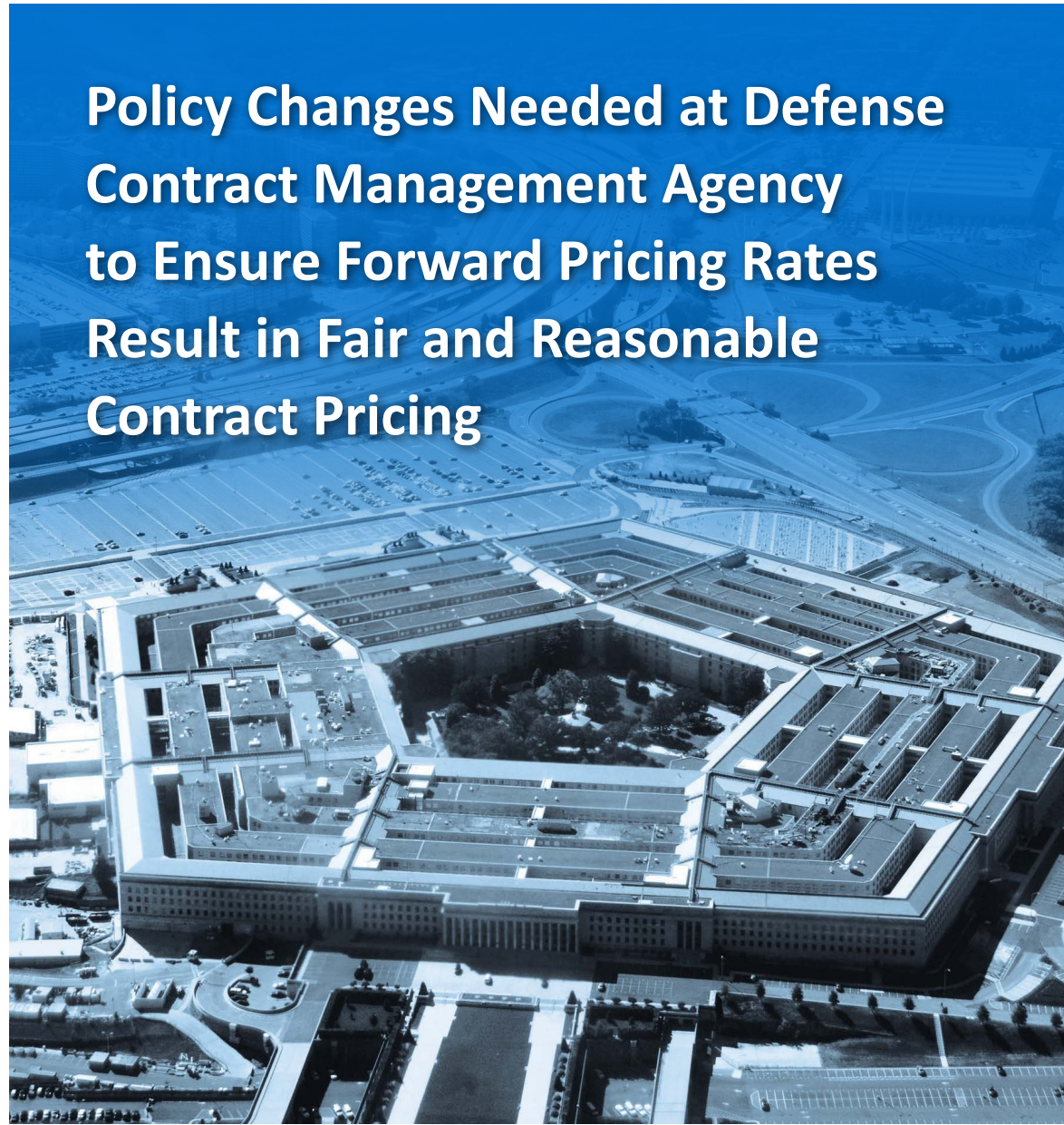




INSPECTOR GENERAL

U.S. Department of Defense

OCTOBER 9, 2014



Policy Changes Needed at Defense Contract Management Agency to Ensure Forward Pricing Rates Result in Fair and Reasonable Contract Pricing

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Results in Brief

Policy Changes Needed at Defense Contract Management Agency to Ensure Forward Pricing Rates Result in Fair and Reasonable Contract Pricing

October 9, 2014

Objective

We reviewed Defense Contract Management Agency (DCMA) forward pricing rate policy and practice for indirect rates for compliance with the Federal Acquisition Regulation (FAR) and DoD policy. DCMA forward pricing rate policy covers the 353 contractor locations where DoD contracting officers use DCMA forward pricing rates to negotiate at least \$70 billion in Government sales.

Findings

DCMA policy does not adequately address Federal Acquisition Regulation (FAR) requirements to (1) perform cost analysis to establish fair and reasonable forward pricing rates, (2) tailor the requests for audit services, and (3) document a contract case file. The case file documentation at the eight sites we visited was not sufficient to demonstrate that use of DCMA forward pricing indirect rates to negotiate an estimated \$4.5 billion in contractor-proposed indirect costs resulted in fair and reasonable contract prices. The contract case files did not demonstrate that the administrative contracting officers (ACOs) had tailored the request for audit services to reflect only the minimum essential supplementary information needed by the ACO to conduct a cost analysis, an action

Findings (cont'd)

that can help ensure that scarce DoD contract administration and contract audit services are used efficiently. Finally, DCMA policy does not require the ACO to establish a contract case file. Without sufficient case file documentation, DCMA cannot demonstrate that use of their forward pricing rates to negotiate at least \$70 billion in Government sales results in fair and reasonable contract prices.

In response to our findings, DCMA revised its policy on July 21, 2014, to require the ACO perform a cost analysis and identify and address any cost analysis techniques and procedures that can be used to ensure fair and reasonable rates.

Recommendations

We recommend that DCMA revise its forward pricing rate policy to require the ACO (1) tailor any requests for audit services in accordance with the FAR, (2) establish, maintain, and dispose of Government contract case files, and (3) provide training on the use of the revised DCMA forward pricing rate policy.

