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Acronyms

DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
FAR	Federal Acquisition Regulation
IG	Inspector General



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

April 20, 2007

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
VIRGINIA FIELD OFFICE

SUBJECT: Report on Defense Contract Management Agency Virginia's Actions on Incurred
Cost Audit Reports (Report No. D-2007-6-004)

We are providing this report for your review and comment. We performed this review in accordance with DoD Directive 7640.2, which requires that we monitor and evaluate contract audit follow-up systems in the Department of Defense.

We request that management provide comments that conform to the requirements of DoD Directive 7650.3. Please reconsider your nonconcurrence with Recommendations A.2., A.3., C.1.b., and F.1. Also provide comments on Recommendation F.2., because your response to the draft report did not comment on the recommendation. For Recommendation B., identify the specific quality assurance process DCMA plans to implement in response to the recommendation. For us to consider management comments, we should receive them by June 20, 2007.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to the e-mail address cited in the last paragraph of this memorandum. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. Matters considered by management to be exempt from public release should be clearly marked for Inspector General consideration.

Management comments should indicate concurrence or nonconcurrence with each finding and recommendation. Comments should describe actions taken or planned in response to agreed-upon recommendations and provide anticipated dates for completing the actions. State specific reasons for any nonconcurrence and propose alternative actions, if appropriate.

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Meredith Long-Morin at (703) 604-8739 (DSN 664-8739), meredith.morin@dodig.mil.



Wayne C. Berry
Acting Assistant Inspector General
Audit Policy and Oversight

Table of Contents

Results in Brief	i
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Introduction

Objective	1
Background	1
DoD Directive	1

Findings

A. Assessment of Penalties on Expressly Unallowable Costs	2
Requirement for Assessing Penalties	2
Penalty Assessment	2
Impact on Government	3
Recommendation A	4
B. Actions on Unresolved Costs	6
FAR Requirement	6
Unresolved Costs Identified by DCAA	6
Recommendation B	7
C. Actions on Questioned Direct Costs	7
No Action Taken on Questioned Direct Costs	7
Lack of Coordination With Procurement Office	8
Recommendation C	8
D. Accuracy of Reported Data	9
Data Accuracy Requirements	9
Inaccurate Questioned Costs	9
Incorrect Sustained Questioned Costs	10
Incorrect Status of Audit	10
Incorrect Resolution and Disposition Dates	10
Missing Reportable Audits	10
Recommendation D	11
E. Timeliness of Resolution and Disposition of Audit Reports	11
Timeliness Requirement	11
Untimely Resolution	11
Untimely Disposition	11
Recommendation E	12
F. Adequacy of Negotiation Documentation	12
Documentation Requirements	12
Inadequate Documentation	12
Recommendation F	13

G. Performance Standards and Controls for Contract Audit Follow-up	14
Performance Standards and Measures	14
Internal Controls	14
Recommendation G	15

Appendixes

A. Scope and Methodology	17
B. Disposition of Audits With Unresolved Costs	18
C. Accuracy of Reported Questioned Costs	19
D. Accuracy of Reported Sustained Costs	20
E. Accuracy of Reported Status of Audit	21
F. Accuracy of Reported Resolution and Disposition Dates	22
G. Timeliness of Resolution and Disposition	23
H. Adequacy of Negotiation Memorandums	24
I. Report Distribution	25

Management Comments

Acting Director Defense Contract Management Agency Comments	26
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Results in Brief

April 20, 2007

Defense Contract Management Agency Virginia's Actions on Incurred Cost Audit Reports

What We Did

We reviewed the actions that Defense Contract Management Agency (DCMA) Virginia contracting officers took on 13 of 29 incurred cost audits they reported as complete through disposition during the semiannual reporting periods from September 30, 2003, through March 31, 2005.

What We Found

DCMA Virginia failed to assess penalties of \$3.2 million on expressly unallowable costs and took ineffective actions on \$41 million in questioned direct costs and some of the \$970 million in unresolved costs. In addition, DCMA Virginia inaccurately reported contract audit followup data, and did not timely conduct or adequately document the resolution and disposition of audit reports. Contracting officers did not have enough accountability or management focus on the contract audit followup program.

What We Recommended

DCMA Virginia management needs to assess and collect penalties on expressly unallowable costs and negotiate and recoup outstanding questioned direct costs. DCMA contracting officers should ensure that unresolved costs are audited before accepting them. DCMA Virginia

management should improve the processes for taking timely and proper actions on audit report findings, including holding contracting officers accountable for their actions.

Management Comments

In responding to the January 24, 2007 draft of this report, the DCMA Acting Director concurred with 10 of the 15 recommendations. We request that the DCMA Acting Director reconsider its nonconcurrence with four of the recommendations. In addition, the DCMA Acting Director should provide comments on one recommendation not specifically addressed in the DCMA response to our draft report. We request that DCMA provide management comments to the final report by June 20, 2007.

United States Department of Defense Office of Inspector General
{Project No. D2005-DIPOAI-0252.000}

Introduction

Objective

We evaluated the actions taken by DCMA Virginia to resolve and disposition reportable DCAA incurred cost audit reports for the semiannual reporting periods September 30, 2003, through March 31, 2005. See Appendix A for details regarding our scope and methodology.

Background

Defense Contract Management Agency. DCMA is the Department of Defense (DoD) Component that works directly with Defense suppliers to help ensure that DoD, Federal, and allied government supplies and services are delivered on time at projected cost and meet performance requirements. DCMA, acting through its 50 field offices, resolves and completes the disposition of most contract audit reports for the Army, Navy, Air Force, and Defense Logistics Agency. This report focuses on the DCMA Virginia field office.

Defense Contract Audit Agency (DCAA). DCAA provides audit and financial advisory services to all DoD Components, including DCMA. DCAA issues audit reports resulting from several types of audits of government contracts, including audits of Government contractor incurred costs. The DCMA Virginia field office receives approximately 12 percent of all DCAA audit reports issued to DCMA.

DCAA performs incurred cost audits to determine whether the costs incurred by a contractor and charged on Government contracts are allowable, allocable, and reasonable based on applicable criteria in the Federal Acquisition Regulation (FAR), Defense Federal Acquisition Regulation Supplement, and Cost Accounting Standards.

DoD Directive

DoD Directive 7640.2. DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports," dated February 12, 1988, prescribes DoD policy and procedures for the resolution and disposition of reportable contract audit reports. For incurred cost audit reports showing more than \$100,000 in questioned costs, the Directive requires contracting officers to report on their actions to achieve timely and effective settlement with the contractor or issue a final decision under the Disputes Clause. According to the Directive, the DoD Inspector General (IG) is responsible for evaluating the effectiveness of contract audit follow-up systems implemented at each DoD Component, including DCMA.

DoD Directive 7640.2 also requires all DoD Components to submit semiannual status reports on reportable contract audits to the DoD IG. The DoD IG includes a summary of the status reports for all DoD Components in its Semiannual Report to Congress.

Findings

A. Need to Assess Penalties on Expressly Unallowable Costs

Contracting officers failed to assess penalties or justify a waiver of the penalties on \$3.7 million in expressly unallowable costs as required by FAR Subpart 42.7, “Indirect Cost Rates.” As a result, the Government will lose up to \$3.2 million if penalties are not assessed.

Requirement for Assessing Penalties. The penalty provisions for the submission of expressly unallowable costs are included in United States Code—10 U.S.C. 2324(a) through (d)—and implemented by FAR 42.709. According to 10 U.S.C. 2324(b), a penalty shall be assessed if a contractor submits costs that are expressly unallowable under a FAR cost principle and the costs are included in a proposal for settlement of indirect costs. The first-level penalty is equal to the amount of expressly unallowable costs allocable to contracts covered by 10 U.S.C. 2324(b) (A), plus interest. The second-level penalty is equal to twice the amount of the expressly unallowable costs if the costs were determined by the contracting officer to be unallowable before the contractor submitted a subsequent incurred cost proposal.

