Evaluation Report

DISPOSITIONED DEFECTIVE PRICING REPORTS AT THE NAVAL AIR SYSTEMS COMMAND

Report Number 99-048 December 8, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CAF	Contract Audit Followup
DCAA	Defense Contract Audit Agency
OIG	Office of Inspector General
FAO	Field Audit Office
FAR	Federal Acquisition Regulation
NAVAIR	Naval Air Systems Command
OMB	Office of Management and Budget
PMR	Procurement Management Review
TINA	Truth in Negotiations Act
U.S.C.	United States Code

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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December 8, 1998

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation Report on Dispositioned Defective Pricing Reports at the Naval Air Systems Command (Report No. 99-048)

We are providing this evaluation report for information and use. We considered management comments on a draft of this report in preparing the final report.

The Navy comments conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, additional comments are not required.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation report should be directed to Mr. Wayne K. Million at (703) 604-9312 (DSN 664-9312) or Mr. Michael DiRenzo at (703) 604-9314 (DSN 664-9314). See Appendix D for the report distribution. Audit team members are listed inside the back cover.

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For Auditing

Office of the Inspector General, DoD

Report No. 99-048 **December 8, 1998**
(Project No. 70C-9013.03)

Dispositioned Defective Pricing Reports at the Naval Air Systems Command

Executive Summary

Introduction. This report is the third in a series relating to our evaluation of dispositioned defective pricing reports at selected DoD buying commands. The first two evaluation reports, Policy and Oversight 97-145 and Policy and Oversight 98-603, cover the results of our evaluations at the Warner Robins Air Logistics Center and the U.S. Army Aviation and Troop Command. The DoD Appropriations Act of 1981 (Public Law 96-527) and Office of Management and Budget Circular A-50, "Audit Followup," require resolution of contract audit reports, other than preaward reports, within 6 months of report issuance. The Truth in Negotiations Act, 10 United States Code, 2306(a), requires Government contractors to submit cost or pricing data and to certify that such data are accurate, complete, and current upon agreement to contract price. The act also requires a downward adjustment to the contract price, including profit or fee, if the price was increased because the contractor submitted defective cost or pricing data and the Government relied on the defective data when negotiating the contract price.

Evaluation Objectives. The overall evaluation objective was to determine whether contracting officers at selected DoD major buying commands processed defective pricing audit reports in a timely and appropriate manner. Specifically, we determined whether Naval Air Systems Command contracting officers followed DoD policy and regulations in processing defective pricing audit reports. We evaluated the adequacy of the Defense Contract Audit Agency coverage of postaward audits of contracts awarded by the command. We also reviewed the adequacy of the management control program as it applied to the overall objective.

Evaluation Results. We reviewed 32 defective pricing reports that questioned costs of $34.3 million. The problems identified during a review of Naval Air Systems Command disposition of defective pricing audits, conducted in 1994, have persisted. Contracting officers continued to experience compliance problems with the DoD policy and regulations relating to timely resolution and disposition of defective pricing audit reports, contract debt collection, and assessment of interest. Two findings warrant Command attention.

- Navy contracting officers experienced delays of up to four years in settling 13 defective pricing audit reports that questioned $12.9 million. This significantly delayed the downward price adjustment of defectively priced contracts and recoupment of contract overpayments and applicable interest (Finding A).

- Navy contracting officers issued demand letters that understated interest charges and were untimely. This resulted in understated interested payments and delayed recoveries of contract debts (Finding B).

Recommendations in this report, if implemented, will result in process and operational improvements, including correction of material management control weaknesses. Refer to Appendix A for a discussion of the management control program.

Summary of Recommendations. We recommend that the Commander, Naval Air Systems Command, direct contract managers to periodically monitor resolution and disposition of defective pricing audit reports and conduct a self assessment of existing management controls as they apply to the contract audit followup program. We also recommend that the Commander, Naval Air Systems Command, direct contract managers to conduct a review of pending demands for payments in their respective divisions to verify compliance with DoD contract debt collection policy, regulations, and procedures, including proper assessment of applicable interest.

Management Comments. The Deputy Assistant Secretary of the Navy (Planning, Programming and Resources) concurred with the recommendations. Beginning in FY 1999, the Naval Air Systems Command will require contract managers to review the audit reports monthly and report the overall status of audit reports to senior management. The command will conduct a self-assessment of existing management controls as they apply to the contract audit followup program. Also, the Navy directed contracting officers to follow Contract Competency Instruction 4367.1, Defective Pricing Actions, which contains a sample demand letter that complies with DoD collection policy. See Part I for the complete discussion of management comments and Part III for the complete text of management comments.

Evaluation Response. The Navy comments are fully responsive to the recommendations and additional comments are not required.

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Part I - Evaluation Results

Evaluation Background

This report is the third in a series about our FY 1997 evaluation of dispositioned defective pricing reports at selected DoD buying commands. Defective pricing occurs when a contractor or subcontractor does not submit or disclose to the Government cost or pricing data that is accurate, complete, and current as of the date of agreement on contract price. The underlying statute is 10 United States Code 2306(a), the Truth in Negotiation Act. The report summarizes our review of resolution and disposition actions taken on defective pricing audit reports by the Naval Air Systems Command (NAVAIR). Appendix A contains a summary of prior coverage.