Management Comments and Our Response

The Director, DCMA concurred with our recommendation to establish policy on contract case files and training. Regarding the FAR requirement to tailor a request for audit services, DCMA concurred in principle. Although DCMA identified potential obstacles to promptly implementing corrective actions, these obstacles should not prevent DCMA from appropriately tailoring audit requests in accordance with the FAR. The management comments were responsive and no additional comments are required.

Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Director, Defense Contract Management Agency	None	A, B.1.a, B.1.b, B.2, C.1, and C.2.



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE**
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

October 9, 2014

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY

SUBJECT: Policy Changes Needed at Defense Contract Management Agency (DCMA) to
Ensure Forward Pricing Rates Result in Fair and Reasonable Contract Pricing
(Report No. DODIG-2015-006)

We are providing this report for your information and use. We found that DCMA policy does not adequately address Federal Acquisition Regulation (FAR) requirements to (1) perform cost analysis to establish fair and reasonable forward pricing rates, (2) tailor the requests for audit services, and (3) document a contract case file. DCMA forward pricing rates are used to negotiate at least \$70 billion in Government sales.

We considered management comments when preparing the final report. DCMA concurred with all recommendations but indicated obstacles may prevent implementation of Recommendations B.1.a and B.1.b. We find that application of existing FAR and DoD policy can overcome these obstacles. The comments from DCMA conformed to DoD Directive 7650.3; therefore, we do not require additional comments.

We appreciate the courtesies extended to our staff. Please direct any questions to Ms. Carolyn R. Davis at (703) 604-8877 (DSN 664-8877) or email at Carolyn.Davis@dodig.mil.

A handwritten signature in black ink, appearing to read "R. Stone", is positioned above the name of the Deputy Inspector General.

Randolph R. Stone
Deputy Inspector General
Policy and Oversight

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Introduction

Objective

We performed an oversight review of the actions taken by the Defense Contract Management Agency (DCMA) to establish forward pricing rate recommendations (FPRR) and forward pricing rate agreements (FPRA) for proposed indirect rates and costs¹ at eight large DoD contractor locations. Purchasing supplies and services from responsible sources at fair and reasonable prices is a requirement of Federal Acquisition Regulation (FAR) 15.402, "Pricing Policy." Contracting officers use FPRRs and FPRAs to assist them in this process. Our objective was to evaluate the procedures performed by DCMA administrative contracting officers (ACOs) to establish FPRRs and FPRAs and to evaluate whether those procedures meet the requirements of the FAR and DoD policy. See Appendix A for our scope and methodology.

Background

Indirect Costs

Contractors estimate and incur direct and indirect costs when performing Government contracts. The Defense Acquisition University's Acquisition Community Connection website provides Contract Pricing Reference Guides in five volumes. Volume 4 – "Advanced Issues in Contract Pricing," Chapter 2, "Evaluating Indirect Costs," paragraph 2.1.1, describes a typical indirect cost as follows:

Costs that **cannot** be specifically identified with the production or sale of a particular product or completion of a single contract. In accounting terms, these costs cannot be identified with a single final cost objective. Instead they are identified with two or more final cost objectives or an intermediate cost objective.

Defense Contract Management Agency

FAR Part 42, "Contract Administration and Audit Services," assigns the ACO the contract administration function of negotiating forward pricing rate agreements. DoD Directive 5105.64, "Defense Contract Management Agency (DCMA)," states that DCMA shall perform contract administration services for DoD and others, as authorized.

¹ For this review, we focused on actions taken by DCMA ACOs to establish forward pricing rates for contractor-proposed overhead costs, fringe benefit costs, and general and administrative expenses.

FPRRs and FPRAs in Pricing Negotiated Government Contracts

DCMA Instruction 130, “Forward Pricing Rates,” states that a FPRR or FPRA shall be established for all contractors with more than \$200 million in negotiated Government sales in the prior contractor fiscal year. DCMA has identified 353 contractor locations that meet this standard. At a minimum of \$200 million per contractor location, these 353 contractor locations accounted for at least \$70 billion in negotiated Government sales.²

For this review, we selected eight contractor locations where DCMA had established an FPRR or FPRA. Based on information provided by the DCMA ACO at each location, we estimated that these eight contractors had a total of \$21.5 billion in negotiated Government sales during the periods covered by the particular FPRR or FPRA (see Table 1).

Table 1. DCMA-Identified Value of Negotiated Government Sales at the Eight Contractor Locations Visited

Contractor	Rate Vehicle (Note)	Negotiated Government Sales (billions)
Lockheed Martin Missiles & Fire Control, Orlando	FPRA	\$ 2.7
Raytheon Missile Systems	FPRR	4.1
Bell Helicopter-Textron, Inc.	FPRR	2.3
Boeing Integrated Logistics & Training	FPRR	1.0
General Atomics Aeronautical Systems, Inc.	FPRA	1.9
BAE Systems Land & Armaments L.P. – York	FPRR	1.6
Northrop Grumman Information Systems	FPRR	6.4
L-3 Communications Mission Integration Division	FPRR	1.5
Total		\$21.5

Note: FPRA refers to a Forward Pricing Rate Agreement and FPRR refers to a Forward Pricing Rate Recommendation.

² The Director, Cost and Pricing Policy, DCMA, advised the OIG that DCMA does not compile (1) the value of negotiated Government sales in its management information system for the contractor locations that meet the dollar criteria for establishing forward pricing rates or (2) the value of proposed indirect costs that were negotiated based on the use of its FPRRs and FPRAs.

Finding A

DCMA Forward Pricing Rates Did Not Demonstrate Fair and Reasonable Contract Prices

The DCMA case file documentation we reviewed did not demonstrate that the DCMA forward pricing indirect rates used to negotiate an estimated \$4.5 billion³ in contractor-proposed indirect costs resulted in fair and reasonable contract prices. Without sufficient case file documentation, we cannot provide a reliable estimate of the monetary impact that use of the DCMA FPRRs and FPRAs may have had on the prices negotiated by Government contracting officers for the proposed indirect costs. Additionally, DCMA forward pricing rate policy does not adequately address the FAR requirements to perform a cost analysis to establish fair and reasonable FPRR or FPRA rates at the 353 locations where DCMA administers forward pricing rates. FAR 15.402, Pricing Policy, states that contracting officers shall purchase supplies and services from responsible sources at fair and reasonable prices. Inadequate forward pricing rate policy at DCMA can jeopardize DoD checks and balances used to ensure that at least \$70 billion in negotiated U.S. Government sales result in fair and reasonable contract prices for DoD and the taxpayer.

