers at all five contractor locations visited. DCAA analyses of contractor compliance with cost accounting standards included analysis and reporting of intracompany transfers. For example, the divisional administrative contracting officer and DCAA personnel reported and resolved contractor cost accounting standard deficiencies at the United Technologies Corporation's Pratt and Whitney Government Engine Business subsidiary. The cost accounting standard deficiencies focused on proper allocation of indirect overhead costs to intracompany transfers.

DCAA also performed specific audits of intracompany transfers. For example, DCAA performed initial and followup audits of intracompany work transfers at Lockheed Aeronautical Systems Company. DCAA found continued management control weaknesses within the contractor's intracompany transfer processing system. DCAA stated that the management control weaknesses were caused by the contractor's failure to comply with its own policies and procedures on intracompany transfers.

Government Administration of Corporate Restructuring and Consolidations. Defense contractors were actively pursuing restructuring and consolidation of divisions at all five DPROs reviewed. DPRO or DCAA personnel at four of the five locations were analyzing or had scheduled reviews concerning the impact of corporate consolidations and restructuring on intracompany transfers. In the other instance, DPRO and DCAA personnel at McDonnell Douglas Corporation, while aware of corporate restructuring plans, had yet to schedule a review. The Government corporate administrative contracting officer at McDonnell Douglas was unsure of the extent of the impact that corporate restructuring and shifts in intracompany work efforts were having on current contracts. The corporate administrative contracting officer noted that McDonnell Douglas planned accounting system changes should result in increased coverage of intracompany costs.

Management Comments

We provided a draft of this report to management on November 1, 1995. Because this report contains no findings or recommendations, written comments were not required, and none were received. Therefore we are publishing this report in final form.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Garold E. Stephenson, Audit Program Director, at (703) 604-9332 (DSN 664-9332) or Mr. Charles M. Hanshaw, Audit Project Manager, at (703) 604-9256 (DSN 664-9256). The distribution of this report is listed in Enclosure 3. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Enclosures

Intracompany Transfers in Weapon Systems Contracts

Procurement Command	Contract	Weapon System	Contractor	Value of Contract (millions)[1]
Army Missile Command				
	DAAH01-92-C-0251	Patriot Missile	Raytheon Company, Missiles Systems Division	$ 1,105.2
	DAAH01-92-C-0260	TOW[2] Missile	Hughes Aircraft, Missile Systems Group	270.5
	DAAH01-92-C-0038	Army Tactical Missile System	Loral Vought Systems	407.1
Naval Air Systems Command				
	N00019-94-C-0100	Harpoon Missile	McDonnell Douglas Aerospace	136.7
Air Force Aeronautical Systems Center				
	F33657-89-C-0002	Tanker Transport Training System	McDonnell Douglas	865.3
	F33657-89-C-0032	F-117-PW-100 Engines	Pratt & Whitney, Government Engines and Space Propulsion	265.1
	F33657-89-C-2170	Special Operations Forces Aircrew Training System	Loral Corporation, Defense Systems Division	659.8
	F33657-90-C-0071	C-130 Aircraft	Lockheed Aeronautical Systems Company	2,062.8
	F33657-90-C-2002	F-16 A/B Aircraft	Lockheed Fort Worth Company	659.8
	F33657-92-C-2102	F-15E Fighter Aircraft	McDonnell Douglas, McDonnell Aircraft Company	384.1
	F33657-91-C-0007	Advanced Tactical Fighter Engine	Pratt & Whitney, Government Engines and Space Propulsion	1,375.1
			Total	**$ 8,191.5**[3]

[1]At time of negotiation agreement, including value of unexercised options.
[2]Tube-launched, Optical-tracked, Wire Command-link Guided.
[3]Includes $489.1 million in contractor proposed intracompany transfers.

Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology, Washington, DC
  Director, Defense Procurement, Washington, DC
  Deputy Under Secretary of Defense (Acquisition Reform), Washington, DC

Department of the Army

Army Materiel Command, Alexandria, VA
  Missile Command, Redstone Arsenal, AL
Auditor General, Department of the Army, Washington, DC

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller), Washington, DC
Assistant Secretary of the Navy (Research, Development, and Acquisition), Washington, DC
Naval Air Systems Command, Washington, DC

Department of the Air Force

Assistant Secretary of the Air Force (Acquisition), Washington, DC
Assistant Secretary of the Air Force (Financial Management and Comptroller), Washington, DC
Air Force Materiel Command, Wright-Patterson Air Force Base, OH
  Aeronautical Systems Center, Wright-Patterson Air Force Base, OH

Defense Organizations

Defense Contract Audit Agency, Alexandria, VA
- Defense Contract Audit Agency, Central Region Resident Office, Hughes Missile Systems Company, Tucson, AZ
- Defense Contract Audit Agency, Central Region Resident Office, McDonnell Douglas Corporation, St. Louis, MO
- Defense Contract Audit Agency, Eastern Region Resident Office, Lockheed Aeronautical Systems Company, Marietta, GA
- Defense Contract Audit Agency, Eastern Region Resident Office, Raytheon Corporation, Andover, MA
- Defense Contract Audit Agency, Eastern Region Resident Office, United Technologies Corporation, West Palm Beach, FL

Defense Logistics Agency, Alexandria, VA
- Defense Contract Management Command, Alexandria, VA
  - Defense Contract Management District-East, Boston, MA
    - Defense Plant Representative Office, Raytheon Corporation, Burlington, MA
  - Defense Contract Management District-South, Atlanta, GA
    - Defense Contract Management Area Operations Atlanta, GA
    - Defense Plant Representative Office, Lockheed Aeronautical Systems Company, Marietta, GA
    - Defense Plant Representative Office, United Technologies Corporation, West Palm Beach, FL
  - Defense Contract Management District-West, El Segundo, CA
    - Defense Plant Representative Office, Hughes Missile Systems Company, Tucson, AZ
    - Defense Plant Representative Office, McDonnell Douglas Corporation, St. Louis, MO

Non-Government Organizations

McDonnell Douglas Corporation, St. Louis, MO

Pratt and Whitney Government Engine Business, United Technologies Corporation, West Palm Beach, FL

Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Director, Defense Procurement
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Assistant to the Secretary of Defense (Public Affairs)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, National Security Agency
  Inspector General, National Security Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Audit Team Members

This report was produced by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD.

Paul J. Granetto
Garold E. Stephenson
Charles M. Hanshaw
Benjamin A. Mehlman
Arthur M. Hainer
David P. Cole
Cheryl C. Henderson
Bradford G. Valka