Evaluation Objectives

The overall evaluation objective was to determine whether contracting officers at selected DoD major commands complied with DoD policies and regulations in processing defective pricing audit reports. For this review, we evaluated NAVAIR contracting officer compliance with DoD policies and regulations in processing defective pricing audit reports, including recovery of contract overpayments and applicable interest. We also evaluated DCAA coverage of postaward audits of NAVAIR contracts, including audit support of contracting officer resolution and disposition of postaward audit reports. We reviewed the adequacy of the management control program as it applied to the overall objective. See Appendix A for a discussion of the evaluation process and the results of our review of the management controls at NAVAIR.

Finding A. Managing Defective Pricing Audit Reports

Contracting officers at NAVAIR experienced delays of up to 4 years in settling 13 defective pricing audit reports that questioned $12.9 million. Four factors: contracting officers, auditors, contractors, and inadequate management controls caused delays which significantly affected the downward price adjustment of defectively priced contracts and recovery of contract overpayments and applicable interest.

Criteria for Managing the Contract Audit Followup Program

The DoD Appropriations Act of 1981 (Public Law 96-527) and Office of Management and Budget Circular A-50, "Audit Followup," require resolution of contract audit reports, other than preaward reports, within 6 months of report issuance. The DoD has implemented those requirements in DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports." The Navy and NAVAIR have established audit followup procedures that incorporate OMB and DoD policies. In addition, DCAA has developed policies and procedures to facilitate contract audit resolution and disposition as part of its mission to provide audit advisory services to DoD contracting officers.

DoD Policy on Contract Audit Followup. DoD Directive 7640.2 prescribes the management responsibilities and resolution and disposition standards for contract and grant audits conducted by DCAA.

Management Responsibilities. The directive requires the Secretaries of the Military Departments and the Directors of Defense agencies to:

- Direct periodic evaluations of their followup systems to determine whether the systems are adequate and result in timely resolution and disposition of audit reports.
- Establish procedures to maintain up-to-date records on all reportable contract audit reports from receipt through disposition.
- Establish procedures to monitor and ensure the proper and timely resolution and disposition of contract audit reports.

Resolution Standard. The directive includes the requirement that contract audit reports should be resolved within 6 months of report issuance. Resolution is the point at which the auditor and the contracting officer agree on the action to take on audit report findings and recommendations. For most contract audit reports, the contracting officer should obtain contractor comments and other technical advice before formulating a position on the audit recommendations.

Disposition Standard. The directive requires that disposition take place as soon as possible after resolution but no later than 12 months after report issuance. After 12 months an open report is considered "overage" in accordance with DoD Directive 7640.2.

Navy Followup Policies and Procedures. Supplemental Navy guidance on resolution and disposition is found in Navy Acquisition Procedures Supplement Subpart 5242.191, "Audit Resolution and Disposition." NAVAIR has implemented defective pricing documentation and review procedures in Contracts Group Instruction 4367.1, "Defective Pricing Actions," issued January 10, 1994.

DCAA Followup Responsibilities. The DCAA Contract Audit Manual, Chapter 15.600, "Contract Audit Followup," requires DCAA to provide timely and complete responses to any contracting officer who requests further audit opinions on the audit issues under review.

NAVAIR Requirements for Official Contract Files. NAVAIR Contracts Group Instruction 5211.4D, February 3, 1989, establishes policy, procedures, and responsibilities for including contractual and supporting documents in official contract files. The instruction requires that documentation in contract files constitute a complete history of the procurement so information is available for reviews and investigations and to furnish essential facts for litigation or congressional inquiries. The instruction also provides procedures for retrieval of official files.

Factors Contributing to Resolution or Disposition Delays

Contracting officers experienced average delays of 27 months with 13 of the 32 defective pricing audit reports we reviewed. Due to the delays, the reports exceeded the resolution and disposition standards prescribed by law and policy. Four major factors contributed to processing delays, with some reports delayed for more than one reason:

- contracting officers did not take timely resolution or disposition actions;
- DCAA auditors did not respond promptly to contracting officers' requests for additional audit assistance;
- contractors did not provided timely comments on audit recommendations and contracting officers did not take aggressive actions to obtain them; and
- management controls were not adequate to ensure that timely and appropriate action was taken on audit recommendations.

Appendix B lists the 32 defective pricing audit reports reviewed. Table 1 summarizes the delay factors and number of occurrences identified for the 13 overage reports and their related occurrence percentages. The total recommended price adjustments were $6 million relating to the 13 reports.

Table 1. Delay Factors Affecting Processing of Defective Pricing Reports

Delay Factors	Number of Occurrences	Percent of Total
Contracting Officers	11	50.0
DCAA Auditors	5	22.7
Contractors	6	27.3
Total	**22**	**100.0**

Timeliness of Contracting Officer Actions

Of the 13 overage reports reviewed, 11 audit reports became overage partly because contracting officers did not take timely actions leading toward resolution and disposition of contract audit recommendations. As a result, resolution and disposition of defective pricing issues was delayed for up to four years. Further, contract managers at NAVAIR did not use existing management controls that would have ensured more timely processing of defective pricing findings and recommendations. As an example, the NAVAIR Procurement Management Information System contains information on the status of contract audit reports. We saw no evidence, however, that contract managers used the system to monitor contracting officers' progress on defective pricing cases or to question lengthy periods of inactivity or missed milestones. Table 2 lists those 11 audit reports.