³ See Appendix A, Scope and Methodology, Table A-1 *Estimated Value of Proposed Indirect Costs at the Eight Locations*.

Indirect Cost Allocation Rates

Contractors allocate indirect costs to their Government contracts through the use of indirect cost allocation rates. Regarding how indirect cost rates are developed, the Defense Acquisition University in its Contract Pricing Reference Guide, Volume 3 – “Cost Analysis,” Chapter 9, “Analyzing Indirect Costs,” paragraph 9.1, states:

Indirect cost rates are expressed in terms such as dollars per hour or percentage of cost. Indirect cost rates are calculated for each accounting period by dividing a pool of indirect cost for the same period by the allocation base (e.g., direct labor hours or direct labor cost) for the same period.

The Guide, paragraph 2.2, also states:

Once a rate is established, you can use it to determine the amount of indirect cost that should be allocated to the contract. Simply multiply the rate by the estimated or actual base in the contract for that period. Contracts with a greater share of the allocation base (e.g., direct labor dollars) will be charged a greater share of the related indirect cost pool (e.g., manufacturing overhead). Contracts with a smaller share of the base will be charged a smaller share of the related indirect cost pool.

Forward Pricing Rate Recommendations and Agreements

The Glossary, DCMA Instruction 130, “Forward Pricing Rates,” defines a FPRR as:

[A] set of rates and factors unilaterally established by the ACO for use by the Government in negotiations or other contract actions when: (a) FPRA negotiations have not been completed; (b) when the contractor will not agree to a FPRA; (c) if the audit report is not consistent with a current FPRA or FPRR . . . ; or (d) as an alternative when an FPRA is not in the best interest of the Government.

In the same Instruction, DCMA defines, in part, a FPRA as:

[A] written agreement negotiated between a contractor and the Government to make certain rates, factors or other allocation methods available for use in pricing contracts, modifications, and other contractual actions that will be performed during the period covered by the agreement. The FPRA or FPRR should represent reasonable projections of specific costs that are not easily estimated, identified with or generated by a specific contract end item or task. The FPRA or FPRR could include rates for direct labor, indirect costs, general and administrative expenses, and cost of money factors.

FAR Criteria

FAR 42.1701(b) requires that the ACO shall obtain the contractor’s forward pricing rate proposal and require that it includes cost or pricing data that are accurate, complete, and current as of the date of submission. When a contracting officer receives a proposal submitted with certified cost or pricing data, FAR 15.404-1(a)(3) requires that “cost analysis shall be used to evaluate the reasonableness of individual cost elements when certified cost or pricing data are required.” When performing cost analysis, FAR 15.404-1(c)(2) states:

The Government may use various cost analysis techniques and procedures to ensure a fair and reasonable price, given the circumstances of the acquisition. Such techniques and procedures include the following:

- (i) Verification of cost data or pricing data and evaluation of cost elements, including—
 - (A) The necessity for, and reasonableness of, proposed costs, including allowances for contingencies...

FAR 15.404-1(c)(2) provides five additional subdivisions that identify multiple cost analysis techniques and procedures that a contracting officer may use to establish that a contractor’s proposal is fair and reasonable (See Appendix B).

DCMA Policy

DCMA Instruction 130, “Forward Pricing Rates,” establishes policies, assigns responsibilities, and provides procedures for developing and monitoring FPRRs and FPRAs. Chapter 3, “Procedures,” paragraph 3.3.1, “Conduct Proposal Analysis,” states that:

The objective of the analysis is to determine whether the ACO may accept the contractor’s proposed rates as being fair and reasonable.

The Instruction lists five techniques and procedures that the ACO shall include as a minimum in their analysis. In Appendix B we have listed the five DCMA procedures as well as the cost analysis techniques and procedures provided at FAR 15.404-1(c)(2).

We identified the following policy inadequacies in DCMA Instruction 130, “Forward Pricing Rates,” that diminish the likelihood that the ACO will perform sufficient cost analysis techniques and procedures to demonstrate fair and reasonable contract pricing. DCMA Instruction 130, “Forward Pricing Rates,” does not clearly address:

- the requirement identified at FAR 15.404-1(a)(3) that cost analysis⁴ shall be used to evaluate the reasonableness of individual cost elements when certified cost or pricing data are required.
- the cost analysis techniques and procedures, including those identified in Appendix B, that the ACO needs to perform to establish that a DCMA forward pricing rate recommendation will demonstrate fair and reasonable pricing.
- the cost analysis techniques and procedures, including those identified in Appendix B, that the ACO needs to perform to establish that a DCMA forward pricing rate agreement will demonstrate fair and reasonable pricing.

DCMA Practice at Eight Contractor Locations

We visited eight contractor locations and held fact finding sessions with the DCMA ACO.⁵ Significant findings resulting from the site visits included the following:

- At six of eight locations, DCMA was not able to demonstrate with case file documentation (i), the cost analysis techniques and procedures performed

⁴ FAR 15.404-1(c)(1) states that cost analysis is the review and evaluation of any of the separate cost elements and profit or fee in a contractor’s proposal as needed to determine a fair and reasonable price.

⁵ At each fact-finding session, the acquisition policy in FAR 15.4 was discussed and the ACO was given the opportunity to demonstrate with existing documentation how they had met the policy. The results of the fact-finding were shared with each ACO and each ACO was given a second opportunity to demonstrate with case file documentation that they had met the FAR policy. In each case, at the culmination of the site visit the ACO acknowledged concurrence with the OIG observations.

to verify the contractor's cost or pricing data (FAR 15.404-1(c)(2)(i)) and (ii) the cost analysis techniques and procedures used to evaluate the necessity for, and reasonableness of proposed costs (FAR 15.404-1(c)(2)(i)(A)).