According to FAR 42.709-5, the contracting officer shall waive the penalty when one of the following conditions exists.

- The contractor withdraws the proposal before the formal initiation of an audit and submits a new proposal.
- The amount of the unallowable costs subject to penalty is \$10,000 or less.
- The contractor demonstrates that appropriate policies and controls are in place to preclude unallowable costs subject to penalties from being included in indirect cost proposals, and the unallowable costs subject to penalties were inadvertently incorporated in the proposal.

Penalty Assessment. DCAA recommended the assessment of penalties in 12 of 13 incurred cost audits we reviewed at DCMA Virginia. For 5 of the 12 audits with recommended penalties, DCMA Virginia contracting officers did not apply penalties or justify a waiver as required by FAR Subpart 42.7. As shown in Table 1, these five audits identified \$4.9 million in questioned costs that DCAA believed to be expressly unallowable and subject to penalty.

Table 1. DCMA Virginia Contracting Officers Sustained Costs Questioned

Audit Report Number	Disposition Date	DCAA- Questioned Costs Subject to Penalty	Questioned Costs Sustained by Contracting Officers
6311-1999E10110020	4/24/03	\$ 746,047	\$ 746,047
6161-1999T10100002	1/28/04	622,401	622,401
6221-2001R10100051	10/28/03	2,000,000	2,000,000
6161-2000T10100001	11/9/04	961,550	281,066
6161-2001T10100001	3/15/05	578,412	29,425
Total		\$4,908,410	\$3,678,939

The contracting officers sustained¹ \$3,678,939 of the \$4,908,410 questioned costs but did not assess the DCAA-recommended penalties. Examples of the sustained questioned costs that are subject to penalty include:

- \$2,000,000 in reorganization costs associated with a business combination that are expressly unallowable per FAR 31.205-27;
- \$170,700 in expressly unallowable costs subject to a second-level (double) penalty because they were determined to be unallowable before the indirect cost proposal was submitted by the contractor; and
- \$24,093 in airfare costs that were unallowable based on FAR 31.205-46(d) because they exceeded the coach-class rates.

The remaining \$1,229,471 that was not sustained by contracting officers includes idle facility costs and legal and consulting fees. The contracting officers, in consultation with DCAA, accepted those costs based on additional information provided by the contractor during negotiations.

For the first three audits listed in Table 1, contracting officers failed to explain in the contract files why they did not assess penalties. For the remaining two audits, the negotiation memorandums state that penalties would be assessed during the incurred cost negotiations scheduled for the subsequent year (planned for August 2005). More than 1 year has passed, and the contracting officers have not assessed penalties. The contracting officers should have promptly assessed penalties when they determined the costs were unallowable. The failure of contracting officers to assess penalties promptly has allowed the contractor free use of Government funds, which will continue until the penalties are imposed.

Impact on the Government. As detailed in Table 2, we estimate that the Government will lose up to \$3.2 million if the contracting officers assigned to these five audits do not assess penalties.

¹ Questioned costs are sustained when the contracting officer upholds the DCAA determination and does not reimburse the contractor for DCAA questioned costs.

Table 2. Unassessed Penalties Exceed \$3 Million

Audit Report Number	Questioned Costs Agreed to by Contracting Officers	Amount Allocable to Covered Contracts ¹	First-level Penalty ²	Second-level Penalty ²	Total Penalty
6311-1999E10110020	\$ 746,047	\$ 144,733	\$ 144,733	0	\$ 144,733
6161-1999T10100002	622,401	591,281	420,581	\$341,400	761,981
6221-2001R10100051	2,000,000	2,000,000	2,000,000	0	2,000,000
6161-2000T10100001	281,066	267,013	267,013	0	267,013
6161-2001T10100001	29,425	27,954	27,954	0	27,954
Total	\$3,678,939	\$3,030,981	\$2,860,281	\$341,400	\$3,201,681

¹We multiplied the adjusted expressly unallowable costs by the percent of government participation in flexibly priced contracts to estimate the amount allocable to contracts covered by the penalty clause.

²The first-level penalty is equal to the amount allocable to covered contracts, except for Audit Report No. 6161-1999T10100002, which includes \$420,581 subject to first-level penalty, and \$170,700 subject to second-level (double) penalty.

Recommendation, Management Comments and DoD IG Response

Recommendation A. We recommend that the Director, DCMA Virginia:

1. Establish a quality assurance process that requires contracting officers to address penalty recommendations promptly.

Management Comments. The DCMA Acting Director concurred with the recommendation. DCMA Virginia established a new quality assurance process that requires contracting officers to address penalties in both the pre and post-negotiation memorandums. This process will be implemented by the 3rd quarter of FY 2007.

DoD IG Response. We request that DCMA Virginia provide a copy of the quality assurance process being implemented.

2. Direct those contracting officers assigned to the five audits referred to above to take prompt action to assess penalties.

Management Comments. The DCMA Acting Director did not concur to assessing penalties on two of the five audits. Regarding Audit Report No. 6161-1999T10100002, DCMA Virginia will not assess level 2 penalties because level 1 penalties were not previously assessed. Regarding Audit Report No. 6221-2001R10100051, DCMA Virginia will not assess penalties based on a contrary legal opinion which recommended against the assessment of penalties.

DoD IG Response. We accept DCMA's agreement to assess penalties on 3 of the 5 reports. Regarding Audit Report No. 6161-1999T10100002, we request that DCMA reconsider its position in responding to the final report. We disagree with DCMA's basis for not assessing a level 2 penalty. According to FAR 42.709-1(2), a level 2 penalty is appropriate when the disallowed costs were determined to be unallowable prior to the contractor submitting its indirect cost proposal. The FAR does not require that the contracting officer assess a level 1 penalty prior to assessing a level 2 penalty. In addition, the DCMA comments do not indicate whether a level 1 penalty would apply in lieu of a level 2 penalty. Regardless of the appropriate penalty level, the contracting officer must assess penalties for the expressly unallowable costs identified in Audit Report No. 6161-1999T10100002 unless a penalty waiver is justified in accordance with FAR 42.709-5.

Regarding Audit Report No. 6221-2001R10100051, we requested that DCMA Virginia provide a copy of the contrary legal opinion referred to in its response. As of April 17, 2007, DCMA Virginia has not provided the legal opinion for our review and consideration. We request that DCMA provide a copy of the contrary legal opinion in its response to the final report or assess the penalty.

3. Review all dispositions of incurred cost audit reports not covered in this review to determine whether contracting officers properly applied and recouped penalties recommended by the Defense Contract Audit Agency.

Management Comments. The DCMA Acting Director did not concur and stated that the Agency exercised due diligence and met the requirements for disposition of audit reports. According to DCMA Virginia, a majority of the actions taken on the audit reports is backed by a legal opinion on cost disallowance and penalties. The DCMA Acting Director believes the recommendation is not appropriate because it was not vetted with DCMA management or included in the DoD IG discussion draft.

DoD IG Response. We request that DCMA reconsider its position. The recommendation is warranted given that contracting officers failed to address recommended penalties in 42 percent (5 of 12) of the audits we reviewed, resulting in a potential loss to the Government of \$3.2 million. Since the potential for additional penalty losses is high, DCMA Virginia needs to review other dispositions of incurred cost audits to ensure that the Government has recouped all required penalties.

We disagree that the recommendation was not "vetted" with DCMA management. Prior to issuing the draft report, we advised DCMA management that we added the recommendation.