Table 2. Overage Audit Reports Due to Contracting Officer Delays

Audit Report Number	Original Report Date	Superseding Report Date	Contractor	Delay (Months)
2441-0A42000-1-S2	10/17/89	08/24/94	Grumman	32
2441-91A42097-014-S2	10/15/90	04/11/94	Grumman	35
2441-92A42097-010-S1	10/30/91	06/30/95	Grumman	29
2441-94A42020-002	09/30/94		Grumman	19
2441-9A42000-1-S3	06/21/89	08/20/90	Grumman	50
3421-92A42097-021-S1	10/09/92	02/07/96	McDonnell	17
3421-95J42097-002	12/16/94		McDonnell	8
3421-95J42097-003	12/16/94		McDonnell	8
3431-92B42097-001-S1	02/06/92	09/30/93	McDonnell	12
4521-0D42028-7	09/28/90		Hughes A/C	56
6221-6A42000-1-S1	05/23/86	05/19/87	Singer Co.	35

Timeliness of DCAA Auditor Actions

The DCAA San Diego and East Bay Branch Offices and the McDonnell Douglas Aerospace Resident Office did not provide timely responses to contracting officers' requests for additional audit support on defective pricing audit issues in five cases. However, we are not making a recommendation on this matter because DCAA initiated corrective action on March 16, 1998. DCAA issued Memorandum For Regional Directors, and Director, Field Detachment, 98-PFC-034(R), to implement the OIG, DoD, recommendations in Policy and Oversight Report No. 98-603. That report addressed auditor delays in responding to contracting officer requests for additional audit support at the U.S. Army Aviation and Troop Command. See Appendix C for the full text of the DCAA guidance.

Timeliness of Contractor Responses

For most contract audit reports, DoD Directive 7640.2 requires the contracting officer to obtain contractor comments and technical advice necessary to formulate a Government prenegotiation position. The DCAA Contract Audit Manual requires auditors to discuss pertinent factual matters with contractors by providing them with copies of draft reports, exhibits, and other significant audit evidence. This practice gives contractors the opportunity to review allegations and provide additional information for the auditors' consideration before the FAO issues the final report.

Ideally, contractor responses to defective pricing allegations and auditor rejoinders should be included in the final report to minimize resolution delays. Some contractors, however, decline to provide official comments on the allegations until after DCAA issues the audit report. In those instances, the contracting officer may solicit contractor comments. When a contractor ignores or fails to respond to requests for comments or additional information, the contracting officer should followup with the contractor to obtain a response. If a response is not submitted, the contracting officer should issue a final decision on the audit findings and recommendations.

In six instances, contractors did not respond for 3 to 14 months to requests by contracting officers for comments on defective pricing findings and recommendations. Contracting officers did not issue final decisions in any of those cases. Table 3 lists those six audit reports.

Table 3. Overage Audit Reports Due to Contractor Delays

Audit Report Number	Contractor	Comments Due Date	Comments Receipt Date	Delay (Months)
2441-92A42097-010	Grumman	10/30/91	12/22/92	14
2441-92A42097-012	Grumman	12/05/91	04/30/92	5
2441-95A42097-001	Grumman	02/95	07/14/95	5
2441-9A42000-1-S3	Grumman	05/31/96	08/26/96	3
3421-92A42097-021-S1	McDonnell	04/15/96	01/09/97	9
6221-6A42000-1-S1	Singer Co.	11/26/94	05/06/95	5

Adequacy of Documentation in Official Contract Files

NAVAIR reported 38 closed defective pricing audit reports during the semiannual reporting periods ended September 30, 1995, March 31, 1996, and September 30, 1996, representing $36.4 million in recommended price adjustments. We were able to review only 32 defective pricing cases because the files on 6 cases were missing. The six cases are listed in Table 4.

Table 4. Missing Defective Pricing Case Files

Audit Report Number	Contractor
2180-6N42000-60772	Honeywell
3731-94D42097-010	Texas Instruments
7131-9J42004-1	NAVCOM Defense
2641-91D42097-501-S2	Pratt & Whitney
2201-89G42010-001-S2	Eaton
2201-89G42010-001-S3	Eaton

On October 23, 1996, we transmitted to the Navy CAF Monitor, Assistant Secretary of the Navy (Research, Development, and Acquisition) a copy of the memorandum announcing our evaluation of dispositioned defective pricing audit reports at selected DoD buying commands. On November 15, 1996, we provided the NAVAIR point of contact and the Office of Inspector General, NAVAIR copies of the announcement letter and a list of the audit reports to be reviewed. We provided updated lists of audit reports to be reviewed on November 25, 1996, and March 3, 1997, and conducted the site visit in April 1997.

NAVAIR contracting officials were provided ample time and information to ensure that complete contract files on defective pricing cases were available. However, they were not able to locate files on six cases. Adequate management controls were not implemented to ensure that complete, valid, and reliable data were being maintained on each defective pricing case to provide assurance that the cases were settled properly.

Management Controls Over the Contract Audit Followup Program

NAVAIR Self-Assessment. NAVAIR did not conduct any recent self-evaluations of its management control program for contract audit followup. The Office of the Assistant Secretary of the Navy (Research, Development, and Acquisition) conducted a Procurement Management Review (PMR) at NAVAIR from March 4 to March 15, 1996. The PMR team did not identify the material management control weaknesses identified by this evaluation. The PMR team found that procurement at NAVAIR was fully satisfactory in most respects and there were no major deficiencies. One of the areas reviewed by the PMR team covered CAF-related responsibilities in performance appraisals. The PMR team found that NAVAIR has integrated disposition of defective pricing actions and audit reconciliation into the "Performance Standards and Work Plan Augmentation" for all contract specialists in grades 13, 14, and 15 and that the augmentation is appropriately placed and balanced with the other performance appraisal elements. The PMR report had no recommendations on this area. However, the PMR team did not conduct transaction testing to validate how effectively contracting officers were discharging their CAF-related responsibilities. The PMR team did not evaluate management processes and controls in place to determine whether the tracking and reporting system and the processing of defective pricing audit reports resulted in timely and appropriate resolution and disposition of audit recommendations.

