

Inspector General

United States
Department of Defense



Oversight Review

September 28, 2007

Actions on Reportable Contract Audit Reports
by the Defense Contract Management Agency's
Northrop Grumman El Segundo Office

Report No. D-2007-6-009

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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
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

September 28, 2007

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
COMMANDER, NORTHROP GRUMMAN EL SEGUNDO

SUBJECT: Report of Actions on Reportable Contract Audit Reports by the Defense Contract Management Agency's Northrop Grumman El Segundo Office
(Report No. D-2007-6-009)

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 systems in the Department of Defense for follow-up on contract audits.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Management did not comment on a draft of this report. We request that management provide comments to the final report that conform to the requirements of DoD Directive 7650.3. We should receive the management comments by November 28, 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.

A handwritten signature in black ink, appearing to read "Wayne C. Berry", is positioned above the typed name.

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

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Actions on Reportable Contract Audit Reports by the Defense Contract Management Agency's Northrop Grumman El Segundo Office

Results In Brief

What We Did

We evaluated the actions that contracting officials in the Defense Contract Management Agency's (DCMA) Northrop Grumman El Segundo Office took on reportable contract audits conducted by the Defense Contract Audit Agency for the semiannual reporting periods ended March 31, 2005, through March 31, 2006.

What We Found

The contracting officer failed to address the allowability of \$615,000 in litigation settlement costs questioned by the auditor. Instead of making a proper determination, the contracting officer exchanged the costs for the contractor not claiming other unrelated expressly unallowable costs. The government potentially lost \$615,000.

In addition, the contracting officer did not adequately document in three of six post-negotiation memoranda the actions on \$400,000 of questioned costs and \$416 million of unresolved costs that the Defense Contract Audit Agency reported.

What We Recommended

The DCMA Director should (1) publish policy for contracting officers requiring a written legal opinion when a contracting officer's disagreement with an audit report involves payment for litigation expenses and

other potentially unallowable costs and (2) establish internal control procedures to ensure contracting officers prepare adequate post-negotiation memoranda that adhere to Federal Acquisition Regulation and Defense Federal Acquisition Regulation requirements. The DCMA Northrop Grumman El Segundo Commander should take appropriate corrective actions to address the contracting officer's failure to make a determination on the allowability of the \$615,000 in questioned litigation settlement costs and the improper agreement to exchange the costs for other unallowable costs.

Management Comments

The DCMA did not comment on a May 31, 2007 draft of this report. We request that the DCMA provide comments on the final report by November 28, 2007.

United States Department of Defense
Office of Inspector General
Project No. D2005-DIP0AI-0228.000
Report No. D-2007-6-009
September 28, 2007

Introduction

Objective

Our objective was to review the actions taken by the DCMA Northrop Grumman El Segundo Office to resolve and disposition contract audit reports prepared by the Defense Contract Audit Agency (DCAA) for the semiannual reporting periods ended March 31, 2005, through March 31, 2006. See Appendix A for details regarding our scope and methodology and for prior coverage.

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 DoD agencies. This report focuses on DCMA Northrop Grumman El Segundo.

Defense Contract Audit Agency. DCAA performs contract audits and provides accounting and financial advisory services to all DoD Components (including DCMA). DCAA issues a wide variety of reports resulting from several types of audits, such as audits of Government contractors' incurred costs, their management and accounting systems, and their compliance with Cost Accounting Standards.

DoD Directive

DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports," February 12, 1988, prescribes the responsibilities, reporting requirements, and follow-up procedures on contract audits. Reportable contract audits generally include all contract audits with findings and recommendations, except for audits of pre-award proposals. Paragraph 6.5 of the Directive requires the contracting officer to prepare a post-negotiation memorandum covering the disposition of all significant audit report findings, including the underlying rationale for such dispositions. The DoD Inspector General (IG) evaluates the effectiveness of contract audit follow-up systems implemented at each DoD Component, including DCMA, for compliance with this directive.

Findings

A. Litigation Settlement

The contracting officer failed to address the allowability of \$615,000 in litigation settlement costs that the DCAA had questioned. Instead of making a proper determination on these costs, the contracting officer exchanged the costs for the contractor not claiming other unrelated expressly unallowable costs. This action resulted in the Government potentially losing \$615,000.