B. Actions on Unresolved Costs

DCMA Virginia contracting officers did not obtain an audit opinion on a portion of the \$970 million in costs DCAA reported as unresolved. In accepting the unresolved costs without an audit opinion, DCMA Virginia contracting officers put the Government at significant risk of paying unallowable costs.

FAR Requirement. FAR 42.705-1(b)(4) states that contracting officers shall not resolve questioned costs until they obtain adequate documentation supporting the costs and the auditor's opinion on the allowability of the costs.

Unresolved Costs Identified by DCAA. In 7 of 13 incurred cost audits, DCAA reported a portion of the costs proposed by the contractor as "unresolved." The DCAA office classified the costs as "unresolved" because it did not receive the results of assist audits² of subcontract costs in time for incorporation into the audit report. Upon receipt of the assist audit results, DCAA will issue an opinion on the allowability of unresolved costs either through a supplemental report or a cumulative allowable cost worksheet³.

One of the contracting officers assigned to five of the seven audits accepted some of the unresolved costs before obtaining an audit opinion on the allowability of those costs. The contracting officer stated that she had relied on the cumulative allowable cost worksheet furnished by DCAA in accepting the contractor's incurred costs, including the unresolved costs. However, the cumulative allowable cost worksheet failed to provide information on the status of assist audits on subcontract costs, as DCAA procedures require. DCAA eventually added information on the status of the subcontract costs to the cumulative allowable cost worksheet, but the contracting officer had already accepted some of the unresolved costs and closed the related contracts. Despite our repeated requests, DCMA said it was unable to determine how much of the \$970 million in unresolved costs was accepted on closed contracts without an audit opinion.

DCAA has recently clarified and enhanced its guidance on tracking and updating the cumulative allowable cost worksheet for the status of subcontract assist audits. These clarifications and enhancements may help prevent the future acceptance of unresolved costs that have not been audited. However, the contracting officer is ultimately responsible for ensuring that all unresolved costs are audited for allowability before accepting them on Government contracts.

² An assist audit involves a DCAA office performing an audit of selected costs (for example, subcontract costs) at the request of another DCAA office.

³ A cumulative allowable cost worksheet is a summary schedule of cumulative allowable contractor costs for each contract through the last year for which indirect cost rates have been negotiated.

Recommendation, Management Comments and DoD IG Response

Recommendation B. We recommend that the Director, DCMA Virginia establish a quality assurance process to prevent contracting officers from accepting unresolved costs until they receive an audit opinion on costs that DCAA reported as unresolved.

Management Comments. The DCMA Acting Director concurred.

DoD IG Response. Although the DCMA response meets the intent of our recommendation, DCMA needs specific procedures to ensure that contracting officers obtain an audit opinion before accepting the unresolved costs on Government contracts.

C. Actions on Questioned Direct Costs

Of the 13 incurred cost audits we reviewed, the 5 audits listed in Table 3 included questioned direct costs. Although DCMA Virginia reported these 5 audits as complete through disposition, 2 audits included \$40.5 million in questioned direct costs that have not been settled (negotiated).

Table 3. Unsettled Direct Costs Remain in Audits Reported as Complete Through Disposition

Audit Report Number	Date of Disposition	Settled Questioned Direct Cost	Unsettled Questioned Direct Costs	Total Questioned Direct Costs
6161-2000T10100001	11/9/04		\$36,969,263	\$36,969,263
6161-2001T10100001	3/15/05		3,507,066	3,507,066
6331-2000F10100779	6/26/04	\$5,287	0	\$5,287
6161-1999T10100002	1/28/04	495,598	0	495,598
6141-1999B10100012	5/24/04	37,496	0	37,496
Total		\$538,381	\$40,476,329	\$41,014,710

No Action Taken on Questioned Direct Costs. The questioned direct costs of \$40.5 million have remained unsettled for at least a year since the reported disposition of the audits, and at least 2 years since DCAA issued the audits. DoD Directive 7640.2 requires that contracting officers take timely and proper actions in response to all audit findings. The contracting officer said the unsettled direct costs would be negotiated when the contracts are complete. However, this approach results in the contractor having free use of Government funds until a contract is complete. Completion of the contract could span several years. Other DCMA Virginia

contracting officers said they negotiate questioned direct costs at the same time as the indirect costs.

Lack of Coordination With Procurement Office. The contracting officer stated that the procurement office is responsible for negotiating the unsettled direct costs. However, the contracting officer had not notified the procurement office of the questioned direct costs. DoD Directive 7640.2, paragraph 6.7, states that the contracting officer is responsible for coordinating with procurement offices to ensure that the questioned costs are addressed. OMB Circular A-50, paragraph 8a(7), states the contract audit follow-up system must provide for coordinating resolution and corrective action on recommendations involving more than one program, agency, or level of Government.

Recommendations, Management Comments, and DoD IG Response

Recommendation C. We recommend that the Director DCMA Virginia:

1. Direct the contracting officer assigned to the two audits with unsettled direct costs to take the following steps immediately:

- a. Work with the procurement office to negotiate the questioned direct costs of \$40.5 million.**

Management Comments. The DCMA Acting Director concurred. The Director DCMA Virginia instructed the contracting officer to reissue the rate letter and clarify that the questioned direct costs have not been negotiated. The contracting officer will distribute the rate letter to affected organizations, including all procurement offices. DCMA Virginia will complete these actions by the 3rd quarter of FY 2007.

DoD IG Response. The management comments meet the intent of our recommendation. DCMA should request that the responsible procurement office provide an estimated date for completing negotiations of the questioned direct costs, and include the estimated date in its response to the final report.

- b. Reinstate the two audits to open status in the contract audit follow-up system until the negotiation of the questioned direct costs is completed and documented in accordance with DoD Directive 7640.2.**

Management Comments. The DCMA Acting Director did not concur. DCMA believes there is no need to reinstate the audits in the contract audit follow-up system because the actions taken on Recommendation C.1.a. will close out the issue for the contracting officer.

DoD IG Response. We request that DCMA reconsider the recommendation in its response to the final report. The audits should remain open in the contract audit follow-up system until negotiation of the questioned direct costs is completed. Including the audits in the contract audit follow-up system will ensure that the status of negotiations is tracked and that the negotiation results are included in the DoD IG Semiannual Report to Congress.

2. Establish a quality assurance process that will provide consistent procedures among contracting officers and require all contracting officers to address all audit findings, including any questioned direct costs, before completing audit disposition.

Management Comments. The DCMA Acting Director concurred.

D. Accuracy of Reported Data

DCMA Virginia does not maintain accurate records of reportable incurred cost audit reports. Our review of 13 incurred cost audits assigned to DCMA Virginia and the contracting officer files describing action on those audits disclosed the following data errors:

- inaccurate questioned costs reported for nine audits,
- incorrectly reported sustained questioned costs for nine audits,
- incorrectly reported status of actions taken for five audits,
- inaccurate disposition dates reported for three audits, and
- missing reportable supplemental audits for two audits.

As a result, DCMA management, the DoD Inspector General, and Congress do not have accurate information on contracting officer actions taken in response to contract audit reports.

Data Accuracy Requirements. DoD Directive 7640.2 requires that DoD Components:

- establish procedures for maintenance of up-to-date records on all reportable contract audits from receipt through disposition, and
- maintain accurate and complete information regarding the status of reportable audit reports from the time reports are received through final disposition.

Inaccurate Questioned Costs. DCMA Virginia incorrectly reported questioned cost amounts for 9 of the 13 incurred cost audits we reviewed. As a result, DCMA Virginia understated the questioned cost amounts by \$17.9 million. (See Appendix C) Of the 9 exceptions, 6 were attributable to contracting officers not ensuring that the reported amounts agreed with the actual amounts shown in the DCAA audit report.