Effect of Implementation of Adequate Management Controls. The management controls at NAVAIR, if applied, should have ensured proper management and oversight of defective pricing audit reports. Contracting officers and contract managers had copies of applicable DoD regulations and Navy acquisition procedures and guidance governing defective pricing processing. Contract managers were provided with contracting officers' performance standards, which require contracting officers to meet the requirements of DoD Directive 7640.2. Contract managers had access to the NAVAIR automated tracking and reporting system for use in capturing, tracking, and establishing a plan to bring NAVAIR contracting officers into compliance. Those controls did not ensure NAVAIR management that the CAF program had been properly monitored and resulted in the untimely, improper settlement of defective pricing cases, and the loss of official contract files on defective pricing cases. As a result, the Government is unlikely to recover overpayments and related interest consistently on defectively priced contracts.

Management Comments on the Finding and Evaluation Response

Office of the Deputy Assistant Secretary of the Navy Comments. The Navy did not concur completely with the statistics in Table 1 because it believes the audit concludes that 11 of the 13 reports became overage solely because of contracting officer delays. However, the Navy agreed that NAVAIR contracting officers must give closer attention to defective pricing audit reports.

Evaluation Response. We did not intend to imply that the 11 reports became overage solely because of contracting officer delays and have changed the wording that the reports became overage "partly" because of contracting officer delays. Although several of the 11 reports became overage for contractor or auditor delays, we noted that all 11 did experience contracting officer delays as well.

Recommendations and Management Comments

A. We recommend that the Commander, Naval Air Systems Command:

1. Direct contract managers to periodically monitor resolution and disposition of defective pricing audit reports to ensure progress is being made to settle open defective pricing cases.

Office of the Deputy Assistant Secretary of the Navy Comments. The Navy concurred with the recommendation stating that beginning in FY 1999, NAVAIR will require contract managers to review the audit reports monthly and report the overall status of audit reports to senior management. In addition to monthly reviews, NAVAIR plans to implement internal submission of the Contract Audit Follow-up Report on a quarterly basis.

2. Conduct a self-assessment of existing management controls as they apply to the Naval Air System Command contract audit followup program, including compliance with Contracts Group Instructions 4367.1 and 5211.4D, and initiate corrective action of identified management control weaknesses.

Office of the Deputy Assistant Secretary of the Navy Comments. The Navy concurred with the recommendations stating that the NAVAIR Systems Command Contracts Competency Management Plan established a system for instituting and monitoring the overall quality, accuracy, and compliance of our procurement system. This plan provides for review of contract files and documentation to ascertain compliance to the Federal Acquisition Regulation, Defense Federal Acquisition Regulation Supplement, Navy Acquisition Procedures Supplement as well as NAVAIR Instructions. The first assessment will be conducted by December 31, 1998, and will contain a review of the contract audit follow-up program as a special interest item.

Finding B. Demand Letters and Assessment and Collection of Interest

Contracting officers issued nine demand letters that improperly assessed applicable interest and 3 of 9 demand letters were untimely by an average of 19 months, because the contracting officers either ignored or misinterpreted current DoD contract debt collection regulations and guidance. This resulted in delayed recoveries of contract debts totaling $6.95 million and understated interest payments.

Defective Pricing Criteria

The Truth in Negotiations Act. The Truth in Negotiations Act (TINA), 10 United States Code (U.S.C.), 2306a, requires Government contractors to submit cost or pricing data and to certify that such data are accurate, complete, and current upon agreement to contract price. TINA also requires a downward adjustment to the contract price, including profit or fee, if the price was increased because the contractor submitted defective cost or pricing data and the Government relied on the defective data when negotiating the contract price.

TINA requires contractors to pay interest on overpayments due to defective cost or pricing data. Interest is due from the time of overpayment to the time of repayment, using the underpayment rates prescribed by the Secretary of the Treasury under 26 U.S.C. 6621(a)(2) of the Internal Revenue Code of 1986. The statutory requirements on interest and penalties for overpayments apply to negotiated contracts entered into on or after November 8, 1985, as well as modifications entered into after that date. For contracts awarded before that date, interest begins to accrue 30 days after contractor receipt of the demand letter, not from the date the overpayment was made.

Federal Acquisition Regulation (FAR) 15.804-7, "Defective cost or pricing data." FAR 15.804-7 (applicable at the time of review) implements 10 U.S.C. 2306a, and prescribes procedures for adjusting defectively priced contracts and assessing and collecting interest on overpayments. FAR 15.804-7 also states that overpayments occur when the Government pays the contractor for accepted supplies or services that were defectively priced.

FAR Requirements on Demands for Payment. If the Government makes overpayments for defectively priced supplies or services, FAR 32.610 (a) requires that a demand for payment be issued to the contractor as soon as the Government has computed the amount of refund due. FAR also prescribes the required elements of a demand letter.

Purpose of Demand Letters. A demand letter provides the contractor with instructions on how, when, and where to repay a contract debt and informs Government comptroller officials to establish an account receivable. It is critical that the contracting officer sends a copy of each demand letter to the payment office designated in the contract and requests an acknowledgment of receipt.