- At three of eight locations, DCMA was not able to demonstrate with case file documentation the cost analysis techniques and procedures used to compare costs proposed by the offeror for individual cost elements with actual costs previously incurred by the same offeror (FAR 15.404-1(c)(2)(iii)(A)).
- At six of eight locations, DCMA was not able to demonstrate with case file documentation the cost analysis techniques and procedures used to compare costs proposed by the offeror for individual cost elements with forecasts of planned expenditures (FAR 15.404-1(c)(2)(iii)(E)).
- At seven of eight locations, DCMA was not able to demonstrate with case file documentation the cost analysis techniques and procedures used to verify that the contractor's rate proposal was in accordance with the contract cost principles and procedures in FAR Part 31 and, when applicable, the requirements and procedures in 48 Code of Federal Regulations Chapter 99 (Appendix to the FAR loose leaf edition), Cost Accounting Standards (FAR 15.404-1(c)(2)(iv)).

At each location, the DCMA ACOs was not able to demonstrate that they had performed any other cost analysis technique or procedure, including those identified at paragraph 3.3.1 of DCMA Instruction 130, "Forward Pricing Rates," to attain the same result. Additionally, in only one instance did the DCMA ACO have a working knowledge of the cost model used by the contractor to estimate its proposed forward pricing indirect rates.

DCMA policy should direct ACOs to perform a cost analysis. It should identify the minimum cost analysis techniques and procedures that should be performed to demonstrate that use of a DCMA FPRR or FPRA will result in fair and reasonable contract prices, a requirement of FAR 15.402. With adequate DCMA policy direction, DoD contracting officers will be better positioned to negotiate fair and reasonable contract prices for the Government and taxpayer on at least \$70 billion in negotiated Government sales.

Management Actions Taken

On July 21, 2014, DCMA revised Instruction 130, "Forward Pricing Rates." The revisions address the requirement to perform cost analysis. They identify and address cost analysis techniques and procedures, including those identified in FAR 15.404-1(c)(2), that can be used to ensure fair and reasonable rates. The Instruction also includes the mandatory use of two checklists that were developed in order to incorporate the DoDIG findings; the FPRP Adequacy Checklist and the FPRA Review checklist.

Recommendation, Management Comments, and Our Response

Recommendation A

We recommend the Director, DCMA, provide training to the ACO community on the use of cost analysis to determine fair and reasonable FPRR and FPRA rates.

Director, Defense Contract Management Agency Comments

The Director, DCMA concurred to the recommendation and is implementing classroom and on the job training to improve the cost analyst skill set of the ACO community.

Our Response

The management comments to the recommendation are responsive and no additional comments are required.

Finding B

ACOs Did Not Tailor Requests for Audit Services to Reflect the Minimum Information Needed to Perform a Cost Analysis

FAR 15.404-2 states that a contracting officer should request field pricing assistance, which may include audit, when the information available at the buying activity is inadequate to determine a fair and reasonable price. It requires that contracting officers tailor the request to reflect the minimum essential supplementary information needed to conduct a cost analysis. The DCMA case file documentation that we reviewed did not demonstrate the requirement that the ACO tailor the request for audit services. Additionally, DCMA's forward pricing rate policy does not adequately address this requirement. DCMA has established a 30-day target for issuing a FPRR and a 60-day target for issuing a FPRA after receipt of a contractor forward pricing rate proposal. Defense Contract Audit Agency (DCAA) took at least 163 days to provide an audit report at the five locations where DCAA responded to the ACO request. A tailored request for audit services can ensure that scarce DoD contract administration and contract audit services are used effectively and efficiently. It can also increase the likelihood that DCMA will receive a timely report from the auditor that addresses only the minimum essential supplementary information needed by the ACO to demonstrate that the DCMA FPRR and FPRA rates are fair and reasonable.

FAR Criteria

FAR 15.404-2, "Data to Support Proposal Analysis," provides guidance to the contracting officer when requesting field pricing assistance, which may include audit assistance. It states that the contracting officer:

- should request field pricing assistance when the information available at the buying activity is inadequate to determine a fair and reasonable price,
- shall tailor requests to reflect the minimum essential supplementary information needed to conduct a cost analysis, and
- shall tailor the type of information and level of detail requested by the buying activity in accordance with the specialized resources available as well as the magnitude and complexity of the required analysis.

DCMA Policy

DCMA Instruction 130, "Forward Pricing Rates," Chapter 3, "Procedures", paragraph 3.3.2.1, "DCAA Audit", subparagraph 3.3.2.1.1, "Request", states that:

The [ACO] may request a DCAA audit when the contractor submits a rate proposal [...] and the [ACO] determines that functional support from audit is required to support a sound rate position for negotiation. While awaiting the results of the audit, if delay of issuing the audit report is anticipated, the [ACO] shall continue to analyze and develop a negotiation objective and proceed to establish an FPRR as a minimum.

We identified the following policy inadequacies in DCMA Instruction 130, "Forward Pricing Rates," that diminish the likelihood that the ACO will tailor a request for audit services in accordance with FAR 15.404-2. DCMA Instruction 130, "Forward Pricing Rates" does not address the requirements identified at:

- FAR 15.404-2(a)(1) that the contracting officer shall tailor audit requests to reflect the minimum essential supplementary information needed to conduct a cost analysis, and
- FAR 15.404-2(a)(2) that the contracting officer must tailor the type of information and level of detail requested in accordance with the specialized resources available at the buying activity and the magnitude and complexity of the required analysis.

DCMA Practice at Eight Contractor Locations

The DCMA case file documentation at the eight contractor locations we visited did not demonstrate that the ACO had tailored the request for audit services to reflect the minimum essential supplemental information needed to perform a cost analysis, a requirement of FAR 15.404-2(a)(1). At none of the eight locations did we find that the request for audit had been tailored to reflect the minimum essential supplementary information needed to conduct a cost analysis. Likewise, the case file documentation did not demonstrate that the ACO had tailored the type of information and level of detail requested in accordance with the specialized resources available and the magnitude and complexity of the required analysis.