DCAA provides an electronic listing of reportable audit reports to DCMA each month, including the amount questioned for each audit report. Although some of the questioned cost amounts that DCAA provided were inaccurate, DCMA contracting officials are ultimately responsible for the accuracy of information provided for the semiannual reporting. Contracting officers need to ensure the accuracy of the DCAA information by verifying questioned costs against the DCAA audit report before submitting the data used for semiannual reporting.

Incorrect Sustained Questioned Costs. Of the 13 incurred cost audits we reviewed, DCMA Virginia reported 9 incorrectly. DCMA Virginia understated the sustained questioned costs by \$39.4 million. (See Appendix D) For 7 of the 9 exceptions, the contracting officer did not include the unallowable cost as sustained even though the contractor had previously agreed during the DCAA audit that the cost was unallowable. According to DoD Directive 7640.2, paragraph E2.1.5, sustained questioned costs include questioned costs accepted by the contractor as well as those upheld by the contracting officer. For 2 of the 9 exceptions, the contracting officer did not include documentation in the negotiation file showing how the amount reported as sustained was determined.

Incorrect Status of Audit. DCMA Virginia inaccurately reported the status of follow-up actions on 5 of 13 incurred cost audits. (See Appendix E) DoD Directive 7640.2 requires that the status of follow-up actions be reported as unresolved, resolved, complete through disposition, or in litigation.⁴ Inaccurately reporting the status of follow-up actions precludes DoD Component management and the DoD Inspector General from effectively carrying out its responsibilities for monitoring actions taken by contracting officials in accordance with DoD Directive 7640.2.

Incorrect Resolution and Disposition Dates. DCMA Virginia did not accurately report the disposition date for three of the incurred cost audits. Appendix F shows the reported and actual disposition dates by audit report.

Missing Reportable Audits. DCMA Virginia did not include two reportable supplemental audit reports as shown in Table 4, which superseded previously issued audit reports. DCMA Virginia incorrectly reported the questioned costs under the previously issued audit reports. DoD Directive 7640.2, paragraph 6.3.4.2, requires that the questioned costs be reported under the supplemental audit report, not the previously issued report.

⁴ An audit report is considered to be “in litigation” status if an appeal has been filed with the Armed Services Board of Contract Appeals, the United States Court of Federal Claims, or any other Federal or State court.

Table 4. DCMA Virginia Excluded Two Audit Reports

Audit Report Number	Report Date	Questioned Cost
6161-2001B10100003-S2	2/13/04	\$13,124,170
6321-2003B10100001-1	2/1/05	30,569,509

Recommendation, Management Comments, and DoD IG Response

Recommendation D. We recommend that the Director, DCMA Virginia establish quality assurance processes to ensure the accuracy of the data reported in the contract audit follow-up system.

Management Comments. The DCMA Acting Director concurred.

E. Timeliness of Resolution and Disposition of Audit Reports

Contracting officer actions on 5 of 13 incurred cost audits were not completed within the timeframes required by DoD Directive 7640.2. Timely resolution and disposition ensure that the Government promptly recoups unallowable costs, penalties, and interest.

Timeliness Requirement. DoD Directive 7640.2 requires that resolution of audit reports be completed within 6 months and that their disposition be completed within 12 months. Resolution of an audit report takes place when the contracting officer prepares a written action for responding to the reported findings. Disposition generally occurs when the contracting officer reaches a settlement with the contractor on the reported findings or issues a final decision under the Disputes Clause.

Untimely Resolution. Of the 13 reports we reviewed, 4 audits exceeded the 6-month resolution requirement, and the contract file did not include justification for exceeding the requirement. (See Appendix G.)

Untimely Disposition. Contracting officers did not complete the disposition of 5 of the 13 incurred cost audit reports within the required 12 months, including the 4 audits that exceeded the 6-month resolution requirement and 1 additional audit. The contract files also did not include justification for exceeding the 12-month disposition requirement. These 5 audits reported questioned costs of \$24.7 million, including expressly unallowable costs of \$3 million. (See Appendix G.)

Recommendation and Management Comments

Recommendation E. We recommend that the Director, DCMA Virginia establish quality assurance procedures requiring contracting officers and their staff to:

1. resolve and complete the disposition of contract audit reports within the required timeframes, or
2. include adequate written justification in the contract file for any resolutions or dispositions that occur beyond the specified timeframes.

Management Comments. The DCMA Acting Director agreed to take the action recommended.

F. Adequacy of Negotiation Documentation

For 11 of the 13 incurred cost audits we reviewed, the DCMA Virginia contract files either did not include a negotiation memorandum covering the disposition of the reported findings or had a negotiation memorandum that was inadequate. As a result, we were unable to determine the contracting officer's rationale for allowing DCAA questioned costs of \$64.1 million.

Documentation Requirements. Paragraph 6.5 of DoD Directive 7640.2, Notification of Final Disposition of Contract Audit Report," requires the contracting officer to prepare a memorandum covering the disposition of all audit reports. When negotiating indirect cost rates, FAR 42.705-1(b)(5)(iii) requires contracting officers to prepare a negotiation memorandum covering the disposition of all significant matters in the audit report, along with reasons why any recommendations made by the auditor were not followed.

Inadequate Documentation. The contract files for seven of the incurred cost audits did not have a negotiation memorandum. The contract files for the six remaining audits had negotiation memorandums, but four were inadequate.

- Two did not address all the audit findings and recommendations or provide enough detail or rationale to support the negotiation position.
- One did not cover recommended penalties or include questioned costs that the contractor agreed to during the audit.
- One did not include questioned costs that the contractor agreed to during the audit.

For the 11 audits with inadequate documentation, DCAA had questioned \$64.1 million in proposed costs that were not sustained by contracting officers. (See

Appendix H.) Contracting officers did not maintain adequate documentation to explain why they did not sustain the \$64.1 million questioned costs.

The negotiation memorandum is important because it serves as the primary means of documenting and reviewing actions the contracting officer took on contract audit reports. The memorandum demonstrates whether the contracting officer's actions were timely and consistent with applicable law and regulations. It also serves to protect the Government's interests in the event of future disputes.

Recommendation, Management Comments, and DoD IG Response

Recommendation F. We recommend that the Director, DCMA Virginia:

1. Establish quality procedures requiring contracting officers to prepare price negotiation memorandums with appropriate information covering all significant findings in the audit report.

Management Comments. DCMA did not fully concur. DCMA Virginia established a new quality assurance process to address all audit findings, which will be implemented by the 3rd quarter of FY 2007. However, DCMA Virginia stated that the negotiation memorandum does not need to address questioned costs that the contractor agrees to during the audit. DCMA Virginia believes the negotiation memorandum should only address questioned costs that are included in the DCAA Form 1 (when the indirect rates are auditor-determined in accordance with FAR 42.705-2).

DoD IG Response. We request that DCMA reconsider the recommendation in responding to the final report. In accordance with FAR 42.705-1(b)(iii)(B), the negotiation memorandum should include a reconciliation of all questioned costs, regardless of whether the contractor agrees to the questioned costs during the audit. This will also ensure that contracting officers address penalties applicable to questioned costs agreed to during the audit.

2. Implement management controls necessary to prevent contracting officers from reporting the disposition of audit reports before preparing a negotiation memorandum.

Management Comments Required. The DCMA Acting Director did not provide specific comments on this recommendation. We request that DCMA provide comments on the recommendation in responding to the final report.

G. Performance Standards and Controls for Contract Audit Follow-up

DCMA Virginia should set an environment that recognizes the importance of adequately and timely resolving and completing the disposition of contract audit reports by:

- establishing employee performance standards and measures related to contract audit follow-up, and
- including the contract audit follow-up function as a regular part of DCMA Virginia's Management Control Reviews.