When the contracting officer receives the contractor's check, he or she should immediately send the check to the payment office with a breakout of the principal amount by appropriation and the interest portion identified. For active defectively priced contracts, the contract adjustment should result in a reduction of the contract price or cost allowance, as appropriate, to prevent overpayments on future deliveries. However, where payments have been made for delivered goods or services, the contracting officer should issue a demand for the amounts overpaid and applicable interest until repayment is received.

The demand letter is the only official notice that causes a payment office to establish an account receivable to record the contract debt and any applicable interest. Without an official account receivable, the payment office has no means to follow up on delinquent contractor debts and to update interest calculations. A settlement agreement or a bilateral price-reduction modification does not provide sufficient notice of debt disposition, without receipt of the demand letter.

Issuance of Demand Letters and Assessment of Interest

Issuance of Demand Letters. Sixteen of the 32 cases required repayment from the contractors. Nine of the 16 cases required an official demand for payment letter; the Department of Justice settled the other seven cases and repayments were made according to agreements between contractors and the Department of Justice. In all nine cases where they were required, contracting officers issued improper demand letters, and three of those demand letters were not issued in a timely fashion. Table 6 lists the 9 cases where improper or untimely demand letters were issued.

Table 6. Defective Pricing Audit Reports Requiring Demand Letters

Audit Report Number	Report Date	Contractor	Date Issued	Proper Demand	Timely Demand
2441-91A42097-014-S2	04/11/94	Grumman	08/31/95	No	Yes
2441-92A42097-010-S1	06/30/95	Grumman	08/31/95	No	Yes
2441-94A42020-002	09/30/94	Grumman	05/30/96	No	Yes
2441-95A42097-001	11/23/94	Grumman	08/31/95	No	Yes
3421-95J42097-002	12/16/94	McDonnell	11/13/95	No	No
3421-95J42097-003	12/16/94	McDonnell	11/13/95	No	No
3431-92B42097-001-S1	09/30/93	McDonnell	10/27/95	No	Yes
4521-0D42028-7	09/28/90	Hughes A/C	08/14/95	No	No
2230-94A42020-001	09/26/95	Martin	05/13/96	No	Yes

Demand Letters Undercharged Interest Costs. Eight of the nine cases where demand letters were not properly prepared involved contracts entered into on or after November 8, 1985. The contracting officer assessed interest from the date of the overpayment through the date of the demand letter, instead of computing interest through receipt of the repayment check. Assessment through the date of

the demand letter gave contractors 30 interest free days from the date of the demand letter to repay the overpayment amount and interest. Specifically, the eight demand letters did not include the correct interest payment notification required by FAR 32.610 and FAR 15.804-7(b)(7). Instead, the contracting officer erroneously used the following interest notification language in the demand letters.

> This letter is a demand for payment; therefore, any amounts due and not paid within thirty (30) days from your receipt of this letter will bear interest from the date of the letter at the underpayment rate established by the Secretary of the Treasury under 26 U.S.C. 6621(a)(2).

To prevent similar problems from recurring, demand letters should specify an agreed-to or anticipated repayment date for the principal and interest accrued through that date, and a daily interest amount that will continue to accrue until receipt of contractor repayment. This procedure allows for the daily update of the interest if the agreed-to repayment date is missed and prevents the underassessment of applicable interest. We could not determine why the contracting officer issued improper demands for payment.

The ninth case involved audit report 4521-0D42028-7, alleging defective pricing on a contract with Hughes Aircraft. This contract was entered into before November 8, 1985. The demand letter erroneously referenced the Internal Revenue Code underpayment rate, which applies to contracts awarded after that date.

Length of Time to Issue Demand Letters. FAR 32.610(a) requires that "a demand for payment shall be made as soon as the responsible official has computed the amount of refund due." As shown in Table 6, contracting officers did not issue timely demand letters in three of the nine cases. Delays averaged 30 days. In processing two defective pricing audit reports on McDonnell Douglas Aerospace, the contracting officer concluded negotiations with the contractor on August 8, 1995. However, the contracting officer did not execute the price reduction modifications that incorporated the demands for payment until November 13, 1995, almost 3 months later. The other case involved the untimely demand letter issued by the contracting officer to collect the $737,850 agreed-to defective pricing amount from Hughes Aircraft Company. Negotiations were concluded July 13, 1994; however, the contracting officer did not issue the demand for payment until August 14, 1995, because she did not know how to recover overpayments on a closed contract.

Recommendation and Management Comments

B. We recommend that the Commander, Naval Air Systems Command, direct contract managers to conduct a review of pending demands for payments in their respective divisions to verify compliance with DoD contract debt collection policy, regulations, and procedures, including proper assessment of applicable interest.

Office of the Deputy Assistant Secretary of the Navy Comments. The Navy concurred with the recommendation stating that Contracting Officers were directed in April 1997 to follow Contract Competency Instruction 4367.1, Defective Pricing Actions, which contains a sample demand letter that complies with DoD contract debt collection policy, regulations and procedures, including proper assessment of applicable interest. Contract managers have used this guide and will continue to use it when preparing demand letters.

Part II - Additional Information

Appendix A. Evaluation Process

Scope

Work Performed. We conducted an evaluation of dispositioned defective pricing audit reports at NAVAIR, Arlington, Virginia. We interviewed contracting officers and reviewed contract files related to the disposition of the defective pricing cases.