Regarding audit services, DCAA stated that they will complete the audit of the contractor's forward pricing rate proposal (FPRP) in as short a timeframe as possible while meeting generally accepted government auditing standards. DCAA will provide real-time communication of audit findings to the ACO throughout the audit process but their audits are not impacted by the 30 and 60 day periods

established by DCMA for completion of rate recommendations and agreements. They confirmed that DCAA audit policy is to generally perform limited scope audits and agreed-upon procedures when requested by the ACO. Table 2 identifies the number of FPRP audit reports issued in FYs 2012 and 2103⁶ and the average number of elapsed days between the start of the request for audit and the issuance of the report.

Table 2. DCAA Audit Reports Issued on Contractor FPRPs

Fiscal Year	No. of Audit Reports	Elapsed Days
2012	428	177
2013	412	189

A tailored request for audit can help direct DCAA audit effort to those areas where the ACO has identified the need for specialized audit resources. It can also help the ACO conduct cost analyses while obtaining the minimum essential supplementary information required for the job. Tailored requests for audit can also minimize the potential for duplication of proposal review activities by the ACO and the auditor.

DoD contracting officers need timely, FAR-compliant DCMA forward pricing rates to negotiate fair and reasonable contract prices. DCMA has established 30 and 60 day targets to meet this need. Tailored requests for audit services can help DCMA meet these targets while providing FPRRs and FPRAs that demonstrate fair and reasonable pricing.

Recommendation, Management Comments, and Our Response

Recommendation B.1

We recommend the Director, DCMA:

Evaluate DCMA Instruction 130, “Forward Pricing Rates,” and, where applicable, revise it to:

- a. Address the FAR 15.404-2(a)(1) requirement that the ACO shall tailor the request for audit services to reflect the minimum essential supplementary information needed to conduct a cost analysis.**

⁶ DCAA stated that they had issued revised audit policy on FPRP audits in FY 2012. Audits started after the revised guidance was issued have been completed on average in 145 days.

Director, Defense Contract Management Agency Comments

The Director, DCMA, concurred in principle. DCMA identified two obstacles that, in its opinion, could prevent implementation of FAR 15.404-2(a)(1) at this time. First, DCMA stated it cannot dictate or restrict the DCAA auditor's scope and procedures. Second, the Director stated that DCAA will currently not agree to a tailored request if it needs to rely on work performed by DCMA. DCMA pointed out that it is conducting a pilot project involving the DCMA cost monitoring program to in part evaluate the feasibility of DCAA accepting a tailored audit request. DCMA stated it will amend its policy, as appropriate, based on the results of the pilot.

Our Response

The management comments to the recommendation are responsive and no additional comments are required. We will monitor the DCMA actions resulting from the pilot project for compliance with FAR 15.404-2(a)(1).

To reiterate, DCMA is required to tailor its request for audit services in accordance with FAR 15.404-2(a)(1). The obstacles identified by DCMA should not prevent the ACO from timely implementing the recommendation. The ACO's responsibility to tailor the audit request does not equate to dictating the scope and depth of the audit. Appropriately tailoring an audit request to meet the ACO's needs does not equate to dictating the scope and depth of the audit. In addition, existing DCAA policy does address instances when the auditor should recommend to the contracting officer additional audit procedures beyond the tailored request. However, DCAA Contract Audit Manual 9-103.1.d(4) points out that the final decision for specific cost information rests with the contracting officer.

- b. Address the FAR 15.404-2(a)(2) requirement that the ACO shall tailor the type of information and level of detail requested in accordance with the specialized resources available and the magnitude and complexity of the required analysis.**

Director, Defense Contract Management Agency Comments

The Director, DCMA, agreed. DCMA covered the FAR requirement in the latest version of DCMA Instruction 130.

Our Response

The management comments to the recommendation are responsive and no additional comments are required.

Recommendation B.2

Provide training to the ACO community on the FAR requirement to tailor the request for audit services.

Director, Defense Contract Management Agency Comments

The Director, DCMA concurred to the recommendation and will provide training based on the results of the pilot project.

Our Response

The management comments to the recommendation are responsive and no additional comments are required.

Finding C

DCMA Policy Can Better Identify the Requirements of a Contract Case File for Forward Pricing Rates

The DCMA ACOs at the eight locations we reviewed could not provide a DCMA policy requiring they establish a contract case file for the FPRRs and FPRAs that were used to negotiate an estimated \$4.5 billion in contractor proposed indirect costs. FAR Subpart 4.8 – “Government Contract Files,” states that the head of each office performing contract administration functions shall establish files containing the records of all contractual actions. DCMA policy does not identify the case file documentation that is required to demonstrate the cost analysis techniques and procedures performed by the ACO to determine fair and reasonable forward pricing rates. Without sufficient case file documentation, DCMA is not positioned to demonstrate to Congress the actions taken to oversee the expenditure of least \$70 billion in DoD contract funds.

FAR Criteria

FAR Subpart 4.8 – “Government Contract Files” prescribes requirements for establishing, maintaining, and disposing of contract files and provides that the head of each office performing contracting, contract administration, or paying functions shall establish files containing the records of all contractual actions.⁷ Examples of the records normally required in contract files are cost analysis and data and information related to the contracting officer’s determination of a fair and reasonable price. Additionally, FAR 15.406-3, “Documenting the Negotiation,” requires that the contracting officer shall document in the contract file the principal elements of the negotiated agreement.

DCMA Policy

DCMA Instruction 130, “Forward Pricing Rates,” includes policy for documenting disagreements with the auditor, the ACO’s prenegotiation objectives, and rate monitoring activities. Paragraph 3.4, “Document and Review Prenegotiation Objectives,” identifies the requirement that the ACO prepare the pre-negotiation memorandum (PNOM) and that the PNOM shall be approved prior to negotiation of a FPRA or the issuance of a FPRR. DCMA policy also makes available a standard PNOM template. Regarding records management, DCMA Instruction 130, “Forward Pricing Rates,” provides that all FPRR or FPRA supporting materials shall be retained in accordance with DCMA Instruction 809, “Records Management.”