DCAA Audit Report. In Audit Report No. 4721-2001A10100001, on the contractor's incurred cost proposal¹ for 2001, DCAA questioned \$615,000 in litigation settlement costs, which the contractor paid to settle allegations of discrimination, harassment, and retaliation based on race. DCAA questioned the costs in accordance with FAR 31.201-3(a), which states that a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. DCAA stated that these amounts exceeded a nominal amount. DCAA believed it was unreasonable to expect the Government to reimburse significant out-of-court settlements for cases that should be tried or arbitrated.

Contracting Officer's Determination. As documented in the post-negotiation memorandum dated May 5, 2005, the contracting officer reimbursed the costs in exchange for the contractor's agreeing not to claim \$1 million in unrelated litigation costs. The post-negotiation memorandum stated:

DCMA did not sustain DCAA cost questioned amount of \$615,000 for the above two legal cases because the contractor agreed not to include in their [sic] . . . 2000 final claim \$1,000,000 related to the qui tam litigation legal expenses for F/A 18 for years 1995 through 2000 if DCMA would not accept DCAA questioned cost of \$615,000 for the two discrimination, harassment cases.

The contracting officer should not have entered into this agreement. The contracting officer's determination should have been based solely on whether the \$615,000 is allowable in accordance with FAR Subpart 31.2. The agreement to exclude the unrelated qui tam² costs from the contractor's incurred cost claim should not have

¹ An incurred cost proposal is a contractor's claim for direct and indirect costs charged to Government contracts. DCAA audits the contractor's incurred cost proposal to determine that the costs are reasonable, allocable, and allowable as prescribed by the Federal Acquisition Regulation, the Defense Federal Acquisition Regulation Supplement, and contract provisions.

² Qui tam is a provision of the Federal Civil False Claims Act that allows a private citizen to file a suit in the name of the U.S. Government charging fraud by Government contractors and other entities that receive or use Government funds, and to share in any money recovered.

played a role in the contracting officer's decision to reimburse the \$615,000 in litigation settlement costs. In a November 7, 2003, memorandum, a DCMA attorney had already notified the contracting officer that the \$1 million in unrelated qui tam costs were expressly unallowable in accordance with FAR 31.205-47(c)(1).

Legal Opinion. The contracting officer did not obtain a legal opinion on the allowability of the \$615,000 in litigation settlement costs. DCMA procedures recommend, but do not require, that contracting officers obtain a legal opinion. A DCMA contracting officer has sole discretion for determining whether a legal opinion is necessary before rendering a final determination. However, OMB Circular A-50, Paragraphs 6(a) and 8(a)(6) state that, where differences of opinion with the auditor involve legal issues, the contracting officer must document the legal basis for the determination. The contracting officer should have obtained a legal opinion on the allowability of the \$615,000 in litigation costs because the settlement involved alleged violations of Federal law and allowing the costs may set a precedent for future settlements of a similar nature.

Recommendation A.

A.1. We recommend that the Director of Defense Contract Management Agency publish policy for contracting officers requiring a written legal opinion when a contracting officer's disagreement with an audit report involves payment for litigation expenses and other potentially unallowable costs.

A.2. We recommend that the Commander, Defense Contract Management Agency Northrop Grumman El Segundo take corrective actions to address the contracting officer's failure to properly assess the allowability of \$615,000 in questioned litigation settlement costs and improper exchange with the contractor.

Management Comments Required.

The Defense Contract Management Agency did not comment on a draft of this report dated May 31, 2007. We request that the Defense Contract Management Agency provide comments on the final report.

B. Adequacy of Negotiation Memoranda

Three of the six post-negotiation memoranda reviewed were inadequate and did not comply with FAR or DoD Directive 7640.2. The post-negotiation memoranda did not adequately address \$416 million of unresolved costs in the audit reports, or adequately explain why the contracting officer did not uphold \$400,000 of the DCAA questioned costs. As a result, the memoranda could not adequately protect the Government's interests in the event of a future dispute.

Requirement for Post-Negotiation Memoranda. When negotiating indirect cost rates, FAR 42.705-1(b)(5)(iii) requires contracting officers to prepare a post-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. Paragraph 6.5 of DoD Directive 7640.2, “Notification of Final Disposition of Contract Audit Report,” requires the contracting officer to prepare a post-negotiation memorandum covering the disposition of all audit reports.

Post-Negotiation Memoranda. The post-negotiation memorandum is a critical part of the contract file because it serves as the primary means of documenting and showing the actions the contracting officer took on contract audit reports. The post-negotiation memorandum demonstrates whether the contracting officer’s actions were timely and consistent with applicable law and regulations. It also serves to protect Government’s interests in the event of future disputes.