Such procedures recognize and emphasize the significance of the actions taken on contract audit findings and recommendations and the fiduciary responsibility of contracting officers.

Performance Standards and Appraisals. We reviewed the performance standards and year-end appraisals of seven contracting officials, including four contracting officers, two site monitors, and one project leader. Only two of the standards and appraisals had comments that addressed contract audit follow-up effectiveness. DoD Directive 7640.2, paragraph 5.2.4, requires agencies to "ensure that performance appraisals of appropriate acquisition officials reflect their effectiveness in resolving and dispositioning audit findings and recommendations in a timely manner, while fully protecting the Government's interests." The number of exceptions we identified at DCMA Virginia necessitates that contracting officers be held accountable for any future improper or untimely actions taken to resolve contract audit reports.

Internal Controls. Management processes and procedures (internal controls) provide that what needs to happen does happen. Our review identified numerous deficiencies with DCMA Virginia's actions on incurred cost audit findings and recommendations, and we have recommended that the Director establish specific procedures to improve the contract audit follow-up process. (See findings A through F.) Such procedures are consistent with an internal control program required by OMB Circular A-123 Revised, "Management's Responsibility for Internal Control," December 21, 2004, effective for Fiscal Year 2006, and DoD Instruction 5010.40, Management Control Program Procedures. DoD Directive 7640.2, paragraph 5.2.3, also requires periodic evaluations of the contract audit follow-up process.

OMB Circular A-123 states: "Continuous monitoring and testing should help to identify poorly designed or ineffective controls and should be reported upon periodically." OMB Circular A-123 further states:

Monitoring the effectiveness of internal control should occur in the normal course of business. In addition, periodic reviews,

reconciliations, or comparisons of data should be included as part of the regular assigned duties of personnel. Periodic assessments should be integrated as part of management's continuous monitoring of internal control, which should be ingrained in the agency's operations.

In accordance with OMB Circular A-123 and DoD Directive 5010.40, DCMA Virginia annually plans and performs management control reviews on various processes or products identified as "higher risk." Since its establishment in January 2003, DCMA Virginia has not performed a management control review of the contract audit follow-up function. The lack of management attention and oversight of the contract audit follow-up function may have contributed to the serious weaknesses in the contract audit resolution and disposition program we identified at DCMA Virginia. When the contract audit follow-up program is appropriately identified as a key process, the resolution and disposition of audit issues are more visible, they are trackable, and they receive higher priority. The DCMA Virginia Team Leader stated that a management control review of the contract audit follow-up function was planned for the first quarter of Fiscal Year 2007. As of January 17, 2007, DCMA Virginia has not started its management control review of the contract audit follow-up function.

Recommendation and Management Comments

Recommendation G. We recommend that the Director, DCMA Virginia take the following actions:

1. Revise the performance standards of appropriate acquisition officials to measure their performance in resolving and completing the disposition of contract audit reports in accordance with paragraph 5.2.4 of DoD Directive 7640.2 and meeting established performance measures.

Management Comments. The DCMA Acting Director concurred. Contracting officers and their supervisors now have measures of contract audit follow-up performance their performance plans, such as the requirement to monitor the contract audit follow-up database.

2. Perform a management control review of the contract audit follow-up function in FY 2007.

Management Comments. The DCMA Acting Director concurred and DCMA Virginia has scheduled a management control review of the contract audit follow-up process in the 4th quarter of FY 2007.

3. Make the contract audit follow-up function a regular part of the DCMA Virginia Management Control Review program.

Management Comments. The DCMA Acting Director concurred and stated that the contract audit follow-up process will be subjected to an annual management control review until all recommendations are fully implemented (closed). Thereafter, a review of the contract audit follow-up process will be performed every three years.

Appendix A. Scope and Methodology

We evaluated the actions that contracting officials took in response to incurred cost audits reported by DCMA Virginia in the semiannual reporting periods ended September 30, 2003, through March 31, 2005. DCMA Virginia reported the disposition of 29 incurred cost audits during these reporting periods. We judgmentally selected 13 of the 29 audits to determine whether:

- contracting officials assessed penalties on expressly unallowable costs;
- contracting officials effectively completed the disposition of all significant audit findings and provided sound rationale for not sustaining any costs that were questioned;
- contract audit follow-up data were accurate;
- audit reports were resolved and their disposition completed within the required timeframes of 6 months for resolution and 12 months for disposition, and whether any delays were justified and documented in the contract file;
- disposition actions were adequately documented in accordance with the FAR and Agency procedure;
- contracting officials are evaluated on their effectiveness in resolving and completing the disposition of audit findings on time; and
- periodic evaluations of the contract audit follow-up program are conducted to ascertain the program's effectiveness.

We performed this review from July 2005 through December 2006.

Use of Computer-Processed Data. We did not rely on any computer-processed data as part of our review. DCMA has a Web-based eTools system that maintains data on the status of contract audit reports. However, we were unable to rely on the accuracy of the eTools data because our sample review disclosed several errors with the data.

Prior Coverage

During the last 5 years, the DoD IG has issued two reports related to contract audit follow-up actions on incurred cost audit reports.

- DoD IG Report No. D-2005-6-003, "Oversight Review of the DCMA Santa Ana's Actions on Incurred Cost Audits," March 17, 2005
- DoD IG Report No. D-2004-6-006, "Oversight Review of the Naval Sea Systems Command Contract Audit Follow-up Process," July 8, 2004

Appendix B. Disposition of Audits With Unresolved Costs

Audit Report Number	Reported Unresolved or Qualified Costs	Note
6321-1999M10100121	\$ 60,878,865	1
6321-2000M10100001	77,831,232	1
6321-2001B10100001	108,091,086	1
6161-2000T10100001	1,455,278	
6161-2001T10100001	575,317,696	
6321-2002B10100001	98,112,616	1
6321-2003B10100001-1	48,187,082	1
Total	\$969,873,855	
<p>Note</p> <p>1. The contracting officer accepted a portion of the unresolved costs on closed contracts prior to receiving a supplemental report or cumulative allowable cost worksheet. DCMA said it was unable to determine how much of the unresolved costs were accepted on closed contracts without an audit opinion.</p>		

Appendix C. Accuracy of Reported Questioned Costs

Audit Report Number	Actual Questioned Cost in DCAA Report (including effect of Supplemental)	Questioned Cost in CAFU* System	Difference	Note
6321-1999M10100121	\$ 11,070,823	\$ 5,922,086	\$ 5,148,737	1
6321-2000M10100001	10,296,083	4,670,276	5,625,807	1
6321-2001B10100001	22,168,253	11,488,801	10,679,452	1
6311-1999E10110020	746,047	746,047	0	-
6331-2000F10100779	2,368,371	2,368,371	0	-
6161-1999T10100002	41,334,469	0	41,334,469	1
6221-2001R10100051	2,000,000	2,000,000	0	-
6141-1999B10100012	215,412	215,412	0	-
6161-2001B10100003	0	13,124,170	(13,124,170)	2
6161-2000T10100001	42,406,769	52,428,858	(10,022,089)	1
6161-2001T10100001	38,682	10,292,704	(10,254,022)	1
6321-2002B10100001	30,386,016	11,279,582	19,106,434	3
6321-2003B10100001-1	0	30,569,509	(30,569,509)	2
Total	\$163,030,925	\$145,105,815	\$17,925,109	-
<p>Notes:</p> <ol style="list-style-type: none"> 1. The contracting officer did not compare the amounts in the DCAA audit report with the amounts stated in the eTools contract audit follow-up system for accuracy. 2. The contracting officer did not revise the questioned cost in the eTools contract audit follow-up system to zero when the audit report was superseded or replaced, as required by DoD Directive 7640.2, paragraph 6.3.4.2. 3. The contracting officer found the questioned amount in the eTools contract audit follow-up system was lower than the amount stated in the DCAA audit report. The contracting officer attempted to revise the questioned cost in the eTools contract audit follow-up system, but the system would not accept the revised questioned amount. <p>*Contract Audit Follow-up</p>				