⁷ FAR 4.802 describes what a contract file should generally consist of and provides that, if appropriate, the contracting office and contract administration contract files may be combined; e.g., if all or any combination of functions are performed by the same office.

We identified the following policy inadequacies in DCMA's record management policy that diminish the likelihood the ACO will document the contract file in accordance with the requirements of FAR Subpart 4.8, "Government Contract Files."

- DCMA Instruction 130, "Forward Pricing Rates," does not require the ACO to document and include in the contract case file the cost analysis performed by the ACO to determine fair and reasonable rates.
- DCMA Instruction 130, "Forward Pricing Rates," does not require the ACO to include in the contract case file the data and information related to the contracting officer's determination of fair and reasonable prices.
- The standard PNOM template, Section I, "Cost Analysis," does not include reference to any cost analysis techniques and procedures performed by the ACO.
- DCMA Instruction 809, "Records Management," does not provide policy for establishing, maintaining, and disposing of Government contract case files sufficient to constitute a complete history of a FPRR and FPRA transaction.

DCMA Practice at Eight Contractor Locations

During our site visits to the eight DCMA locations, we made the following observation:

- At all eight locations, the ACO could not provide a DCMA policy that included a requirement to establish a contract case file containing the complete record of all contractual actions as they relate to the FPRR and FPRA.

With clear policy, DCMA ACOs can be in a position to establish a contract case file that complies with the requirements of FAR Subpart 4.8. Such a contract case file can provide a record of the actions the ACO has taken to establish fair and reasonable FPRR and FPRA rates that contracting officers use to negotiate at least \$70 billion in negotiated Government sales at the 353 locations where DCMA administers forward pricing rates.

Management Actions Taken

On July 21, 2014, DCMA revised Instruction 130, "Forward Pricing Rates." The revision addresses the need for the ACO to include in the contract case files the cost analysis techniques and procedures that were performed to determine fair and reasonable FPRR and FPRA rates.

Recommendation, Management Comments, and Our Response

Recommendation C.1

We recommend the Director, DCMA:

Evaluate DCMA Instruction 809, “Records Management,” and, where applicable, revise it to comply with FAR Subpart 4.8, “Government Contract Files” when establishing, maintaining, and disposing of Government contract case files sufficient to constitute a complete history of an FPRR or FPRA transaction.

Director, Defense Contract Management Agency Comments

The Director, DCMA concurred to the recommendation and is rescinding and revising DCMA policy to comply with FAR Subpart 4.8 and ensure the proper handling of Government contract case files.

Our Response

The management comments to the recommendation are responsive and no additional comments are required.

Recommendation C.2

Provide training to the ACO community on (1) the need to document in the contract case file the cost analysis performed and the data and information related to the contracting officer’s determination of fair and reasonable FPRR and FPRA rates, (2) the use of the revised PNOM template, and (3) any revisions made to DCMA Instruction 809, “Records Management,” to ensure the Government contract case file is sufficient to constitute a complete history of an FPRR or FPRA transaction.

Director, Defense Contract Management Agency Comments

The Director, DCMA concurred to the recommendation and will provide training on the need to document in the case file the cost analysis performed, the use of the revised PNOM template, and the changes resulting from the revised policy.

Our Response

The management comments to the recommendation are responsive and no additional comments are required.

Appendix A

Scope and Methodology

We conducted this review from May 2013 through March 2014 in accordance with the Council of the Inspectors General on Integrity and Efficiency “Quality Standards for Inspection and Evaluation.” As part of the review, we selected eight contractor locations where DCMA administers forward pricing rates from a listing of DCAA price proposal audit reports issued between October 2011 and February 2013. Our selection of the eight locations was based on our consideration of dollar value of the contractor proposals submitted to the U.S. Government and the military service (Army, Navy or Air Force) making the procurement.

To estimate the amount of proposed indirect costs included in the negotiated Government sales, we judgmentally selected a high-dollar firm-fixed price contract proposal submitted to the Government for each contractor identified in Table 1 of this report. The eight proposals had an average proposed price of \$1.2 billion and ranged in proposed price from \$296 million to \$2.5 billion. For these eight proposals, the proposed indirect costs equaled approximately \$1.9 billion of the total proposed price of approximately \$8.9 billion, or 21 percent of the total proposed price. As reflected in Table A-1, we roughly estimate that the DCMA FPRRs and FPRAs we reviewed were used as the basis to negotiate approximately \$4.5 billion in contractor proposed indirect costs at the eight locations.

Table A-1. Estimated Value of Proposed Indirect Costs at the Eight Locations

Value of negotiated Government sales, eight locations:	\$21.5 billion
Percent of proposed indirect costs to proposed price	21 %
Estimated value of indirect costs included in negotiated Government sales	\$4.5 billion

The 21 percent factor provides a rough-order-of-magnitude estimate of proposed indirect costs for use in determining a potential magnitude of indirect cost dollars in the Forward Pricing Rate arena. As stated in Footnote 2, DCMA does not compile this information. As shown in Table A-2, we estimate the value of indirect costs to be roughly \$14.7 billion for all 353 contractor locations where DCMA administers forward pricing rates.

Table A-2. Non-statistical Approximation of Proposed Indirect Costs Negotiated Using DCMA Provided FPRA and FPRR Indirect Rates

Estimated value of negotiated Government sales at the 353 contractor locations where DCMA establishes forward pricing rates:	\$70 billion
Percent of proposed indirect costs to proposed price at eight locations reviewed:	21 %
Non-statistical approximation of negotiated indirect costs	\$14.7 billion

DCMA also establishes FPRRs and FPRAs for contractor proposed direct labor costs, facilities capital cost of money and other cost estimating factors, depending upon the contractor and the needs of the contracting officers. We did not review these rates and factors as part of this review.

Use of Computer-Processed Data

In selecting audits, we relied on a DCAA FY 2012 and FY 2013 listing of reports generated from the DCAA Management Information System. We did not selectively test the listing for accuracy and completeness.