Limitations of Evaluation Scope. We limited our review to cover only defective pricing audit reports closed during the semiannual reporting periods ended September 30, 1995; March 31, 1996; and September 30, 1996. NAVAIR reported 38 closed defective pricing audit reports during the semiannual reporting periods ended September 30, 1995; March 31, 1996; and September 30, 1996; representing $36.4 million in recommended price adjustments. We were able to review only 32 defective pricing cases because the files on 6 cases were missing. See the discussion in Part I, Finding A.

DoD-Wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to GPRA, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objectives and goals:

Objective: Fundamentally reengineer the Department and achieve a 21st century infrastructure.

Goal: Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

General Accounting Office High Risk Area. The General Accounting Office has identified several high risk areas in the Department of Defense. This report provides coverage of the Defense Weapons System Acquisition high risk area.

Methodology

Use of Computer-Processed Data. We relied on computer-processed data from the OIG, DoD, Contract Audit Reporting and Tracking System to determine the buying commands to visit and to determine the evaluation universe. The Contract Audit Reporting and Tracking System is a database comprised of semiannual reports submitted by DoD Components to the OIG, DoD. Although we did not perform a formal reliability assessment of the computer-processed data before selection of the universe, we ran the built-in error checks to test the reliability of the data. During the field work, we performed further data validation by tracing reported data from the Contract Audit Reporting and Tracking System to source documentation, such as audit reports, business clearance memorandums, and other

contract file documentation. Where we found reporting errors, we adjusted the universe to preclude statistics from being distorted.

Evaluation Process. We ascertained whether NAVAIR contracting officers fully complied with regulatory guidelines and DoD policies in processing defective pricing audit reports with positive findings. We also evaluated the adequacy of DCAA support of contracting officers to settle the postaward audit reports. Our field visits and other followup actions included the review of the following:

- existing statutory provisions, regulations, and Navy guidelines on defective pricing;
- contract file documentation, such as price-reduction modifications, contracting officer final decisions, demand letters, prenegotiation and postnegotiation business clearances, followup correspondence, and memorandums for record;
- method of recovery and the status of recovery actions;
- assessment and collection of statutory interest and penalties and posting of recovered funds;
- defective pricing audit reports, subcontractor assist audit reports, and supplements thereto; DCAA rejoinders; fraud referrals, if any, and other advisory memorandums; and
- communications and correspondence between contracting officers, contractors, contract auditors, and payment or accounting and finance offices.

Universe. The universe covered 38 defective pricing audit reports that were reported closed by NAVAIR contracting officers during the 18-month period covered by our review. After validating the reliability of reported data during our field work, we adjusted the universe to exclude six audit report files that were either incomplete, missing, or lost.

Evaluation Type, Dates, and Standards. We performed this program evaluation from April 1997 through April 1998 in accordance with standards implemented by the Inspector General, DoD. We informed representatives from the Office of Inspector General, NAVAIR, of a management decision to report separately on our evaluations of Warner Robins Air Logistics Center and the U.S. Army Aviation and Troop Command. Consequently, we completed the evaluation of the defective pricing program at NAVAIR during the second quarter of FY 1998. We included tests of management controls considered necessary.

Contacts During the Evaluation. We visited or contacted individuals and organizations within DoD. Further details are available on request.

Management Control Program

DoD Directive 5010.38, " Management Control Program," August 26, 1996, requires DoD Components to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls.

Scope of Review of Management Control Program. We reviewed the adequacy of NAVAIR management controls over the CAF program as they relate to the processing of defective pricing audit reports, including maintenance of official defective pricing files.

Adequacy of Management Controls. We identified material management control weaknesses in the NAVAIR CAF program as defined by DoD Directive 5010.38. NAVAIR management controls were not adequate to ensure that contracting officers resolved and dispositioned defective pricing reports in accordance with DoD policy and regulations. Implementation of Recommendations A.1. and 2. will improve the NAVAIR CAF program for processing defective pricing audit reports. A copy of the report will be provided to the Navy senior official responsible for management controls.

Adequacy of Management Self-Assessment. NAVAIR management did not identify CAF as an assessable unit for FY 1997 and, therefore, did not identify or report the material management control weakness identified by this evaluation.

Prior Coverage

Inspector General, DoD, Analysis and Followup Memorandum No. CAFR-21, "Contract Audit Followup Review of the Naval Air Systems Command," June 16, 1994.

Inspector General, DoD, Policy and Oversight Report No. 97-045, "Evaluation of Dispositioned Defective Pricing Audit Reports at the Warner Robbins Air Logistics Center," September 24, 1997.

Inspector General, DoD, Policy and Oversight Report No. 98-063, "Dispositioned Defective Pricing Audit Reports at the U.S. Army Aviation and Troop Command," December 23, 1997