Appendix D. Accuracy of Reported Sustained Costs

Audit Report Number	Actual Sustained Cost According to Negotiation Files	Sustained Cost Reported by DCMA in CAFU* System	Difference	Note
6321-1999M10100121	\$ 5,291,328	\$ 4,736,070	\$ 555,258	1
6321-2000M10100001	5,426,520	3,189,439	2,237,081	1
6321-2001B10100001	11,221,181	8,870,262	2,350,919	1
6311-1999E10110020	746,047	0	746,047	1
6331-2000F10100779	2,368,371	2,368,371	0	-
6161-1999T10100002	41,334,469	0	41,334,469	1
6221-2001R10100051	2,000,000	2,000,000	0	-
6141-1999B10100012	174,584	0	174,584	1
6161-2001B10100003	0	0	0	-
6161-2000T10100001	(7,450,827)	0	(7,450,827)	2
6161-2001T10100001	(6,841,181)	444,000	(7,285,181)	2
6321-2002B10100001	20,742,300	13,997,552	6,744,748	1
6321-2003B10100001-1	0	0	0	-
Total	\$75,014,811	\$35,605,694	\$39,409,117	
<p>Notes:</p> <ol style="list-style-type: none"> 1. The contracting officer did not include the unallowable cost that the contractor previously agreed to during the DCAA audit. 2. The contracting officer did not include documentation showing how the reported sustained amount was determined in the negotiation file. <p>*Contract Audit Follow-up</p>				

Appendix E. Accuracy of Reported Status of Audit

Audit Report Number	Actual Status of Negotiation	Status Reported by DCMA in CAFU* System	Note
6321-1999M10100121	Disposition	Disposition	-
6321-2000M10100001	Disposition	Disposition	-
6321-2001B10100001	Disposition	Disposition	-
6311-1999E10110020	Disposition	Disposition	-
6331-2000F10100779	Resolved	Disposition	1
6161-1999T10100002	Disposition	Disposition	-
6221-2001R10100051	In litigation	Disposition	2
6141-1999B10100012	Disposition	Disposition	-
6161-2001B10100003	Disposition	Resolved	3
6161-2000T10100001	Unresolved	Disposition	4
6161-2001T10100001	Unresolved	Disposition	4
6321-2002B10100001	Disposition	Disposition	-
6321-2003B10100001-1	Disposition	Disposition	-
<p>Notes:</p> <ol style="list-style-type: none"> 1. The audit's disposition was completed on September 22, 2003; however, the indirect rate agreement was not signed until June 24, 2004. 2. The semiannual report inaccurately reported the status as complete through disposition while the audit was in litigation. 3. The semiannual report inaccurately reported the status as resolved when the audit was superseded by a supplemental audit report. 4. The contracting officer did not negotiate the questioned direct costs. <p>*Contract Audit Follow-up</p>			

Appendix F. Accuracy of Reported Resolution and Disposition Dates

Audit Report Number	Actual Date of Resolution or Disposition	Date Reported by DCMA in CAFU* System	Note
6321-1999M10100121	Disposition=9/15/03	Disposition=9/15/03	-
6321-2000M10100001	Disposition=9/12/03	Disposition=9/12/03	-
6321-2001B10100001	Disposition=9/12/03	Disposition=9/12/03	-
6311-1999E10110020	Disposition=4/24/03	Disposition=4/24/03	-
6331-2000F10100779	Disposition=6/26/04	Disposition=9/22/03	1
6161-1999T10100002	Disposition=1/28/04	Disposition=1/28/04	-
6221-2001R10100051	Disposition=10/28/03	Disposition=10/28/03	-
6141-1999B10100012	Disposition=5/24/04	Disposition=4/13/04	1
6161-2001B10100003	Resolution=3/21/05	Resolution=3/21/05	-
6161-2000T10100001	Disposition=11/9/04	Disposition=11/9/04	-
6161-2001T10100001	Disposition=3/15/05	Disposition=3/15/05	-
6321-2002B10100001	Disposition=1/24/05	Disposition=1/24/05	-
6321-2003B10100001-1	Disposition=2/1/05*	Disposition=3/3/05	2
<p>Notes:</p> <ol style="list-style-type: none"> 1. The contracting officer reported the disposition of the audit in the contract audit follow-up system prior to negotiating the audit findings. 2. The contracting officer did not report the date of final disposition as the issuance date of the supplemental audit report in the contract audit follow-up system. <p>*Contract Audit Follow-up **Reflects the report date of superseding Audit Report No. 6321 2003B10100001-1.</p>			

Appendix G. Timeliness of Resolution and Disposition

Audit Report Number	Audit Report Date	Months Past 6-Month Resolution Rule	Months Past 12-Month Disposition Rule	DCAA Report		Note
				Questioned Costs (including Supplemental Impact)	Expressly Unallowable Costs	
6321-1999M10100121	12/20/01	6	9	\$11,070,823	\$1,900,219	1
6321-2000M10100001	3/29/02	3	6	10,296,083	312,644	1
6321-2001B10100001	11/14/02	-	-	22,168,253	818,730	-
6311-1999E10110020	6/11/01	16	22	746,047	746,047	1
6331-2000F10100779	8/21/02	7	10	2,368,371	36,426	1
6161-1999T10100002	9/16/03	-	-	41,334,469	522,401	-
6221-2001R10100051	6/27/03	-	-	2,002,019	2,000,000	-
6141-1999B10100012	12/23/02	-	5	215,411	820	1
6161-2001B10100003-S2	2/13/04	8	5	0	0	2
6161-2000T10100001	3/5/04	-	-	42,406,769	961,550	-
6161-2001T10100001	4/26/04	-	-	38,682	578,412	-
6321-2002B10100001	3/12/04	-	-	30,386,016	102,257	-
6321-2003B10100001-1	2/10/05	-	-	30,569,509	791,762	-
Notes:						
1. The negotiation file did not include justification for exceeding the resolution and/or disposition requirements.						
2. Although the resolution and disposition actions were not completed within the required timeframes, the contracting officer correctly waited for supplemental information from DCAA to resolve \$20.1 million prior to the audit's disposition.						

Appendix H. Adequacy of Negotiation Memorandums

Audit Report Number	Status	Does a Negotiation Memorandum Exist?	Is the Negotiation Memorandum Adequate?	Questioned Costs Not Sustained	Note
6321-1999M10100121	Disposition	No	No	\$ 5,779,495	1
6321-2000M10100001	Disposition	No	No	4,869,563	1
6321-2001B10100001	Disposition	No	No	10,947,072	1
6311-1999E10110020	Disposition	No	No	0	1
6331-2000F10100779	Disposition	Yes	Yes	0	-
6161-1999T10100002	Disposition	No	No	0	1
6221-2001R10100051	Disposition	No	No	0	1
6141-1999B10100012	Disposition	No	No	40,828	1
6161-2001B10100003-S2	Resolution	Yes	Yes	0	-
6161-2000T10100001	Disposition	Yes	No	42,406,769	2
6161-2001T10100001	Disposition	Yes	No	38,682	2
6321-2002B10100001	Disposition	Yes	No	0	3
6321-2003B10100001-1	Disposition	Yes	No	0	4
Total				\$64,082,409	

Notes:

1. The contracting officer did not prepare a negotiation memorandum or it could not be located.
2. The negotiation memorandum was inadequate because it did not comply with FAR 42.705-1(b)(5)(iii) by not:
 - addressing all the findings and recommendations as stated in the DCAA audit report, including questioned direct costs, unresolved costs, questioned costs that were agreed to by the contractor during the audit, and recommended penalties, or
 - providing enough detail or rationale to support the negotiation position.
3. The negotiation memo was partly inadequate because it did not address recommended penalties or include questioned costs that were previously agreed to by the contractor during the audit.
4. The negotiation memorandum was partly inadequate because it did not include unallowable costs that the contractor previously agreed to during the audit.