In obtaining negotiated Government sales data at the eight contractor locations we visited, we relied upon information provided by the DCMA ACOs. We did not selectively test the negotiated Government sales data for accuracy and completeness.

In obtaining information on the number of FPRP audit reports issued by DCAA, we relied upon information generated from the DCAA Management Information System. We did not selectively test the listing for accuracy and completeness.

Prior Coverage

During the last 5 years, the DOD IG has issued one report related to the cost analysis performed by DCMA. The unrestricted DoD IG report can be accessed at <http://www.dodig.mil>.

DoD IG Report No. DODIG-2013-015, "Actions to Align Defense Contract Management Agency and Defense Contract Audit Agency Functions," November 13, 2012

Appendix B

Identification of Cost Analysis Techniques and Procedures Included in the FAR and in DCMA-Instruction 130, “Forward Pricing Rates”

1. FAR 15.404-1 “Proposal Analysis Techniques,” (c) “Cost Analysis,” Paragraph (2) provides regulatory guidance on the use of cost analysis techniques and procedures, as follows:

The Government may use various cost analysis techniques and procedures to ensure a fair and reasonable price, given the circumstances of the acquisition. Such techniques and procedures include the following:

- (i) Verification of cost data or pricing data and evaluation of cost elements, including—
 - (A) The necessity for, and reasonableness of, proposed costs, including allowances for contingencies;
 - (B) Projection of the offeror’s cost trends, on the basis of current and historical cost or pricing data;
 - (C) Reasonableness of estimates generated by appropriately calibrated and validated parametric models or cost-estimating relationships; and
 - (D) The application of audited or negotiated indirect cost rates, labor rates, and cost of money or other factors.
- (ii) Evaluating the effect of the offeror’s current practices on future costs. In conducting this evaluation, the contracting officer shall ensure that the effects of inefficient or uneconomical past practices are not projected into the future. In pricing production of recently developed complex equipment, the contracting officer should perform a trend analysis of basic labor and materials, even in periods of relative price stability.
- (iii) Comparison of costs proposed by the offeror for individual cost elements with—
 - (A) Actual costs previously incurred by the same offeror;
 - (B) Previous cost estimates from the offeror or from other offerors for the same or similar items;

- (C) Other cost estimates received in response to the Government's request;
 - (D) Independent Government cost estimates by technical personnel; and
 - (E) Forecasts of planned expenditures.
- (iv) Verification that the offeror's cost submissions are in accordance with the contract cost principles and procedures in FAR Part 31 and, when applicable, the requirements and procedures in 48 CFR Chapter 99 (Appendix to the FAR loose leaf edition), Cost Accounting Standards.
 - (v) Review to determine whether any cost data or pricing data, necessary to make the offeror's proposal suitable for negotiation, have not been either submitted or identified in writing by the offeror. If there are such data, the contracting officer shall attempt to obtain and use them in the negotiations or make satisfactory allowance for the incomplete data.
 - (vi) Analysis of the results of any make-or-buy program reviews, in evaluating subcontract costs (see FAR 15.407-2).
2. DCMA Instruction 130, "Forward Pricing Rates," provides at Chapter 3, "Procedures," paragraph 3.3.1, "Conduct Proposal Analysis," that:
- 3.3.1. The objective of the analysis is to determine whether the ACO may accept the contractor's proposed rates as being fair and reasonable. The analysis shall include at a minimum an assessment of whether:
 - 3.3.1.1. The contractor's bases of estimates are reasonable.
 - 3.3.1.2. The supporting cost or pricing data are current, accurate, and complete as of the date of submission (FAR 42.1701, paragraph (b) (Reference (d))).
 - 3.3.1.3. The contractor's estimating practices comply with the contractor's disclosed or established cost accounting practices. Potential Cost Accounting Standard (CAS) non-compliance issues will be addressed during the CAS administration process and will not impede the establishment of FPRR/FPRAs.
 - 3.3.1.4. Projected business volume, allocation bases, and indirect costs are reasonable and consistent with contractor and customer business projections.
 - 3.3.1.5. Rate computations are mathematically correct.

Management Comments

Defense Contract Management Agency Comments



DEFENSE CONTRACT MANAGEMENT AGENCY
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FORT LEE, VA 23801-1809

SEP 11 2014

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL, AUDIT POLICY AND
OVERSIGHT, OFFICE OF THE INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Response to DODIG Draft Report, "Policy Changes Needed at Defense Contract
Management Agency to Ensure Forward Pricing Rates Result in Fair and Reasonable
Contract Pricing," August 13, 2014 (Project No. D2013-DAP0CF-0081.001)

The attached is in response to the subject DODIG draft report dated August 13, 2014 that
addresses the DCMA actions taken to implement the recommendations stated in the report.

The Point of contact for this response is Ms. Joan Sherwood, DCMA-AQD, who may be
contacted at (804) 734-0480 or Joan.Sherwood@dcma.mil.


Wendy M. Masello, Lt Gen, USAF
Director

Attachment:

DCMA Response to DODIG Recommended Actions

Defense Contract Management Agency Response to DoDIG Recommended Actions

RECOMMENDATION A: We recommend the Director, DCMA, provide training to the ACO community on the use of cost analysis to determine fair and reasonable FPRR and FPRA rates.

DCMA RESPONSE: We agree with the draft report recommendation. To implement the recommendation, we will and have implemented two different approaches: classroom training and on the job training.

On October 28, 2011, DCMA, and the Defense Acquisition University established the College of Contract Management (CCM) to provide “reduction to practice courses” specifically geared toward training in the skills required by DCMA personnel performing business processes in the contract administration role. A suite of courses currently being developed will teach cost analysis techniques for all proposal pricing and, more specifically, the use of cost analysis to determine fair and reasonable FPRR and FPRA rates. The courses are CMP 200 “Integrated Cost Proposal Evaluation,” CMP 210 “Cost Monitoring,” CMP 210A “Final Indirect Rates,” and CMP 210B “Forward Pricing Rates.” The CCM plans to deploy these courses by the end of calendar year 2015. In addition, the current CPAC 123 – Cost Monitoring Training which is the current DCMA course for new ACOs and cost monitors, will be reinforced by allocating more time to discuss cost analysis techniques.