Appendix B. Defective Pricing Audit Reports Reviewed

Audit Report Number	Report Date	Contractor	Amount Questioned (Thousands)
1271-95S42040-04553	09/30/95	Contraves	$ 357.0
2191-0142020-404-S3	11/10/93	Israel A/C	5,296.2
2191-0I42020-421-S1	02/05/91	Israel A/C	1,947.4
2191-6I42000-1	01/31/90	Israel A/C	1,498.5
2191-91I42030-419-S1	11/07/91	Israel A/C	2,278.4
2191-92I42030-438-S1	04/09/93	Israel A/C	981.4
2230-94A42020-001	09/26/95	Martin	778.0
2441-0A42000-1-S2	08/24/94	Grumman	782.9
2441-0A42000-1-S3	07/26/95	Grumman	689.3
2441-91A42097-014-S2	04/11/94	Grumman	293.8
2441-92A42097-010	10/30/91	Grumman	643.3
2441-92A42097-010-S1	06/30/95	Grumman	63.8
2441-92A42097-012	09/30/91	Grumman	269.5
2441-94A42020-002	09/30/94	Grumman	3,975.9
2441-94A42097-003-S1	10/22/93	Grumman	149.7
2441-95A42097-001	11/23/94	Grumman	355.2
2441-95A42097-002	11/17/94	Grumman	400.7
2441-9A42000-1-S3	08/20/90	Grumman	549.6
2661-93B42098-001-S1	09/15/94	Sikorsky	78.6
3311-95A42010-001	09/01/95	Bell Helicopter	303.7
3421-92A42097-021-S1	02/07/96	McDonnell	4,856.0
3421-94J42010-006	09/08/95	McDonnell	3,795.7
3421-95J42097-002	12/16/94	McDonnell	3.9
3421-95J42097-003	12/16/94	McDonnell	3.9
3431-92B42097-001-S1	09/30/93	McDonnell	144.2
4391-93J42030-001-S1	09/29/95	Litton	1,737.1
4521-0D42028-7	09/28/90	Hughes A/C	937.9
6121-0A42000-2	09/25/90	CAE-Link	178.4
6121-9A42000-2	09/29/89	CAE-Link	402.2
6141-94J-42040-001	03/25/96	Pioneer UAV	86.9
6221-6A42000-1	05/23/86	CAE-Link	320.5
6221-6A42000-1-S1	05/19/87	CAE-Link	106.0
Total			**$34,265.6**

Appendix C. Memorandum for Regional Directors and Director, Field Detachment 98-PFC-034 (R)

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

IN REPLY REFER TO

730.5.23.1

16 March 1998
98-PFC-034(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Timeliness of Audit Support to Contracting Officers on Resolution of Audit Findings

SUMMARY

This memorandum is issued in response to the Department of Defense Inspector General's (DoDIG) review of dispositioned defective pricing reports at selected buying commands. In these reviews, the DoDIG found that we need to improve our timeliness on responding to contracting officer requests for follow-up audit support on the resolution of audit findings. In addition, they found that we need to improve our follow-up on overage defective pricing reports.

BACKGROUND

The DoDIG conducted reviews of dispositioned defective pricing audits at the Army-Aviation and Troop Command (ATCOM), Warner Robins Air Logistics Center, and Naval Air Systems Command (NAVAIR). The overall objective of the reviews was to determine whether contracting officers complied with regulatory and statutory guidelines in processing defective pricing audit reports. They also reviewed the adequacy of DCAA's postaward audit coverage of contracts.

During the reviews of ATCOM and NAVAIR, the DoDIG identified specific instances where field audit offices (FAOs) were not timely in their follow-up audit support to contracting officers. The DoDIG identified delays of up to 10 months for issuing rejoinders or supplemental reports, responding to contractor rebuttals, or providing additional comments on contracting officer decisions. In addition, the DoDIG found that some FAOs did not routinely follow-up on overage defective pricing reports. For example, at one buying command, there was follow-up on only 31 percent of the audits reviewed.

GUIDANCE

CAM 14-122, *Discussing Audit Findings*, states

> The auditor must coordinate and communicate with contracting officers and prime contract auditors on a regular basis to enable the government to achieve timely and maximum resolution of defective pricing findings. The accomplishment of the DCAA defective pricing program (in terms of completing planned audits,

730.5.23.1
SUBJECT: Timeliness of Audit Support to Contracting Officers on Resolution of Audit Findings

> supporting audit findings, and helping contracting officers achieve price reductions) requires a DCAA commitment to coordination and communication with government personnel.

In addition, CAM 14-125a, *Resolution of Audit Findings*, states

> The auditor must continue to coordinate and communicate with the contracting officer after postaward audit reports are issued in order to enable the government to achieve a timely and favorable resolution either by negotiation or litigation of the defective pricing findings. During periodic discussions with the contracting officer, the auditor should always determine the status of open defective pricing issues. In addition, the auditor should continuously offer assistance such as commenting on data received by the contracting officer after the audit report was issued and offer to attend negotiation conferences. When assistance is requested by the contracting officer, it should be given high priority.

As stated in CAM, follow-up audit support or assistance requested by the contracting officer should be given high priority, therefore, it is important to respond to the contracting officer's request in a timely manner. These requests should be treated as demand assignments. If the additional audit support requested will take longer than initially planned, the contracting officer should be contacted to ensure that the revised due date is acceptable.

In addition. FAO personnel should routinely follow-up on overage defective pricing audits. As we work to reduce the Agency backlog of overage defective pricing audits, we are finding that it becomes increasingly more difficult to resolve the issues as time passes. Therefore, as a minimum, FAO personnel should determine the status of open defective pricing issues during periodic discussions with the contracting officer.

CONCLUDING REMARKS

If FAO personnel have any questions, they should contact their regional personnel. If regional personnel have any questions, they may contact Mr. Daniel Tucciarone, Chief; Pricing, Finance, and Claims Division at (703) 767-2270.