Three of the six post-negotiation memoranda we reviewed at DCMA Northrop Grumman El Segundo were inadequate because they did not explain the actions the contracting officer took on costs that DCAA questioned or reported as unresolved.³ The post-negotiation memorandum for:

- Audit Report No. 4721-2002A10100001 did not adequately explain or support the contracting officer’s acceptance of \$234.1 million that DCAA reported as unresolved, or the reasons why the contracting officer reimbursed \$288,000 in questioned cafeteria costs.
- Audit Report No. 4721-2001A10100001 did not adequately explain or support the contracting officer’s decision to accept \$181.9 million in costs that DCAA reported as unresolved.
- Audit Report No. 4721-2001S10100001-S1 did not adequately explain the reasons why the contracting officer did not sustain \$112,000 in questioned employee welfare costs.

Although we took no exception to negotiation results of the three audits, the contracting officer should have adequately documented the negotiation results to demonstrate that applicable regulations were followed.

Prior Review. In April 2007, we issued Report No. D-2007-6-004 citing that 11 of 13 negotiation memoranda at DCMA Virginia were inadequate. The post-negotiation memoranda did not address all the audit findings and recommendations or provide enough detail or rationale to support the negotiation position. The lack of detailed

³ DCAA classifies costs as “unresolved” when its auditors do not receive the results of assist audits in time for incorporation into the audit report. An assist audit involves one DCAA office performing an audit of selected costs (for example, corporate, home office, subcontract, or intracompany costs) at the request of another DCAA office.

post-negotiation memoranda appears to be a deficiency needing DCMA policy guidance.

DCMA Policy on Preparing Post-Negotiation Memoranda. DCMA does not have a policy describing the actions that contracting officers are required to take when preparing post-negotiation memoranda. DCMA has a guidebook that offers suggestions to enhance the performance of the contracting officer; however, the contracting officer is not required to follow the suggestions.

Recommendation B.

B.1. We recommend that the Director, Defense Contract Management Agency:

- a. Convert the applicable DCMA guidebook processes into formal policy outlining the required steps that contracting officers must take when resolving and completing the disposition of contract audit reports.
- b. Establish internal controls to verify that contracting officers are performing the steps outlined in B.1.a. in accordance with FAR 42.705-1(b)(5)(iii) and DoD Directive 7640.2.

B.2. We recommend that the Commander, Defense Contract Management Agency Northrop Grumman El Segundo establish and direct contracting officers to use a checklist of the requirements found in FAR 42.705-1(b)(5)(iii) and DoD Directive 7640.2.

Management Comments Required.

The Defense Contract Management Agency did not comment on a draft of this report dated May 31, 2007. We request that the Defense Contract Management Agency provide comments on the final report.

Appendix A. Scope and Methodology

We evaluated the actions that a DCMA Northrop Grumman El Segundo contracting officer took on 12 contract audit reports during the semiannual reporting periods ended March 31, 2005, through March 31, 2006. The contracting officer was in the process of setting up the negotiation position or negotiating for 6 of the 12 contract audit reports. Negotiations were finalized and the contracting officer completed disposition of the remaining six contract audit reports. Of the 12 reports, 9 were incurred cost reports, 1 was a cost accounting standard noncompliance report, 1 was an operations audit report, and 1 was a cost impact statement report. We reviewed contract audit reports from the semiannual reporting periods to determine whether:

- contract audit follow-up data were accurate;
- audit reports were resolved and their disposition completed within the required timeframes (6 months for resolution and 12 months for disposition) and, if not, whether any delays were justified and documented in the contract file;
- contracting officials effectively completed the disposition of all significant audit findings and provided a sound rationale for not sustaining any costs that DCAA had questioned;
- contracting officials assessed penalties on expressly unallowable costs;
- disposition actions were adequately documented in accordance with FAR, DoD Directive 7640.2 and DCMA policy;
- 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 June 2005 through April 2007. We suspended the project for 14 months within this timeframe to address other projects.

Use of Computer-Processed Data. DCMA maintains a Web-based eTools contract audit follow-up database to provide the status of contract audit reports. We did not rely on the computer-processed data generated by the eTools database. We traced the semiannual report data from the eTools database to source documents.

Prior Coverage. In the last 5 years, we issued one report with findings similar to those in this report. DoD IG Report No. D-2007-6-004, "Defense Contract Management Agency Virginia Actions on Incurred Cost Audit Reports," April 20, 2007.

Appendix B. Report Distribution

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Commander, Defense Contract Management Agency Northrop Grumman El Segundo
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Inspector General Department of Defense