On the job, where most training takes place, DCMA subjects all FPRA/R pre-negotiation and FPRA post negotiation memorandums to a thorough review at FPRA Boards of Review (BoR) held by the CACO/DACO Group in the Cost and Pricing Center. The BoR includes the review of the cost analyses performed to establish an FPRA/R. The BoR consists of experienced CACOs, DACOs, supervisory price/cost analysts and legal counsel. DCAA personnel are invited to attend and actively participate. Lessons learned regarding the level of cost analysis to support an FPRR/A are shared among the teams and the best practice examples are available to review for establishing fair and reasonable rates. Additionally, the current on the job training will benefit from the use of “FPRP review checklist” which was newly developed and included as a requirement in the most recent update of DCMA Instruction 130 “Forward Pricing Rates” dated July 21, 2014.

RECOMMENDATION B.1.: *Evaluate DCMA Instruction 130, “Forward Pricing Rates,” and, where applicable, revise it to:*

a. Address the FAR 15.404-2(a)(1) requirement that the ACO shall tailor the request for audit services to reflect the minimum essential supplementary information needed to conduct a cost analysis.

b. Address the FAR 15.404-2(a)(2) requirement that the ACO shall tailor the type of information and level of detail requested in accordance with the specialized resources available and the magnitude and complexity of the required analysis.

DCMA RESPONSE: We agree in principle with the draft report recommendation B.1.a.; however we cannot agree to implement the policy recommendation at this time. When an ACO determines audit support is necessary, the scope of the audit should be tailored to cover areas to be reviewed that can best be performed by an auditor. However, DCMA cannot dictate or restrict any audit procedures or audit scopes. Such is within the exclusive purview of DCAA and outside of the control of the ACO. Currently, if an ACO tailors a request to DCAA for a limited review of elements in a forward pricing rate proposal, DCAA will not agree to the tailored request if DCAA has to rely on DCMA's work to cover the areas DCAA determines it needs to audit over and above the tailored request. At the current time, DCAA field audit offices have no guidance regarding relying on the work of a DCMA cost monitoring team in lieu of performing required audit steps.

We want to use advisory experts wisely and only to the extent necessary in conformance with the cited FAR provision. Currently, we are conducting a pilot project with DCAA looking at the DCMA cost monitoring program performance where DCAA might accept a tailored audit request. The outcome hinges on whether DCAA can rely on the work of DCMA cost monitoring teams and under what conditions. A copy of the signed charter for the pilot is attached. If the results of the pilot project drive any DCMA/DCAA process changes, we will amend our policy accordingly. We should be able to make the determination by February 2015.

We agree with draft report recommendation B1.b. and we have adequately addressed the recommendation in the most current version of our policy. On July 21, 2014, we published an annual update of DCMA Instruction 130 "Forward Pricing Rates" and determined the language in the following paragraphs adequate to cover the FAR requirement.

3.3.4.1.1. Request. The ACO or the CMS delegated by the ACO requests a DCAA audit when the contractor submits a rate proposal or updated rate position and the ACO or the CMS determines that functional support from DCAA is required to support a sound rate position for negotiation. If the ACO and/or the CMS determine that a DCAA audit is not necessary because they have the capability to conduct a thorough review, they should justify the decision in the PNOM. While awaiting the results of the audit, if delay in issuing the audit report is anticipated, the ACO and/or the CMS shall continue to analyze and develop a negotiation objective and proceed to establish an FPRR as a minimum.

3.3.4.2. Technical support reviews such as Overhead Should-Cost Reviews, pension/insurance specialists, engineering, industrial specialists, or legal review should be obtained where subject matter expertise is expected to be beneficial to the development of rates. The ACO shall be responsible for determining the need for the reviews and audit.

RECOMMENDATION B.2: Provide training to the ACO community on the FAR requirement to tailor the request for audit services.

DCMA RESPONSE: We agree with the draft report recommendation and will provide training when and if the current process changes as a result of the pilot project conclusions. Please refer to the discussion under draft audit report finding B.1.

RECOMMENDATION C.1: Evaluate DCMA Instruction 809, "Records Management," and, where applicable, revise it to comply with FAR Subpart 4.8, "Government Contract Files" when establishing, maintaining, and disposing of Government contract case files sufficient to constitute a complete history of an FPRR or FPRA transaction.

DCMA RESPONSE: We agree with the draft report recommendation. DCMA INST 809 "Records Management" is to be rescinded, pending memo coordination. The policy, along with DCMA INST 808 "Data Management", will be superseded by an overarching Enterprise Architecture (EA) policy, which will address both records management and data management. The policy will also support FAR Subpart 4.8 when referencing the proper handling of our Government contract case files. The Enterprise Architecture Division has identified 2nd QTR February 2015 as the proposed completion date for the overarching EA policy.

RECOMMENDATION C.2: Provide training to the ACO community on (1) the need to document in the contract case file the cost analysis performed and the data and information related to the contracting officer's determination of fair and reasonable FPRR and FPRA rates,

(2) the use of the revised PNOM template, and (3) any revisions made to DCMA Instruction 809, "Records Management," to ensure the Government contract case file is sufficient to constitute a complete history of an FPRR or FPRA transaction.

DCMA RESPONSE: We agree with the draft report recommendation. As discussed in our response to recommendation A, we will train on the need to document in the case file the cost analysis performed and the use of the revised PNOM template. IT will coordinate any requisite training needed as a result of the release of overarching Enterprise Architecture policy, which will replace DCMA INST 809 "Records Management."

Acronyms and Abbreviations

ACO	Administrative Contracting Officer
CAS	Cost Accounting Standards
DCMA	Defense Contract Management Agency
DCAA	Defense Contract Audit Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DoD	Department of Defense
FPRP	Forward Pricing Rate Proposal
FPRR	Forward Pricing Rate Recommendation
FPRA	Forward Pricing Rate Agreement
FAR	Federal Acquisition Regulation
OIG	Office of Inspector General
PNOM	Pre-negotiation Memorandum

Whistleblower Protection

U.S. DEPARTMENT OF DEFENSE

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