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

DISTRIBUTION: C

Appendix D. Report Distribution

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  Director, Defense Procurement
Under Secretary of Defense (Comptroller)
Assistant 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)
Assistant Secretary of the Navy (Research, Development, and Acquisition)
Commander, Naval Air Systems Command
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

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Senate Committee on Armed Services
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House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, Committee 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

Part III – Management Comments

Department of the Navy Comments

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(Research, Development and Acquisition)
WASHINGTON, D C 20350-1000

OCT 2 6 1998

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: DODIG DRAFT AUDIT REPORT ON DISPOSITIONED DEFECTIVE PRICING REPORTS AT THE NAVAL AIR SYSTEMS COMMAND (PROJECT NO. 7OC-9013.03)- Information Memorandum

REFERENCE: (a) DODIG Memorandum of 24 Aug 98

Enclosure: (1) Department of the Navy Response

The Department of the Navy response to reference (a) is provided at enclosure (1). We partially concur with Finding A, fully concur with Finding B, and fully concur with all recommendations. We agree that NAVAIR Contracting Officers must give closer attention to defective pricing audit reports to ensure timely processing of defective pricing findings and recommendations.

WILLIAM J. SCHAEFER
Deputy Assistant Secretary
of the Navy
Planning, Programming, and
Resources

Copy to:

FMO (31)
NAVINSGEN (02)
COMNAVAIRSYSCOM (AIR-09G)

Final Report Reference

DEPARTMENT OF THE NAVY RESPONSE
TO
DODIG DRAFT REPORT OF 24 AUGUST 1998
ON
DISPOSITIONED DEFECTIVE PRICING REPORTS AT THE
NAVAL AIR SYSTEMS COMMAND
(PROJECT NO. 7OC-9013.03)

Finding A: Managing Defective Pricing Audit Reports

Contracting officers at NAVAIR experienced delays of up to 4 years in settling 13 defective pricing audit reports that questioned $12.9 million Four factors: contracting officers, auditors, contractors, and inadequate management controls caused delays which significantly affected the downward price adjustment of defective priced contracts and recovery of contract overpayments and applicable interest.

Specific Comments:

Table 1. Delay Factors Affecting Processing of Defective Pricing Reports, Page 5. "Of the 13 overage reports reviewed, 11 audit reports became overage because contracting officers did not take timely actions leading toward resolution and disposition of contract audit recommendations."

NAVAIR Response: Do not concur completely with the statistics displayed in Table 1. The audit concludes that 11 of the 13 overage reports reviewed became overage solely because Contracting Officers did not take timely actions leading toward resolution and disposition of contract audit recommendations This is not correct because 6 of the 11 audits listed in this Table experienced delays from the Defense Contract Audit Agency auditor, contractor, as well as the contracting officer. We agree that NAVAIR Contracting Officers must give closer attention to defective pricing audit reports to ensure timely processing of defective pricing findings and recommendations.

Revised

Recommendations:

A. We recommend that the Commander, Naval Air Systems Command

1. Direct contract managers to periodically monitor resolution and disposition of defective pricing audit reports to ensure progress is being made to settle open defective pricing cases.

NAVAIR Response:

Concur. Beginning in Fiscal year 1999, NAVAIR will require contract managers to review the audit reports monthly and report the overall status of audit reports to senior

Enclosure (1)

management. The first monthly status report meeting is scheduled for 13 October 1998. In addition to monthly reviews, NAVAIR plans to implement internal submission of the Contract Audit Follow-up Report on a quarterly basis. This report will assist contract managers in tracking the progress of each audit and will assist senior management in the overall management of audit follow-up system.

2. Conduct a self-assessment of existing management controls as they apply to Naval Air Systems Command contract audit follow-up program, including compliance with Contracts Group Instructions 4367.1 and 5211.4d, and initiate corrective action of identified management control weaknesses.

NAVAIR Response:

Concur. NAVAIR Systems Command Contracts Competency Management Plan established a system for instituting and monitoring the overall quality, accuracy, and compliance of our procurement system. The plan recognizes the need for continuous process improvement and personnel training as the means of achieving and maintaining the highest quality in all contracting actions. This plan provides for review of contract files and documentation to ascertain compliance to the Federal Acquisition Regulation, Defense Federal Acquisition Regulation Supplement, Navy Acquisition Procedures Supplement as well as NAVAIR's instructions. The reviewers will use checklists for reviewing files and collecting data on quality and will review contract files and documentation for actions completed in the prior year. The first assessment will be conducted by 31 December 1998 and will contain a review of the contract audit follow-up program as a special interest item. This assessment, coupled with the monthly status reports, will provide senior management with the tools to monitor the overall audit follow-up process.

Finding B: Demand Letters and Assessment and Collection of Interest

Contracting Officers issued nine demand letters that improperly assessed applicable interest and were untimely because the contacting officers either ignored or misinterpreted current DoD contract debt collection regulations and guidance. This resulted in delayed recoveries of contract debts and understated interest payments.

NAVAIR Response:

Concur.

Recommendation B: We recommend that the Commander, Naval Air Systems Command, direct contract managers to conduct a review of pending demands for payments in their respective divisions to verify compliance with DoD contract debt collection policy, regulations, and procedures, including proper assessment of applicable interest.

Enclosure (1)

Final Report Reference

NAVAIR Response:

Concur. Contracting Officers were directed in April 1997 to follow Contract Competency Instruction 4367.1, Defective Pricing Actions, which contains a sample demand letter that complies with DoD contract debt collection policy, regulations and procedures, including proper assessment of applicable interest. Contract managers have used this guide and will continue to it when preparing demand letters.

Enclosure (1)

Evaluation Team Members

The Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD, produced this report.

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Wayne K. Million
Michael A. DiRenzo
Veronica H. Harvey