Appendix I. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Director, Defense Procurement and Acquisition Policy

Department of the Army

Inspector General, Department of the Army

Department of the Navy

Naval Inspector General

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)

Other Defense Organizations

Director, Defense Contract Audit Agency
Policy Quality Assurance Division Chief, Policy and Plans Directorate
Director, Defense Contract Management Agency
Director, Defense Contract Management Agency Virginia
Director, Contract Business Operations
Director, Independent Assessment, Internal Review Team

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Oversight and Government Reform

Acting Director Defense Contract Management Agency Comments



DEFENSE CONTRACT MANAGEMENT AGENCY

6350 WALKER LANE, SUITE 300
ALEXANDRIA, VA 22310-3241

MAR 26 2007

IN REPLY
REFER TO

DCMA-DMI

MEMORANDUM FOR PROGRAM DIRECTOR, AUDIT POLICY AND
OVERSIGHT, DEPARTMENT OF DEFENSE INSPECTOR
GENERAL, OFFICE OF THE ASSISTANT INSPECTOR
GENERAL

SUBJECT: Department of Defense (DoD) IG Draft Report, Project Number
D2005-DIPOAI-0252, Audit of Defense Contract Management Agency
Virginia Actions on Incurred Cost Audit Reports

Reference: DoDIG draft audit report, Project Number, D2005-DIPOAI-0252,
subject as above.

We have attached the Headquarters, Defense Contract Management Agency
response to the finding and recommendations cited in the subject report.

Point of contact is Ms. Sonya Moman at (703) 530-3163 or
sonya.moman@dcma.mil.


KEITH D. ERNST
Acting Director

Acting Director Defense Contract Management Agency Comments

FINDING A:

Contracting officers failed to assess penalties or justify a waiver of the penalties on \$3.7M in expressly unallowable costs as required by FAR Subpart 42.7, "Indirect Cost Rates." As a result, the Government will lose up to \$3.2M if penalties are not assessed.

Recommendation A. We recommend that the Director, DCMA Virginia do the following:

1. Establish a quality assurance process that requires contracting officers to address DCAA penalty recommendations promptly.
2. Direct those contracting officers assigned to the five audits referred to above to take prompt action to assess penalties.
3. Review all remaining dispositions of incurred cost audit reports not covered in this review to determine if contracting officers had properly applied and recouped penalties recommended by the Defense Contract Audit Agency.

DCMA COMMENTS:

A-1: Concur. The CMO has established a new quality assurance process to address all audit findings. This process includes: 1) A monthly review of all open reportable audits in CAFU by the CMO's CAFU Monitor and the responsible Supervisor(s); 2) Monitoring of Resolution and Disposition dates to ensure mandated timeframes are met or as appropriate, posting of documentation to the file and making annotations in the E-Tools CAFU database; 3) Standardization of all CAFU files to include proper documentation; 4) Institution of ongoing CAFU Training sessions for all 1102s; and 5) Inclusion of a requirement in the CMO's Pre-Post Negotiation Memorandum (PNM) Standard Operating Procedures (SOP), that requires the ACO to address penalties in both the Pre and the Post-Negotiation Memorandums. This process will be implemented by the 3rd Quarter FY 07.

A-2: Non-concur. The contracting officers will not be directed to assess penalties where this type of action would be inappropriate. Specifically, as it relates to two of the five reports cited as a basis for this finding and recommendation (audit report numbers: 6221-2001R10100051 and 6161-1999T10100002) assessing penalties would be inappropriate. The actions are inappropriate because a contrary legal opinion was rendered for audit report 6221-2001R10100051 and level 2 penalties can not be assessed for audit report 6161-1999T10100002 because level 1 penalties were not previously assessed.

A-3: Non-concur. This is not a reasonable or appropriate recommendation. The CMO has already exercised its professional due diligence and met mandated governing requirements for disposition of audit reports. The Agency requires their ACOs to consider penalties prior to final disposition of the audit reports and in the

Acting Director Defense Contract Management Agency Comments

majority of the cases their decisions related to the actions taken on the audit reports are backed by a legal opinion on costs disallowance and penalty issues. Additionally, the CMO has established new procedures and will ensure that more detailed documentation is on file (all current and future files) that identifies both the ACO's rationale for their decision on penalties assessed and decisions agreed to by legal counsel. Finally, this recommendation is not appropriate because it was not vetted with the management or included in the discussion draft that was forwarded to DCMA Virginia for comments.

FINDING B:

DCMA Virginia contracting officers did not obtain an audit opinion on a portion of the \$970 million in costs DCAA reported as unresolved. In accepting the unresolved costs without an audit opinion, DCMA Virginia contracting officers put the Government at significant risk of paying unallowable costs. Actions on Unresolved Costs

Recommendation B: We recommend that the Director, DCMA Virginia establish a quality assurance process to prevent contracting officers from accepting unresolved costs until they receive an audit opinion on the DCAA reported unresolved costs.

DCMA COMMENTS:

Concur. The CMO has established a new quality assurance process and will now use more detailed DCAA audit reports (the DCAA audit report now includes information pertaining to subcontract assist audits) to address unresolved costs occurrences. This process includes: 1) A monthly review of all open reportable audits in CAFU by the CMO's CAFU Monitor and the responsible Supervisor(s); 2) Monitoring of Resolution and Disposition dates to ensure mandated timeframes are met or as appropriate, posting of documentation to the file and making annotations in the E-Tools CAFU database; 3) Standardization of all CAFU files to include proper documentation; and 4) Institution of ongoing CAFU Training sessions for all 1102s. This process will be implemented by the 3rd Quarter FY 07.

FINDING C:

Of the 13 incurred cost audits we reviewed, the 5 audits listed (Table 3, page 5, of the IG Report) included questioned direct costs. Although DCMA Virginia reported these 5 audits as complete through disposition, 2 included \$40.5 million in questioned direct costs that have not been settled (negotiated). (Reference: "Actions on Questioned Direct Costs")

RECOMMENDATION C: We recommend the Director DCMA Virginia:

1. Direct the contracting officer assigned to the two audits with unsettled direct costs to take the following steps immediately:

a. Work with the procurement office to negotiate the questioned direct costs of \$40.5 million.

Acting Director Defense Contract Management Agency Comments

b. Reinstate the two audits to open status in the contract audit follow-up system until the negotiation action on the questioned direct costs is completed and documented in accordance with DoD Directive 7640.2.

2. Establish a quality assurance process that will provide consistent procedures among contracting officers and require all contracting officers to address all audit findings, including any questioned direct costs, before completing audit disposition.

DCMA COMMENTS:

C-1a: Concur. The CMO Director has instructed the DACO to reissue a rate letter with a clarification that the questioned direct costs have not been negotiated and will include the schedule of those costs. The DACO will redistribute the package to all parties identified in the audit report to include all procurement offices. This action will be completed by the 3rd Quarter FY 07.

C-1b: As a result of actions identified in our C-1a response, this will close out this issue for the DACO and notify the PCOs and DCAA to make sure they address any questioned direct costs at the time of contract closeout. Therefore, there is no need to reopen the audit reports.

C-2: Concur. The CMO has established a new quality assurance process to address all audit findings. This process includes: 1) A monthly review of all open reportable audits in CAFU by the CMO's CAFU Monitor and the responsible Supervisor(s); 2) Monitoring of Resolution and Disposition dates to ensure mandated timeframes are met or as appropriate, posting of documentation to the file and making annotations in the E-Tools CAFU database; 3) Standardization of all CAFU files to include proper documentation; 4) Institution of ongoing CAFU Training sessions for all 1102s; and 5) Inclusion of a requirement in the CMO's Pre-Post Negotiation Memorandum (PNM) Standard Operating Procedures (SOP), that requires the ACO to address penalties in both the Pre and the Post-Negotiation Memorandums. This process will be implemented by the 3rd Quarter FY 07.

FINDING D:

DCMA Virginia does not maintain accurate records of reportable incurred cost audit reports. Our review of 13 incurred cost audits assigned to DCMA Virginia and the contracting officer files describing action taken on the incurred cost audits disclosed several data errors, including:

- inaccurate questioned costs reported for 9 audits;
- incorrectly reported sustained questioned costs reported for 9 audits;
- incorrectly reported status of actions taken reported for 5 audits;
- inaccurate disposition dates reported for 3 audits; and
- missing reportable supplemental audits for 2 audits.

Acting Director Defense Contract Management Agency Comments

As a result, DCMA management and Congress do not have accurate information on contracting officer actions taken in response to contract audit reports.

Recommendation D. We recommend that the Director, DCMA Virginia establish quality assurance processes to ensure the accuracy of the data reported in the contract audit follow-up system.

DCMA Comments:

Concur. The CMO has established a new quality assurance process to address all audit findings. This process includes: 1) A monthly review of all open reportable audits in CAFU by the CMO's CAFU Monitor and the responsible Supervisor(s); 2) Monitoring of Resolution and Disposition dates to ensure mandated timeframes are met or as appropriate, posting of documentation to the file and making annotations in the E-Tools CAFU database; 3) Standardization of all CAFU files to include proper documentation; and 4) Institution of ongoing CAFU Training sessions for all 1102s. This process will be implemented by the 3rd Quarter FY 07.

FINDING E:

Contracting officer actions on 5 of 13 incurred cost audits were not completed within the timeframes required by DoD Directive 7640.2. Timely resolution and disposition ensure that the Government promptly recoups unallowable costs, penalties, and interest.

Recommendation E. We recommend that the Director, DCMA Virginia establish quality assurance procedures requiring contracting officers and their staff to:

1. resolve and complete the disposition of contract audit reports within the required timeframes specified, or
2. include adequate written justification in the contract file for any resolutions or dispositions that occur beyond the specified timeframes.

DCMA COMMENTS:

E1 & E2: Concur. The CMO has established a new quality assurance process to address all audit findings. This process includes: 1) A monthly review of all open reportable audits in CAFU by the CMO's CAFU Monitor and the responsible Supervisor(s); 2) Monitoring of Resolution and Disposition dates to ensure mandated timeframes are met or as appropriate, posting of documentation to the file and making annotations in the E-Tools CAFU database; 3) Standardization of all CAFU files to include proper documentation; and 4) Institution of ongoing CAFU Training sessions for all 1102s. This process will be implemented by the 3rd Quarter FY 07.

FINDING F

For eleven (11) of the thirteen (13) incurred cost audits we reviewed, the DCMA Virginia contract files either did not include a negotiation memorandum covering the disposition of the reported findings or had a negotiation memorandum that was

Acting Director Defense Contract Management Agency Comments

inadequate. As a result, we were unable to determine the contracting officer's rationale for allowing DCAA disallowed cost of \$64.1M.

Recommendation F. We recommend that the Director, DCMA Virginia, do the following:

1. Establish quality procedures requiring contracting officers to prepare price negotiation memorandums with appropriate information covering all significant findings in the audit report, and

2. Implement management controls necessary to prevent contracting officers from reporting the disposition of audit reports before they prepare a negotiation memorandum.

DCMA COMMENTS:

Partially concur. Where files did not include a Negotiation Memorandum, we concur. Where the Negotiation Memorandum was present in the file, and the IG states that it is inadequate, we do not concur.

Regarding IG Note 3, the CMO does not fully concur with this recommendation. The Negotiation Memorandum should not address Penalties or include questioned costs agreed to by the Contractor during the DCAA audit, where the ACO negotiation was for a specific cost identified in a Form 1. Pre/Post Neg (PNM) addresses only the costs addressed in Form 1 from DCAA that was submitted to the ACO for negotiation. After this was negotiated, DCAA would use the contractor agreed to costs to develop recommendations that the ACO would use to finalize rates. Further, the Memorandum for Record discussing Penalty is in the file.

Regarding IG Note 4, again the CMO does not fully concur with the recommendation. The Negotiation Memorandum should address not unallowable costs agreed to by Contractor during their audit where the ACO negotiation was a specific cost identified in a Form 1 that DCAA was unable to settle with the contractor. The Pre/Post Neg does address only the costs in Form 1 that was submitted to the ACO by DCAA. Reference Audit No. 6141-1999B10100012: Indirect Cost Rate (G&A) & Roll-Forward Agreement was signed by the ACO on 5/24/04, and this action is still open.

Additionally, the CMO has established a new quality assurance process to address all audit findings. This process includes: 1) A monthly review of all open reportable audits in CAFU by the CMO's CAFU Monitor and the responsible Supervisor(s); 2) Monitoring of Resolution and Disposition dates to ensure mandated timeframes are met or as appropriate, posting of documentation to the file and making annotations in the E-Tools CAFU database; 3) Standardization of all CAFU files to include proper documentation; 4) Institution of ongoing CAFU Training sessions for all 1102s; and 5) Inclusion of a requirement in the CMO's Pre-Post Negotiation Memorandum (PNM) Standard Operating Procedures (SOP), that requires the ACO to

Acting Director Defense Contract Management Agency Comments

address penalties in both the Pre and the Post-Negotiation Memorandums. This process will be implemented by the 3rd Quarter FY 07.

FINDING G: DCMA Virginia should set an environment that recognizes the importance of adequate and timely resolution and complete disposition of contract audit reports by:

- including the contract audit follow-up function in employee performance standards,
- establishing performance indicators related to contract audit follow-up , and
- including the contract audit follow-up function as a regular part of DCMA Virginia's Management Control Reviews.

Such procedures recognize and emphasize the significance of the actions taken on contract audit findings and recommendations and the fiduciary responsibility of contracting officers.

Recommendation G: We recommend that the Director, DCMA Virginia take the following actions:

1. Establish performance indicators to measure success in improving DCMA Virginia's handling of incurred cost audit findings and recommendations.
2. Revise the performance standards of appropriate acquisition officials to measure their performance in resolving and completing the disposition of contract audit reports in accordance with paragraph 5.2.4 of DoD Directive 7640.2 and meeting established performance indicators.
3. Perform a management control review of the contract audit follow-up function in Fiscal Year 2007.
4. Make the contract audit follow-up function a regular part of the DCMA Virginia Management Control Review program.

DCMA COMMENTS:

Concur. The following procedures have been implemented in response to this recommendation: 1) Supervisors and all 1102s now have performance indicators associated with their annual performance plans. Specifically, the requirement to monitor the CAFU database is included as a Contribution to Mission Accomplishment (CTMA), as appropriate, on their Individual Performance Plan (IPP); 2) The CAFU process is scheduled for a MCR in 4th Quarter of FY07; and 3) Starting in FY08, the CAFU process will be scheduled for an annual review in the MCR Program until all CAFU-related recommendations are officially closed. Once the recommendations are officially closed; the CAFU Process will be reviewed every 3 years. These actions will be implemented by the 4th Quarter FY 07.



Inspector General Department of Defense

